

CFTC Letter No. 99-67**December 16, 1999****No-Action****Division of Trading & Markets**

Re: "X's Market"

Dear :

This is in response to the letter dated May 5, 1999 to the Division of Trading & Markets (the "Division") of the Commodity Futures Trading Commission (the "Commission") on behalf of "X", as supplemented by additional correspondence and telephone conversations and meetings with Commission staff. By this correspondence, as supplemented, "X" requests that the Division confirm its conclusions with respect to the "Market", an automated system for the purchase and sale of electricity for delivery in the future, in California, that (1) the "Market" is a market for the sale of electricity for "deferred shipment or delivery" and, accordingly, (2) "Y", the unincorporated division of "X" that operates the "Market", need not be designated by the Commission as a contract market and (3) "Y" and participants in the "Market" (the "Participants") are subject only to those provisions of the Commodity Exchange Act (the "Act")¹ and Commission regulations promulgated thereunder,² applicable to cash commodities.

Based upon the representations made on behalf of "X" in written correspondence, telephone conversations and meetings with Commission staff, including information contained in public documents related to Federal Energy Regulatory Commission ("FERC") review of the "Market,"³ we understand the facts to be as set forth below.

I. Background

"X" is a California non-profit public benefit corporation that was created by the California legislature as part of the restructuring of the California electricity market. Established in 1997, "X" operates an automated system for day-of and day-ahead electricity purchases and sales. Since June 10, 1999, "Y" has operated the "Market", an automated system for the purchase and sale of electricity for "on-peak" hours of a specified delivery month, up to 12 months in advance of delivery.

FERC has determined that "X" is a "public utility" under the Federal Power Act, and therefore it is subject to FERC jurisdiction as such.⁴ On March 23, 1999, "X" submitted for filing on behalf of "Y", "Market" Rate Schedule FERC No.1 (the "Rate Schedule"), which included as appendices the "Market" Participation Agreement (the "Participation Agreement") and the "Market" Trading Rules (the "Trading Rules").⁵ In response to public comments, "X" amended the Rate Schedule on April 27, 1999.⁶ FERC accepted for filing the amended Rate Schedule, with requirements for further modification, by order of May 26, 1999 (the "Acceptance Order").⁷ "X" subsequently submitted a compliance filing on June 9, 1999, which addressed the requirements contained in the Acceptance Order.⁸

The Acceptance Order imposed upon "Y" certain reporting requirements specifically related to the operation of the "Market."⁹ In this regard, "Y" must file a quarterly index of Participants, quarterly reports detailing the purchase and sale transactions undertaken in the prior quarter, and an updated market analysis within three years of the date of the

Acceptance Order and every three years thereafter. "Y" also is required to inform FERC of any change in status that would reflect a departure from the characteristics FERC relied upon in approving market-based pricing. ¹⁰

II. "The "Market"

A. *General Characteristics*

"X" has represented that the "Market" is a physical delivery trading system for use by commercial entities, designed to facilitate the wholesale purchase and sale of electricity for on-peak hours in one-month blocks, up to 12 months in advance of delivery. We understand that transactions executed in the "Market" have the following characteristics:

- they are between parties that are commercial entities that produce, consume, buy and/or sell electricity at wholesale pursuant to law;
- they are the result of anonymous matching of bids to buy and offers to sell electricity;
- they establish binding, specific physical delivery obligations;
- they do not allow parties to make cash settlement in lieu of delivery and do not provide a contractual right to extinguish delivery obligations (absent a Bona Fide Commercial Reason or Uncontrollable Force, as discussed below); and
- they are not direct obligations of "X" or "Y", are not guaranteed by "X" or "Y", and are not subject to variation margin payments.

B. *Participants*

Only "Eligible Entities," as that term is defined in Appendix 1 to the Rate Schedule, may qualify to participate in the "Market."¹¹ Stated in general terms, only public utilities and state-law authorized buyers and sellers of electricity, *e.g.*, investor-owned utilities, non-utility generators, power marketers,¹² non-utility wholesale customers and certain large industrial customers, are eligible to become Participants. Each Participant must be capable of making, taking or arranging for delivery of the electricity purchased or sold in the "Market." A Participant may purchase or sell for its own account or for the account of other Eligible Entities. Members of the general public, securities brokers, financial speculators, commodity pools, passive collective investment vehicles, and other entities that are not involved in electricity commerce are not eligible to become Participants.

In order to participate in the "Market", Eligible Entities must meet specific financial and collateral requirements established by "Y".¹³ In this regard, Participants: (1) must have a minimum of \$2 million in total current assets; (2) provide individual security in the amount of \$5 million (*e.g.*, by means of an irrevocable letter of credit, a surety bond, or guarantee by a parent company that has a short-term debt rating of not less than A1 or P1 by Standard and Poor's or Moody's, respectively); and (3) provide collateral (in the form of cash or other liquid, marketable collateral such as a letter of credit or a surety bond) based upon the value of the Participant's outstanding contracts and its delivery dates. The collateral requirement is calculated daily at the end of each trading session based upon the closing price for that day, the amount of time before the delivery periods of the contracts held, and the number of contracts held by the Participant. "X" will draw on this collateral only if the Participant defaults. This collateral will not be used to pay participants on the opposite side of the market unless there is a default.

Each Participant is required to notify "Y" immediately if it fails at any time to meet any eligibility requirements. If a Participant fails to satisfy the eligibility requirements, "Y" may suspend or terminate the Participant's Participation Agreement, including outstanding bids or offers, without prior notice; require the Participant to post additional collateral security; prohibit the Participant from entering new bids or offers; and/or act as agent or attorney-in-fact for the Participant to liquidate the Participant's existing obligations.

Each Participant must execute a standard Participation Agreement which, in conjunction with the Trading Rules, sets forth the terms and conditions for participation in the "Market." Under the Participation Agreement, the Participant warrants, among other things, that: (1) each Match (as described below) will be a forward contract; (2) the Participant is capable of making, taking or arranging for delivery of all purchases or sales made by it pursuant to the Participation Agreement and the Trading Rules; and (3) except as may be excused for a Bona Fide Commercial Reason or due to an Uncontrollable Force, each purchase and sale the Participant makes through the "Market" will be for actual delivery either bilaterally or using "X's" day-ahead market (the "Day-Ahead Market").

A Participant may assign or delegate its rights or obligations under the Participation Agreement only with the prior written consent of "Y". "Y" may assign or delegate its rights or obligations under the Participation Agreement (1) to any person, with the Participant's consent, or (2) to any affiliate or as collateral security, without obtaining the Participant's consent.

C. Matching of Bids and Offers

Participants, on an anonymous basis, enter bids to purchase and offers to sell electricity into the "Market", specifying price, quantity, delivery month and delivery location.¹⁴ "Y" utilizes a computer algorithm to match bids and offers according to the priorities set forth in the Trading Rules. Currently, purchases and sales can be made only for peak electricity usage hours, *i.e.*, for each hour occurring Monday through Saturday (except for certain electric power "holidays" or bank holidays) between the hours of 6:00 a.m. and 10:00 p.m. Pacific prevailing time, for the specified calendar month. Each transaction in the "Market" is documented by a "Matching Notice" that "X" sends to the parties to each Match.

D. Delivery Obligations

A Match constitutes the legal, valid and binding obligation (1) of the Participant making the offer to sell electricity, to deliver or arrange for delivery, and (2) of the Participant making the bid to purchase electricity, to accept or arrange for the acceptance of delivery, each in accordance with the terms of the Match. There is no contractual right to make cash settlement. In addition, there is no contractual right to extinguish these obligations except for a Bona Fide Commercial Reason or due to an Uncontrollable Force, as such terms are defined in Appendix 1 to the Rate Schedule.¹⁵

Although Participants are expected to fulfill their obligations to make or take delivery, a Participant, acting in the ordinary course of its business, could hold both a long and short position for the same delivery point and the same delivery period. In such circumstances, the Participant's delivery obligation is the net of its long and short positions. "X" has represented that in the first six months of its operation of the "Market", most Participants have taken positions on only one side of the market, not both.

Participants can effect delivery by either entering their bids into the Day-Ahead Market or by arranging for delivery in the bilateral market. "Y" maintains the anonymity of the parties to a Match, and any Participant that seeks to deliver bilaterally is responsible for locating a Participant as a bilateral counterparty. Participants that elect bilateral delivery must provide "Y" with appropriate written notification.¹⁶ In all cases, title transfers from the seller to the buyer and does not pass to "X" or "Y".

E. *Monetary Obligations*

Monetary obligations include the payment of administrative fees due to "Y", amounts payable to "Y" for purchases made in the "Market", and damages for failure to meet delivery obligations. Participants are responsible for meeting all monetary obligations even if they are otherwise excused from meeting delivery obligations due to the presence of a Bona Fide Commercial Reason or Uncontrollable Force, or if they seek to deliver through the Day-Ahead Market and their bid is not selected.

"Y" performs administrative and bookkeeping functions, and settles Participant accounts on a monthly basis. Invoices or statements sent to Participants reflect administrative fees due and payable to "Y" as well as adjusted amounts due to or from "Y" for each Match.¹⁷ In addition, Participants that arrange for delivery in the Day-Ahead Market receive invoices from "X" that reflect amounts due to "X" for those deliveries.

In the event a Participant does not meet its payment obligations, "Y" is authorized (but not required) to mitigate the effects of the default pursuant to the terms of the Trading Rules. In general, "Y" will first draw on the Participant's outstanding collateral, then liquidate the Participant's positions and draw on its individual security. If these actions are insufficient, "Y" will draw on a pool insurance policy. If there are still insufficient funds to cover a Participant's default, "Y" will reduce payments to all Participants proportionately. "Y" will account for such payment reduction as amounts due and owing by the defaulting Participant to each other Participant. Any subsequent recovery by "Y" from the defaulting Participant will be proportionately paid to all non-defaulting Participants.¹⁸

III. "Y" Monitoring of "Market" Transactions

"X" has represented that transactions executed in the "Market" are expected to routinely result in the physical delivery of electricity. "X" has further represented that from the period June 10, 1999 through November 9, 1999, more than 99% of the total volume of electricity contracted in the "Market" was physically delivered. "X" anticipates that not less than 90% of all contracts executed in the "Market" will go to physical delivery.

"X" has represented that "Y" will monitor "Market" transactions to identify any speculative or hedging activities. "Y", for each monthly delivery period, will compare contract quantities with quantities actually delivered through the Day-Ahead Market or through bilateral deliveries. At the end of each delivery period, "Y" will examine individual patterns of non-delivery. If, for any Participant, the delivery percentage is consistently less than 90% of the Participant's netted delivery obligation for that month, "Y" will inquire as to whether non-delivery was based upon a Bona Fide Commercial Reason or an Uncontrollable Force. "Y" may take disciplinary action if it is unable to find that delivery was excused due to a Bona Fide Commercial Reason or an Uncontrollable Force.

IV. Conclusion

Based upon the foregoing, and subject to compliance with the terms and conditions stated herein, the Division will not recommend that the Commission institute enforcement action against "X", "Y" or the Participants as a result of "Y" having neither sought nor obtained designation as a contract market pursuant to Section 5 of the Act.¹⁹ The Division notes that "X" has represented that the purpose of the "Market" is the purchase and sale of electricity for physical delivery.

The Division's no-action position is subject to compliance with the following conditions:

- "Y" will monitor transactions on a monthly basis, both in terms of the overall market as well as individual Participants;

- "Y" will notify the Division immediately if it determines that less than 75% of the total volume of electricity contracted in the "Market", measured on an annual basis and calculated at the end of each calendar month, is delivered;²⁰ and

- Consistent with "Y's" FERC requirements, "Y" will keep and maintain transaction and financial records regarding the "Market" and will make them available to the Commission staff and submit data to the Commission staff promptly, upon request. "Y" also will provide, upon request by the Commission staff, such documents as may be necessary to assess whether the percentage of deliveries is as represented, and any other information with respect to the operation of the "Market".

"X" has represented that it understands that in the event that less than 75% of the total volume of electricity contracted in the "Market", calculated as provided herein, is delivered, the Division may consider added terms and conditions in order to extend any relief granted herein, and the Division reserves the right to revoke the relief granted herein and require compliance with the Act's designation and other requirements.

This letter is based upon the representations cited herein and upon other information that has been provided to us on behalf of "X", including publicly available information related to the FERC proceedings with respect to the "Market". Any different, changed or omitted material facts or circumstances might render this letter void. You must notify us immediately in the event the activities of the "Market" change in any material way from those represented to us, including the adoption of material changes to the Trading Rules or Participation Agreement.

This letter represents the views of this Division only. It does not necessarily represent the views of the Commission or of any other office or division of the Commission. If you have any questions concerning this correspondence, please contact Phyllis Dietz, an attorney on my staff, at (202) 418-5430.

Very
truly
yours,

John C. Lawton

Acting
Director

1

See 7 U.S.C. § 1 et seq. (1994).

2

Commission regulations are found at 17 C.F.R. Ch. I (1999).

3

See FERC Docket No. ER99-2229-000. Certain documents related to the FERC proceeding have been provided to the Commission as enclosures to correspondence submitted on behalf of "X".

4

See Order Conditionally Authorizing Establishment of an Independent System Operator and Power Exchange, Conditionally Authorizing Transfer of Facilities to an Independent System Operator, and Providing Guidance, 77 FERC ¶ 61,204 (1996).

5

See Application for Acceptance of Market-Based Rates and Other Authorizations and Waivers for Electricity "Market", FERC Docket No. ER99-2229-000, filed March 23, 1999.

6

See Answer to Motions to Reject and Motions Seeking Modifications, FERC Docket No. ER99-2229-000, filed April 27, 1999.

7

See Order Accepting For Filing Proposed "Market", As Modified, 87 FERC ¶ 61,203 (1999).

8

See Compliance Filing on Commission Order Accepting Proposed "Market", As Modified, FERC Docket No. ER99-2229-000, filed June 9, 1999. The FERC proceedings have continued with further consideration of "X's" cost allocation methodologies. We note that the cost allocation issue is not relevant to our consideration of the applicability of the Act and the Commission's regulations to the "Market."

9

"X" also is subject to FERC reporting requirements independent of its operation of the "Market." For example, the Acceptance Order noted that as to "X's" entire operations, "X" is subject to the accounting and reporting requirements of Parts 41, 101 and 141 of FERC regulations. (FERC regulations are found at 18 C.F.R. Ch. I (1999).)

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The Acceptance Order permits "Y" to elect to notify FERC of such changes "promptly" or to report such changes every three years with its updated market analysis.

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An "Eligible Entity" is defined as "(i) any 'public utility' as defined in the Federal Power Act (including any power marketer), Federal power marketing agency, or any person lawfully generating Energy for sale or resale pursuant to Federal or state law; Energy sold or produced by such entity may be Energy produced in the United States, Canada or Mexico; however, such entity is not eligible for transmission service that would be prohibited by Section 212(h)(2) of the Federal Power Act; and (ii) any retail customer or qualified energy service provider taking unbundled transmission service pursuant to a state retail access program."

12

Power marketers are wholesale power entities approved by FERC to buy and sell wholesale power from and to each other and other public utilities at market-based prices. They do not own generating facilities, but purchase generating capacity and/or actual generation power output for resale. A power marketer participating in the "Market" may be affiliated with a non-utility generator or an out-of-state or California utility. The "Market" requires that power marketers have actual means for the delivery or acceptance of the electricity that they buy or sell.

13

When a Participant trades for the account of another, "Y" will look to the Participant to meet financial, collateral and delivery requirements.

14

Delivery may take place at two locations in California, the delivery regions known as North Path 15 (NP15) and South Path 15 (SP15).

15

A "Bona Fide Commercial Reason" is defined as "a change of circumstances that makes it necessary or commercially advisable for a Participant to change its method or quantity of delivery in whole or in part." Examples of a Bona Fide Commercial Reason include the failure of supply to materialize as projected (*e.g.*, a drought-related reduction in hydroelectric generation), an unexpected generation outage, weather changes that reduce demand, economic factors that reduce industrial demand, default by a bilateral counterparty, transmission line failures, or the failure of a supplier's supplier to deliver.

An "Uncontrollable Force" is defined, in relevant part, as "any act of God, labor disturbance, act of the public enemy, war, insurrection, riot, fire, storm, flood, earthquake, explosion, breakdown of communication or trading facilities, any curtailment, order, regulation or restriction imposed by governmental, military or lawfully established civilian authorities or any other cause beyond the reasonable control of "Y" or the Participant (as the case may be) which could not be avoided through the exercise of Good Utility Practice."

16

Participants effecting delivery bilaterally must provide "Y" with written notice no later than the close of business on the last trading day for the applicable delivery period. The notice must contain the names of the Participants that are delivering and accepting delivery, and a description of the transaction including delivery quantities that will not be delivered through the Day-Ahead Market.

17

The amounts to be paid by or to the Participant for each Match ("Matching Price" *multiplied by* "Matching Quantity") are adjusted to reflect the amount to be paid by or to the Participant settled against the Day-Ahead Market (the "Average Zonal Market Clearing Price") according to the following formula: (Matching Price *minus* Average Zonal Market Clearing Price) *multiplied by* (Matching Quantity). Negative amounts constitute amounts payable to the buyer, and positive amounts constitute amounts payable to the seller. This adjustment is made for all deliveries, whether effected through the Day-Ahead Market or bilaterally. It results in the Participant effecting delivery for the price that was set at the time of the Match, and reflected in the Matching Notice.

18

In addition, the Trading Rules require that "Y" reveal to affected Participants the identity of any defaulting Participant whose default results in a payment reduction, loss or expense. Injured Participants have the right to sue or seek other lawful remedies against a defaulting Participant.

19

See 7 U.S.C. § 7 (1994).

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For purposes of calculating the percentage of volume delivered, "Y" will include only that amount of electricity that is physically delivered in the Day-Ahead Market and the bilateral market.