

# Before the Commodity Futures Trading Commission

April 30, 2012

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In the Matter of the Application for an Exemptive Order Under Section 4(c) of the Commodity Exchange Act by ISO New England Inc.

Request for Supplemental Order

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## I. Introduction

Section 722 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)<sup>1</sup> added section 2(a)(1)(I)(i) to the Commodity Exchange Act, 7 U.S.C. §1 *et seq.* (“Act”), providing that nothing in the Act shall limit the authority of the Federal Energy Regulatory Commission (“FERC”) or a State regulatory authority under the Federal Power Act, 16 U.S.C. § 796 *et seq.* (“FPA”), with respect to an agreement, contract, or transaction that is entered into pursuant to a tariff or rate schedule approved by FERC or a State regulatory authority that is not executed, traded, or cleared on a CFTC-registered entity or trading facility; or is executed, traded, or cleared on a registered entity or trading facility owned or operated by a regional transmission organization (“RTO”) or an independent system operator (“ISO”). In addition, nothing in Section 722 of the Dodd-Frank Act limits or affects any statutory authority of the Commodity Futures Trading Commission (“Commission”) with respect to such agreements, contracts or transactions.

Section 722 of the Dodd-Frank Act also added section 4(c)(6) to the Act, providing that if the Commission determines that the exemption would be consistent with the public interest and the purposes of the Act, the Commission shall, in accordance with sections 4(c)(1) and 4(c)(2) of the Act, exempt from the requirements of the Act an agreement, contract, or transaction that is entered into pursuant to a tariff or rate schedule approved or permitted to take effect by FERC or by the applicable State authority.

Each of six independent system operators or regional transmission organizations (“ISO/RTOs”) applied to the Commission in a consolidated request for an Order under the specific provisions of section 722 of the Dodd-Frank Act (section 4(c)(6) of the Act) and pursuant to the general exemptive authority of section 712(f)(4) of the Dodd-Frank Act, (“Consolidated Request for Relief”)<sup>2</sup> exempting the contracts, agreements and transactions defined therein and any persons, including the requesting ISO/RTOs and their members or other market participants offering, entering into, rendering advice, or rendering other services with

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<sup>1</sup> Public Law 111–203, 124 Stat. 1376 (2010).

<sup>2</sup> See “In the Matter of the Application for a Exemptive Order Under Section 4(c) of the Commodity Exchange Act by California Independent Service Operator Corporation, *et al.*,” filed on February 7, 2012 with the Commodity Futures Trading Commission.

respect to such contracts, agreements, or transactions from the Act and Commission rules thereunder, with certain exceptions.<sup>3</sup>

ISO New England Inc. (the "ISO" or "ISO NE") hereby files this Request for a Supplemental Order ("Supplemental Request") under section 722 of the Dodd-Frank Act (section 4(c)(6) of the Act) and pursuant to section 712(f)(4) of the Dodd-Frank Act, to supplement and amend the Order requested in the Consolidated Request for Relief. The requested amendment clarifies that the contracts, agreements and transactions defined in this Supplemental Request, each of which is a class of contract, agreement or transaction authorized under the ISO's FERC approved tariff, is exempt from the Act and Commission regulations thereunder to the same degree and extent as the relief prayed-for in the Consolidated Request for Relief.

By submitting this Supplemental Request, the ISO is not seeking to delay in any way consideration of the Consolidated Request for Relief. ISO NE has filed this Supplemental Request in light of the fact that the requested clarification relates only to the Order requested by ISO NE under the Consolidated Request for Relief, and not to the Orders requested by the remaining five ISO/RTOs. Moreover, ISO NE, without diminishing the importance of this Supplemental Request in providing clarity to the market and to the well-functioning of the transmission of electrical energy within their respective service areas, does not wish that the Commission's consideration and issuance to ISO-NE of the Order requested by the Consolidated Request for Relief be delayed while the Commission considers this Supplemental Request.

For the reasons discussed below, the requested Supplemented and Amended exemptive Order fulfills the conditions of sections 4(c)(1), 4(c)(2) of the Act and section 722 of the Dodd-Frank Act (4(c)(6) of the Act), and is consistent with the public interest and the purposes of the Act.

## **II. Requestor**

ISO NE, the Requestor of this Supplemental Exemptive Order under section 4(c)(6) of the Act is a nonstock corporation organized under the laws of Delaware and recognized as a 501(c)(3) tax-exempt organization by the Internal Revenue Service, recognized by FERC as an ISO in 1997 and as an RTO in 2005 and responsible for ensuring the day-to-day reliable operation of New England's bulk power generation and transmission system; overseeing and ensuring the fair administration of the region's wholesale electricity markets; and managing comprehensive, regional planning processes.

## **III. Transactions Covered by the Supplemental Request**

ISO NE seeks a supplemental Order amending the Order in the Consolidated Request for Relief to clarify that certain contracts, agreements or transactions that are currently settled by the ISO and for which the ISO will act as Central Counter Party ("CCP") under its Tariff as it will

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<sup>3</sup> The Consolidated Request for Relief did not request exception from sections 4b, 4o, 6(c) and 9(a)(2) of the Act to the extent that those sections prohibit fraud or manipulation of the price of any swap, contract for the sale of a commodity in interstate commerce, or for future delivery on or subject to the rules of any contract market.

be amended, are included within the scope of the Commission's Order. These contracts, agreements or transactions, which have been an integral part of the ISO NE electricity markets for decades, are termed "IBT" transactions. The ISO is submitting this Supplemental Request because these contracts, agreements or transactions are not described in detail in the Consolidated Request for Relief and an amendment to the text of the Order would provide certainty that IBT transactions as cleared by ISO NE are within the scope of the Order.

The transactions that are within the scope of this Supplemental Request are limited to Market Participants that participate as generators, suppliers, end users, alternative resource providers (renewable generation or load resource providers), transmission owners and Municipal utilities. All such entities are subject to FERC established minimum eligibility requirements to become a market participant on ISO NE.

IBT transactions, among other functions, operate as a bridge between bilateral long-term and fixed-price energy agreements entered into between ISO market participants, such as load serving entities ("LSE") and generators, and the spot and Day-Ahead forward electricity markets administered by ISO NE. In the electricity markets, generators sell electricity (generation), and consumers purchase electricity (load), through accessing markets administered by ISO NE. These markets, however, operate as conduits for the transmission of pooled electricity at floating prices based on the marginal cost of delivery to specific nodes. In the Real-Time market, these marginal prices, which are tied to the real-time delivery of electricity, change throughout the day, at intervals of one hour and fractions thereof. In the Day-Ahead market, these prices change hourly. As such, the markets administered by ISO NE are delivery markets.

In order to be able to purchase and sell electricity forward at fixed prices, market participants may enter into bilateral contracts that are, through IBT transactions, integrated with pooled ISO market transactions. Through the use of the IBTs, market participants are able to substitute bilateral obligations entered into off of the ISO market with ISO market obligations. Transactions involving IBTs therefore tie long-term contracts for electricity to spot and short term electricity purchases and sales at floating market prices.

In this regard it should be noted that the ISO generally distinguishes between the various functions of an ISO acting as clearinghouse into a "clearance" function, under which the market price is determined through the interaction of supply and demand at various nodes using complex algorithms and the ISO's "settlement" function, under which parties to transactions make payment to, or receive payment from, the ISO for the delivery of electricity. IBT transactions are included only in the "settlement" function of the ISO. Under section 1a(15) of the Act, a "Derivatives Clearing Organization" is defined as a clearinghouse or similar entity that "arranges or provides on a multilateral basis for the settlement or netting of obligations." Accordingly, "clearing" is referred to throughout this Supplemental Request as any one of the functions of a DCO within the meaning of section 1a(15) of the Act, and does not imply that IBT transactions are included in the algorithms used by the ISO to determine market price, which they are not.

Two examples of the typical use of IBTs in the electricity markets follow:

1. Two parties enter into a three-month forward contract for the supply (generation) and consumption (load) of electricity. The load pays a fixed price for the forward purchase of

electricity. The generator agrees to deliver a specified amount of electricity at that negotiated fixed price, but must make delivery through the ISO. As discussed above, in the electricity markets, generation can only be purchased and sold by accessing the pooled electricity markets administered by the ISO where prices are floating based on the marginal cost of delivering electricity to specific nodes.

In order to facilitate payment for delivery of the electricity to load at the agreed upon fixed price, the parties also enter into a floating price agreement evidenced by a confirmation sent to the ISO whereby the generator agrees to pay a floating price for a MWH obligation to the load at an ISO-market determined price. Typically for ISO NE, this is the Day-Ahead market price, but it could also be the Real-Time market price. In order to benefit from the centralized settlement of transactions at these market-set prices, the parties, via the confirmations sent to the ISO, present their obligation to make or take payment at the floating (Day-Ahead or Real-Time market price) to the ISO for "clearing."<sup>4</sup>

Upon acceptance by the ISO as CCP, the IBTs are cleared together with transactions for electricity executed in the Day-Ahead or Real-Time market. In such cases, the generator becomes the buyer of the MWH obligation at a floating price (the Day-Ahead or Real-Time market price) and the load becomes the seller of the MWH obligation referencing delivery to a specific node.

By becoming the buyer, the generator pays an amount under the transaction that is determined by floating market prices and the load (as the seller) receives an amount that is determined by the floating price of the MWH obligation. These transactions are integrated with, and involve the sale, purchase and delivery of electricity from the generator to the load by: 1) off-setting ISO-market floating price positions leaving the parties with no exposure to the ISO-market floating price of electricity; and 2) leaving a remaining off-market obligation that is functionally the equivalent of a forward contract for the sale of electricity at a fixed price.

2. Market participants with both generation and load affiliates that trade independently also may use IBT transactions to manage their overall rights from, and obligations to, the ISO markets. If, for example, a corporate parent has two subsidiaries – one that is a generator and another that is an LSE – IBT transactions may be used to allow netting of existing ISO market positions held by the generator and LSE. Thus, for example, a generator can transfer its right to receive the ISO floating price payment to an affiliated LSE in exchange for an off-market obligation by the LSE to pay the generator a fixed price for its contribution of a specified amount of electricity to the ISO pool. After the exchange, the LSE has both an obligation to pay a floating price to the ISO and the right to receive a floating price payment from the ISO for the specified amount of electricity. This nets the LSE's payment to and from the ISO market in exchange for an off-market obligation by the LSE to pay the affiliated generator a fixed price for the specified amount of electricity contributed to the ISO pool. Thus, the two affiliates have exchanged the generator's ISO market position for an off-market obligation of the LSE to pay the generator a fixed price for electricity. This integrated transaction effectively converts the floating price market obligations of the affiliates into the functional equivalent of a fixed price

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<sup>4</sup> As noted above, throughout the Supplemental Request, "clearing" is used as defined in section 1a(15) of the Act. In terms of the operation of the ISO, the obligation is presented for settlement to the ISO.

forward contract between the two affiliates for the purchase and sale of a specified amount of electricity.

It is important to note several elements described above regarding both of these types of transactions. First, they do not impact the determination of electricity prices in any ISO NE market; rather, the ISO settles established positions using market-set prices. Second, IBTs may be submitted electronically to the ISO in advance, but they are accepted for settlement through the ISO only for same day or next day settlement. Accordingly, if submitted in advance, an IBT can be withdrawn at will until it is accepted by the ISO for same day or next day settlement. No collateral is required for IBTs submitted in advance; collateral is only required during the same day or next day settlement period in which the IBTs are being settled. Moreover, the fixed price obligations are off-market positions that are not settled through the ISO's settlement systems. Finally, it should be noted that ISO NE is not requesting under this Supplemental Request that the Commission grant any relief or make any determination with respect to the off-market component of IBT transactions which take place outside the ISO market and are not submitted to the ISO NE settlement systems.

*IBT Transactions are Comparable to EDRPs Used in the Futures Markets*

As noted above, these typical uses of IBT transactions (like Financial Transmission Rights ("FTRs")) are integrated with the operation of the ISO in their mission to provide electricity to the wholesale power markets within their respective service areas. The ISO accepts these transactions for clearing using similar mechanics historically used by the futures markets to bridge the cash and futures markets--the Exchange of Derivatives for Related Positions ("EDRPs").

Under an IBT transaction, two parties to a contract for the purchase and sale of electricity agree to submit a bilaterally negotiated off-market obligation ("Related Transaction") to the ISO for clearance and settlement at an ISO-market determined price through the creation or exchange of a related market position ("ISO Position"). One party is a buyer of the off-market Related Transaction and the seller of an ISO Position, and the other party a seller of the off-market Related Transaction and a buyer of an ISO Position. As will be provided under the ISO's amended Tariff, the term "Related Transaction" is a spot, forward or derivatives contract that contemplates the transfer of energy or a MW obligation to or from a Market Participant. And, the ISO Position may be any obligation that can be entered into on the markets administered by the ISO based on openly and competitively determined Day-Ahead, Real-Time, Ancillary Services, or Forward Capacity market prices.

Consistent with the requirements of proposed Commission rule 38.505 for bona fide EDRPs, the parties to an IBT transaction will be required by the ISO NE's amended Tariff to be separate beneficial owners of the obligations or, if affiliated parties, to be trading for separately controlled accounts or profit centers. As amended, the ISO's Tariff will further require that the IBT transaction involve commercially appropriate obligations that impose a real duty to transfer electricity or a MWH obligation from the seller to the buyer, or from the buyer to the seller, with performance taking place within a reasonable time in accordance with prevailing cash market

practices. Moreover, ISO NE's Tariff as amended will prohibit an IBT from being contingent on any other obligation.

As noted above, the prices at which the transactions occur are the prices determined in a competitive ISO administered market and thus the components of the overall transaction will be priced at differentials reflecting commercial realities and prevailing market conditions. Finally, the ISO-related contracts will be for an amount which reflects the notional amount of the underlying off-market electricity or MWH obligation. All of these conditions are consistent with the requirements of proposed Commission rule 38.505 for bona fide EDRPs.

ISO NE's Tariff will provide a number of requirements to safeguard against the use of non-bona fide IBT transactions. Under ISO NE's Tariff as it will be amended, each IBT transaction will be separately identified in the records of the parties to the transaction and of the ISO. All IBT transactions will be settled through the ISO acting as the CCP. Further, each party to an IBT transaction is required to maintain, and produce upon request to ISO NE, records demonstrating compliance with the Tariff provisions governing these transactions. The required records must include information relating to:

1. the identity of the counterparties; and
2. the material economic terms of the Transaction, including the price, tenor, quantity and execution time of the Transaction.

The amended Tariff provisions governing these transactions all provide that each party have prior authorization from ISO NE to enter into IBT transactions and provide upon request of the ISO information demonstrating compliance with all transaction requirements. ISO NE retains the authority to not permit or to cancel an IBT transaction that the ISO determines does not comply with its requirements.

#### **IV. Exemption Criteria of Section 722 of the Dodd-Frank Act (section 4(c)(6) of the Act)**

As discussed in greater detail in the Consolidated Request for Exemptive Relief, section 4(c)(6) of the Act, as added by the Dodd-Frank Act, provides that the Commission shall exempt contracts, agreements or transactions entered into pursuant to a tariff or rate schedule approved or permitted to take effect by FERC if it determines such exemption is consistent with the public interest and the purposes of the Act.<sup>5</sup>

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<sup>5</sup> The Dodd-Frank Act amendments to section 4(c) became effective on July 16, 2011. Specifically, section 4(c)(6) of the Act provides that:

If the Commission determines that the exemption would be consistent with the public interest and the purposes of this Act, the Commission shall, in accordance with paragraphs (1) and (2) [of section 4(c) of the Act], exempt from the requirements of this Act an agreement, contract, or transaction that is entered into—

(A) pursuant to a tariff or rate schedule approved or permitted to take effect by the Federal Energy Regulatory Commission;

Paragraphs (1) and (2) of section 4(c) are incorporated by reference in section 4(c)(6). Paragraph (1) provides that the Commission, after notice and opportunity for hearing, may upon application of any person, exempt any agreement, contract, or transaction and any persons or class of person offering, entering into, rendering advice or rendering other services with respect to that agreement, contract or transaction from any of the requirements of the Act. Paragraph (2) provides that the Commission shall not grant an exemption unless it determines that:

1. the exemption would be consistent with the public interest and the purposes of this Act;
2. the agreement, contract or transaction will be entered into solely between appropriate persons; and
3. the agreement, contract or transaction will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act.<sup>6</sup>

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(B) pursuant to a tariff or rate schedule establishing rates or charges for, or protocols governing, the sale of electric energy approved or permitted to take effect by the regulatory authority of the State or municipality having jurisdiction to regulate rates and charges for the sale of electric energy within the State or municipality; or

(C) between entities described in section 201(f) of the Federal Power Act (16 U.S.C. 824(f)).

<sup>6</sup> Section 4(c) of the Act provides in part:

(1) In order to promote responsible economic or financial innovation and fair competition, the Commission by rule, regulation, or order, after notice and opportunity for hearing, may (on its own initiative or on application of any person, including any board of trade designated or registered as a contract market or derivatives transaction execution facility for transactions for future delivery in any commodity under section 5 of this Act) exempt any agreement, contract, or transaction (or class thereof) that is otherwise subject to subsection (a) (including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract, or transaction), either unconditionally or on stated terms or conditions or for stated periods and either retroactively or prospectively, or both, from any of the requirements of subsection (a), or from any other provision of this Act . . . .

(2) The Commission shall not grant any exemption under paragraph (1) from any of the requirements of subsection (a) unless the Commission determines that—

(A) the requirement should not be applied to the agreement, contract, or transaction for which the exemption is sought and that the exemption would be consistent with the public interest and the purposes of this Act; and

(B) the agreement, contract, or transaction—

(i) will be entered into solely between appropriate persons; and

(ii) will not have a material adverse effect on the ability of the Commission or any contract market or derivatives transaction execution facility to discharge its regulatory or self-regulatory duties under this Act.

As with the contracts, agreement and transactions discussed in the Consolidated Request for Exemptive Relief, ISO NE requests that the Commission clarify and provide legal certainty that IBT transactions fall within the terms of the amended exemptive Order without first making a determination as to the status or classification of the transactions under the Act; or with respect to, or in connection with these transactions that: (i) ISO NE operates Swap Execution Facilities or provides clearing services that require registration as a Derivatives Clearing Organization; or (ii) ISO NE market participants or those rendering advice with respect to such transactions are subject to any requirements under the Act with respect to these transactions, except for those sections of the Act reserved in the Order requested in the Consolidated Request.

ISO NE through this Supplemental Request is neither suggesting or requesting that the Commission, in making a determination to exempt IBT transactions under section 4(c) of the Act, also is making a determination with respect to the applicability of the Act and Commission regulations thereunder or the regulatory requirements that may, or may not apply, to any spot, forward or derivatives contract for the purchase or sale of electricity or a MWH obligation that takes place outside of the ISO settlement systems.

**V. The Supplemental Request is Consistent with the Public Interest and Purposes of the Act**

The Consolidated Request for Exemptive Relief details the long-standing regulatory framework established by FERC for the offer and sale of the transactions discussed therein. IBT transactions are also part of, and inextricably linked to, the organized wholesale ISO NE electricity market that is subject to FERC's comprehensive regulation and oversight. The Consolidated Request for Exemptive Relief demonstrates that the regulatory framework that FERC administers and that applies to the transactions offered and sold in the ISO/RTO markets are consistent with the public interest, as defined by Congress in the FPA<sup>7</sup> and as defined by section 3 of the Act. The offer and sale and clearing of IBT transactions, as demonstrated in this Supplemental Request, is similarly consistent with the public interest as defined by section 3 of the Act, and with the specific Core Principles and Commission precedent relating to similar transactions carried out in the futures markets.

Section 3 of the Act describes the public interests served by the Act as ensuring that the benefits of providing a means for managing or assuming price risk and discovering prices occurs through trading in liquid, fair and financially secure trading facilities. Section 3 describes as the purposes of the Act to foster these public interests by, among other things, deterring and preventing price manipulation or any other disruptions to market integrity; ensuring the financial integrity of all transactions subject to the Act; and protecting market participants from fraudulent or abusive sales practices. IBT transactions as carried out under the Tariff of ISO NE and overseen by FERC meet all of these section 3 goals.

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<sup>7</sup> See discussion of declarations of public interest in the FPA, Consolidated Request for Relief, pp. 12-13.



As discussed in the Consolidated Request for Exemptive Relief, under section 201(b)(1) of the FPA, FERC's jurisdiction is comprehensive.<sup>8</sup> FERC has recognized that IBTs offer an important method to reduce systemic risk through the netting or offsetting of a market Participant's payment obligations to an ISO/RTO and that IBTs encourage LSEs to purchase longer-term bilateral contracts from wholesale suppliers. Accordingly, FERC has determined to encourage the use of IBTs by ISO/RTOs. Specifically, FERC stated in its 2004 Policy Statement on Credit-Related Issues for Electric OATT Transmission Providers, Independent System Operators and Regional Transmission Organizations, that, "three basic types of netting should be adopted, to the extent practicable, by ISO/RTOs: . . . 3) netting internal bilateral energy contracts."<sup>9</sup> Thus, FERC, operating within its jurisdiction and pursuant to its Congressional mandate has determined that IBTs are in the public interest as defined and protected by the FPA.

## **VI. The Transactions Facilitate Market Participants' Ability to Lock in Long-Term Prices**

As explained above, IBT transactions further the goal of, and make possible, longer-term power arrangements. They do so by making such longer term contracts possible within the wholesale markets administered by the ISO for competitively priced, floating rate Day-Ahead and Real-Time markets. The formation and structure of these floating priced Day Ahead and Real Time markets were encouraged, and are regulated and overseen, by FERC.<sup>10</sup> Below we demonstrate how IBT transactions as provided under the amended Tariff of the ISO are consistent with the public interest and purposes of section 3 of the Act (*i.e.*, to provide for trading in liquid and fair trading facilities). This is specifically evidenced by IBT transactions meeting the bona fide EDRP requirements of section 5(d)(9) of the Act.

### **1. Futures-style Exchange Of Derivatives For Related Positions**

In the futures markets, exchanges of futures for physicals ("EFPs"), more recently referred to as exchanges of derivatives for related positions, or EDRPs, fulfill a very similar market function as, and operate in a manner very similar to, IBT transactions. Like IBT transactions, EDRPs are the transactions that link the cash or OTC bilateral markets with the exchange-traded futures markets. An EDRP is a Congressionally-approved process for bringing off-market transactions to the centrally traded and cleared futures markets at a negotiated price consistent with commercial market realities. Section 5(d)(9) provides that boards of trade, among other conditions, in order to be designated as a contract market, must in their operation:

<sup>8</sup> 16 U.S.C. § 824(b)(1), provides that, "[T]he Commission shall have jurisdiction over all facilities for such transmission of electric energy in interstate commerce and to the sale of electric energy at wholesale in interstate commerce . . . ."

<sup>9</sup> "Policy Statement on Credit-Related Issues for Electric OATT Transmission Providers, Independent System Operators and Regional Transmission Organizations," FERC Docket No. PL05-3-000 (November 19, 2004).

<sup>10</sup> FERC Order No. 2000 encouraged the formation of ISO/RTOs to operate the electric transmission grid and to create organized wholesale electric markets.

provide a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade. The rules of the board of trade may authorize, for bona fide business purposes . . . an exchange of—(I) futures in connection with a cash commodity transaction; (II) futures for cash commodities; or (III) futures for swaps . . . .

An EDRP, like IBT transactions, involves separate but integrally related transactions in the same or a related commodity. To be a bona fide EDRP transaction, there must be a price correlation and quantitative equivalence between transaction legs. An EDRP transaction consists of a buyer of a cash contract or a derivative who is the seller of the corresponding related exchange position, and a seller of a cash contract or derivative who is the buyer of the corresponding exchange position. EDRPs enhance price discovery by providing an additional mechanism for tying the cash (and derivatives) markets to the futures markets, enhancing transparency as transaction details are publicized and reducing counterparty credit risk by bringing bilateral cash or derivative market obligations to be cleared by a CCP.

EDRPs have been a common, and readily accepted market transaction for more than 75 years. Their use pre-dates the Act. In 1920, while observing grain trading at the Chicago Board of Trade, the Federal Trade Commission noted the acceptance of EFPs as a bona fide form of exit transaction.<sup>11</sup> In 1936, when Congress adopted the Act, it included section 4c(a), which in relevant part explicitly permitted EFPs, stating that:

Nothing in this section shall be construed to prevent the exchange of futures in connection with cash commodity transactions or of futures for cash commodities, . . . if made in accordance with board of trade rules applying to such transactions and such rules shall have been approved by the Commission.

Congress included this provision in recognition that “the exchange of cash commodities for futures is a common and necessary practice.”<sup>12</sup>

The Commission in 1998 issued a Concept Release to consider the regulation of off-market transactions, including EFPs.<sup>13</sup> After a number of intervening studies and proposals, the Commission in 2010 as part of its implementation of the amendments to the Act by the Dodd-Frank Act, proposed Commission rule 38.505.<sup>14</sup> Commission rule 38.505, which remains pending, would codify bona fide EDRP principles first announced in the 1998 Concept Release for a bona fide EFP transactions.

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<sup>11</sup> Report of the Federal Trade Commission on the Grain Trade, Vol V, at 146-48 (1920).

<sup>12</sup> Commodity Short Selling, H.R. Rep. No. 1551, 72d Cong., 1st Sess. 3 (1932). As discussed further below, the relevant language in section 4a(c) of the Act remained substantially unchanged until the passage of the Commodity Futures Modernization Act of 2000 (“CFMA”), when the provisions recognizing EDRPs were transferred from CEA section 4a and to new Core Principle 9 for designated contract markets (“DCMs”).

<sup>13</sup> 63 *Fed. Reg.* 3708 (January 26, 1998) (“Concept Release”).

<sup>14</sup> “Core Principles and Other Requirements for Designated Contract Markets,” 76 *Fed. Reg.* 14825 (June 3, 2011).

Under rule 38.505(a)(2), a bona fide exchange of derivatives for related positions transaction must include separate but integrally related transactions involving the same or a related commodity, where there is a price correlation and quantitative equivalence between the derivative and related position legs, and a buyer of a derivative who is the seller of the corresponding related position, and a seller of a derivative who is the buyer of the corresponding related position. In addition, proposed rule 38.505(a)(2) provides that EDRPs must result in an actual transfer of ownership of the related position, which must take place between parties with different beneficial owners or, if between affiliates, between affiliates under separate control. Proposed rule 38.505(a)(2) would also require that the price differential between the futures leg and the commodities or derivatives leg or position should reflect commercial realities, and at least one leg of the transaction should be priced at the prevailing market price. Finally, proposed Commission rule 38.505 includes special rules for transitory exchanges of futures and prohibits contingent exchanges of futures.

IBT transactions as described in this Supplemental Request, and as provided under the terms of the amended ISO NE Tariff provisions, are regulated comparably to EDRPs under proposed Commission rule 38.505(a) and come within the traditional guidance with respect to bona fide EDRPs as identified by the Commission's 1998 Concept Release. Accordingly, by being comparably regulated to the provisions of proposed Commission rule 38.505(a), IBT transactions further the goal of section 3 of the Act of operating fair and liquid markets.

## 2. Financially Secure Markets

Section 3 of the Act also establishes as a goal that the markets regulated by the Commission be financially secure. As discussed in the Consolidated Request for Exemptive Relief, ISO NE has determined, in response to recently issued FERC Orders No. 741 and 741-A,<sup>15</sup> to "reinforce the ability of the ISO/RTO to offset market obligations owed to market participants against market obligations owed by market participants" by becoming a CCP with respect to ISO NE transactions. As noted above, IBT transactions are cleared by ISO NE. These transactions tie related cash and derivatives transactions to the centrally traded and cleared ISO NE markets. The use of IBT transactions, as described above, permit market participants to net certain payments that arise in connection with the operation of the floating price Day-Ahead and Real-Time markets in relation to the longer-term contracts favored by many market participants, including generators and LSEs. These transactions, including their novation by the ISO as CCP, are in furtherance of the goal of the Act to reduce systemic risk.

## 3. Deterring Disruptions to Market Integrity

As discussed above, the Tariff of the ISO NE would require that those entering into IBT transactions meet a number of conditions which will deter market participants from entering into non-bona fide IBT transactions, in furtherance of the section 3 of the Act goal of deterring disruptions to market integrity. These conditions include requiring that each party have prior authorization from the ISO to enter into IBT transactions, that each IBT will be properly collateralized and represent to the ISO that the party meets all of the requirements for submitting such transactions to the ISO. In addition, as discussed above, IBT transactions will be required

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<sup>15</sup> "Credit Reforms in Organized Wholesale Electric Markets" ("Credit Reform Orders").

to be separately identified in the records of the parties and the parties will be required to keep full records relating to the transactions. The ISO can request that the parties make such information available as requested. The required records must include information relating to the full economic terms of the transactions, including information on the related cash or derivative transaction. ISO NE retains the authority to not permit or to cancel an IBT transaction that it determines does not comply with its requirements.

#### 4. Customer Protection

A third goal of section 3 of the Act is the protection of market participants from fraudulent or other abusive practices.<sup>16</sup> The protections that have been required by FERC with respect to the transactions covered by the Consolidated Request for Exemptive Relief, as discussed therein, apply equally to IBT transactions.

### VII. Enforcement.

ISO NE, ISO NE transactions, including IBT transactions, and ISO NE market participants are subject to comprehensive enforcement regimes pursuant to ISO NE's Tariff and FERC oversight. These are discussed in detail in the Consolidated Request for Exemptive Relief. Those authorities apply equally to the transactions which are the subject of this Supplemental Request. The ISO is not seeking exemptions from sections 4b, 4o, 6(c) or 9(a)(2) of the Act to the extent that those sections prohibit fraud in connection with transactions subject to the Act, or manipulation of the price of any swap or contract for the sale of a commodity in interstate commerce or for future delivery on or subject to the rules of any registered entity.

In addition to the market monitoring function required by FERC, the FERC-regulated ISO and the transactions covered by the Supplemental Request and market participants are subject to oversight by FERC's Office of Enforcement, Division of Energy Market Oversight, which conducts real-time monitoring of all markets subject to FERC's jurisdiction in its Market Monitoring Center. Daily information for each electricity market is posted at <http://www.ferc.gov/market-oversight/mkt-electric/overview.asp>. Moreover, the Division of Energy Market Oversight maintains regular communication with the independent ISO market monitors and analyzes all reports from the market monitors. FERC's Office of Energy Market Regulation also maintains regular communication with the ISO/RTOs.

### VIII. The Appropriate Person Requirement

Section 4(c)(2)(B)(i) of the Act requires that, in order to grant the exemptions requested herein, the Commission must determine that the agreements, contracts, or transactions that will be subject to the exemptions will be "entered into solely between appropriate persons." The term "appropriate persons," is defined for these purposes to include, *inter alia*, corporations or other business entities with net worth exceeding \$1,000,000 or total assets exceeding \$5,000,000."<sup>17</sup>

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<sup>16</sup> See section 3 of the Act.

<sup>17</sup> Section 4(c)(3)(F) of the Act.

“Appropriate persons,” also includes “[s]uch other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections.”<sup>18</sup>

In Order No. 741, FERC directed each of the ISO/RTOs to establish minimum criteria for market participants.<sup>19</sup> FERC did not specify the criteria the ISO/RTOs should apply, but rather directed them to establish criteria through their stakeholder processes.<sup>20</sup> Accordingly, ISO NE submitted to FERC proposals to establish minimum criteria for participation in their markets. As discussed in the Consolidated Request for Exemptive Relief, these proposals were accepted by FERC subject to a supplemental compliance filing to provide for verification of risk management policies and procedures. These criteria will apply equally to IBT transactions which are the subject of this Supplemental Request.

#### **IX. The Exemptions Will Not Have a Material Adverse Effect on the Ability of the Commission or any Contract Market to Discharge its Regulatory Function**

The Commission’s ability to discharge its statutory mandates will not be adversely affected by the requested exemptions. Under section 4(d) of the Act, the Commission will retain authority to conduct investigations to determine whether ISO NE is in compliance with any exemption granted in response to this request. As noted in the Consolidated Request for Exemptive Relief, the requested exemptions, including relief relating to the transactions covered by the Supplemental Request, consistent with section 722 of the Dodd-Frank Act, would also preserve the Commission’s existing enforcement jurisdiction over fraud and manipulation.

#### **X. Conclusion and Proposed Exemptive Orders**

As demonstrated above IBT transactions, as will be provided under the amended Tariff of ISO NE, would be comprehensively regulated by FERC in a manner which is comparable to the Commission’s regulation of highly similar transactions under section 5(d)(9) of the Act and Core Principle 9 for DCMs. Accordingly, the inclusion of IBT transactions within the section 4(c) relief requested by ISO NE is consistent with the public interest and the purposes of the Act as evidenced by the Core Principles with respect to markets and clearing organizations.

The amendment to the exemptive Order is being requested to ensure that the public interest in regulating these markets is met “in a manner so as to ensure effective and efficient regulation.”<sup>21</sup> Moreover, IBT transactions would only be entered into between appropriate persons, and the transactions will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act.

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<sup>18</sup> Section 4(c)(3)(K) of the Act.

<sup>19</sup> FERC Order No. 741 at 131.

<sup>20</sup> *Id.* at 132.

<sup>21</sup> See section 720 of the Dodd-Frank Act.

Accordingly, ISO NE asks that the Commission issue an Order under section 722 of the Dodd-Frank Act (section 4(c)(6) of the Act) supplementing the Order it requested under the Consolidated Request for Exemptive Relief, to provide greater certainty with respect to the regulatory requirements that will apply to ISO NE, IBT transactions, and ISO NE market participants. ISO NE asks that the Commission through the requested Supplemental Order amend the previously requested exemption without determining whether: (1) IBT transactions are swap, futures or option contracts within the meaning of section 1a of the Act; and (2) that ISO NE operates a Swap Execution Facility, DCM or provides clearing services in connection with the Transactions.

The text of the amendments to the requested Order is as follows:

In paragraph (a)(2), amend subparagraphs (iii), (iv) and (v), in paragraph (b), renumber subparagraphs (b)(6), (b)(7) and (b)(8) as (b)(7), (b)(8) and (b)(9) respectively and add a new subparagraph (b)(6) to read as follows:

(a) Scope.

(1) \* \* \*

(2) \* \* \*

(iii) Forward Capacity Transactions, as defined in paragraph (b)(4);

(iv) Reserve or Regulation Transactions, as defined in paragraph (b)(5); or

(v) Internal Bilateral Transactions, as defined in paragraph (b)(6).

(b) Definitions.

(1) \* \* \*

(6) "Internal Bilateral Transactions" mean transactions:

(i) Which constitute an exchange of an Energy Transaction, Forward Capacity Transaction, Reserve or Regulation Transaction for an off-market transaction ("Related Transaction"):

(A) Entered into at a price based on openly and competitively determined Day-Ahead, Real-Time Market, Ancillary Services, or Forward Capacity Market prices; and

(B) Where the Related Transaction, which is not cleared and settled by ISO NE as central counterparty, is a spot, forward or derivatives contract that contemplates the transfer of energy or a MW obligation to or from a Market Participant;

(ii) Which are executed between separate beneficial owners or separate parties trading for independently controlled accounts;

(iii) Where the Related Transaction must involve commercially appropriate obligations that impose a duty to transfer electricity or a MW obligation from the seller to the buyer, or from the buyer to the seller, with performance taking place within a reasonable time in accordance with prevailing cash market practices;

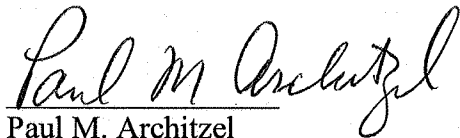
(iv) Where the Related Transaction is not contingent on either party to carry out the Transaction; and

(v) Where the Transaction and Related Transaction are separately identified in the records of the parties to the transaction; and where the Transaction shall be separately identified in the records of ISO New England and settled through ISO New England as the central counterparty.

(vi) Each party to the Transaction and Related Transaction shall maintain, and produce upon request of ISO New England, records demonstrating compliance with the requirements of this paragraph (b)(6) for the Transaction, the Related Transaction and any other transaction that is directly related to, or integrated in any way with, the Related Transaction, including the identity of the counterparties and the material economic terms of the transactions including their price, tenor, quantity and execution date.

(vii) Each party to such Transaction must have prior authorization from ISO New England to effect such Transaction and that such authorization may be provided on a blanket basis.

Respectfully submitted,



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