09-17
(2)

HUNTON&
WILLIAMS

HUNTON & WILLIAMS LLP
1900 K STREET, N.W.
WASHINGTON, D.C. 20006-1109

TEL 202 • 955 • 1500
FAX 202 • 778 • 2201

MARK W. MENEZES
DAVID T. MCINDOE
R. MICHAEL SWEENEY, JR.
EMAIL: mmenezes@hunton.com
dmcindoe@hunton.com
rsweeney@hunton.com

FILE NO: 76142.2

October 26, 2009

COMMENT

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

<u>VIA ELECTRONIC MAIL</u>

Re: *Significant Price Discovery Contract Proceeding, Chicago Financial Basis Contract*

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP submits the following comments in response to the request for public comment set forth in the Notice of Intent ("NOI") issued by the Commodity Futures Trading Commission ("CFTC" or "Commission") and published in the *Federal Register* on October 6, 2009,[1] addressing whether the Chicago Financial Basis Contract ("Chicago Contract") offered for trading on the IntercontinentalExchange, Inc. ("ICE") performs a significant price discovery function.

The Working Group is a diverse group of commercial firms in the domestic energy industry whose primary business activity is the physical delivery of one or more energy commodities to customers, including industrial, commercial and residential consumers. Members of the Working Group consist of energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

---

1 *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), to Undertake a Determination Whether the Chicago Financial Basis Contract, Offered for Trading on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function*, 74 Fed. Reg. 52,198 (Oct. 9, 2009).

As discussed further in these comments, the Working Group does not believe that the Chicago Contract serves a significant price discovery function and should not be designated as a significant price discovery contract ("SPDC") at this time.

I. COMMISSION AUTHORITY AND DISCRETION TO DESIGNATE CONTRACTS AS SPDCS.

In 2000, Congress enacted the Commodity Futures Modernization Act ("CFMA"),[2] which amended the Commodity Exchange Act ("CEA"), 7 U.S.C. §§ 1 *et seq.*, to create a tiered approach to the regulation of futures and derivatives markets to replace the CEA's then-existing "one size fits all" regulatory framework. As part of this tiered approach, the CFMA created exempt commercial markets ("ECMs"). ECMs are principal-to-principal electronic trading platforms designed to encourage electronic trading of derivatives by sophisticated market participants.. ECMs were subject to limited Commission regulation and oversight under the CFMA amendments to the CEA.

In June 2008, Title XIII of the Food, Conservation and Energy Act of 2008[3] was enacted and, in relevant part, amended the CEA to include new Section 2(h)(7).[4] CEA Section 2(h)(7) expanded the Commission's limited authority over ECMs to identify and list contracts that serve a significant price discovery function.[5] Specifically, this provision sets forth enumerated factors that the Commission must consider when determining whether a contract performs a significant price discovery function: (1) Price Linkage; (2) Arbitrage; (3) Material Price Reference; (4) Material Liquidity; and (5) Other Factors.

The purpose of new CEA Section 2(h)(7) is to make the regulation of certain contracts traded on ECMs similar to the Commission's regulation of those contracts traded on designated contract markets ("DCMs"). Accordingly, in situations where the Commission determines that ECM contracts serve a significant price discovery function similar to contracts traded on a DCM, those contracts are subject to comparable regulation.

On March 23, 2009, the Commission issued a final rule implementing the provisions of new CEA Section 2(h)(7) subjecting ECMs with SPDCs to self-regulatory and reporting requirements, as well as certain Commission oversight authorities, with respect to those contracts.[6] The SPDC Final Rule became effective on April 22, 2009. Among other things,

---

2 Incorporated as Appendix E of the Consolidated Appropriations Act of 2001, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

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

4 7 U.S.C. § 2(h)(7).

5 Section 13204(c) of the Reauthorization Act requires the Commission to identify contracts that it deems appropriate for designation as SPDCs within 180 days after issuing rules implementing new CEA Section 2(h)(7).

6 *See Significant Price Discovery Contracts on Exempt Commercial Markets*, 74 Fed. Reg. 12,178 (Mar. 23, 2009) ("SPDC Final Rule"); 17 C.F.R. § 36.3 (2009).

the Commission adopted regulations establishing the procedures and the standards by which it will determine whether an ECM contract performs a significant price discovery function and provided guidance with respect to compliance with nine statutory core principles applicable to ECMs.[7]

The Commission has broad discretion when determining whether to designate a contract as a SPDC. Importantly, not all of the various statutory factors must be present to support a determination that a contract performs a significant price discovery function. In this regard, CEA Section 2(h)(7) neither prioritizes nor specifies the degree to which a contract must conform to the various factors.

II. PROPOSED DESIGNATION OF THE CHICAGO CONTRACT AS AN SPDC.

The Chicago Contract is a monthly contract that is cash settled based on the difference between the price of natural gas at the Chicago Citygate Hub for the month of delivery in the first publication of the month, as published by Intelligence Press, Inc., in *NGI's Bidweek Survey* ("Chicago Hub"), and the final settlement price of the NYMEX physically-delivered Henry Hub (Louisiana) natural gas futures contract for the same calendar month ("NYMEX NG Contract"). The NOI states that the Chicago Contract appears to satisfy the Material Liquidity, Price Linkage, and Material Price Reference factors required for SPDC designation.[8]

The Working Group fully supports the Commission's efforts to exercise in a disciplined and deliberate manner its statutory obligations under the Reauthorization Act to designate contracts traded on ECMs that meet the statutory criteria set forth in CEA Section 2(h)(7) as SPDCs. However, as discussed below, it is not clear that the Chicago Contract satisfies the Material Price Reference, Price Linkage, and Material Liquidity factors. Accordingly, the Working Group respectfully submits that the Commission should refrain from designating the Chicago Contract as an SPDC.

The Working Group respectfully submits that the designation of the Chicago Contract as an SPDC will not further in a meaningful manner other policy concerns identified by the Commission to the extent that they relate to (a) protecting the NYMEX NG Contract and (b) the underlying physical markets at Henry Hub and Chicago Hub from excessive speculation or manipulation. The designation of the Chicago Contract as an SPDC and the required imposition of position limits on this contract by ICE have the potential to harm liquidity regarding the NYMEX NG Contract and at the Henry Hub and Chicago Hub physical gas markets, which, in turn, could result in industrial, commercial and residential consumers incurring higher energy prices.

---

7 *Id.* at § 36.3(c)(3).

8 NOI at p. 52,199.

Specifically, existing NYMEX-enforced accountability levels and position limits protect the NYMEX NG Contract and the underlying physical Henry Hub market from the effects of excessive speculation and manipulation.[9] In addition, physical pricing at Henry Hub is also protected from excessive speculation in over-the-counter ("OTC") derivatives markets through position limits enforced by ICE for the Henry Financial LD1 Fixed Price contract that was recently designated as an SPDC.[10]

The Commission also has ample authority under CEA Section 9(a)(2) to protect against entities engaged in CFTC-jurisdictional activities from manipulating physical prices at Henry Hub and at the Chicago Hub.[11] This authority is complemented by the Federal Energy Regulatory Commission's ("FERC") jurisdiction under the Natural Gas Act ("NGA"), 15 U.S.C. § 717 *et seq.*, to regulate wholesale, physical natural gas markets and FERC's broad authority to prohibit the manipulation of natural gas markets under NGA Section 4A, 15 U.S.C. § 717c-1.

A. <u>Material Price Reference.</u>

The NOI states that the Chicago Contract may perform a significant price discovery function as it appears to satisfy the Material Price Reference factor. CEA Section 2(h)(7)(B)(iii) requires 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.[12] Guidance set forth in Appendix A to Section 36 of the Commission's regulations states that the Commission will rely on one of two sources of evidence, direct or indirect, that the contract is a Material Price Reference.[13] A direct reference would be whether the cash market quotes the ECM contract.[14] An indirect reference would be whether an industry publication quotes the ECM contract's price.[15] The Chicago Contract does not meet either of these standards.

1.. <u>Direct Reference.</u>

---

9 *See* <<http://www.nymex.com/NG_spec.aspx>>. The NYMEX-enforced accountability levels and position limits for the NYMEX NG Contract are "12,000 net futures, but not to exceed 1,000 in the last three days of trading in the spot month."

10 *See Order Finding that the ICE Henry Financial LD1 Fixed Price Contract Traded on the IntercontinentalExchange, Inc., Performs a Significant Price Discovery Function*, Final Order, 74 Fed. Reg. 37,988 (July 30, 2009).

11 7 U.S.C. § 9(a)(2).

12 7 U.S.C. § 2(h)(7)(B)(iii).

13 17 C.F.R. Part 36, Appendix A (2009) (Guidance on Significant Price Discovery Contracts).

14 *Id.*

15 *Id.*

There are no other related contracts traded in any market that settle to, or reference, the Chicago Contract. The Material Price Reference for the Chicago Contract itself is derived from physical transactions that create the bidweek price index for the Chicago Hub and the settlement price for NYMEX NG Contract. Neither the Chicago Hub nor the NYMEX NG Contract are based on the Chicago Contract. Although the Chicago Contract is influenced by these direct references, the Chicago Contract itself neither influences the settlement of the NYMEX NG Contract nor does it influence physical pricing at Henry Hub or the Chicago Hub.

2. Indirect Reference.

As to the indirect reference regarding whether an industry publication quotes the ECM contract's price, the only publications to which the CFTC refers is the "Midcontinent Gas End of Day" and "OTC Gas End of Day," ICE publications. It is logical that ICE would publish the prices of its own contracts, as would any other contract market. However, the fact that ICE publishes the settlement prices of its own contracts does not constitute sufficient evidence of a Material Price Reference necessary to satisfy the requirements of CEA Section 2(h)(7)(B)(iii). The only price reference that market participants rely on are the physical prices published by *NGI's Bidweek Survey* for the Chicago Hub and the settlement price for the NYMEX NG Contract available through NYMEX. There is no evidence whatsoever that a contract in any market is tied directly or indirectly to the settlement price of the Chicago Contract.

B. PRICE LINKAGE.

To establish Price Linkage, an agreement, contract or transaction must use or otherwise rely on a settlement price or other major price parameter of a contract(s) listed for trading on a DCM or an SPDC on an ECM.[16] As noted in the NOI, the Chicago Contract is technically linked to the NYMEX NG Contract. Notwithstanding this partial linkage, the Chicago Contract does not appear to perform a significant price discovery function.

Guidance set forth in Appendix A of Part 36 of the Commission's regulations is instructive in this regard as it states, in relevant part, that:

> A price-linked contract is a contract that relies on a contract traded on another trading facility to settle, value or otherwise offset the price linked contract. The link may involve one-to-one linkage, in that the value of the linked contract is based on a single contract's price, or it may involve multiple contracts.
>
> . . . .

16 17 C.F.R. § 36, Appendix A(B).

> *For a linked contract, the mere fact that a contract is linked to another contract will not be sufficient to support a determination that a contract performs a significant price discovery function.* To assess whether such a determination is warranted, the Commission will examine the relationship between transaction prices of the linked contract and prices of the referenced contract. *The Commission believes where material liquidity exists, prices for the linked contract would be observed to be substantially the same as or move substantially in conjunction with prices of the referenced contract(s).*[17]

As established below, publicly-available, empirical data shows that the Chicago Contract (a) is not substantially the same as the NYMEX NG Contract nor (b) does it move substantially in conjunction with NYMEX NG Contract.

A head-to-head comparison of the Chicago Contract with the NYMEX NG Contract settlement prices published during the 75-day period beginning July 10, 2009 through October 23, 2009, clearly establishes that these contracts are not "substantially the same." For example, the price for the November NYMEX NG Contract during this period is approximately $5.00/mmbtu. In contrast, the basis price of the Chicago Contract ranged from $.11/mmbtu below the NYMEX NG Contract price to $.32/mmbtu above the NYMEX NG price. Price data published during this period also provides evidence that the Chicago Contract does not "move substantially in conjunction with" the NYMEX NG Contract. Specifically, the correlation of the daily changes between the NYMEX NG Contract and the Chicago Contract is negative 27 percent for this period.

C. <u>Material Liquidity</u>.

To meet the Material Liquidity test, CEA Section 2(h)(7)(B)(iv) requires 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.[18] The Commission also states "[l]iquidity is a broad concept that captures the ability to transact immediately with little or no price concession."[19] As demonstrated below, the Chicago Contract lacks both (a) a material effect on other contracts and (b) sufficient liquidity to perform a significant price discovery function.

---

17 17 C.F.R. § 36, Appendix A(B)(2) (emphasis added).

18 7 U.S.C. § 2(h)(7)(B)(iv).

19 17 C.F.R. Part 36, Appendix A (2009).

1. No Material Affect on Other Contracts Listed for Trading.

Trading in the Chicago Contract has no affect whatsoever on any contract listed for trading on a DCM, ECM or even in the OTC market. As noted in Section II.A., above, there is no evidence of other related contracts traded in any market that settle to, or reference, the Chicago Contract. Although the Chicago Contract is influenced by physical transactions in the Chicago Hub or the settlement of the NYMEX NG Contract, it has no affect on the NYMEX NG Contract itself or on the actual prices of natural gas at Henry Hub or at the Chicago Hub.[20]

2. Liquidity in the Chicago Contract is Insufficient for Designation as an SPDC.

Guidance set forth in Appendix A to Section 36 of the Commission's regulations states, in relevant part, that "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, to "a market where trades occur multiple times per minute." The quoted language indicates two factors that can show liquidity: (a) a narrow bid/ask spread, and (b) a trade frequency of multiple trades per minute.[21] The NOI does not address either of these factors. Rather, it states that the Chicago Contract was transacted on an average daily basis of 24.6 times. Based on the average daily trade data set forth in the NOI, the trade frequency of the Chicago Contract in terms of multiple trades per minute is extremely low. Because neither factor is presented by the Chicago Contract, trading in this contract fails to meet this standard.

III. 30-DAY COMMENT PERIOD.

The NOI relating to this contract was posted in the *Federal Register* on October 9, 2009, the same day as similar NOIs proposing to designate twelve other ICE gas contracts as SPDCs. A 15-day comment period was established for all of the NOIs published on October 9th, thus providing the Working Group and other interested stakeholders only 15 days to consider, develop, and submit comments regarding thirteen separate contracts. In addition to these thirteen contracts, the CFTC has issued during this time several other NOIs seeking to

20 As discussed in Section II.A, above, the Commission possesses broad existing statutory and regulatory authority to protect against excessive speculation and manipulation involving the NYMEX NG Contract which, in turn, could result in the manipulation of physical prices at Henry Hub. Additionally, it possesses broad anti-manipulation authority to address jurisdictional activity could result in the manipulation of physical pricing at Henry Hub or at the Chicago Hub. This authority complements FERC's jurisdiction under the NGA over wholesale, physical gas markets and its own broad anti-manipulation authority under NGA Section 4A.

21 Because the NOI does not expressly address how the Chicago Contract satisfies the guidance in Appendix A of the Commission's regulation for Material Liquidity (*i.e.*, narrow bid/ask spread and trade frequency of multiple trades per minute), the OTC Working Group respectfully submits that the Commission expressly identify the criteria supporting its view that the Chicago Contract appears to meet the Material Liquidity test.

designate additional power and gas contracts as SPDCs; again, establishing only a 15-day comment period.

Although the Working Group appreciates the CFTC's interest in prompt and timely action on this issue, the Working Group believes that, in light of such ongoing and overlapping activity, 15 days is inadequate to allow for the development of public comments that fully and properly consider the specific circumstances of each contract. As such, the Working Group respectfully requests that the CFTC consider establishing a 30-day comment period for subsequent NOI issuances related to the designation of power and gas contracts as SPDCs.

IV. CONCLUSION.

The Working Group appreciates this opportunity to comment, and requests that the Commission consider these comments as it develops a final rule in this proceeding. Given the limited time provided for public comment, the Working Group expressly reserves the right to supplement these comments as deemed necessary and appropriate.

Respectfully Submitted,

/s/ Mark W. Menezes
Mark W. Menezes
David T. McIndoe
R. Michael Sweeney, Jr.

Counsel for the
Working Group of Commercial Energy Firms