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November 6, 2009

COMMENT

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

RE: Determination whether the PJM contracts 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 PJM Real Time Peak Daily (``PDP'') contract; PJM WH Real Time Peak (``PJM'') contract; PJM WH Real Time Off-Peak (``OPJ'') contract; PJM WH Day Ahead LMP Peak Daily (``PDA'') contract; and the PJM WH Real Time Off-Peak Daily (``ODP'') contract (collectively "PJM contracts") serve a significant price discovery function.

ICE believes that these 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"). In addition to the absence of minimum liquidity thresholds and the lack of a material price reference preclude 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[1] 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

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

IntercontinentalExchange
2100 RiverEdge Parkway
Suite 500
Atlanta, GA 30328

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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.[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 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."[3]

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

*The PJM Contracts*

ICE was formed as an electronic platform to increase the transparency and liquidity in the wholesale power and natural gas markets. Over the years, ICE has been an innovator in the power markets, including screen-based trading to provide more visibility into formerly opaque markets, as well as the development of the first cleared power swaps, bringing needed risk management practices including daily mark-to-market and reduction in counterparty risk. In addition to these enhancements, the power markets have evolved significantly over the past decade as a result of regulation. Following the passage of the Federal Energy Policy Act of 1992, the Federal Energy Regulatory Commission has encouraged the formation of Independent System Operators ("ISO") to ensure the safe and reliable transportation of electricity.

The PJM (Pennsylvania-New Jersey-Maryland) regional transmission organization (RTO) distributes power to thirteen states and the District of Columbia. PJM formed the first ISO in 1997 to operate the transmission systems and to create a bid based energy market. PJM, regulated by the Federal Energy Regulatory Commission, creates the locational marginal prices ("LMP") that the PJM contracts reference.

*The CFTC's Analysis*

The CFTC believes that the PJM contracts could potentially serve a significant price discovery function based upon two factors: (1) material liquidity and (2) material price reference. ICE does not believe that the PJM contracts meet these tests.

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[2] The Joint Explanatory Statement of the Committee of Agriculture Conference, H.R. Rep. No. 1110 at 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)

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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 "liquidity 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".[4] 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."[5]

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 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 have been misinterpreted and misapplied. First, 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 example, in the PJM contract, only 68% of all trades were executed on ICE OTC platform. Similarly, for the OPJ contract only 47% of the all trades were executed on the screen. However, *volume*, rather than *number of trades*, is a much more meaningful indicator of actual liquidity and therefore price discovery. In deciding whether or not to participate in a market, traders consider volume, not number of trades. On a volume-basis, only about 53% of the total PJM volume was actually

[4] Appendix A to Part 36, 17 C.F.R. 36 (2009).
[5] Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1624 (June 18, 2008).

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executed on the ICE platform. For the OPJ contract, only 28% of total volume was executed on the ICE platform. Even a daily contract, like ODP, had a significant amount of volume (47%) executed off exchange.

Second, the CFTC's figures, as requested of and provided by ICE, include trades made in all months of each contract or all days of each daily or day ahead contract. Furthermore, some of the trades were executed in seasonal (summer or winter) or quarterly 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. This is especially true in weather-sensitive markets like natural gas and electric power where seasonal prices vary widely. For the PJM contract, only 20% of the trades actually executed on the ICE platform occurred in the single most liquid month of the contract. However, again, from the more important volume-standpoint, only 13% of all PJM volume actually executed on the ICE platform occurred in the single most liquid month of the contract. Similarly, for the OPJ contract, only 21% of trades and 10% of volume actually executed on the ICE platform occurred in the single most liquid month of the contract.

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 PJM contract traded an average of 124 times per day, but only 14% (68% x 20%) of these trades (and an even lower 7% of total volume) were actually executed on the ICE platform in the single most liquid month of the contract. Given an eight hour trading day[6], this means that the most liquid month of the PJM contract traded only about once every 28 minutes on the ICE platform. Similarly, the OPJ contract traded 6.8 times per day, but since only 10% (47% x 21%) of those trades was executed on the ICE platform in the most liquid month, the actual number of trades was less than one per day.

The dailies and day ahead contracts had similar low levels of liquidity when considering that the CFTC totals include all 38 days of trading. The most liquid contract, the PJM daily real time contract, PDP, trades on average 228 times per day on the OTC platform, but this is spread out over 38 days. The most liquid day of the PDP contract, the next day market, accounts for 72% of trades. Thus in the most liquid daily contract, there is a trade on screen every 3 minutes. Liquidity drops steeply on the other daily contracts, with the PDA contract trading 16 times per day and the OPD contract trading 11 times per day. This equates to a trade every 30 or 43 minutes, respectively.

[6] Note that ICE's OTC markets are actually open 22 hours.

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

For the PJM contracts, the CFTC relies on one reason 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 power contracts." This argument is nearly impossible to respond to as the ECM report did not mention these contracts as a potential significant price discovery contract, instead focusing exclusively on the Henry Hub LD1 natural gas swap. It is impossible to say which market participants made this statement *in 2007 or the contracts that were referenced, or whether the participants distinguish "price transparency" from the legal meaning of "price discovery".* 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 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.

For the PJM contracts, the PJM Independent System Operator ("ISO") determines the price of the underlying cash market. Therefore the cleared price of electricity, the Locational Marginal Price or "LMP", in PJM for each hour reflects natural forces of real-time supply and demand for the physical commodity at each pricing point. The PJM contracts do not, and cannot, influence the LMP determined by the PJM ISO. As PJM states in their comment letter: "the ICE contracts do not determine LMPs in PJM's day-ahead and real-time electricity markets. Rather, the prices of the ICE contracts are driven

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by prices in PJM's LMP based markets."[7] While this is critically relevant for all ISO-settled electric power swaps, it is especially so for daily contracts such as PDP, PDA, and ODP which are overwhelmingly traded on the day of and day before publication of LMPs.

Also, if the CFTC determines, despite ICE's arguments to the contrary, that an ICE PJM contract qualifies as a SPDC, then similar derivatives offered and cleared by ISOs, such as financial transmission rights (FTR)[8] and DA/RT virtual markets, presumably meet the same SPDC criteria requiring either SPDC designation and oversight by the CFTC or an equivalently prescriptive FERC framework featuring position limits and large trader reporting. These PJM ISO contracts, like the ICE PJM contracts, are cash-settled on ISO LMPs and cleared.

Finally, the PJM contracts fail the CFTC's material liquidity test and by the plain intent of Congress, can not serve as a material price reference.

*Conclusion*

Based on the failure to meet virtually all of the criteria for SPDC determination, it is clear that the PJM contracts do not serve as a material price reference or trade with material liquidity. Therefore, the Commission should not deem this contract as a significant price discovery contracts. Congress ordered the Commission to review the electronic OTC markets for contracts that serve a significant price discovery function. Overreaching in this process could force OTC trading back to the opaque voice brokered markets. It is important for the Commission to remember that Exempt Commercial Markets perform a very important function in bringing transparency and credit intermediation to the OTC markets, and should not be disadvantaged relative to the opaque, off-exchange markets where no such requirements exist.

Thank you for the opportunity to comment.

Sincerely,

R. Trabue Bland
Director of Regulatory Affairs
Assistant General Counsel

[7] http://www.cftc.gov/lawandregulation/federalregister/federalregistercomments/2009/09-032.html
[8] http://www.pjm.com/markets-and-operations/ftr.aspx