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

David A. Stawick  
Secretary  
Commodity Futures Trading Commission  
1155 21<sup>st</sup> Street, NW  
Washington, DC 20581

COMMENT

Re: "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 WH Real Time Peak Daily Contract, PJM WH Real Time Peak Contract, PJM WH Real Time Off-Peak Contract PJM WH Day Ahead LMP Peak Daily Contract and PJM WH Real Time Off-Peak Daily Contract All Offered for Trading on the Intercontinental Exchange, Inc. Perform Significant Price Discovery Functions," 74 Fed. Reg. 54966 (October 26, 2009)

Dear Mr. Stawick:

The Electric Power Supply Association ("EPSA")<sup>1</sup> respectfully files comments on the Commodity Futures Trading Commission's ("CFTC" or "Commission") notice of intent ("Notice" or "NOI") to determine whether the PJM WH Real Time Peak Daily Contract, PJM WH Real Time Peak Contract, PJM WH Real Time Off-Peak Contract PJM WH Day Ahead LMP Peak Daily Contract and PJM WH Real Time Off-Peak Daily Contract ("PJM Western Hub Contracts") - all offered for trading on the Intercontinental Exchange, Inc. ("ICE") - perform significant price discovery functions

The Notice, published in the Federal Register on October 26, 2009, and establishing a 15 day comment period, is a further consideration by the Commission of whether certain power contracts perform a significant price discovery function pursuant to the authority granted to the Commission by the CFTC Reauthorization Act of 2008 ("Reauthorization Act"). EPSA believes that these contracts do not serve a significant price discovery function for two reasons: (1) due to the manner in which the PJM Interconnection, Inc ("PJM") produces and disseminates Locational Marginal Prices ("LMP"), the contracts do not serve as a material price reference, and (2) the contracts do not meet the material liquidity standard.

<sup>1</sup> The comments contained in this filing represent the position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

In light of these facts, as discussed below, none of the PJM Western Hub Contracts meet the tests necessary to be designated as a Significant Price Discovery Contract ("SPDC").

## **THE ELECTRIC POWER SUPPLY ASSOCIATION**

EPSA is the national trade association representing competitive power suppliers, including generators and marketers. These suppliers, who account for 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities serving global power markets. EPSA seeks to bring the benefits of competition to all power customers.

Many of EPSA's member companies are active market participants in and members of the PJM market and participate in eastern power markets. Accordingly, EPSA has a direct and substantial interest in the outcome of this proceeding. Therefore, allowing EPSA to actively participate based on the input from its members in this proceeding would be in the public interest, particularly as this proceeding represents the first instance in which the Commission will determine whether particular contracts which settle against prices within the PJM market serve a significant price discovery function.

## **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 the category of exempt commercial markets ("ECMs"), which are principal to principal electronic trading platforms that serve sophisticated market participants. ECMs were designed to encourage electronic trading of derivatives by sophisticated market participants, and were subject to limited CFTC oversight. The CFTC Reauthorization Act of 2008<sup>2</sup> 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.

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<sup>2</sup> Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1623 (June 18, 2008).

The CFTC NOI indicates that the PJM Western Hub Contracts meet Material Price Reference and Material Liquidity elements.<sup>3</sup> In this context, it is important to note that Congress gave the CFTC this authority to capture: (1) contracts that trade with enough volume to impact trading on a designated contract market, or (2) contracts that trade with enough volume to be quoted as an independent price reference by the public.<sup>4</sup> The purpose of an SPDC designation is to create oversight for contracts the trading of which impacts other contracts or markets (such as the natural gas "Henry Hub look alike contract"). SPDC designation is to be a selectively used tool only for contracts that meet the requisite criteria. It is not a general grant of jurisdiction to the Commission to designate as SPDCs those contracts that do not serve a price discovery function or have no meaningful price linkage.

EPSA supports efforts to improve the transparency of markets. In doing so, there should be a balance between providing market oversight rules that allow for a broad use of market-based risk management tools to conduct business while providing regulators with the needed information and transparency to protect against market manipulation and control excessive speculation. Based on these goals and the criteria set out to define a SPDC, the PJM Western Hub Contracts do not serve a significant price discovery function.

## THE CONTRACTS

As the Commission correctly notes, the PJM Western Hub Contracts are financially settled contracts based upon the volumetric weighted average of LMPs occurring in the PJM Western Hub.<sup>5</sup> The LMPs are derived from the PJM electricity market and result from the PJM tariff structure approved and regulated by the Federal Energy Regulatory Commission ("FERC").<sup>6</sup>

It is important to note that the physical electricity market reflects the unique nature of electricity as a commodity with prohibitive storage costs. In order to ensure the reliability of the electrical grid, supply must equal demand at all times. The procurement of power on the PJM grid for each 5-minute settlement interval of the day is accomplished through a complex process overseen by federal

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<sup>3</sup> As the Commission has focused on these factors, EPSA will do so as well. As can be seen from these comments, however, EPSA has demonstrated that the contracts do not meet other criteria such as price linkage and arbitrage.

<sup>4</sup> The Joint Explanatory Statement of the Committee of Agriculture Conference, H.R. Rep. No. 1110 627, 110 Cong., 2nd Sess. at 978-86 (2008).

<sup>5</sup> For example, for the PJM WH Real Time Peak Daily contract, "the Floating Price will be a price in USD and cents per MWh equal to the arithmetic average of the hourly real-time Locational Marginal Price (LMPs) during the settlement (nominal) date for PJM West published by PJM Interconnect for all peak hours in the day of production as per ISDA commodity definitions."

<sup>6</sup> The PJM electricity market is also subject to FERC regulated price mitigation to prevent the exercise of locational market power by any supplier.

regulators which takes into account reliability and competitive market forces. An LMP, regardless of whether it is a day ahead LMP or a real-time LMP, is a product of the intersection of supply and demand at a specific pricing point on the grid. As a result, the price of electricity in PJM for each 5-minute settlement interval, the LMP, reflects forces of supply and demand for the physical commodity at each pricing point. The hub price is a weighted average of particular pricing points in a geographic area.<sup>7</sup> The process is overseen by FERC based upon its successful implementation of Regional Transmission Organization/Independent System Operator ("RTO" or "ISO") markets across the United States. PJM is the longest standing of such markets and has been in existence over a decade.

For the Day Ahead LMP, the PJM market receives offers from suppliers to provide generation ("supply") the day before expected delivery, and bids to buy power are received, establishing the demand for delivery of electricity ("load"). PJM matches the offers to sell or deliver electricity to the amount of load that is bid. The Day Ahead market is an essential part of the planning and modeling required to ensure the reliability of the electrical grid.

The Real-Time market is a market where power deliveries to the market reflect the actual real-time load and supply offers occurring in the delivery day. As electricity supply and demand are a product of ever-changing factors such as weather and equipment availability (generators, transmission, etc), real-time supply and load will often diverge from day-ahead expectations. The Real-Time LMP reflects this unpredictable and volatile matching of supply and demand across numerous locations on the grid on a moment-by-moment basis.

As a result, the LMP reflects the forces of supply and demand for the physical commodity at each pricing point as provided for under the PJM open access transmission tariff. This system is the product of a well developed and longstanding market design. The market functions are embodied in a FERC-approved tariff on file with FERC. The LMP prices created by this process are the outcome of the highly mitigated and transparent physical cash market driven by the level of load-side demand and available supply. In fact, the market is closely monitored by an independent market monitor which has the ability to make referrals to FERC and has the responsibility for calculating offer caps (the "three pivotal suppliers test" caps supply offers at cost plus ten percent if a supplier is determined to have locational market power). Further, sellers in the PJM market may not make market-based offers unless they have made a threshold showing to FERC of a lack of generation market power. EPSA

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<sup>7</sup> The PJM Western Hub is comprised of 109 electrical busses (generators and substations) defined by PJM, primarily physically located in western and central Pennsylvania, and chosen for their "electrical proximity." The price for the PJM Western Hub is a simple average of the LMP for such buses calculated every 5 minutes.

contends that FERC-regulated RTO/ISO markets may be the most significantly regulated and transparent physical cash markets in existence

External financial transactions such as the ICE swaps market do not and cannot impact the LMP in PJM. Under the PJM tariff, the algorithm for setting LMP prices at a specific location on the grid for each settlement interval is driven solely by the available supply and demand for physical electricity, subject to operating conditions on the PJM grid.

## **THE CFTC'S ANALYSIS OF THE CONTRACTS AS POTENTIAL SPDCS**

The CFTC's NOI indicates that the PJM Western Hub Contracts may serve a significant price discovery function for two reasons: (1) they each serve as a material price reference, and (2) each contract is materially liquid. A reading of the Reauthorization Act and the Commission's SPDC rules, in light of the facts of how PJM operates and how these contracts are traded, demonstrates that the PJM Western Hub Contracts meet neither of these tests.

### **1. Material Price Reference**

The first basis for the Commission's preliminary determination is that the PJM Western Hub contracts serve as a material price reference. 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 if the cash market quotes the ECM contract. An indirect reference would be whether an industry publication quotes the ECM's contract's price. The PJM Western Hub contracts meet neither of these standards.

The CFTC NOI has not identified any contracts in any market that settle to, or reference, the ICE PJM Western Hub contracts. This is not surprising, because the cash market risk that these contracts hedge is the volatility in the PJM markets. This pricing point does not need a proxy pricing vehicle (such as the PJM Western Hub Contracts) as the actual cash price is constantly and transparently produced by the FERC-regulated PJM market. That is, the source of price discovery for the Day Ahead and Real Time LMPs in the PJM market is the PJM market itself. The LMPs for the PJM Day Ahead and Real Time markets are the direct reflection of supply and demand in PJM, and are readily and transparently available.<sup>8</sup>

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<sup>8</sup> Beyond these LMPs, a relevant indication of longer-dated pricing trends in the PJM market may be the price of natural gas (which is often the marginal fuel in PJM).

Logically, parties desiring to reference the PJM Western Hub LMPs in a contract, whether peer-to peer, voice-brokered, or traded on a designated contract market or otherwise, do so directly by referencing the actual, published LMPs, rather than indirectly by referencing the Western Hub Contracts. EPSA is not aware of any circumstances in which commercial parties reference the Western Hub Contracts rather than the PJM LMPs themselves for settlement or other purposes (nor can EPSA identify any reason why commercial parties would do so). Simply put, the transparent, FERC-regulated readily available PJM LMP pricing provides the price discovery for parties.

As to the indirect reference regarding whether an industry publication quotes the ECM's contract's price, the only publication that the NOI refers to is the "PJM Power End of Day" and "OTC Power End of Day" data packages. These are ICE data sets and it is logical that ICE would publish historic prices of its own contracts, as do other contract markets. However, the fact that ICE offers this data package does not provide a basis for a finding of a material price reference. As stated above, EPSA is not aware of, and the NOI has provided no evidence of, any contracts settling on this reference. Nor does the NOI identify any circumstance where the forward price quotes for the PJM contracts would be used as a reference. The PJM LMP is the most reliable and transparent price reference for the PJM market.

## 2. Material Liquidity

To find material liquidity, the Commission needs to determine not only that the contract traded on the ECM must trade with sufficient volume, but that the trading of the contract must "have a material effect on other agreements, contracts, or transactions listed for trading...on a designated contract market"<sup>9</sup> or ECM. The PJM Western Hub Contracts do not meet the required measure of material liquidity.

EPSA is not aware that trading in the PJM Western Hub Contracts has any effect whatsoever on any contract listed for trading in a designated contract market ("DCM"), ECM or even in the OTC market. The NOI does not provide any indication otherwise. Logically, other PJM-related contracts, either listed on DCMs or traded in the OTC market, would settle on or reference the PJM market Day Ahead and Real Time LMPs directly, rather than do so indirectly by referencing the PJM Western Hub Contracts. Additionally, trading in the PJM Western Hub Contracts has no effect and can have no effect on the FERC-regulated PJM market Day Ahead and Real Time LMPs.

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<sup>9</sup> 17 C.F.R. § 36.3 (c) (2) (2009)

While the NYMEX does list PJM Western Hub contracts, those contracts, like the ICE contracts, settle on the LMP prices thereby removing any price linkage as neither exchange's contracts settle based upon the other. In addition, the NYMEX contracts have little liquidity thereby removing any meaningful arbitrage possibility.

Further, the Commission states 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, "a market where trades occur multiple times per minute."<sup>10</sup> While the PJM Western Hub contracts trade in excess of five trades per day, they do not meet a "continuous... multiple times per minute" test. Indeed, EPSA believes that the contracts generally do not trade continuously, rather there may be trading in the morning of a day, but very little in the afternoon. Thus, there are times of the trading day when there is little ability to execute a transaction. There rarely is "continuous" trading.

In addition, EPSA is concerned the Commission used inadequate measures of material liquidity. The various contracts identified by the Commission include contracts with varying sizes that may not perfectly match the physical market standards and which trade in ways that may lead to a misleading conclusion regarding their liquidity (e.g. EPSA understands that the overwhelming majority of contract "PDP" trades in the balance-of-day market, meaning the contract only exists for a few hours). Further, according to the NOI, several of the contracts trade low volumes - some with a daily average of under 15 trades per day - which are not reflective of liquidity. In addition, the contract specification sheets discuss various contract sizes and the recording of lots in various number for certain of the contracts (e.g. for contract "PJM", a separate lot is recorded for each on-peak day of the traded month) which may overstate liquidity. Finally, these contracts trade over extended contract series (e.g. for contract "OPJ" up to 86 months of trading), which could indicate the stated volumes being spread thinly over the entire series. The foregoing indicates that, for the contracts that appear to trade more frequently, simple volume numbers are insufficient and additional analysis is needed before the Commission can conclude that there is sufficient liquidity in each of the noticed contracts.

Thus, the material liquidity measure requiring trading to not only exceed a volumetric threshold but have a "*material effect*" on other exchange traded contracts simply is not met with regard to the PJM Western Hub contracts.

## **CONCLUSION**

The PJM Western Hub Contracts meet neither the material price reference nor material liquidity standard. The Commission has identified no other contract in

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<sup>10</sup> Appendix A to Part 36,17 C.F.R. § 36 (2009)

any market that is tied to the settlement price of these ICE contracts. Trading in the PJM Western Hub Contracts cannot reasonably be expected to have any effect whatsoever on PJM market Day Ahead and Real Time LMPs. As other PJM-related contracts, either on DCMs or in the OTC market, will simultaneously reference, or settle to, PJM LMPs directly, trading in the PJM Western Hub Contracts will have no effect on the prices of contracts in other markets. As explained above, PJM market Day Ahead and Real Time LMPs themselves provide the only material price reference for the market. The PJM Western Hub contracts do not perform a significant price discovery function.

EPSA believes that the FERC-regulated, tariff-based PJM power market is intrinsically reflective of competitive prices. Unlike certain other commodities markets, EPSA is not aware of concerns regarding speculation driving power market prices as they are closely overseen by FERC. Thus, subjecting market participants to position limits or other regulatory elements relating to SPDC status can only negatively limit risk management opportunities for market participants for a volatile commodity without serving the purpose of an SPDC designation as intended by Congress.

Thank you for the opportunity to comment.

Respectfully submitted,



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Nancy E. Bagot  
Vice President of Regulatory Affairs

cc: Chairman Gensler  
Commissioner Dunn  
Commissioner Chilton  
Commissioner Sommers  
Commissioner O'Malia  
Daniel Berkovitz, General Counsel  
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