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Petition for Order under CFTC Rule 39.14(b)

March 23, 2012

VIA E-MAIL to secretary@cftc.gov

David A. Stawick
Secretary,
Commodity Futures Trading Commission
1151 21st St., N.W.
Washington, D.C. 20581

Re: Petition for Order under CFTC Rule 39.14(b) ("Daily Settlements")

Dear Mr. Stawick:

On behalf of our client, Natural Gas Exchange Inc ("NGX"),[1] we hereby Petition the Commodity Futures Trading Commission ("Commission") for an Order under Commission Rule 39.14(b) permitting NGX to provide for settlement of variation adjustments to collateral using an accrual, rather than a daily payment and collection, methodology.

Commission Rule 39.14(b) provides that,

> Except as otherwise provided by Commission order, a derivatives clearing organization shall effect a settlement with each clearing member at least once each business day, and shall have the authority and operational capacity to effect a settlement with each clearing member, on an intraday basis, either routinely, when thresholds specified by the derivatives clearing organization are breached, or in times of extreme market volatility.[2]

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[1] NGX's main business address is Natural Gas Exchange, Inc., Suite 2330, 140–4th Avenue SW, Calgary, Alberta T2P 3N3, main business telephone number is (403) 974-1000, and main business fax number is (403) 974-1719.

[2] "Derivatives Clearing Organization General Provisions and Core Principles," 76 *Fed. Reg.* 334 (Nov. 8, 2011) ("Final Rulemaking").

This exemptive provision, which was not included in Rule 39.14 as originally proposed by the Commission, was added in response to concerns expressed by NGX in comments to the Commission. The Commission, in adopting the exemptive provision of Rule 39.14(b), noted that NGX, "requested that the Commission afford recognition to a clearing model that does not require daily variation margin payments and collections but permits accrual accounting with respect to certain energy products."[3] As the Commission explained in adopting Commission Rule 39.14(b), although the Commission did not include alternative risk management frameworks for Derivative Clearing Organizations ("DCO") within the rule as adopted, it provided that

> a particular DCO may petition the Commission for an exemption if it believes that it can demonstrate that the daily accrual of gains and losses provides the same protection to the DCO as would daily variation margin payments and collections.

Final Rulemaking at 69386. For the reasons explained below, NGX's accrual methodology for settlement of daily variation adjustments to collateral provides the same protection to NGX as would daily variation margin payments and collections.

NGX

NGX operates a trading and clearing system for energy products that provides electronic trading, central counterparty clearing and data services to the North American natural gas, electricity and oil markets. NGX has been operating since 1994. On December 12, 2008, NGX, which is located in Calgary, Alberta, was registered by the Commission as a DCO.[4]

NGX trades and clears a number of different products, including physical contracts in natural gas. A high percentage of contracts cleared by NGX are settled through physical delivery. NGX clears and settles exchange traded and over-the-counter ("OTC") contracts annually with a notional value of over $60 billion.

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[3] Final Rulemaking at 69386. As the Commission noted in the Final Rulemaking, NGX in its comment letter "stated that its clearing model generally does not require daily variation margin payments and collections, and that settlement on its energy contracts occurs only on a monthly basis, after clearing participant obligations have been netted, consistent with practices in the cash market and with the end-user nature of the vast majority of NGX clearing participants. NGX noted that, therefore, the type of daily settlement risk that proposed § 39.14 addresses is not present in the NGX model and the degree of risk in the monthly settlement process is reduced." *Id.*

[4] NGX notified the Commission on November 5, 2002, of its operation as an exempt commercial market ("ECM") in connection with its trade execution activities. By submission dated September 13, 2010, NGX petitioned the Commission under Section 723(c)(2) of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") for an Order permitting NGX and its Participants and their Authorized Representatives to continue operating subject to section 2(h) of the Commodity Exchange Act (7 U.S.C. §2(h)) as in effect prior to the date of enactment of the Dodd-Frank Act. The Commission granted NGX's Petition permitting it to continue operating as an ECM until July 16, 2012. NGX, on February 21, 2012 applied for registration as a Foreign Board of Trade ("FBOT") in connection with its trade execution activities.

NGX offers a non-intermediated trading and clearing model; each clearing participant only clears for itself. None of NGX's participants clear (or trade) for customers.

The participants in the NGX market are predominantly composed of commercial end-users. These participants typically make or take delivery on a routine basis in the cash markets. Moreover, among the contracts traded on NGX and cleared by NGX DCO are forward contracts in the physical commodity. Reflecting its focus on commercial end-user participants, NGX DCO extends its guarantee as central counterparty ("CCP") through completion of the settlement process.[5] Accordingly, NGX as CCP arranges for deliveries and settlement payments to be made. NGX DCO ultimately stands behind the settlement process, and in case of default, will complete the delivery process to the non-defaulting party.

NGX's Accrual Margining System

With the exception of its electricity contracts,[6] NGX, since beginning clearing operations, has used an accrual-style adjustment to reflect daily variation in the value of a clearing participant's positions in relation to its posted collateral. This method of accounting for the variation in the value of a clearing participant's positions relative to posted collateral is reflective of practices in the OTC swaps and physical forward markets for energy.

NGX's accrual-methodology operates as follows. Each clearing participant posts with NGX initial margin for the transactions which it clears. As the position is marked to market, the daily accrual of gains and losses occurs in the clearing participant's account. Funds are not moved, however, between the accounts of clearing participants. Specifically, NGX calculates on a daily basis the change in the overall risk of the clearing participant's position relative to its posted collateral. Positive daily variation amounts are treated as gains that are recognized in the NGX risk management system and in the overall calculation of margin requirements for a clearing participant's portfolio. Typically, these gains on variation payments are not realized by the clearing participant until settlement, which for physical natural gas contracts is the 25th day following the month of delivery. Although it is possible for a clearing participant to withdraw funds that are in excess of its collateral obligations, clearing participants in natural gas contracts typically permit gains to accumulate in the clearing participant's account while the contract remains open, and the gains are realized by the clearing participant in the final settlement, which is at full contract value.

Where there is a negative daily variation valuation, the losses are recognized in the risk management system. If the clearing participant has insufficient collateral posted as a result of these declines when compared to the overall risk of its positions, the clearing participant must

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[5] This is in contrast to many DCOs which step out of the settlement process.

[6] A small number of NGX contracts require settlement of daily variation movements though pays and collects and are not within the scope of this request. Specifically, the NGX power contracts provide for daily payment and collection with respect to variation adjustment to positions. However, the vast majority of NGX contracts which reflect cash market practice in the natural gas and oil markets do not use daily payment and collection with respect to variation adjustment to positions.

post with NGX an amount necessary to restore the collateral account to an acceptable level. Specifically, clearing participants with a declining portfolio value are required to top-up the collateral on deposit when the value of the deposited collateral has eroded to 85% of the amount required to be maintained.

NGX's mark-to-market process is conducted continuously and in real time. The amount of collateral needed by a clearing participant is recalculated throughout the day to reflect new exchange transactions. NGX makes margin calls throughout the day based on mark-to-market values that reflect current pricing, ensuring that deposited collateral and exposures remain in sync.

NGX's Margining System Provides Same Protection As Daily Pay and Collect

Since its inception, NGX has used its accrual methodology to reflect daily gains and losses in each clearing participant account without moving funds between such accounts. The NGX accrual margining system provides an effective means of conducting risk management, tailored to the markets that it clears, particularly in light of the high number of contracts that are physically delivered and therefore settled through NGX at full contract value.

NGX is not adversely exposed from the accrual of daily variation amounts in the accounts of its clearing participants and is no less protected in the event of a clearing participant default as compared to the daily payment and collection margining framework mandated by Commission Rule 39.14(b). Because every participant on NGX self-clears, there is no less protection to NGX from its accrual method of settlement compared to a daily payment and collection settlement system. Daily pays and collects among clearing members do not increase the amount of collateral available to a DCO over that which is available to NGX under its accrual methodology. In either settlement system, a clearing participant will be required to top-up the amount of collateral in its account to reflect relative declines in the value of its positions. And in either case, such amounts will be available to the DCO in case of the default of the clearing participant.

Although unstated in the Final Rulemaking, there may be one public policy reason to favor a daily movement of funds among clearing members over accrual of daily variation adjustments. Where a clearing member clears for customers, the daily movement of variation payments facilitates appropriate segregation of customer funds, which includes money "accruing to such customer as the result of such trades or contracts."[7] However, this is inapplicable to NGX because every NGX clearing participant clears only for its own account. The risk to NGX as a non-intermediated clearing house is the same regardless of whether there is a daily transfer among clearing members of payments and collections reflecting the net difference in variation payments.

Finally, it should be noted that requiring daily payments and collections is operationally more complex than accruing variation adjustments for both NGX and its clearing participants.

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[7] *See* section 4d of the Act.

The increased operational complexity of daily payments and collections is merited where clearing members hold customer funds which must be deposited into the proper segregated customer account. However, as discussed above, in the case of NGX, which is non-intermediated, daily payment and settlement offers no corresponding benefit.

Moreover, although a clearing participant is not prohibited from withdrawing excess collateral which has been accrued, funds are not routinely paid by NGX on a daily basis, thereby encouraging clearing participants to maintain greater levels of collateral in their accounts until final settlement takes place. This reduces the potential default risk to NGX during the delivery period, when contracts must be fully collateralized. Accordingly, failure by the Commission to grant an Order permitting NGX to continue using its accrual method of settlement will increase the overall operational and default risks to NGX.

Conclusion

NGX has used its accrual methodology for accounting for variation adjustments in the relative value of posted collateral for nearly 20 years. As described above, NGX's long-standing accrual methodology meets the criteria for exemptive relief provided by the Commission under Commission Rule 39.14(b) by providing "the same protection to [NGX] . . . as would daily variation margin payments and collections." In addition, the NGX accrual method reduces potential operational risk to NGX and its clearing participants and ameliorates default risk during contract settlement.

For the foregoing reasons, NGX respectfully Petitions the Commission to issue an Order exempting NGX from the provisions of 39.14(b) conditioned upon NGX's calculation of daily variation and the daily posting of such gains or losses in its risk management system to the account of each NGX clearing participant.

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Please feel free to contact Cheryl Graden, NGX Chief Legal Counsel, via telephone at (416) 947-4359 or the undersigned, outside counsel to NGX, at (202) 663-6240, with any questions concerning this Petition.

Respectfully submitted,

Paul M Architzel

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Cc: Chairman Gary Gensler
Commissioner Bart Chilton
Commissioner Jill Sommers
Commissioner Scott O'Malia
Commissioner Mark Wetjen
Ananda Radhakrishnan, Division of Clearing and Risk
Phyllis Dietz, Division of Clearing and Risk
Robert Wasserman, Division of Clearing and Risk
Cheryl Graden, NGX

Certification and Undertaking Pursuant to Rule 140.99(c)(3)

I hereby certify that the material facts set forth in the attached Petition for Order Under CFTC Rule 39.14(b), dated March 23, 2012, are true and complete to the best of my knowledge.

NGX hereby undertakes that, if at any time prior to the issuance of the requested exemptive letter by the Commission to NGX, any material representation made in the attached Petition ceases to be true and complete, NGX will ensure that the Commission staff is informed promptly in writing of all materially changed facts and circumstances. Further, if a material change in facts or circumstances occurs subsequent to the Commission's issuance of such Order, NGX will promptly so inform the Commission staff.

Peter Krenkel
CEO and President