October 21, 2009

VIA Email: secretary@cftc.gov

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

Re: "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 SP-15 Financial Day-Ahead LMP Peak Contract; SP-15 Financial Day-Ahead LMP Peak Daily Contract; SP-15 Financial Day-Ahead LMP Off-Peak Daily Contract; SP-15 Financial Swap Real Time LMP—Peak Daily Contract; SP-15 Financial Day-Ahead LMP Off-Peak Contract; NP-15 Financial Day-Ahead LMP Peak Daily Contract; and NP-15 Financial Day-Ahead LMP Off-Peak Daily Contract, Offered for Trading on the IntercontinentalExchange, Inc., Perform Significant Price Discovery Functions," 74 *Fed. Reg.* 51264 (October 6, 2009).

Dear Mr. Stawick:

The Electric Power Supply Association ("EPSA")[1] respectfully files comments on the Commodity Futures Trading Commission's ("CFTC" or "Commission") notice of intent ("notice" or "NOI") to determine whether the SP-15 Financial Day-Ahead LMP Peak ("SPM") contract, SP-15 Financial Day-Ahead LMP Peak Daily ("SDP") contract, the SP-15 Financial Day-Ahead LMP Off-Peak Daily ("SQP") contract, the SP-15 Financial Swap Real Time LMP - Peak Daily ("SRP") contract, the SP-15 Financial Day-Ahead LMP Off-Peak ("OFP") contract, the NP-15 Financial Day-Ahead LMP Peak Daily ("DPN") contract, and the NP-15 Financial Day-Ahead LMP Off-Peak Daily ("UPN") contract, all offered for trading on the Intercontinental Exchange, Inc. ("ICE"), perform significant price discovery functions.

The notice, published in the Federal Register on October 6, 2009, and establishing a 15 day comment period, is the first review by the Commission of whether particular power contracts perform a significant price discovery function pursuant to the authority granted by the CFTC Reauthorization Act of 2008 ("Reauthorization Act"). EPSA believes that these contracts do not serve a significant price discovery function for two reasons: (1) based on how the California Independent System Operator ("CAISO") operates and utilizes Locational Marginal Prices ("LMPs"), the contracts do not serve as a material price reference, and (2) the contracts are not materially liquid. In light of these facts

[1] The comments contained in this filing represent the position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

discussed below, the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts do not meet either of the tests necessary to function as Significant Price Discovery Contracts ("SPDCs").

THE ELECTRIC POWER SUPPLY ASSOCIATION

EPSA is the national trade association representing competitive power suppliers, including generators and marketers. These suppliers, who account for 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities serving global power markets. EPSA seeks to bring the benefits of competition to all power customers.

Many of EPSA's member companies are active market participants in and members of the CAISO market and participate in western power markets. Accordingly, EPSA has a direct and substantial interest in the outcome of this proceeding. Therefore, allowing EPSA to actively participate based on the input from its members in this proceeding would be in the public interest, particularly as this proceeding represents the first instance in which the Commission will determine whether particular contracts which settle against prices within an organized wholesale electricity market serve a significant price discovery function.

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 principal to principal electronic trading platforms that serve sophisticated market participants. ECMs were designed to encourage electronic trading of derivatives by sophisticated market participants, and were subject to limited CFTC oversight. The CFTC Reauthorization Act of 2008[2] 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.

The CFTC NOI asserts that the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts meet Material Price Reference and Material Liquidity elements. In this context, it is important to note that Congress gave the CFTC this authority to capture: (1) contracts that trade with enough volume to impact trading on a designated contract market, or (2) contracts that trade with enough volume to be quoted as an independent price reference by the public.[3]

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

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

EPSA supports efforts to improve the transparency of markets. In doing so, there should be a balance between providing market oversight rules that allow for a broad use of market-based risk management tools to conduct business while providing regulators with the needed information and transparency to protect against market manipulation and control excessive speculation. Based on these goals and the criteria set out to define a significant price discovery function, the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts do not serve a significant price discovery function.

THE CONTRACTS

As the Commission correctly notes, the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts are financially settled contracts based upon the volumetric weighted average of LMPs occurring in various CAISO market locations.[4] The LMPs are derived from the CAISO electricity market and result from the CAISO tariff structure approved and regulated by the Federal Energy Regulatory Commission ("FERC").[5]

It is important to note that the physical electricity market reflects the unique nature of electricity as a commodity with prohibitive storage costs. In order to ensure the reliability of the electrical grid, supply must equal demand at numerous locations at all times. As one would imagine, a complex process overseen by federal regulators, taking into account reliability and competitive market forces, is required to procure power across all locations on the CAISO grid for each settlement interval of the day. An LMP, regardless of whether it is a day ahead LMP or a real-time LMP, is a product of the intersection of supply and demand at a specific location on the grid. As a result, the price of electricity in CAISO for each settlement interval, the LMP, reflects forces of supply and demand for the physical commodity at each pricing point. Further, the process is overseen by FERC based upon its successful implementation of Regional Transmission Organization/Independent System Operator ("RTO" or "ISO") markets across the United States.

For the Day Ahead ("DA") LMP, the CAISO market receives offers from Scheduling Coordinators that schedule generation the day before expected delivery ("supply"), and the CAISO forecasts demand in the CAISO market for delivery of DA electricity ("load"). The CAISO matches the offers to sell or deliver electricity to the forecast load. The Day

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[4] As explained by ICE in an advisory dated March 27, 2009: "On April 1, 2009, the California ISO (CAISO) will launch the new Market Redesign and Technology Upgrade (MRTU) for the California electricity markets. This is only a reminder as in January 2008, ICE added language to the financial swap confirms for NP 15 and SP 15 to reflect the changes in the California markets post MRTU. This change will only affect the Floating Price portion of confirms for Fin Swap Peak, FP for ICE and Fin Swap Off Peak, FP for ICE as follows: Floating Price: …April 1, the "Floating Price" will be the average of the hourly Day Ahead LMP prices posted by CAISO for the [NP-15 or SP 15] EZ Gen Hub. In addition, to comply with the CAISO tariff, ICE will hold open all CAISO cleared swaps for 8 days to allow for any price adjustments by CAISO. All additional language will be retroactive to previous confirmations in these products."

[5] The CAISO electricity market is also subject to FERC directed price mitigation to prevent the exercise of locational market power by any supplier.

Ahead market is an essential part of the planning and modeling required to ensure the reliability of the electrical grid. The day-of (or Real-Time) market is a market where power deliveries to the market reflect the actual real-time load and supply offers occurring in the delivery day. As electricity supply and demand are a product of ever-changing factors such as weather and equipment availability (generators, transmission, etc), real-time supply and load will often diverge from day-ahead expectations. The Real-Time LMP reflects this unpredictable and volatile matching of supply and demand across numerous locations on the grid at each moment.

Therefore, the price of electricity in CAISO for each settlement interval, the LMP, reflects the forces of supply and demand for the physical commodity at each pricing point. That market is the product of an extensive multiyear effort closely overseen and regulated by FERC ("Market Redesign and Technology Update" or “MRTU”). The market functions are embodied in a FERC-approved tariff on file with FERC. The LMP prices created by this process are the outcome of the highly mitigated and transparent physical cash market driven by load needs and supply availability. External financial transactions such as the ICE swaps market do not impact the LMP in CAISO. Under the CAISO’s tariff, the algorithm for setting LMP prices at a specific location on the grid for each settlement interval is driven by the available supply and demand for physical electricity, subject to operating conditions on the CAISO grid.

THE CFTC’S ANALYSIS OF THE CONTRACTS AS POTENTIAL SPDCS

The CFTC’s NOI asserts that the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts serve a significant price discovery function for two reasons: (1) they each serve as a material price reference, and (2) each contract is materially liquid. A reading of the Reauthorization Act and the Commission’s SPDC rules, in light of the facts of how the CAISO operates, demonstrates that the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts meet neither of these tests.

1. <u>Material Price Reference</u>

The first basis for the Commission’s determination is that the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts serve as a material price reference. Congress instructed the 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. The SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts meet neither of these standards.

The CFTC has not identified any contracts in any market that settle to, or reference, the SPM, SDP, SQP, SRP, OFP, DPN or UPN contract. This is not surprising, because the cash market risk that these contracts hedge is the volatility in the CAISO markets. This pricing point does not need a proxy pricing vehicle as the actual cash price is constantly and transparently produced by the FERC-regulated CAISO which is directly involved in assuring reliable power at competitive prices. That is, the price discovery for the day ahead and hourly LMPs in the CAISO market is the CAISO market itself. The LMPs for the CAISO's Day Ahead and Real Time markets are the direct reflection of supply and demand in CAISO, and are readily and transparently available.

Logically, parties desiring to reference the CAISO LMPs in a contract, whether peer-to peer, voice-brokered, or traded on a designated contract market or otherwise, would do so directly by referencing the actual, published LMPs, rather than indirectly by referencing the SPM, SDP, SQP, SRP, OFP, DPN or UPN contracts. EPSA is not aware of any circumstances in which it would make sense to reference those contracts rather than the CAISO LMPs themselves.

As to the indirect reference regarding whether an industry publication quotes the ECM's contract's price, the only publication that the CFTC refers to is the West Power End of Day Package. This is an ICE publication, and it is logical that ICE would publish the prices of its own contracts, as any other contract market does. However, the fact that ICE publishes the settlement prices of its own contracts holds no weight as evidence of a material price reference in this instance. As stated above, EPSA is not aware of and the NOI has provided no evidence of any contracts settling on this reference. The CFTC has not identified any circumstance where the forward price quote for the SPM, SDP, SQP, SRP, OFP, DPN or UPN contract would be used as a reference. The logical reference for trading in or around CAISO is the most reliable price reference, the CAISO market Day Ahead and Real Time LMPs, publicly available on the CAISO website.

2. <u>Material Liquidity</u>

To find 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 also states "[l]iquidity is a broad concept that captures the ability to transact immediately with little or no price concession." [6] The SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts lack both a material effect on other contracts, and sufficient liquidity.

a. No Material Effect on other Contracts Listed for Trading

EPSA is not aware that trading in the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts has any effect whatsoever on any contract listed for trading in a designated contract market ("DCM"), ECM or even in the OTC market. The NOI does not provide any indication otherwise. Logically, other CAISO-related contracts, either listed on DCMs or traded in the OTC market, would be expected to settle or reference the CAISO market Day Ahead and Real Time LMPs directly, rather than doing so indirectly by

[6] Appendix A to Part 36, 17 C.F.R. 36 (2009).

referencing the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts. Additionally, trading in the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts has no effect and can have no effect on the FERC-regulated CAISO market Day Ahead and Real Time LMPs. Thus, neither EPSA nor the NOI can identify any indirect effect on any other contracts listed for trading.

b. Liquidity in these Contracts is Insufficient

The Commission states that “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.”[7] Trading in the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts fails to meet this standard. The statement above reveals two elements that can show liquidity: 1) a narrow bid/ask spread, and 2) a trade frequency of multiple trades per minute, neither of which is present in any of the ICE contracts. For the second quarter 2009, the most active of the identified contracts is the SPD contract, which had an average of 111 trades per day during the quarter. The second highest average was in the SPM contract at 84 trades per day, and the lowest averages were in the MXO and OFP contracts at 10 and 9 trades per day, respectively. Notably, these trade amounts are for all contract months combined, not just the prompt month. Even under a hypothetical scenario that assumes that all trading occurs in the same contract month, the highest daily average of 111 trades per day still falls well short of a “multiple trades per minute” standard. As shown above, even if there is adequate liquidity, there is no material price reference leading to the question of why a contract with liquidity that did not serve as a price reference would be designated as a SPDC.

CONCLUSION

The SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts meet neither the material price reference nor material liquidity standard. The Commission has identified no other contract in any market that is tied to the settlement price of these ICE contracts. Trading in the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts cannot reasonably be expected to have any effect whatsoever on CAISO market Day Ahead and Real Time LMPs. Logically, other CAISO-related contracts, either on DCMs or in the OTC market, could also be expected to reference, or to settle to, the CAISO LMPs directly, so trading in the SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts should have no effect on the prices of contracts in other markets. As explained above, CAISO market Day Ahead and Real Time LMPs themselves provide the only material price reference for the market. The SPM, SDP, SQP, SRP, OFP, DPN and UPN contracts do not perform a significant price discovery function.

EPSA believes that the FERC-regulated, tariff-based CAISO power market is intrinsically reflective of competitive prices. Subjecting market participants to position limits or other regulatory elements relating to SPDC status can only negatively limit risk

[7] Id

management opportunities for market participants for a volatile commodity without serving the purpose that SPDC status was intended by Congress.

Thank you for the opportunity to comment.

Respectfully submitted,

NEBagot

Nancy E. Bagot
Vice President of Regulatory Affairs

cc: Chairman Gensler
Commissioner Dunn
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