REPRINTED FROM
EnergyRisk
COMMODITY RISK MANAGEMENT • TRADING
Risk.net March 2017

Nodal plans power, gas options

Contracts to launch in 2017, while sceptics question the ability of a new exchange to compete with incumbents

Nodal Exchange is planning to launch power and natural gas contracts during the second quarter of 2017, the Virginia-based electricity futures exchange's chief executive officer has told *Risk.net*.

"In order to continue growing our market share, we will introduce options in 2017, which is a product we have not listed yet," says Paul Cusenza, chairman and chief executive of Nodal Exchange. "By having options, that will help us with some of the outright contracts we have not been as strong in."

Established in 2009, Nodal is an independent electronic commodities exchange that offers locational, or nodal, futures contracts to the organised North American electric power markets. Participants can manage basis and market risk using the exchange's offering of cash-settled futures contracts or over-the-counter transactions, which can be submitted to the exchange for clearing.

Nodal's options will physically settle into a futures contract, which then cash settles. The exchange is hopeful that having options will allow it to grow its volumes in natural gas. Though the exchange already offers natural gas products, Cusenza admits volumes are low. He says companies trade natural gas futures along with options, as evidenced by open interest in contracts linked to Henry Hub, the North American natural gas benchmark, being equally split between options and futures.

A greater presence in natural gas will benefit Nodal's customers because they can then enjoy benefits of cross-margining in their power portfolios as well as their natural gas business, he adds.

"The advantage is that customers can cross margin options with their power basis portfolio and other hub contracts that you already have on Nodal Exchange," he explains. "For some of our customers, we are the majority of their open interest and their activity and, because we didn't have the full solution, they have to maintain a relationship with someone else because they want options. Now they don't need to do that."

Nodal will launch a natural gas futures contract into which its options will settle. The new product will be a 'penultimate' contract, which refers to the fact that it expires one day earlier than the flagship Henry Hub contract owned by the Chicago-based exchange CME Group.

"We will launch a penultimate natural gas futures contract in conjunction with the gas options we plan to launch. The penultimate natural gas futures settles one day before the last day of the natural gas futures contract," confirms Demetri Karousos, managing director for market administration and surveillance at Nodal Exchange.

Paul Cusenza, Nodal Exchange

However, sceptics say Nodal may hit a wall in trying to compete with the incumbent exchanges because the new natural gas futures contract is a so-called 'look-alike' contract in that it has the same contract specifications of products listed on CME Group's Nymex and Atlanta-based Ice. While exchanges often lure in market-makers and participants by paying market-makers for order flow, or by slashing execution and clearing fees relative to the competition, critics say the real cost is associated with liquidity and tighter bid/offer spreads.

Albert Helmig, a former vice-chairman of Nymex who also served as president of the Hong Kong Mercantile Exchange, says look-alike contracts hosted by alternative exchanges face a number of hurdles and often struggle to attract liquidity.

"[There are] no real examples in last 30 years of an exchange getting critical mass by offering look-alike contracts," says Helmig, who now works as chief executive officer of Grey House, a New York-based consultancy he founded that advises market participants, exchanges and CCPs on risk-management margining issues. "[The] probability of success is low."

Helmig gives the example of Nasdaq Futures, or NFX, the upstart exchange that the New York-based company launched in 2015, which also offered look-alike contracts on West Texas Intermediate (WTI) crude oil. The exchange "has not 'poached' significant volumes or open interest from the incumbent exchanges," he says.

"All [Nodal] is offering is a different venue," he says. "[Nodal] is offering a clearing mechanism that may or may not be better or more capital efficient. But that doesn't mean they really have a lot of liquidity around it."

Cusenza rejects the comparison with Nasdaq. "Our situation is very different to the Nasdaq situation," he says. "In our case, we are a leader in the basis markets already … We have the most diverse set of locations you can trade on, we have the most liquidity in the basis markets, and the strange thing is that we don't have options that offer a complete solution. Very soon we will."

Nodal Exchange's volumes grew 97% in 2016 compared to 2015, while its share of the monthly power volumes traded was 15% in 2016 and more than 20% in January 2017. The exchange has 27% of the open interest on US power futures, according to the company.

Cusenza says the launch of Nodal's own clearing house – Nodal Clear – in 2015, played a big part in the company's ability to expand into options. Ever since trading on Nodal began in 2009, it had relied on London-based LCH.

To calculate margin requirements, Nodal uses a portfolio-margining approach tailored to the kinds of locational power futures the exchange specialises in. The approach, based on an expected shortfall methodology, is calibrated to cover a two-day loss to a 99.7% confidence level.

"We've been extremely strong in power basis markets and one of the reasons we wanted to self-clear was to introduce new products," he says.

As an example, Cusenza uses a contract linked to the market run by PJM Interconnection, the Pennsylvania-based regional transmission organisation for the sprawling wholesale power market extending across 13 states and the District of Columbia.

"If you look at a contract like PJM western hub real-time power, it is a contract that is the largest in the United States in terms of power and our market share of that product is not nearly as much as what it is in other markets. The reason for that is that we don't have options. People trade that contract as an outright contract and they like to marry that up with options contracts," he says.

"We are focused on the major hubs for options, that is where most of the trading is. But not having options there restricts our ability to serve the outright market, and so therefore we need to introduce it."

Whether or not the options product will be successful will also depend on the willingness of market-makers to get involved, which is linked to volumes and open interest.

"Market-makers come when they see there's liquidity. It becomes a chicken and egg situation," says Grey House's Helmig. "The challenge is to get successful very fast. Otherwise it can be dead on arrival."

Nodal declined to comment on entities that may be acting in a market-making role for the exchange or on details of its market-making programme.

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