# policy and nodal markets

We ran into Ann Sacra, president of the Nodal Exchange, at the SNL/CCRO Risk Summit in Houston recently. She spoke of growth in her corner of the market and hinted at what might be ahead in light of possible policy changes coming down the pike. We followed up with her and CEO Paul Cusenza for more detail.

All eyes are on Capitol Hill right now. What happens in the coming weeks and months will have a huge impact on nodal markets – particularly in terms of credit and clearing, margining and the like. So, how is this changing your strategy or message?

"We believe in central counterparty clearing as being a good idea, regardless of whether it's mandatory or not. We don't know how the legislative elements will turn out, but we certainly understand why the government is so enamored with the central clearing model… it does reduce systemic risk," Cusenza says.

Of course, the Nodal Exchange is a unique proposition to begin with, given its clearing relationship with LCH. Sure they like central clearing, Cusenza says, because its part of their DNA. He also suggested that while mandatory anything typically isn't a popular play in competitive markets, and that while Nodal execs are not exactly lobbying Congress to push the central clearing model, he thinks that folks will gravitate to his market in any case. "We think we offer the right business decision in any case, whether government mandates clearing or not."

Consider all the participants in the market that you might want to do business with? he asks. Most you'll find aren't rated high enough to trade with, if they're even rated, he says. There's that financial credit crisis thing going on and all. "Half of the entities you'll come in contact with are not investment grade, and these are the companies who may be doing the volumes in the FTR markets, for example. And since in any market it's better to do business with more parties, and not less, at least on a pricing standpoint, you have few options but to clear," he says. "I didn't even bring up default risk, which is really what we're protecting against. All things considered, clearing is a bargain if price transparency and mitigating default risk are important to you."

Once clearing is mandated by the government (and he thinks it will be to a certain extent), the next question on people's minds should be "who's clearing model is best?" Cusenza says. After all, not all clearing is created or priced the same.

"The process might be the same, but the mechanisms in capital efficiency are quite different. We use VaR as the margining method. We believe it is the most effective way to do it. We think it more accurately accounts for the correlations and the risks associated with your positions," he says. Nodal offers inter-ISO margining for example, not just intra-ISO margining. He says spreads or other positions are correlated much like firms do internally. "Typically they use VaR." True enough.

Many competing exchanges that offer clearing services don't use VaR for margining, but choose the standard SPAN. We won't debate that particular question here, only to say that each methodology has particular benefits. We've never been totally convinced one is actually "better" than the other, but VaR is certainly in the minority for exchange margining.

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As for 2010, Cusenza says he's seeing "progressive growth" for the exchange, despite the drop in power demand, trading and thus congestion. The good news, of course, is that power demand is indeed coming back. We're noting upticks across the many ISOs, with month-on-month consistency. He says to watch Nodal for some big announcements in the near term.

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We read a release recently involving the Nodal Exchange and YesEnergy (note their regularly featured analytics for power markets on page 24). Sounded like a good match to us. YesEnergy developed an application set of price mapping tools specifically for Nodal customers (NodalView). We'll talk to the YesEnergy on this deal soon.



# sdg&e spanked (modestly) for wash trading

OK, so when we read the Wash Trading headline on the CFTC release, we thought it was a spoof. Seriously. Wash trades on NYMEX? Gas futures no less. Not like anybody is watching that stuff carefully or anything, right? Without reading past the first couple lines we reckoned the trader(s) involved must have been in middle school around the time of the Enron implosion. Nonetheless, the CFTC order was somewhat devoid of details, unlike wash trading cases in the past. What's up with that? Like, naming the perp and motive. The order accompanying the settlement states that "an SDG&E employee" contacted an introducing broker to place the trades. It mentions that SDG&E had established as a price hedge a long position in NYMEX natural gas futures for delivery months Aug thru Oct 2006. So an employee was involved and the motivation had something to do with that price hedge, presumably to maintain it going forward during that period. Without knowing more facts behind this gem here's our guess as to what is going on: The order also says in a footnote that "there is no allegation or finding that any SDG&E employee engaged in any fraudulent misconduct... [but that] the fact that SDG&E and it employees may have engaged in [wash trading] to effect a legitimate economic purpose is not a defense under the Act." So there was no bad motivation, and indeed, the order tacitly acknowledges that it was done for "a legitimate economic purpose." Reading between the lines, and the relatively low amount of civil money penalty (though $80K for a minor technical infraction is nothing to sneeze at), this means that the case was brought because the CFTC found a "technical" violation (that did no harm). We wonder if this had anything to do with high frequency trading? We understand that wash trades are (potentially) a frequent occurrence in that situation. Hmm. At deadline, the CFTC had not provided additional details to our various questions. More next time.