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June 1, 2011

Mr. Robert Wasserman  
Associate Director, Division of Clearing & Intermediary Oversight  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW  
Washington, DC 20581

Re: Discussion of FTR exemption pursuant to Section 722 of the Dodd-Frank Act

Dear Mr. Wasserman:

Following our discussion on May 9<sup>th</sup>, 2011, Nodal Exchange would like to offer the following comments on establishing provisions for Financial Transmission Right (FTR) exemption from the Commodity Exchange Act (Act) requirements pursuant to Section 722 of the Dodd-Frank Act. In this letter, we use the term FTR to broadly refer to the organized power market products called various names including: Financial Transmission Rights (FTRs), Congestion Revenue Rights (CRRs) and Transmission Congestion Contracts (TCCs).

The FTR auctions are unique in that the Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs), as such organized markets are regulated by the Federal Energy Regulatory Commission (FERC) or the Public Utility of Texas (PUCT), are able to use the characteristics of the physical grid to match differing participant paths and solve for unique FTR auction clearing prices for each node (location). Therefore, FERC and the PUCT are well positioned to continue to monitor and oversee the RTO/ISO FTR auction process. In accordance with section 4(c)(6)(A) of the Act as revised by the Dodd-Frank Act, it would be consistent with the public interest for the organized markets to seek exemption from CFTC oversight for FTRs. However, as part of the exemption process, it should be noted that the RTO/ISO auctions, while relying on the underlying physical grid capacity, issue instruments that settle financially. This is exemplified by the fact that participants can sell short capacity (counterflow FTRs) that can be effectively matched with participants bidding to purchase an FTR, creating a purely financial transaction between a buyer and a seller.

In fact, FTRs very closely mirror the economics of the products offered by Nodal Exchange and other cleared markets overseen by the CFTC, and many participants trade in both the FTR markets and the cleared markets. While FTR participants are awarded a complete path, identified by a "source" and a "sink", participants replicate these path

economics on Nodal Exchange by purchasing one contract while simultaneously selling a contract at a different location, creating a financial spread. For example, a participant can purchase an FTR on the PJM Western Hub to PSEG Zone path, or purchase a PSEG Zone contract and sell the PJM Western Hub contract on Nodal Exchange to obtain very similar economics. The FTR contract will settle to the difference between the congestion quantities reported by the RTO/ISO for the two locations, while the Nodal Exchange spread will settle to the difference between congestion and loss between the two locations; however, loss amounts are often quite small and/or much less volatile than congestion, and market participants use both instruments for similar hedging purposes. It should also be noted that participants currently complete similar financial transactions in the large non-cleared bilateral power market across the United States.

By necessity, locational prices in the grid and the FTRs that represent their congestion spreads are determined at individual geographic locations or nodes. This nodal granularity enables the contracts to represent actual power flows, which is essential to match the financial prices to the physical integrity of the system. While FTRs are available for very large numbers of paths, much of the value in the FTR markets is on the same paths that frequently trade in the cleared basis markets, namely hub-to-hub and hub-to-zone paths. In the recently completed PJM 2011/2012 planning year auction, hub to zone or hub to hub paths comprised almost 30% of the awarded FTR value when self-scheduling awards are excluded.<sup>1</sup> ISO-NE's 2011 annual auction produced a similar result, with over 40% of the auction value in hub to zone FTRs.

Given the overlap between the FTR market and the bilateral and cleared markets, it is recommended that the CFTC's exemption process for FTRs ensure that the FTR markets do not serve as a potential vehicle for participants who might seek to avoid CFTC oversight of either their trading or positions. To achieve this, Nodal Exchange recommends the following criteria, which are further elaborated below:

1. That Swap Dealers and Major Swap Participants in FTR transactions be subject to the Act's requirements, whereby FTRs are designated as a single type/class. Subject to the Act's requirements, Swap Dealers or Major Swap Participants must submit FTR transactions that incorporate at least one location (e.g., hub, zone or node) subject to mandatory clearing to third party derivative clearing organization (DCO) clearing options;
2. To support (1), require that RTOs/ISOs provide a mechanism to permit development of third party DCO clearing options;
3. Establish consistency in market rules and credit risk protection standards to ensure that exempted FTR markets are not unfairly advantaged versus CFTC regulated cleared markets;
4. New offerings beyond those existing in any one of the RTOs/ISOs today should not be exempted from CFTC review prior to launch.

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<sup>1</sup> Self-scheduled FTRs represent Auction Revenue Rights directly converted into FTRs, and thus are not a new auction award.

Financial organizations that could likely be classified as Swap Dealers or Major Swap Participants already comprise a significant amount of FTR market activity. For example, in the recently completed 2011/12 PJM annual auction, financial entities – banks and hedge funds - were awarded over 50% of the volume in the auction, measured in MWh. As noted above, hub and zone trading activity, which could likely be subject to CFTC mandatory clearing provisions, is a significant portion of FTR trading as well. To avoid having the FTR markets become a potential haven for participants seeking to avoid the mandatory clearing requirements of the Dodd-Frank Act, Nodal Exchange recommends that Swap Dealer and Major Swap Participant activity not be exempted under the CFTC’s waiver. If a blanket instrument exemption is created for FTRs, the CFTC will create a distorted incentive scheme in which current and future participants could have an incentive to trade in the FTR market rather than the cleared market. By focusing the requirement on the contracts and participants subject to mandatory clearing, the CFTC will allow much of the commercial hedging in the FTR auctions to continue as it does today, while ensuring that financial participants who are already under the CFTC’s jurisdiction do not use the FTR markets as a way to avoid CFTC requirements.

In order to ensure that Swap Dealers and Major Swap Participants have the ability to submit FTRs subject to mandatory clearing to third party DCO clearing options, the RTOs/ISOs will have to establish third party clearing options for their participants. These options should be available to all participants, but only required for those who are subject to any mandatory clearing requirements. By creating this option, the RTOs/ISOs will build a bridge to the cleared market structure overseen by the CFTC. This structure will create a regulatory regime with clear distinctions in which FERC oversees the FTR auctions and initial FTR creation, while the CFTC oversees any cleared contracts created from an FTR conversion (either as required or at the option of the participant). Creation of third party clearing options should be possible and should not be an undue burden on the RTOs/ISOs.

As the CFTC moves to exempt the existing RTO/ISO products and activities from its jurisdiction, it also needs to ensure that exempted FTR markets appropriately manage credit risks and do not create unfair and inappropriate advantages versus CFTC regulated markets. As Nodal Exchange has commented in letters to the CFTC, current proposed rules for SEFs appear to effectively prohibit a blind auction format, putting Nodal Exchange and other potential alternatives to the FTR blind auctions at a significant disadvantage if these draft rules are not revised. In a similar vein, if the RTO/ISO were permitted to hold collateral amounts far less than those judged prudent by the CFTC for cleared markets, then FTR markets would have a significant unfair and inappropriate advantage versus cleared markets.<sup>2</sup> Thus, ensuring a reasonable alignment between what the CFTC permits the RTOs/ISOs to do through the exemption process and what is permitted for CFTC regulated entities will be critical to ensuring proper market

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<sup>2</sup> Given the large overlap between cleared and FTR market activity, reliable cleared market data would be available to the RTO/ISOs to establish, for those FTRs significant to the CFTC, that their collateral requirements are reasonably in line with those required in the cleared markets.

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development going forward.

RTOs/ISOs are continually exploring new product offerings and the value and impact of these products in the context of the cleared markets should be evaluated prior to exempting any new products. By having any new products subject to an application for exemption, the CFTC will have an opportunity to determine if there are no unintended adverse effects from exempting these new offerings. We therefore recommend that the proposed exemption be limited to the FTR products currently offered by the RTOs/ISOs and that any new products require an application for exemption. Such application should require demonstrating that the RTO/ISO is appropriately managing the additional risk of these products while enabling the Commission to monitor changes within the FTR markets, including information indicating how the CFTC regulated and cleared markets may not be meeting the participants' needs.

Nodal Exchange appreciates the opportunity to comment on these issues and welcomes any further questions you may have on this topic.

Sincerely,



Paul J. Cusenza  
Chief Executive Officer

cc: Chairman Gary Gensler