EnergyRisk AWARDS 2016

Newcomer of the Year

NODAL CLEAR

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Nodal Exchange, the Virginia-based electricity futures exchange, took a big step forward last year when its new clearing house, Nodal Clear, went live after months – if not years – of preparation.

Ever since trading on Nodal began in 2009, it had relied on London-based LCH.Clearnet for clearing. By 2015, Nodal had more than 20% of the market in North American power futures, measured by open interest, and its leadership felt it was time to take the clearing function in-house. With both trading and clearing, Nodal would look more like the vertically integrated exchange giants it competes against, Chicago-based CME Group and Atlanta-based Ice, and it would capture more revenue from clearing fees.

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Paul Cusenza, Nodal Exchange

Nodal Clear, a wholly owned subsidiary of Nodal Exchange, became a registered derivatives clearing organisation (DCO) with the US Commodity Futures Trading Commission (CFTC) on September 24 last year. On October 19, Nodal migrated all the positions of all its participants from LCH.Clearnet to the new clearing house "in one big bang", recalls Paul Cusenza, chairman and chief executive of Nodal Exchange. The transfer of 340 million megawatt-hours' worth of futures positions, with a notional value of more than $24 billion, went smoothly.

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For a new clearing house to get off the ground, its clearing members need to contribute capital to its guarantee fund, the pool of money drawn upon in the event of a clearing member default. In the case of Nodal Clear, a dozen clearing members – including Bank of America Merrill Lynch, BNP Paribas, Citi, Goldman Sachs and Macquarie – placed a collective $100 million in the guarantee fund in October 2015.

Notably, Nodal Clear also contributed $20 million of its own capital to the default waterfall. In the event of a default, the clearing house would use the initial margin and guarantee fund contribution of the defaulting member, but Nodal's own $20 million would be used in front of the surviving members' contributions. At a time when some clearing houses have come under criticism for failing to have enough 'skin in the game', Nodal is eager to show it is different.

"Of course, the intent is that we'll never need to use that money, because we have a robust risk model providing sufficient protection upfront," Cusenza says. "But from our perspective, we feel that putting up a significant amount of our own capital as a statement of confidence is very relevant."

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, calibrated to cover a two-day loss to a 99.7% confidence level – has won praise from clearing members.

"We have clarity on what Nodal is doing from a risk-management point of view," says a London-based banker in the derivatives and clearing unit at one of Nodal Clear's clearing members. "We have a complete and detailed level of breakdown."

Clearing members have also welcomed Nodal Clear's decision to register with the CFTC as a 'subpart C' DCO, a status that means the clearing house has voluntarily agreed to abide by the same rules as DCOs deemed systemically important by US regulators. No other US clearing house has sought such a status.

"The reason why we chose to do that is that our clearing members will be a lot happier if they know we are adhering to a standard as if we were systemically important, which means we are at the safest levels of how we do things and that we are regulated as such," Cusenza says.

Nodal is already reaping the benefits of clearing for itself. Cusenza says it has become easier to launch new products: in the fourth quarter of 2015, the exchange introduced 66 new contracts in 31 new locations, and it expects to launch natural gas futures and power options in 2016. Revenue is also up. Cusenza estimates that roughly a third of the revenue associated with trading and clearing Nodal contracts was going to LCH.Clearnet before the transition – revenue that is now staying in-house.

"As we sit here today, we are on pace to exceed our prior best year's annual revenue by over 90%," Cusenza says. "That is indicative of this dimension of the extra revenue as a nice thing to have." ■