COMMODITY FUTURES
TRADING COMMISSION
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DEC 9 12 17 PM '97

97-93

June 3, 1997

Re: Electronic Natural
Gas Trading System

Dear :

This is in response to your letters dated July 26, September 13, and November 29, 1995, May 9 and July 12, 1996, and February 5, 1997, submitted on behalf of "Petitioner" and their affiliates, requesting the views of the Off-Exchange Task Force ("OETF") of the Commodity Futures Trading Commission ("Commission") regarding the operation of an electronic natural gas trading system in the United States. Based upon the representations made in the aforesaid letters, telephone conversations, and your presentations to the OETF through February 1997, the OETF understands you have represented the facts to be as set forth below.

The current owners of the electronic natural gas trading system are Petitioner and "Company A." Petitioner has been in the natural gas business since X. The volume of natural gas business marketed by Petitioner in 1995 approximated X cubic feet per day while its pipelines throughput in 1995 was about X British Thermal Units ("BTUs") with associated revenue in excess of $X. Petitioner operates its interstate pipelines under the jurisdiction of the Federal Energy Regulatory Commission ("FERC") and, with nearly X miles of pipeline carrying X% of national natural gas consumption, is the X volume interstate natural gas pipeline owner and operator in the United States. Petitioner' common stock is listed on the New York Stock Exchange ("NYSE") (ticker symbol "X").

Company A has been in the natural gas business since X. The volume of natural gas business marketed by Company A in 1995 approximated X cubic feet per day while its pipeline throughput in 1995 approximated X BTUs with associated revenue of nearly $X. Company A operates its interstate pipelines under the jurisdiction of FERC and, with about X miles of pipelines,

carried in 1995 roughly X% of national natural gas consumption. Company A's common stock is listed on the NYSE (ticker symbol "X").

In X date, Petitioner commenced operation of an electronic natural gas trading system ("System"). Effective X date, Petitioner and Company A combined their energy-related information technology operations, including System, by forming an equally-owned joint venture, "Joint Venture" which, in turn, formed "System Operator" which owns and operates the System. (Hereinafter all references to System Operator, unless otherwise noted, will include the period from X through X when the System was owned and operated exclusively by Petitioner.)

The use of the System is governed by the System User's Agreement ("User's Agreement"). The User's Agreement contains terms and conditions governing subscribers' use of the trading system.

Purchases and sales of natural gas on the System are principal-to-principal transactions between System Operator and commercial subscribers establishing firm delivery commitments that convey the legal right and obligation to transfer natural gas in accordance with the contract's specifications.

Trading on the System is anonymous. Subscribers may observe open bids and offers entered by other System subscribers via their computer screens, but the identity of the subscribers entering such bids or offers is not disclosed and is known only by System Operator. Each user looks to System Operator for performance.

As described in greater detail below, transactions executed on the System are:

(1) System Operator-to-subscriber transactions,

(2) involving qualified commercial parties,

(3) establishing binding physical delivery obligations between System Operator and each subscribing counterparty,

(4) for delivery within customary cash market channels and time frames,

(5) not extinguished until settlement by delivery is made,

(6) direct obligations of System Operator, and

(7) not subject to variation margin payments.

Subscribers execute transactions with System Operator only. Subscribers do not execute transactions with other System subscribers.

Subscribers enter individualized terms as to price, volume, delivery start and end dates, and delivery point for each natural gas contract entered into the System. Bids and offers with identical contractual terms are automatically matched by the System. The System interposes System Operator as the buyer to every seller and the seller to every buyer with respect to all matched transactions. Therefore, all users have contracts solely with System Operator and look exclusively to System Operator for ultimate performance of the delivery and payment obligations contracted thereby.

System Operator may take a position opposite a subscriber for which there is no matching position in extreme market circumstances, but it has no obligation to do so. For example, System Operator actively posted offers and consummated transactions with subscribers without the presence of countervailing offers from other System subscribers after Hurricane Erin disrupted normal gas delivery arrangements of several subscribers during the fall of 1995.

System Operator represents that the System is a physical delivery trading system. Subscribers to the System are limited by System Operator to entities that are commercial participants in the natural gas industry with a proven ability to make and take delivery of natural gas in normal commercial channels. In this regard, participants must have a valid service or transportation agreement in place with a pipeline operator who will transport natural gas to or from the designated delivery points. The User's Agreement requires subscribers to adhere to order number and size limits set by reference to the capacity of their existing or acquired transportation agreements. System Operator represents that the System participants include natural gas producers, end users, and marketers. Applicants to participate on the System must confirm to System Operator that they have a net worth exceeding $1 million and total assets exceeding $5 million. Individual speculators, commodity pools, passive collective investment vehicles, and other non-commercial entities are not eligible to subscribe to the System.

Transactions executed on the System predominately result in the physical movement of natural gas between System Operator and its subscribing buyer or seller. Title to the natural gas transfers from seller to System Operator at the delivery point designated in the contract. System Operator subsequently transfers title to its buyer at the receipt point specified in the contract.

Delivery of natural gas under contracts between System Operator and a subscriber is available at various hubs including X. To date, more than X transactions involving over X cubic feet of natural gas have been transacted on the System.

System Operator may net an individual subscriber's contractual obligations to it if such obligations call for the delivery and receipt of natural gas at the same delivery point during the same period of time. Payments relative to these deliveries also would be netted. All buy and sell obligations remain however open until actual settlement and delivery occurs.[1/]

System Operator represents that the netting of a subscriber's overlapping delivery and receipt obligations with System Operator reduces transaction costs associated with pipeline deliveries and is standard practice in the natural gas cash market as well as other cash markets that use pipelines to effect delivery. System Operator estimates that at least 75 percent of the total quantity of natural gas contracted on the System presently results in physical delivery.[2/]

Relevant Commission staff agrees that the netting procedures mirror current cash market practices for natural gas and other petroleum product pipeline physical delivery systems. Moreover, the percentage of delivery netting that is estimated to occur on the System is not inconsistent with that which has been observed on other physical pipeline delivery systems.

1/ Except in the event of a breach of the User's Agreement or a contractual obligation, where offset may be effected by the non-breaching party, there is no right or guarantee on the part of either the subscriber or System Operator to offset contractual obligations by cash payment in lieu of physical delivery. There are significant penalties in the event of a breach and failure to conclude a transaction is not a contractual right.

System Operator may at some future date seek to receive approval for offsets resulting in immediate cash payments that extinguish liability for contractual obligations. However, this is not currently part of the operation of the System for which relief is being sought. This letter does not address what additional or different conditions might pertain were such approval to be sought.

2/ Contracts executed on the System require, and the commercial participants anticipate, the movement of the underlying commodity through normal cash market channels and that any netting will be incidental to the pipeline delivery mechanism.

As counterparty to every transaction effected on the System, System Operator has contractual responsibility for one side of each transaction entered on the System. To the extent these transactions match, the System effectively guarantees the physical and financial components of each contract. As buyer, System Operator alone is responsible for payment and acceptance of the natural gas and has all risks of ownership from the time when good delivery is received until the natural gas is resold (including resale default risk). The underlying obligations are not extinguished, however, and remain outstanding until delivery actually occurs. As seller, System Operator has sole responsibility for delivery of the natural gas and has all risks of ownership until good delivery is made. System Operator, however, is more than an automated dealer because the prices bid and offered on the System are those of the users, not of System Operator. In effect, System Operator performs a clearing function for guaranteeing physical delivery among subscribers, thereby potentially expanding the base of users with which individual participants can transact, rendering prices bid and offered more transparent and efficient, and administering the delivery process.

The System does not provide for mutualization of loss; System subscribers do not guarantee and are not responsible for defaults of other subscribers. System Operator does not require or maintain any pool of subscriber funds or contributions as security against defaults, nor has System Operator any authority to make assessments against subscribers for such purpose. In the event of a default by a subscriber, System Operator alone is at risk, and any losses incurred therefrom by System Operator are against its own private resources and balance sheet.

System Operator represents that, while the User's Agreement provides it with the right to demand security or collateral, its policy has been not to require subscribers to post such security. The User's Agreement provides that a subscriber that defaults on its delivery or receipt obligations is liable to System Operator for all reasonable costs associated with obtaining a replacement supply or buyer, plus liquidating damages.

System Operator prepares monthly invoices detailing each subscriber's transactions executed with it on the System. Subscribers with a net payment due for natural gas shipments received are required to remit payment to System Operator by wire transfer through the ACH System via Bank A.[3/] Subscribers

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[3/] The ACH System is a clearing house for settling any accounts between member banks accomplished through transfer of information via electronic transfers.

with a net receivable receive payment directly from System Operator by wire transfer through the ACH System.

Based upon the foregoing, the OETF will not recommend that the Commission take enforcement actions against Petitioner, Company A, System Operator or the System subscribers for failing to obtain designation as a contract market, to register under the Commodity Exchange Act ("Act"),[4] or otherwise to comply with the Act or Commission regulations in connection with their operation and use of the System except such parts thereof that relate to manipulation.[5]

This letter is based upon the representations cited herein and the information that has been provided to us, including System Operator's representations regarding the extent of the netting of participants' overlapping delivery and receipt obligations. In this regard, System Operator represents that it will notify the Commission staff immediately if it determines that less than 75 percent of the total volume of natural gas contracted on the System, measured on an annual basis and calculated at the end of each calendar month, is delivered, and understands that the OETF may consider added terms and conditions in such an event to extend any relief granted herein including revocation of the relief granted and requiring compliance with the Act's designation requirements. Furthermore, System Operator represents that it will provide the Commission staff with written notification prior to the implementation of a procedure whereby cash settlement extinguishing a prior delivery obligation may be made in lieu of physical gas deliveries and will not implement such a procedure without further consultations. Any different, changed or omitted facts or conditions, including increases in the level of netting activity, might require a different conclusion.

In addition, System Operator represents that it will keep and maintain trading and financial records regarding the System and make them available to the Commission staff and submit data to the Commission staff promptly upon request and that it will provide cash market information as necessary to the Commission staff for its monitoring of markets subject to its jurisdiction. In this connection, System Operator represents that it will provide on request by the Commission staff such documents as may be necessary to assess whether the percentage of deliveries on the System is as represented and any other information with respect to the operation of the System.

4/ 7 U.S.C. § 1 et seq. (1994).

5/ Commission regulations are found at 17 C.F.R. Ch. I (1996).

The no action position set forth above is that of the Off-Exchange Task Force only and does not necessarily represent the views of the Commission. This relief does not preclude the Commission from taking action against Petitioner, Company A, System Operator or System subscribers for violations of the Act or regulations if the Commission determines that such action is appropriate.

Sincerely,

Andrea M. Corcoran

Daniel R. Waldman
Co-Chairman
Off-Exchange Task Force