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November 4, 2009

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

RE: Determination whether the Southern California Border Basis Swap serves a Significant Price Discovery Function

Dear Mr. Stawick:

COMMENT

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 Southern California Border Basis Contract ("SCL") serves a significant price discovery function.

ICE believes that this contract does 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"). 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 preclude this contract from serving 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 2008¹ 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

¹ Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1623 (June 18, 2008).



market (“DCM”); or (2) contracts that trade with enough volume to be quoted as an independent price reference by the public.² 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 its 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.”³

It is against this backdrop that the Commission makes its determination whether the SCL Basis Contract serves a significant price discovery function.

The Southern California Basis Contract

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 intrastate pipelines converge.⁴ 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 Henry Hub price of natural gas is influential in determining the price of natural gas across the country, local prices of natural gas vary significantly. Factors such as pipeline capacity, storage costs, location-specific demand characteristics 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.⁵ Basis contracts arose to give traders the ability to hedge against this price differential, but do not set the price of natural gas at either Henry Hub or the location.

The SCL contract specified in the CFTC’s notice of intent is comprised of two components: (1) an index of physical natural gas trades compiled by Intelligence Press Inc.; and (2) the price of the Henry Hub LD1 contract traded at the Chicago Mercantile Exchange/New York Mercantile Exchange. The basis price is the differential between these two prices.

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

³ Commodity Futures Trading Commission, *Report of the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets* (October 2007)

⁴ <http://www.sabinepipeline.com/Home/tabid/2/Default.aspx#>

⁵ Energy Information Administration, *Derivatives and Risk Management in the Petroleum, Natural Gas, and Electricity Industries* (October 2002).



The CFTC's Analysis

The CFTC believes that the SCL basis contract 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 the SCL contract does 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”.⁶ Finally, as Congress mandated in the Farm Bill, “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 or to become an independent price reference or benchmark that is regularly utilized by the public.”⁷

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 as it captures nearly every ECM contract, but it is at odds with Congress’s intent that the CFTC include “material liquidity” in its requirements for significant price discovery. If the CFTC has decided to abandon its [Congress’?] rulemaking on Significant Price Discovery Contracts, then it should, at the very least, propose revisions to Part 36 in order to allow the public to comment on whether the CFTC’s *new* threshold meets Congress’ intent in promulgating the Significant Price Discovery Test of the Farm Bill.

Moreover, the statistics [provided by ICE] have been misinterpreted and misapplied. First, the CFTC’s figures include trades made in all 120 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.

⁶ Appendix A to Part 36, 17 C.F.R. 36 (2009).

⁷ Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1624 (June 18, 2008).



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. For the SCL basis swap, only about 29% of the trades occurred in the single most liquid, usually prompt, month of the 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 the SCL basis swap, only about 65% of the trades in the single most liquid, usually prompt, month of the contract were actually executed 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 stream of prices” can be observed. According to the statistics cited by the CFTC, the SCL basis swap traded an average of just 126 times per day, and only 19% (29% x 65%) of these trades were executed on the ICE platform in the single most liquid, usually prompt, month of the contract. Given an eight hour trading day⁸, this means that the SCL basis swap traded only once about every 20 minutes. Clearly, such a low level of liquidity does 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.” In comparison, the single most liquid, usually prompt, month of the ICE Henry Hub LD1 natural gas contract traded, on average, over 4,000 times per day on the ICE platform alone.

In conclusion, it is clear that the SCL contract does not meet the material liquidity standard as contemplated by Congress or the CFTC in its SPDC rulemaking.

Material Price Reference

The second basis for the Commission’s determination is that the SCL contract serves 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

⁸ Note that ICE’s OTC markets are actually open 22 hours.



market quotes the ECM contract. An indirect reference would be whether an industry publication quotes the ECM's contract's price.

For the SCL contract, 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"⁹ and (2) that ICE uses an exclusive index to determine one component of the basis swap.¹⁰ The first reason proposed by the CFTC has been used as a justification for nearly every notice of intent the CFTC has issued for significant price discovery contracts. This argument is nearly impossible to respond to as the ECM report did not mention the SCL as a potential significant price discovery contract. It is hard to say which market participants made this statement *in 2007 or the contracts that were referenced*. Congress, in promulgating the Farm Bill, ordered the CFTC to undertake a very important analysis of the OTC energy markets. Basing a material price reference determination on general statements made in a two year old study does not seem to meet Congress' intent that the CFTC use its considerable expertise to study the OTC markets. Moreover, this ephemeral analysis does not allow the public to comment effectively.

The second reason proposed by the CFTC is that ICE uses an exclusive index to determine the local price of the basis swap. Given that the CFTC's rulemaking on SPDCs requires that the CFTC must find that the cash market "quotes" the ECM price on a "frequent and recurrent basis;" use of an exclusive index is *irrelevant*. The index quoted by the SCL is a reflection of the underlying cash market, not vice versa. Finally, while it is true that ICE uses an exclusive index for the SCL contract, it does not mean that this index is the only price reference at these hubs [this hub?]. In fact, there is a competitive business in natural gas indices, as evidenced by the existence of NGI, Platts, CGPR and others.

Price Linkage

The third basis for the CFTC's determination is that the SCL is price linked to the NYMEX/CME natural gas futures contract (NG). As stated above, 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." The notice of intent implies that any price linkage is significant, even if it does not affect price discovery on a DCM. This analysis misses Congress' intent in promulgating the significant price discovery legislation. The intent, plainly stated above, was to capture contracts that could affect price discovery on a DCM. A basis swap uses the NG price only as a reference to create the basis price. As an

⁹ See, e.g., 72 FR 537223 (October 20, 2009) (the Notice of Intent for the SCL contract).

¹⁰ *Id.*



analogy, implying price linkage on a basis swap is akin to stating that the price at a local pump in Mississippi affects the global price of crude oil. Further, using the CFTC's interpretation of price linkage, given that the SCL is priced in dollars, then the SCL contract could be "price linked" to a U.S. Dollar futures contract traded on a DCM. This is neither a rational result nor Congress' intent. In addition, given the fact that the most liquid contract month of the SCL basis swap trades on the ICE platform fewer than 25 times per day, it is hard to see how the contract affects price discovery in the NG contract.

Conclusion

It is clear that the SCL contract does not serve as a material price reference for the price of natural gas. Further, the SCL contract does not meet the CFTC's criteria for material liquidity and thus 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,

A handwritten signature in cursive script that reads "R. Trabue Bland".

R. Trabue Bland
Director of Regulatory Affairs
Assistant General Counsel