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David A. Stawick  
Secretary  
Commodity Futures Trading Commission  
1155 21st Street, N.W.  
Washington, D.C. 20581

**COMMENT**

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

November 10, 2009

Re: Notice of Intent To Undertake a Determination Whether Certain PJM Contracts Offered for Trading on the IntercontinentalExchange, Inc., Perform Significant Price Discovery Functions

Dear Mr. Stawick:

The Edison Electric Institute (“EEI”) respectfully submits the following comments in response to the Commodity Futures Trading Commission’s (the “Commission” or “CFTC”) 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 PJM Interconnection, LLC (“PJM”) WH Real Time Peak Daily Contract (“PDP contract”); PJM WH Real Time Peak Contract (“PJM contract”); PJM WH Real Time Off-Peak Contract (“OPJ contract”); PJM WH Day Ahead LMP Peak Daily Contract (“PDA contract”); and PJM WH Real Time Off-Peak Daily Contract (“ODP contract”) Offered For Trading on the IntercontinentalExchange, Inc. (“ICE”), Perform Significant Price Discovery Functions.<sup>1</sup>

**I. INTEREST OF EEI IN THE PROPOSED RULEMAKING**

EEI is the association of shareholder-owned electric companies, international affiliates and industry associates worldwide. Our U.S. members serve 95 percent of the ultimate customers in the shareholder-owned segment of the industry, and represent approximately 70 percent of the U.S. electric power industry. Many of EEI’s electric utility company members utilize financial instruments, like the contracts referenced by the Commission in the PJM Notice of Intent, to hedge the price risks associated with buying and selling wholesale power supplies. These tools are a key method used by utilities to provide reliable electric service to consumers at stable prices, and to protect electric customers from higher retail prices that could, without adequate hedging mechanisms, become more volatile because of volatile wholesale electricity prices. As a result, EEI and its member companies have a direct interest in the outcome of these proceedings.

<sup>1</sup> 74 Fed. Reg. 54,966 (Oct. 26, 2009) (the “PJM Notice of Intent”).

## II. OVERVIEW OF EEI'S COMMENTS

EEI appreciates the opportunity to comment upon whether the contracts referenced in the PJM Notice of Intent and traded on the ICE (collectively, the "ICE Contracts") perform significant price discovery functions. As EEI has apprised the Commission before, electric power markets are very complex, owing in large part to the unique physical characteristics of electricity and the delivery and timing issues that result. Customers require electricity around the clock, and our modern economy depends upon having a reliable and steady supply of electricity. Electricity cannot be stored in significant quantities. As a result, it must be generated and consumed almost instantaneously. Moreover, the supply and demand for electricity fluctuates, often dramatically, on a minute-by-minute, hourly, daily, weekly and seasonal basis, reflecting specific weather patterns, economic drivers and human behaviors. In addition, wholesale electricity transactions generally are limited to regional markets because of technical, reliability and efficiency factors. For these reasons, wholesale electricity prices are among the most volatile of any commodity.

To manage this volatility, market participants such as investor-owned utilities and power generators use a variety of financial instruments and tools to address the specific physical characteristics of electricity, and the specific timing and delivery issues they face in providing service to retail customers. The ICE Contracts are an example of these very important price hedging and risk management tools.

In order to serve retail load, EEI members procure and sell substantial quantities of wholesale physical power. The contracts through which they procure and sell this power often provide for delivery not only in the spot month, but often for months or even years into the future.<sup>2</sup> EEI members use the ICE Contracts to hedge the price risk associated with their long and short physical power positions in the PJM electricity markets. The ability of EEI members to hedge their price risk by purchasing and selling the ICE Contracts helps reduce price volatility in the retail markets and, thereby, promotes a reliable flow of electricity to retail customers at more stable prices.

EEI submits the following general comments in response to the PJM Notice of Intent: (1) the short amount of time provided by the Commission to respond to the PJM Notice of Intent is insufficient to allow affected market participants to provide detailed information about whether the ICE Contracts meet the criteria of a significant price discovery contract ("SPDC"); (2) the ICE Contracts do not satisfy the SPDC determination criteria set forth in the Commission's SPDC Order;<sup>3</sup> and (3) the costs and risks associated with designating the ICE Contracts as SPDCs significantly outweigh any potential benefit.<sup>4</sup>

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<sup>2</sup> Under the Federal Power Act, all sales of electric energy at wholesale must be made at prices that are "just and reasonable." See 16 U.S.C. § 824d. In addition, all persons who sell physical power in the interstate wholesale markets are subject to the regulation of the Federal Energy Regulatory Commission. 16 U.S.C. § 824.

<sup>3</sup> Significant Price Discovery Contracts on Exempt Commercial Markets, 74 Fed. Reg. 12,178 (Mar. 23, 2009) (the "SPDC Order").

<sup>4</sup> 17 CFR Parts 15, 16 and 17 (2009).

### **III. THE COMMISSION HAS NOT PROVIDED A SUFFICIENT OPPORTUNITY FOR COMMENT**

The PJM Notice of Intent provides only a 15-day window for filing comments on the Commission's proposals to designate the ICE Contracts as SPDCs. EEI respectfully submits that this limited time period for providing comments is insufficient to give the numerous entities that could be impacted an opportunity to provide detailed information that will assist the Commission in reaching a sound and well-reasoned determination. As noted above, the markets for electricity-related products are exceedingly complex. A full understanding of the particular facts surrounding each power swap contract is needed in order to fully analyze what effect a change in regulation may have on the underlying wholesale power markets. In addition, the Commission has simultaneously announced its intent to designate several energy-related contracts as SPDCs over the last several weeks.<sup>5</sup> This requires users of these contracts to provide details on multiple contracts, in response to multiple Notices of Intent, all within a compressed time period.

Given the unique characteristics of the evolving electricity trading markets, and the fact that the process for designating SPDCs is still new for both the Commission and the affected public (with still only one contract designated to date), the Commission should provide an adequate process that allows for a thorough analysis of whether the ICE Contracts meet the SPDC criteria, and the potential consequences of designating them as SPDCs. In order to give affected entities a sufficient opportunity to provide detailed comments on the PJM Notice of Intent, the Commission should either extend the comment period for 30 days, or establish public hearing procedures to provide further opportunity for comment.<sup>6</sup>

### **IV. THE AVAILABLE EVIDENCE DOES NOT SUPPORT A DETERMINATION THAT THE ICE CONTRACTS ARE SPDCS**

EEI respectfully submits that none of the ICE Contracts satisfy the SPDC determination criteria set forth in the Commission's regulations, which require the Commission to consider factors such as price linkage, arbitrage, material price reference

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<sup>5</sup> See, e.g., 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 SP-15 Financial Day-Ahead LMP Peak Contract; SP-15 Financial Day-Ahead LMP Peak Daily Contract; SP-15 Financial Day-Ahead LMP Off-Peak Daily Contract; SP-15 Financial Swap Real Time LMP Peak Daily Contract; SP-15 Financial Day-Ahead LMP Off-Peak Contract; NP-15 Financial Day-Ahead LMP Peak Daily Contract. See also NP-15 Financial Day-Ahead LMP Off-Peak Daily Contract, Offered for Trading on the IntercontinentalExchange, Inc., Perform Significant Price Discovery Functions, 74 Fed. Reg. 51,264 (Oct. 6, 2009). See also 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 Henry Financial Swing Contract; Henry Financial Basis Contract; and Henry Financial Index Contract, Offered for Trading on the IntercontinentalExchange, Inc., Perform Significant Price Discovery Functions, 74 Fed. Reg. 53,720 (Oct. 20, 2009).

<sup>6</sup> See PJM Notice of Intent at n. 6 (stating: "[w]here appropriate, the Commission may choose to interview market participants regarding their impressions of a particular contract.").

and material liquidity in making its determination.<sup>7</sup> For each contract, the Commission relies on only two of the four factors that it is required to consider: material price reference and material liquidity. The evidence of material price reference and material liquidity cited by the Commission appears to be insufficient to support a determination that any of the ICE Contracts are SPDCs.<sup>8</sup>

A. No Material Price Reference

As evidence to substantiate that the ICE Contracts serve as a material price reference for other transactions, the Commission cites only to its study of exempt commercial markets (“ECM Study”), which found generally that “market participants view the ICE as a price discovery market for certain electricity contracts.”<sup>9</sup> However, the Commission also acknowledges in the PJM Notice of Intent that the ECM Study “did not specifically address the power contracts under review.”<sup>10</sup> A more in depth analysis of the specific contracts demonstrates that there is no material price reference as defined by the Commission.<sup>11</sup>

The bids, offers, and transactions in physical electric power markets are not primarily “based on,” or “determined by referencing, the prices generated by” any of the ICE Contracts, as the Commission’s regulations require.<sup>12</sup> In fact, the opposite is true: the ICE Contracts are priced based on the results of physical commodity trading in PJM’s markets. As the Commission correctly notes in the PJM Notice of Intent, the ICE Contracts settle at Locational Marginal Prices (“LMPs”) that reflect actual physical electric power trading and the forces of local supply and demand in the PJM market.<sup>13</sup> These LMPs are determined by fundamental factors such as consumer demand, economic conditions, weather, generation fuel prices, generation outages, and congestion on the electric transmission system.

Furthermore, LMPs are pervasively regulated by the Federal Energy Regulatory Commission (“FERC”) under its Federal Power Act jurisdiction to ensure that they are just and reasonable. FERC approves filed tariffs that set forth the process for determining LMPs. These tariffs include rules to mitigate prices to ensure that they

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<sup>7</sup> SPDC Order at 12,181.

<sup>8</sup> The Commission does not discuss the remaining two factors – price linkage and arbitrage – in the PJM Notice of Intent. EEI assumes that the Commission has not found any evidence of price linkage or arbitrage. In fact, the ICE Contracts also fail to satisfy these factors. If the Commission decides that it will look to these factors in making any final SPDC determination, it should issue a supplemental notice explaining the evidence it believes relates to these factors, and provide EEI and other market participants with an opportunity to provide specific comments relative to those factors.

<sup>9</sup> See Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets, Oct. 2007 available at [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/pr5403-07\\_ecmreport.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/pr5403-07_ecmreport.pdf); See also PJM Notice of Intent at 54,967, 54,968, 54,969.

<sup>10</sup> PJM Notice of Intent at 54,967, 54,968, 54,969.

<sup>11</sup> ICE Henry Financial SPDC Order at 37,989.

<sup>12</sup> See 17 CFR § 36.3(c)(1)(iii).

<sup>13</sup> An LMP at a particular point on the transmission has three components: the marginal cost of energy, marginal losses, and marginal congestion costs. PJM Open Access Transmission Tariff, Attach. K – Appendix § 2.6.

remain just and reasonable, as well as rules establishing independent market monitors to consistently review market prices and market participant behaviors. FERC also acts on its own to oversee the markets to ensure that they are operating properly and are free from manipulation, and has strong authority to punish actual or attempted market manipulation.

In short, the ICE Contracts settle based on FERC-regulated LMPs that are themselves determined by physical supply and demand factors that exist independent of any related financial contracts. In addition, the ICE contracts only settle on a daily or monthly basis, whereas the physical PJM market provides both day-ahead and real-time pricing, with real-time LMPs calculated every five minutes. For these reasons, the ICE Contracts cannot serve as a material price reference in physical electric power markets. The fact that the ICE Contracts do not serve as a price reference for physical transactions should weigh heavily against a final determination by the Commission that they are SPDCs.<sup>14</sup>

#### B. No Material Liquidity

The PJM Notice of Intent concludes, based solely on the average number of daily contracts and the average number of separate transactions for each of the relevant ICE Contracts, that the ICE Contracts may satisfy the material liquidity provision outlined in the SPDC Order.<sup>15</sup> These aggregated figures do not provide an accurate view of actual liquidity.

First, the ICE Contracts actually are comprised of hundreds of individually traded products. For example, the PJM contract referenced in the PJM Notice of Intent is actually 110 individual products, each designated by a particular month. Similarly, the OPJ contract is comprised of 86 individual monthly products. The PDP, PDA and ODP contracts are 38 individual products, each designated by a particular calendar day. These products are traded individually in the marketplace – for example, a January contract, regardless of its liquidity, is not helpful to a trader who needs to liquidate an October position. For this reason, the contracts should not be aggregated for purposes of determining liquidity. The more appropriate method for determining liquidity is to examine the activity in a single traded month or day, as applicable.<sup>16</sup>

Further, the aggregated data relied on by the Commission in the Notice of Intent also includes a significant percentage of bilaterally negotiated, over-the-counter trades

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<sup>14</sup> See The Joint Explanatory Statement of the Committee of Agriculture Conference, H.R. Rep. No. 1110 627, 110 Cong., 2nd Sess. at 978-86 (2008) (explaining that Congress gave the Commission authority to designate as SPDCs contracts that may be quoted as an independent price reference by the public).

<sup>15</sup> See PJM Notice of Intent at 54,967, 54,968, 54,969. The CFTC used trade data from a required quarterly notification that ICE filed on July 27, 2009.

<sup>16</sup> For example, a high-level review of data available from ICE for September 2009 appears to show that at least two of the ICE Contracts, when broken into their individual contract month or day, had less than five trades per day.

that have been offered to the ICE for clearing. These transactions, which are not offered or bid on ICE, should not be included for purposes of determining material liquidity.

In addition, the material liquidity criterion that the Commission is directed to consider in Rule 36.3(c)(1)(iv) requires the Commission to consider whether the trading volume of the ICE Contracts is “sufficient to have a material effect” on corresponding exchange-traded contracts, *e.g.*, contracts traded on the New York Mercantile Exchange (“NYMEX”), a designated contract market (“DCM”).<sup>17</sup> The Commission does not specify the exchange-traded contracts to which it is comparing the ICE Contracts. While a review of the contracts traded on the NYMEX reveals some contracts that appear to correspond to the ICE Contracts, at least two of the ICE Contracts – the PDA and ODP contracts – do not appear to have any corresponding NYMEX contract.<sup>18</sup> As a result, these ICE Contracts, at a minimum, could not have a “material effect” on any exchange-traded contracts because no corresponding contracts appear to exist.

More broadly, there is no *direct* price linkage between the ICE Contracts and the Corresponding NYMEX Contracts because both sets of contracts reference the day-ahead or real-time hourly LMPs set by physical power trading in the PJM markets (as discussed above). As a result, the ICE Contracts cannot have a direct material effect on the NYMEX contracts: both sets of contracts independently reference LMPs that are determined based on physical factors, entirely separate from ICE or NYMEX. Because trading in the ICE Contracts cannot have a direct “material effect” on the Corresponding NYMEX Contracts, the material liquidity criterion in the Commission’s regulations is not satisfied.<sup>19</sup>

## **V. THE COSTS AND RISKS THAT WOULD RESULT FROM DESIGNATING THE ICE CONTRACTS AS SPDCS OUTWEIGH ANY POTENTIAL BENEFIT**

EEI members and other market participants in U.S. physical power markets rely on the ability to hedge their price risks by purchasing and selling the ICE Contracts. Setting position limits for the ICE Contracts could adversely affect the underlying

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<sup>17</sup> 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. 37,989 (July, 30 2009) (the “ICE Henry Financial SPDC Order”).

<sup>18</sup> The following five NYMEX contracts (“Corresponding NYMEX Contracts”) are most similar to the ICE Contracts: PJM Financially Settled Daily Futures - Peak (JD), which is similar to the ICE PDP contract; PJM Financially Settled Monthly Futures - Peak (JM) and PJM Western Hub Peak Calendar-Month Real-Time LMP Swap Futures (L1), which are each similar to the ICE PJM contract, and; PJM Financially Settled Monthly Electricity Futures - Off-Peak (JP) and PJM Western Hub Off-Peak Calendar-Month Real-Time LMP Swap Futures (N9), which are each similar to the ICE OPJ contract.

<sup>19</sup> See ICE Henry Financial SPDC Order at 37,989 (in which the Commission explained that material liquidity means “the extent to which the volume of agreements, contracts or transactions in a commodity being traded on the electronic trading facility is sufficient to have a material effect on other agreements, contracts or transactions listed for trading on or subject to the rules of a DCM, DTEF [derivatives transaction execution facility] or electronic trading facility operating in reliance on the exemption in section 2(h)(3).”).

physical power markets by limiting the ability of market participants (including electric utilities with obligations to serve consumers) to adequately hedge against volatile physical power prices and deliver a reliable source of power to consumers at stable prices. The resulting reduced liquidity in the physical market could also harm the ability of the market to generate accurate price signals, which are essential to maintaining efficient wholesale markets.

The critical role that these contracts play in ensuring a steady flow of power to retail consumers at reasonably stable prices, coupled with the fact that the SPDC determination criteria weigh against designating the contracts as SPDCs, requires careful analysis by the Commission. In addition to the potential risks discussed above, there is the potential for other unintended consequences that may result from the application of the Commission's comprehensive regulatory program to these contracts. To date, the Commission has no experience with respect to what effect SPDC designation may have on the contracts or the related physical transactions. The first contract to be deemed an SPDC, the ICE Henry Financial LD1 Fixed Price Contract, was identified in July of 2009 and the ICE has not yet completed its implementation of the Commission's regulatory requirements.

As discussed above, in the absence of providing additional time for public comment, the Commission should make a finding that the ICE Contracts are not SPDCs, based on the application of the specific facts associated with these contracts to the criteria for determining SPDCs set forth in the Commission's regulations. If the Commission does not make such a finding, it should delay making a determination as to whether the ICE Contracts are SPDCs until further research can be done on the long-term and market-wide effects such designation may have. In the alternative, the Commission should limit any SPDC designation to a finite number of contracts. If the Commission chooses to do this, it should then study the effect such designation has on those contracts and the underlying physical markets prior to taking any action with respect to the other ICE Contracts.

Finally, to the extent that the ICE Contracts are designated as SPDCs and position limits are imposed, the limits should be crafted in such a way that they allow for hedging of transactions in physical markets at current levels well forward on the price curve and allow automatic position increases as a result of load growth or new generation. Additionally, the Commission should provide for the opportunity to reassess any determination that the ICE Contracts are SPDCs, and to reassess any position limits imposed, based on actual experience.

## CONCLUSION

For the foregoing reasons, EEI respectfully recommends that the Commission not designate the ICE Contracts as SPDCs. If you have any questions regarding these comments, please do not hesitate to contact Richard F. McMahon, Jr., Executive Director, at (202) 508-5571, or Jeff Dennis, Director, Federal Regulatory Affairs, at (202) 508-5098.

Respectfully Submitted,

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