

November 10, 2009

Via Electronic Mail: Secretary@cftc.gov

Mr. David Stawick, Secretary  
U.S. Commodity Futures Trading Commission  
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## COMMENT

Re: PJM WH Real Time Peak Daily (PDP) Contract  
PJM WH Real Time Peak (PJM) Contract  
PJM WH Real Time Off-Peak (OP) Contract  
PJM WH Day Ahead LMP Peak Daily (PDA) Contract and  
PJM WH Real Time Off-Peak Daily (ODP) Contract

Mr. Stawick,

The Financial Institutions Energy Group ("FIEG") is comprised of investment and commercial banks that provide a broad range of financial services to all segments of the U.S. and global economy. Its Members and their affiliates play a number of roles in the wholesale power and natural gas markets, including acting as marketers, lenders, underwriters of debt and equity securities, and proprietary investors. The Federal Energy Regulatory Commission ("FERC") has authorized FIEG's power-marketer Members to sell energy, capacity and ancillary services at market-based rates. FIEG Members are active participants in the various organized electricity markets administered by independent system operators ("ISOs") and regional transmission organizations ("RTOs") in North America.

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These comments echo those that FIEG and others filed in response to the Commission's proposal to treat certain ICE contracts in the West as significant price discovery contracts.<sup>1</sup> Because electricity prices are volatile, it is critical that market participants, including public power companies, investor-owned utilities and power marketers, be able to adequately hedge their price risks.<sup>2</sup> Such market participants use the above-referenced ICE PJM contracts (the "ICE Contracts") to hedge their long and short physical positions in the Mid-Atlantic and Northeast electric power markets. These underlying physical positions can be substantial and require delivery not only in the spot month, but often extend forward for months or even years as a result of the manner in which market participants procure and sell physical power.<sup>3</sup>

<sup>1</sup> See comments in Comments File 09-011 and 09-012.

<sup>2</sup> In addition, trading and managing risk related to power is inherently different from natural gas and oil because power cannot be stored.

<sup>3</sup> Under the Federal Power Act ("FPA"), all sales of electric energy at wholesale must be made at prices that are "just and reasonable." In addition, all persons who sell physical power in the wholesale markets are subject to regulation by the FERC.

## Comments

The factors the Commission must consider when evaluating whether a contract is an SPDC are: (1) price linkage; (2) arbitrage; (3) material price reference; and (4) material liquidity. Three of the four criteria (all but material price reference) require the Commission to compare the ICE Contracts to contracts listed for trading on or subject to the rules of a designated contract market or derivatives transaction execution facility, or to other SPDCs.<sup>4</sup>

FIEG respectfully submits that the ICE Contracts do not appear to meet the SPDC determination criteria set forth in the Commission's SPDC Order.<sup>5</sup> For each contract, the Commission has identified alleged evidence for only two of the four factors it is required to consider pursuant to its regulations and Section 2(h)(7) of the Commodity Exchange Act: material price reference and material liquidity.<sup>6</sup> With regard to the remaining two factors, the Commission apparently has not found any evidence of price linkage or arbitrage with other contracts. Although not all factors are required to be present to support a determination that a particular contract performs a significant price discovery function, the absence of price linkage and arbitrage significantly reduces the likelihood that a contract performs a significant price discovery function.<sup>7</sup> Moreover, the alleged evidence of material price reference and material liquidity proposed by the Commission appear to be insufficient for an SPDC determination.

- *No price linkage with NYMEX contracts.* The ICE Contracts reference the day-ahead or real-time Locational Marginal Prices ("LMPs") set by physical demand and supply in the PJM Interconnection ("PJM"). Such prices in physical power markets are regulated by the FERC, which is charged with ensuring that prices are just and reasonable.<sup>8</sup> None of the ICE

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<sup>4</sup> See 17 CFR § 36.3(c)(1)(i, ii, & iv). The following four NYMEX contracts appear to be the most similar to the ICE Contracts:

- PJM Western Hub Peak Calendar-Month Day-Ahead LMP Swap Futures (J4)
- PJM Western Hub Off-Peak Calendar-Month Day-Ahead LMP Swap Futures (E4)
- PJM Western Hub Peak Calendar-Month Real-Time LMP Swap Futures (L1)
- PJM Western Hub Off-Peak Calendar-Month Real-Time LMP Swap Futures (N9).

<sup>5</sup> Significant Price Discovery Contracts on Exempt Commercial Markets, 74 Fed. Reg. 12,178 (Mar. 23, 2009) ("SPDC Order").

<sup>6</sup> See 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, Offered for Trading on the Intercontinental Exchange, Inc., Perform Significant Price Discovery Functions, 74 Fed. Reg. 54,966 (Oct. 26, 2009).

<sup>7</sup> SPDC Order at 12,197 ("The presence of any of these factors, however, would not necessarily be sufficient to establish the contract as a significant price discovery contract.")

<sup>8</sup> "All rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful." 16 U.S.C. § 824d(a).

Contracts “uses or otherwise relies on a daily or final settlement price, or other major price parameter, of a contract or contracts listed for trading on or subject to the rules of a designated contract market or a derivatives transaction execution facility ... to value a position, transfer or convert a position, cash or financially settle a position, or close out a position.” See 17 CFR § 36.3(c)(1)(i) (2009). Unlike the ICE Henry Financial LD1 Fixed Price contract, which uses the NYMEX physically-delivered Natural Gas (Henry Hub) Futures (NG) contract to determine its final settlement price, the ICE Contracts’ settlement prices are determined by actual physical purchases and sales of electricity in PJM.<sup>9</sup>

- *No arbitrage between ICE and NYMEX contracts.* The Commission provides no evidence of arbitrage between the ICE Contracts and any NYMEX contracts. Therefore, notwithstanding any similarities in the referenced prices used to settle the contracts (likely due to the fact that both ICE and NYMEX contracts settle based on LMP prices), there is no support for a conclusion that market participants can “effectively arbitrage between the markets by simultaneously maintaining positions or executing trades in the contracts on a frequent and recurring basis.” See 17 CFR § 36.3(c)(1)(ii) (2009).
- *No material price reference.* As noted above, each of the ICE Contracts settle at LMPs set by physical demand and supply in PJM. Thus, the bids, offers, or transactions in physical power at PJM Western Hub are not “based on,” or “determined by referencing, the prices generated by” any of the ICE Contracts. See 17 CFR § 36.3(c)(1)(iii) (2009). In fact, the opposite is true; the ICE Contracts are priced based on the results of physical demand and supply in PJM’s markets. Therefore, although the ICE Contracts can be useful for hedging price risk, any reference to the ICE Contracts in the cash market is likely to be only a reference to the formula used by ICE to calculate the arithmetic average LMPs during the specified periods, not a reliance on the ICE Contracts as a price discovery contract.

The Commission relies on two sources of evidence when determining whether a contract is being used as a material price reference: (1) evidence that cash market bids, offers or transactions frequently reference the price of the contract in question; or (2) evidence that the price of “the contract is being routinely disseminated in widely distributed industry publications – or offered by the ECM itself for some form of remuneration – and consulted on a frequent and recurring basis by industry participants in pricing cash market transactions.”<sup>10</sup> The only evidence in the record of references to the price of the ICE Contracts in cash markets is a general conclusion in a 2007 study that found that market participants generally view the ICE as a price discovery market for certain electricity

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<sup>9</sup> See Order Finding that the ICE Henry Financial LD1 Fixed Price Contract Traded on the Intercontinental Exchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 37,988 (July 30, 2009) (designating the ICE Henry Financial LD1 Fixed Price contract an SPDC based on satisfaction of three of the four factors, including price linkage).

<sup>10</sup> See SPDC Order at 12,198.

contracts; but as the Commission notes in its proposal, the ECM Study did not specifically address the use of the ICE Contracts.<sup>11</sup> With regard to routine dissemination and use of the price, although ICE sells its price data to market participants, there is no evidence in the record regarding how many participants purchase the information or whether the information is used to price cash market transactions.

- *No material liquidity.* To establish the criterion of “material liquidity” it is insufficient for the Commission to note that the trading volume of the ICE Contracts meets or exceeds numerical thresholds for the reporting requirements in 17 CFR § 36.3(c)(2) (2009). Instead, the material liquidity criterion in section 36.3(c)(1)(iv) of the Commission’s regulations requires the Commission to consider whether the trading volume of the ICE Contracts is “sufficient to have a material effect” on exchange-traded contracts such as the NYMEX contracts listed above.<sup>12</sup> As noted, there is no evidence of direct price linkage or arbitrage between the ICE Contracts and any similar NYMEX contracts. Because trading in the ICE Contracts cannot have a “material effect” on the corresponding NYMEX contracts, the material liquidity criterion is not satisfied.<sup>13</sup>

The Commission also may want to consider fundamental differences between power markets and other energy markets such as oil and natural gas as it considers the question of any potential position limits. Prices in the underlying physical power markets at PJM Western Hub are generally not influenced by financial trading that occurs on platforms such as ICE and are calculated using physical supply and demand subject to market power mitigation rules under FERC’s “just and reasonable” standard. Access to liquid financial contracts offers physical generators and load additional flexibility to hedge their physical positions.<sup>14</sup> The absence of adequate hedging is one of factors that in the past contributed to problems in physical power markets (*e.g.*, in California in 2000-2001). Imposing position limits on financial trading in markets that do not currently face any known problems can run the risk of inadvertently harming the risk management and hedging opportunities available to physical market participants and should not be done without careful deliberation.

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<sup>11</sup> Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets at 10 (Oct. 2007) available at [http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/pr5403-08\\_ecmreport.pdf](http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/pr5403-08_ecmreport.pdf).

<sup>12</sup> See n.4, *supra*.

<sup>13</sup> Moreover, based on the Commission’s notice, in the second quarter of 2009, the OPI, PDA, and ODP contracts had very low daily average numbers of separate transactions (6.8, 16.6, and 11.3, respectively). It would seem, therefore, that at least these three contracts have very limited liquidity.

<sup>14</sup> The financial hedging in power includes spot, monthly, quarterly and calendar year terms and have grown as physical power markets have developed, *see, e.g.*, Figure 29 in FERC’s 2008 State of the Markets Report <http://www.ferc.gov/market-oversight/st-mkt-ovr/2008-som-final.pdf>.

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Considering the balance of known factors weighing against the designation of the ICE Contracts as SPDCs, the Commission should exercise extreme care; particularly in light of the yet unknown potential for unintended consequences that may result from the application of the Commission's comprehensive regulatory program to these contracts. To date, the Commission has no experience with respect to what effect SPDC designation may have on the contracts or the related physical transactions. The first contract to be designated an SPDC, the ICE Henry Financial LD1 Fixed Price Contract, was designated in July of 2009, and the ICE has just recently completed its implementation of the Commission's regulatory requirements. Therefore, FIEG respectfully recommends that the Commission not designate the ICE Contracts as SPDCs or in the alternative, that it consider delaying its determination as to whether the ICE Contracts are SPDCs until it has fully reviewed the effects of its regulation on the ICE Henry Financial LD1 Fixed Price Contract.

In addition to its comments, FIEG respectfully reiterates its concern that the short comment deadline may prevent some affected market participants from responding to the Commission's proposal. FIEG proposes that the Commission allow at least 30 days for public comment on SPDC proposals, consistent with its own regulations.<sup>15</sup>

FIEG appreciates the opportunity to provide these comments.

Sincerely,

/s/ Catherine M. Krupka

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<sup>15</sup> 17 CFR § 36.3(c)(3) (2009).