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ICE

Atlanta Calgary Chicago Houston London New York Singapore

November 6, 2009

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

COMMENT

RE: Determination whether the Northwest Pipeline Corporation—Rockies contract serves a Significant Price Discovery Function

Dear Mr. Stawick:

IntercontinentalExchange, Inc. ("ICE") welcomes the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or "Commission") notice of intent ("notice") to determine whether the Northwest Pipeline Corporation—Rockies basis swap ("NWR") serves a significant price discovery function.

ICE believes that this contract does not serve a significant price discovery function, as described herein, and that the Commission may exceed its jurisdiction if it determines that this contract serves as a significant price discovery contract ("SPDC"). In addition to the absence of minimum liquidity thresholds, the inability of a basis swap to affect pricing on a designated contract market and the lack of a material price reference precludes this contract from playing a significant price discovery role.

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 exempt commercial markets ("ECMs"), which are principle to principle electronic trading platforms that serve sophisticated market participants. ECMs were designed to encourage electronic trading of derivatives. Given the sophisticated status of the participants, ECMs were subject to light touch regulation by the CFTC. The CFTC Reauthorization Act of 2008[1] 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. It is important to note that Congress gave the CFTC this authority over ECMs to capture two types of contracts: (1) contracts that trade with enough volume to impact trading on a designated contract

[1] Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1623 (June 18, 2008).

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market ("DCM"); or (2) contracts that trade with enough volume to be quoted as an independent price reference by the public.[2] It is clear that - by giving the CFTC tailored authority - Congress intended to keep the CFMA's tiered regulatory structure. Further, as stated by the CFTC in it's 2007 Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets: "[t]he Commission believes that the CEA's current level of regulation is appropriate for ECM contracts relying on the §2(h)(3) exemption when trading volume remains low and prices are not *significantly* relied upon by other markets."[3]

It is against this backdrop that the Commission makes its determination whether the NWR contract serves a significant price discovery function.

The Northwest Pipeline Corporation--Rockies Basis Swap

As background, the natural gas industry in the United States relies on system of pipelines to deliver gas to consumers across the country. The largest interconnection of pipelines is at the Henry Hub in Erath, Louisiana, where nine interstate pipelines and four intrastate pipelines converge.[4] As the largest hub for natural gas, the Henry Hub price of natural gas serves as the basis for the price of natural gas in North America.

While the Henry Hub price of natural gas is influential in determining the price of natural gas across the country, local prices of natural gas vary significantly. Factors such as pipeline capacity, storage costs, location-specific demand characteristics and transmission costs affect the local price of natural gas and contribute to the difference between the local price and the price of natural gas at the Henry Hub.[5] Basis contracts arose to give traders the ability to hedge against this price differential, but do not set the price of natural gas at either Henry Hub or the location.

The NWR contract specified in the CFTC's notice of intent is comprised of two components: (1) an index of physical natural gas trades at the Northwest Pipeline Corporation, Rockies point, as compiled by Platts; and (2) the price of the Henry Hub LD1 contract traded at the Chicago Mercantile Exchange/New York Mercantile Exchange. The basis price is the differential between these two prices.

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

[3] Commodity Futures Trading Commission, *Report of the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets* (October 2007)

[4] http://www.sabinepipeline.com/Home/tabid/2/Default.aspx#

[5] Energy Information Administration, *Derivatives and Risk Management in the Petroleum, Natural Gas, and Electricity Industries* (October 2002).

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The CFTC's Analysis

The CFTC believes that the NWR contract could potentially serve a significant price discovery function based upon three factors: (1) material liquidity; (2) material price reference; and (3) price linkage. ICE does not believe that the NWR contract meets any of these tests.

Material Liquidity

To prove material liquidity, the Commission needs to determine 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. The Commission has issued guidelines stating "liquidity is a broad concept that captures the ability to transact immediately with little or no price concession". Further, "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".[6] Finally, as Congress mandated in the Farm Bill, "the Commission *should not* make a determination that an agreement, contract, or transaction performs a significant price discovery function on the basis of the price linkage factor *unless* the agreement, contract, or transaction has sufficient volume to impact other regulated contracts or to become an independent price reference or benchmark that is regularly utilized by the public."[7]

In the notice of intent, the CFTC seems to have adopted a five trade-per-day test to determine whether a contract is materially liquid. It is worth noting that ICE originally suggested that the CFTC use a five trades-per-day threshold as the basis for an ECM to report trade data to the CFTC. This arbitrarily low threshold is appropriate for reporting purposes as it captures nearly every ECM contract, but it is at odds with Congress's intent that the CFTC include "material liquidity" in its requirements for significant price discovery. If the CFTC has decided to abandon its rulemaking on Significant Price Discovery Contracts, then it should, at the very least, propose revisions Part 36 in order to allow the public to comment on whether the CFTC's *new* threshold meets Congress' intent in promulgating the Significant Price Discovery Test of the Farm Bill.

Moreover, the statistics have been misinterpreted and misapplied. First, these trades-per-day statistics requested by the CFTC and provided by ICE include transactions that were not even executed on the ICE 2(h)(3) platform and therefore make no contribution to price discovery. Rather, these transactions were executed via voice brokers in the over the counter market and submitted to ICE sometime after-the-fact

[6] Appendix A to Part 36, 17 C.F.R. 36 (2009).
[7] Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1624 (June 18, 2008).

solely for clearing purposes. For the NWR basis swap, only about 79% of all trades were actually executed on the ICE platform. However, *volume in MMBtu's*, rather than *number of trades*, is a much more meaningful indicator of actual liquidity and therefore price discovery. In deciding whether or not to participate in a market, traders consider volume, not number of trades. On a volume-basis, only about 60% of all NWR volume was actually executed on the ICE platform.

Second, the CFTC's figures, as requested of and provided by ICE, include trades made in all 120 months of each contract. Furthermore, some of the trades were executed in seasonal (summer or winter) or calendar year strips that trade separately from and in addition to the contract months. The more appropriate method of determining liquidity is to examine the activity in a *single* traded month or strip of a given contract. The merit of this argument is obvious when you consider that liquidity in a January contract is of no help to a trader who needs to liquidate an October position. For the NWR basis swap, only 28% of the trades actually executed on the ICE platform occurred in the single most liquid, usually prompt, month of the contract. However, again, from the more important volume-standpoint, only 16% of all NWR volume actually executed on the ICE platform occurred in the single most liquid, usually prompt, month of the contract.

The trades-per-day statistics used by the CFTC must be adjusted for both of the factors described above before even considering whether or not a "more or less continuous steam of prices" can be observed. According to the statistics cited by the CFTC, the NWR basis swap traded an average of 126 times per day, but only 22% (79% x 28%) of these trades (and an even lower 10% of total volume) were actually executed on the ICE platform in the single most liquid, usually prompt, month of the contract. Given an eight hour trading day[8], this means that the NWR basis swap traded only about once every 16 minutes across all months. Clearly, such a low level of liquidity does not represent an "ability to transact immediately" or "a more or less continuous stream of prices" and certainly not "a market where trades occur multiple times per minute." In comparison, the single most liquid, usually prompt, month of the ICE Henry Hub LD1 natural gas contract traded, on average, over 4,000 times per day on the ICE platform alone.

In conclusion, it is clear that the NWR contract does not meet the material liquidity standard as contemplated by Congress or the CFTC in its SPDC rulemaking.

Material Price Reference

The second basis for the Commission's determination is that the NWR contract serves as a material price reference. In this determination, Congress instructed the

[8] Note that ICE's OTC markets are actually open 22 hours.

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 whether the cash market quotes the ECM contract. An indirect reference would be whether an industry publication quotes the ECM's contract's price.

For the NWR contract, the CFTC relies on one reason for material price reference: (1) that "the Commission's ECM study, in general, stated that certain market participants referred to ICE as a price discovery market for certain natural gas contracts." This argument is nearly impossible to respond to as the ECM report did not mention these contracts as a potential significant price discovery contract, instead focusing exclusively on the Henry Hub LD1 natural gas swap. It is impossible to say which market participants made this statement *in 2007 or the contracts that were referenced, or whether the participants distinguish "price transparency" from the legal meaning of "price discovery"*. Congress, in promulgating the Farm Bill, ordered the CFTC to undertake a very important analysis of the OTC energy markets. Basing a material price reference determination on general statements made in a two year old study does not meet Congress' intent that the CFTC use its considerable expertise to study the OTC markets. Moreover, this ephemeral analysis does not allow the public to comment effectively.

Price Linkage

The third basis for the CFTC's determination that NWR is a significant price discovery contracts is that it is price linked to the NYMEX/CME natural gas futures contract (NG). As stated above, Congress instructed that the "Commission *should not* make a determination that an agreement, contract, or transaction performs a significant price discovery function on the basis of the price linkage factor *unless* the agreement, contract, or transaction has sufficient volume to impact other regulated contracts." The notice of intent implies that any price linkage is significant, even if it does not affect price discovery on a DCM. This analysis misses Congress' intent in promulgating the significant price discovery legislation. The intent, plainly stated above, was to capture contracts that could affect price discovery on a DCM. A basis swap uses the NG price only as a reference to create the basis price. As an analogy, implying price linkage on a basis swap is akin to stating that the price at a local pump in Mississippi affects the global price of crude oil. Further, using the CFTC's interpretation of price linkage, given that the NWR is priced in dollars, then the NWR contract could be "price linked" to a U.S. Dollar futures contract traded on a DCM. This is not a rational result or Congress' intent. In addition, this contract trades on screen only a few times per day, so it is hard to see

how it affects price discovery in the NG contract. In summary, the NWR contract settles on a reference price that is established by an index provider and is not determined by the ECM or any other DCM as required under the SPDC guidelines.

Conclusion

Based on the failure to meet virtually all of the criteria for SPDC determination, it is clear that the NWR does not serve as a material price reference or trade with material liquidity. Further, the NWR can not be price linked to a designated contract market. Therefore, the Commission should not deem this contract as a significant price discovery contract. Congress ordered the Commission to review the electronic OTC markets for contracts that serve a significant price discovery function. Overreaching in this process could force OTC trading back to the opaque voice brokered markets. It is important for the Commission to remember that Exempt Commercial Markets perform a very important function in bringing transparency and credit intermediation to the OTC markets, and should not be disadvantaged relative to the opaque, off-exchange markets where no such requirements exist.

Thank you for the opportunity to comment.

Sincerely,

R. Trabue Bland
Director of Regulatory Affairs
Assistant General Counsel