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October 26, 2009

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

COMMENT

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C.F.T.C.
OFFICE OF THE SECRETARIAT

RE: Notices of Intent to determine whether certain Basis Swaps serve a Significant Price Discovery Function
Dear Mr. Stawick:

IntercontinentalExchange, Inc. ("ICE") welcomes the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or "Commission") notice of intent ("notice") to determine whether the following contracts serve a significant price discovery function (collectively referred to as "Basis Contracts"):

- Alberta, Nova Inventory Transfer (AECO) (Basis Swap) ("AEC")
- Pacific Gas Transmission - Malin (Basis Swap) ("MLN")
- PG&E - Citygate (Basis Swap) ("PGE")
- El Paso - Permian Basin (Basis Swap) ("PER")
- El Paso - San Juan Basin, Blanco Pool (Primary only) (Basis Swap) ("SNJ")
- Waha Hub - West Texas (Basis Swap) ("WAH")
- Houston Ship Channel (Basis Swap) ("HXS")[1]
- Chicago Citygate (Basis Swap) ("DGD")
- Natural Gas Pipeline Co. of America, TexOk (Basis Swap) ("NTO")
- Dominion - South Point (Basis Swap) ("DOM")
- Transcontinental Gas Pipeline Corp. - Zone 6 (NY) (Basis Swap) ("TZS")
- Tetco M3 (Basis Swap) ("TMT")
- TCO (Basis Swap) ("TCO")

ICE believes that these Basis Contracts do not serve a significant price discovery function, as described herein, and that the Commission may exceed its jurisdiction if it determines that these contracts serve as a significant price discovery contracts ("SPDC").

[1] The CFTC Notice of Intent refers to the Houston Ship Channel contract ("HXS") contract as HSC.

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In addition to the absence of minimum liquidity thresholds, the inability of a basis swap to affect pricing on a designated contract market and the lack of a material price reference precludes many of these contracts from a significant price discovery role.

Background

In 2000, the Commodity Futures Modernization Act ("CFMA") created a system of tiered regulation to replace a "one size fits all" regulatory scheme. As part of the tiered regulatory scheme, Congress created exempt commercial markets ("ECMs"), which are principle to principle electronic trading platforms that serve sophisticated market participants. ECMs were designed to encourage electronic trading of derivatives. Given the sophisticated status of the participants, ECMs were subject to light touch regulation by the CFTC. The CFTC Reauthorization Act of 2008[2] expanded the CFTC's authority over ECMs that list contracts that serve a significant price discovery function. Congress directed the Commission to consider five criteria when making the significant price discovery determination: (1) Price Linkage; (2) Arbitrage; (3) Material Price Reference; (4) Material Liquidity; and (5) Other Factors. It is important to note that Congress gave the CFTC this authority over ECMs to capture two types of contracts: (1) contracts that trade with enough volume to impact trading on a designated contract market ("DCM"); or (2) contracts that trade with enough volume to be quoted as an independent price reference by the public.[3] It is clear that - by giving the CFTC tailored authority - Congress intended to keep the CFMA's tiered regulatory structure. Further, as stated by the CFTC in it's 2007 Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets: "[t]he Commission believes that the CEA's current level of regulation is appropriate for ECM contracts relying on the §2(h)(3) exemption when trading volume remains low and prices are not *significantly* relied upon by other markets."[4]

It is against this backdrop that the Commission makes its determination whether the Basis Contracts serve a significant price discovery function.

The Basis Contracts

As background, the natural gas industry in the United States relies on system of pipelines to deliver gas to consumers across the country. The largest interconnection of pipelines is at the Henry Hub in Erath, Louisiana, where nine interstate pipelines and four

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[2] Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1623 (June 18, 2008).

[3] The Joint Explanatory Statement of the Committee of Agriculture Conference, H.R. Rep. No. 1110 627, 110 Cong., 2nd Sess. at 978-86 (2008).

[4] Commodity Futures Trading Commission, *Report of the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets* (October 2007)

intrastate pipelines converge.[5] As the largest hub for natural gas, the Henry Hub price of natural gas serves as the basis for the price of natural gas in North America.

While the price of natural gas at the Henry Hub is influential in setting the price of natural gas across the country, local prices for natural gas vary significantly. Factors such as pipeline capacity, storage costs, local demand and transmission costs affect the local price of natural gas and contribute to the difference between the local price and the price of natural gas at the Henry Hub.[6] Basis contracts arose to give traders the ability to hedge against this price differential, but such contracts do not set the price of natural gas at either the Henry Hub or the local hub.

Each of the Basis Contracts listed by the CFTC in its notice of intent comprise two components: (1) the local price as determined by an index of physical gas trades; and (2) the price of the Henry Hub LD1 contract traded at the Chicago Mercantile Exchange/New York Mercantile Exchange. ICE uses several indexes as the reference price for each basis locale such as Intelligence Press Inc.'s Natural Gas Bidweek Survey, Platt's Inside FERC, or the Canadian Gas Price Reporter for the AECO natural gas basis swap. Neither ICE nor its customers via ICE Basis Contracts plays a role in determining or setting these index prices. Rather, they are independently set by third parties.

The CFTC's Analysis

The CFTC believes that the Basis Swaps could potentially serve a significant price discovery function based upon three factors: (1) material liquidity; (2) material price reference; and (3) price linkage. ICE believes that these contracts do not meet any of these tests.

Material Liquidity

To prove material liquidity, the Commission needs to determine that the contract traded on the ECM must trade with sufficient volume "to have a material effect on other agreements, contracts, or transactions listed for trading...on a designated contract market" or ECM. The Commission has issued guidelines stating "[l]iquidity is a broad concept that captures the ability to transact immediately with little or no price concession". Further, "in markets where material liquidity exists, a more or less continuous stream of prices can be observed and the prices should be similar," for example, "a market where trades occur multiple times per minute".[7] Finally, as Congress mandated in the Farm Bill, "the Commission *should not* make a determination that an

[5] http://www.sabinepipeline.com/Home/tabid/2/Default.aspx#
[6] Energy Information Administration, *Derivatives and Risk Management in the Petroleum, Natural Gas, and Electricity Industries* (October 2002).
[7] Appendix A to Part 36, 17 C.F.R. 36 (2009).

agreement, contract, or transaction performs a significant price discovery function on the basis of the price linkage factor *unless* the agreement, contract, or transaction has sufficient volume to impact other regulated contracts or to become an independent price reference or benchmark that is regularly utilized by the public."[8]

In the notice of intent, the CFTC seems to have adopted a five trade-per-day test to determine whether a contract is materially liquid. It is worth noting that ICE originally suggested that the CFTC use a five trades-per-day threshold as the basis for an ECM to report trade data to the CFTC. This arbitrarily low threshold is appropriate for reporting purposes, but is at odds with Congress's intent that the CFTC include "material liquidity" in its requirements for significant price discovery.

Moreover, the statistics supplied in the Notices of Intent do not tell the whole story. First, the CFTC's figures, as requested of and provided by ICE, include trades made in all months of each contract. Furthermore, some of the trades were executed in seasonal (summer or winter) or calendar year strips that trade separately from and in addition to the contract months. The more appropriate method of determining liquidity is to examine the activity in a *single* traded month or strip of a given contract. The merit of this argument is obvious when you consider that liquidity in a January contract is of no help to a trader who needs to liquidate an October position. Only about 25-40% of the trades in these basis swaps occurred in the single most liquid, usually prompt, month of each contract.

Second, these trades-per-day statistics requested by the CFTC and provided by ICE include transactions that were not even executed on the ICE 2(h)(3) platform and therefore make no contribution to price discovery. Rather, these transactions were executed via voice brokers in the over the counter market and submitted to ICE sometime after-the-fact solely for clearing purposes. For nine of the contracts: SNJ, TMT, TZS, DGD, DOM, HXS, PER, PGE, and TCO, the majority of trades were not executed on the ICE platform. For MLN, NTO, and WAH, roughly half of the transactions were executed on the ICE platform. Only with the AEC contract is there even a preference for screen trading with 68% of all AEC transactions conducted on the ICE platform.

The trades-per-day statistics used by the CFTC must be adjusted for both of the factors described above before even considering whether or not a "more or less continuous steam of prices" can be observed. The most liquid of the contracts noticed by the CFTC is the AEC basis swap for which the CFTC statistics indicate 113.5 trades per day. However, only 25% of AEC trades occurred in the most liquid contract month, and only 80% of AEC trades in that contract month were executed on the ICE platform.

[8] Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1624 (June 18, 2008).

Given an eight hour trading day[9], this means that the most liquid contract month in the most liquid basis swap traded only about once every 21 minutes. Liquidity in all other basis swaps noticed by the CFTC is far less with each typically trading less than once per hour. It is clear these liquidity statistics do not represent an "ability to transact immediately" or "a more or less continuous stream of prices" and certainly not "a market where trades occur multiple times per minute".

Material Price Reference

The second basis for the Commission's determination is that the Basis Contracts serve as a material price reference. In this determination, Congress instructed the Commission to consider "the extent to which, on a frequent and recurring basis, bids, offers, or transactions in a commodity are directly based on, or are determined by referencing, the prices generated" by the ECM. The Commission elaborates on this by saying that it will rely on one of two sources of evidence, direct or indirect, that the contract is a material price reference. A direct reference would be whether the cash market quotes the ECM contract. An indirect reference would be whether an industry publication quotes the ECM's contract's price.

For the all of the Basis Contracts, the CFTC relies on two reasons for material price reference: (1) that "the Commission's ECM study, in general, stated that certain market participants referred to ICE as a price discovery market for certain natural gas contracts "[10] and or (2) that ICE uses an exclusive index to determine one component of the basis swap.[11] The first reason stated by the CFTC is hard to quantify as the ECM report does not mention any of these basis swaps as potential significant price discovery contracts. It is unknown which market participants made this statement *in 2007* or the contracts that were referenced. This falls short of the evidence required in the CFTC's rulemaking that the cash market "quotes" the ECM price on a "frequent and recurrent basis." The second reason provided by the CFTC is that ICE uses an exclusive index to determine the local price of the basis swap. While it is true that ICE uses exclusive indices for certain of the Basis Contracts, it does not mean that these indices are the only price references at these hubs. In fact, there is a competitive business in natural gas indices, as evidenced by the existence of NGI, Platt's and IPI. Further, and most importantly, the Basis Contracts are only a reflection of the physical price as quoted in the index, not vice versa. Thus, the Basis Contracts do not serve a direct or indirect reference to the cash market.

[9] Note that ICE's OTC markets are open 22 hours.
[10] See, *e.g.*, 72 FR 52206 (October 9, 2009) (Notice of Intent for the HXS contract).
[11] *Id.*

Price Linkage

The third basis for the CFTC's determination is that the Basis Swaps are price linked to the NYMEX/CME natural gas futures contract (NG). The CFTC defines price linkage as a "contract that relies on a contract traded on another trading facility to settle, value or otherwise offset the price-linked contract." In considering price linkage, Congress instructed that the "Commission *should not* make a determination that an agreement, contract, or transaction performs a significant price discovery function on the basis of the price linkage factor *unless* the agreement, contract, or transaction has sufficient volume to impact other regulated contracts." Many of the Basis Contracts trades only a few times per day, it is hard to see how these contracts have sufficient volume affect price discovery in the NG contract. Further, and most importantly, the Basis Contracts only use the NG contract as a reference to create the basis price; there is no price linkage as contemplated by Congress or the CFTC in its rulemaking. A Basis Contract is only the differential between the Henry Hub natural gas futures contract and the local hub; it cannot be used to offset or replace the futures contract.

Conclusion

It is clear that Basis Contracts do not serve as a material price reference for the price of natural gas. Further, the Basis Contracts do not meet the CFTC's criteria for material liquidity and cannot be price linked to a designated contract market. On this basis, the Commission should not deem these contracts as significant price discovery contracts.

Thank you for the opportunity to comment.

Sincerely,

R. Trabue Bland
Director of Regulatory Affairs
Assistant General Counsel