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

VIA ELECTRONIC MAIL

COMMENT

Re: *Significant Price Discovery Contract Proceeding, Phys, BS, LD1 (US/MM), AB-NIT Contract, et al.*, Comment File 09-029

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 20, 2009,¹ addressing whether the Phys, BS, LD1 (US/MM), AB-NIT Contract, et al., offered for trading on the Natural Gas Exchange, Inc. ("NGX") perform significant price discovery functions. Specifically, the Working Group respectfully submits comments that are limited to the following contracts identified in the NOI:

- Phys, BS, LD1 (US/MM), AB-NIT Contract ("Alberta Basis Contract");
- Phys, BS, LD1 (US/MM), Union-Dawn Contract ("Union-Dawn Basis Contract"); and
- Phys, ID, 7a (CA/GJ), AB-NIT Contract ("Alberta Index Contract").²

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 (1) Phys, BS, LD1 (US/MM), AB-NIT Contract, et al., Offered for Trading on the Natural Gas Exchange, Inc., Perform Significant Price Discovery Functions*, 74 Fed. Reg. 53,724 (Oct. 20, 2009).

² The Alberta Basis Contract, Union-Dawn Basis Contract, and Alberta Index Contract are collectively referred to as the "NGX Contracts."

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.

As discussed further in these comments, the Working Group does not believe that these NGX Contracts perform a significant price discovery function and therefore should not be designated as significant price discovery contracts (“SPDCs”) at this time.

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

In 2000, Congress enacted the Commodity Futures Modernization Act (“CFMA”),³ 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.⁴ 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 2008⁵ was enacted and, in relevant part, amended the CEA to include new Section 2(h)(7). 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.⁶ 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

³ Incorporated as Appendix E of the Consolidated Appropriations Act of 2001, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

⁴ The NGX is an ECM.

⁵ 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”).

⁶ 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).

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.⁷ The SPDC Final Rule became effective on April 22, 2009. Among other things, 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.⁸

The Commission has broad discretion when determining whether to designate a contract as an 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 NGX CONTRACTS AS SPDCS.

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, it is not clear that these NGX Contracts satisfy the factors upon which the Commission proposes to base its respective determinations that these contracts perform significant price discovery functions. Accordingly, the Working Group respectfully submits that the Commission should refrain from designating the referenced NGX Contracts as SPDCs.⁹

The designation of the NGX Contracts as SPDCs will not further in a meaningful manner other policy concerns identified by the Commission to the extent that they relate to protecting (a) the NYMEX NG Contract and (b) the underlying physical markets at Henry Hub from excessive speculation or manipulation. The designation of the NGX Contracts as SPDCs and the required imposition of position limits on these contracts by NGX have the potential to harm liquidity, which, in turn, could result in industrial, commercial and residential consumers in the U.S. and Canada incurring higher energy prices.

⁷ 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).

⁸ *Id.* at § 36.3(c)(3).

⁹ Attached as Exhibit 1 is the NGX Price Index Methodology Guide (Oct. 16, 2009 Version) published by NGX (the "Methodology Guide"). The methodology for all of the NGX physical indices is set forth in detail in the Methodology Guide, starting at page 8.

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.¹⁰ 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.¹¹

The Commission also has broad authority under CEA Section 9(a)(2) to protect against entities engaged in CFTC-jurisdictional activities from manipulating physical prices at Henry Hub.¹² With regard to physical prices at Henry Hub, 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 authority to prohibit the manipulation of natural gas markets under NGA Section 4A, 15 U.S.C. § 717c-1.

Each NGX Contract is separately addressed below.

A. ALBERTA BASIS CONTRACT.

The Alberta Basis Contract is a monthly contract that calls for physical delivery of natural gas based on the final settlement price for NYMEX’s Henry Hub physically-delivered natural gas futures contract for the specified calendar month (“NYMEX NG Contract”), plus or minus the price differential (basis) between the Alberta delivery point (“Alberta System”) and the Henry Hub. There is no standard size for the Alberta Basis Contract, although a minimum volume of 100 mmBtu is required in increments of 100 units per day. The Alberta Basis Contract is listed for 60 consecutive calendar months. The NOI states that the Alberta Basis Contract appears to satisfy the Material Liquidity, Price Linkage, and Material Price Reference factors required for SPDC designation.¹³

¹⁰ 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.”

¹¹ 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).

¹² 7 U.S.C. § 9(a)(2).

¹³ NOI at p. 53,726.

1. **MATERIAL PRICE REFERENCE.**

The NOI states that the Alberta Basis 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.¹⁴ 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.¹⁵ A direct reference would be whether the cash market quotes the ECM contract.¹⁶ An indirect reference would be whether an industry publication quotes the ECM contract’s price.¹⁷ The Alberta Basis Contract does not meet either of these standards.

a. **Direct Reference.**

There are no other related contracts traded in any market that settle to, or reference, the Alberta Basis Contract. The Material Price Reference for the Alberta Basis Contract itself is derived from the settlement price for the NYMEX NG Contract and the price differential between the Alberta System and the Henry Hub. Neither price reference is based on the Alberta Basis Contract. Although the Alberta Basis Contract is influenced by these direct references, the Alberta Basis Contract itself neither influences the settlement of the NYMEX NG Contract nor does it influence the price differential between Henry Hub and the Alberta System.

b. **Indirect Reference.**

As to the indirect reference regarding whether an industry publication quotes the ECM contract’s price, the only publication to which the CFTC refers is the “OTC Gas End of Day,” which is published by the IntercontinentalExchange, Inc. (“ICE”), an ECM, on behalf of NGX and its participants. As noted in the NOI, NGX has entered into an alliance with ICE pursuant to which ICE (a) is the exclusive trading platform for virtually all natural gas and electricity products traded in the NGX markets, including the Alberta Basis Contract, and (b) provides clearing and settlement services for physical OTC natural gas contracts on select U.S. trading hubs, including Henry Hub.

The Working Group does not believe the fact that ICE publishes the settlement prices of NGX physical transactions constitutes sufficient evidence of a Material Price Reference

¹⁴ 7 U.S.C. § 2(h)(7)(B)(iii).

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

¹⁶ *Id.*

¹⁷ *Id.*

necessary to satisfy the requirements of CEA Section 2(h)(7)(B)(iii). No data is sold between NGX and ICE and NGX does not publish any trade data on its own website. Given this unique arrangement, it is only logical that ICE publishes transaction data regarding the NGX physical deals in its "OTC Gas End of Day" publication. There is no evidence whatsoever that a contract in any market is tied directly or indirectly to the settlement price of the Alberta Basis Contract.

2. 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.¹⁸ As noted in the NOI, the Alberta Basis Contract is technically linked to the NYMEX NG Contract. Notwithstanding this partial linkage, the Alberta Basis 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.

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).¹⁹

¹⁸ 17 C.F.R. § 36, Appendix A(B).

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

Publicly-available, empirical data shows that the Alberta Basis 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 Alberta Basis Contract with the NYMEX NG Contract settlement prices published during the 75-day period beginning July 21, 2009 through November 2, 2009, clearly establishes that these contracts are not “substantially the same.” For example, the price for the December NYMEX NG Contract during this period is approximately \$5.30/mmbtu. In contrast, the basis price of the Alberta Basis Contract is approximately \$.040/mmbtu below the December NYMEX NG Contract price. Price data published during this period also provides evidence that the Alberta Basis Contract does not “move substantially in conjunction with” the December NYMEX NG Contract. Specifically, the correlation of the daily changes between the December NYMEX NG Contract and the Alberta Basis Contract is negative 35 percent for this period.

3. MATERIAL LIQUIDITY.

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.²⁰ The Commission also states “[l]iquidity is a broad concept that captures the ability to transact immediately with little or no price concession.”²¹ The Alberta Basis Contract lacks both (a) a material effect on other contracts and (b) sufficient liquidity to perform a significant price discovery function.

a. No Material Effect on Other Contracts Listed for Trading.

As noted above, there is no evidence of other related contracts traded in any market that settle to, or reference, the Alberta Basis Contract. The NGX trading platform is unique as it offers both basis contracts, *i.e.*, the Alberta Basis Contract, and outright contracts. Because the pricing components of the basis and outright physical contracts traded on the NGX platform are interrelated, they help to create a market equilibrium within the Canadian system. Consequently, given this equilibrium, although the Alberta Basis Contract is influenced by the price differential of physical gas between the Alberta System and Henry Hub and the settlement of the NYMEX NG Contract, it has no functional effect on the

²⁰ 7 U.S.C. § 2(h)(7)(B)(iv).

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

NYMEX NG Contract itself, nor does it have any effect on actual physical prices at Henry Hub.²²

b. Liquidity in the Alberta Basis 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.²³ The NOI does not address either of these factors. Rather, it states that the Alberta Basis Contract was transacted on an average daily basis of 23.2 times. Based on the average daily trade data set forth in the NOI, the trade frequency of the Alberta Basis Contract in terms of multiple trades per minute is very low.²⁴ Because neither factor is presented by the Alberta Basis Contract, trading in this contract fails to meet this standard.

B. UNION-DAWN BASIS CONTRACT.

The Union-Dawn Basis Contract is a monthly contract that calls for physical delivery of natural gas based on the final settlement price for NYMEX's Henry Hub physically-delivered natural gas futures contract for the specified calendar month ("NYMEX NG Contract"), plus or minus the price differential (basis) between the Dawn delivery point ("Dawn Hub") and the Henry Hub. There is no standard size for the Union-Dawn Basis Contract, although a minimum volume of 100 mmBtu is required in increments of 100 units per day. The Union-Dawn Basis Contract is listed for 60 consecutive calendar months.

²² As discussed 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 that could result in the manipulation of physical pricing at Henry Hub. This authority complements FERC's jurisdiction under the NGA over wholesale, physical gas markets and FERC's broad anti-manipulation authority under NGA Section 4A.

²³ Because the NOI does not expressly address how the Alberta Basis 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 Working Group respectfully requests that the Commission expressly identify the criteria supporting its view that the Alberta Basis Contract appears to meet the Material Liquidity factor.

²⁴ The transaction volume associated with the Alberta Basis Contract is de minimis compared to the transaction volumes of the NYMEX NG Contract or the Henry Financial LD1 Fixed Price contract traded on ICE which was recently designated as an SPDC. The NOI states that the Alberta Basis Contract has a daily trading volume of approximately 6,000,000 mmBtu. Although this figure initially sounds significant, when quantified in the same terms as the NYMEX NG Contract (*i.e.*, 10,000 mmBtu/contract), the daily trading volume for the Alberta Basis Contract is only 600 contracts. Accordingly, the Alberta Basis Contract has a trading volume that, by comparison, is less than 1 percent of trading volume of the NYMEX NG Contract or the Henry Financial LD1 Fixed Price contract traded on ICE.

