THE Risk DESK

December 22, 2016 SPECIAL REPRINT

nodal exchange on markets

Exchange founder and CEO Paul Cusenza is about to finish out his firm's best year yet. And if gas and power prices -- and volatility – continue to rise as expected, 2017 should be even stronger. Last year around this time, Nodal Exchange launched Nodal Clear, thereby adding in-house clearing services to the power derivatives mix. Since that time, Cusenza says business has been great. Earlier this year, Nodal added a Henry Hub gas basis contract as well, for the first time extending the platform beyond power basis futures. So, what about 2017? Growth and expansion for the exchange, he says. And the rest of the marketplace? "A lot of uncertainty," Cusenza says. Price, weather, the incoming administration, policy, you name it. "There are a lot more reasons for price hedging going forward," he says. No kiddin'. Cusenza noted that in Q1 2013, peak power at PJM West was $39. In 2014, it was $87. Last year, $90. And last month it was back at $53. If you trade power for a living, he says, "we have the best price hedging solution for you." The addition of clearing, he says, vaulted the operation to a whole new level, volume-wise. Prior to launching Nodal Clear in 2015, the exchange had a clearing relationship with LCH.Clearnet. Cusenza says that year-on-year volumes have essentially doubled since the introduction of Nodal Clear. "Bringing that together I view as more of an orchestration than anything," he says, "it involved our 12 clearing members, four settlement banks, the support of the ISBs, regulatory approval, and so on. Confidence is high in our markets, and the zonal growth is a reflection of that." Power markets have indeed seen some significant volume growth over the past year, and specifically in the more granular, zonal markets. "Power futures are up 13 percent across the country and up 10 percent at the hubs. In the zones and nodes, a 27 percent increase. And we're accountable for all of the zone and node growth in the US, and the majority of the hub volumes as well." PJM volumes were up 19 percent year on year, he says, but PJM zonal (nonhub volume) is up 51 percent. "This will continue to see very good growth, simply because this is the hedge that ultimately the physical traders both want and need." Policy and technology uncertainty play into the Nodal risk management strategy as well, he says. "There really is massive uncertainty out there in FERC-regulated markets. Look at demand response, on again, off again … what about renewables going forward? State and federal support may be completely different. So, the generation mix is now in flux. Distributed generation … transmission constraints … the list goes on," he says. "The more risks we see out there, the more granular a solution that market participants want."

Currently, he's been spending far more time on CFTC matters than anything else. "Chairman Massad has done an excellent job listening to and reaching out to all constituents, managing a lot of necessary changes to Dodd-Frank. But going forward, and I see two agencies with three openings each, both FERC and the CFTC will name a new chairman in 2017 and two additional commissioners each, shifting the commission majorities back to the GOP. What does this really mean? Again, more uncertainty." Cusenza's solution? "Hedge now while you can … " Funny guy.

Not wanting to delve too deeply into the politics of the moment, he did think current CFTC Commissioner Chris Giancarlo "would make an excellent chairman. His depth of knowledge and vast industry experience is extremely useful." True. Giancarlo has been a strong voice for the energy sector and commodities generally in the past couple years, helping to steer policy considered far more equitable to commercial customers, producers and end-users. All of which, in one way or another, plays into the growth story of each of the five exchange leaders we interview for this issue.

And despite issues with cross-border policy synchronization between US regulators and European or Asian regulators, one other consistent message we hear is the relative growth of foreign participation in our US commodity and energy markets. Cusenza says there's been continual interest in our markets from international players, "and a lot of looking outward too. The internet, improving economies, demand … the world is becoming a smaller place, and this I see as a natural migration that will continue," he says. "Over time this signals greater liquidity to our markets, and, on the other hand, this gives us the chance to expand internationally as well." *Expand internationally*? "Our focus, however, remains on North America."

Hmm. In our other exchange leadership interviews with ICE, CME and Nasdaq, the hint of foreign expansion, of

(Continued)

opening shop in far-flung markets or opportunistically acquiring foreign exchanges was both a hot topic and one that drew very different strategic responses. ICE sees a more distributed model, CME, more of a regional hub model. Given the state of international regulations, the maturing of economies, and the growth of the power sector around the world, we asked Cusenza how all of this plays into his hands.

"In our case, there's a little bit of both (central hub and distributed model)," he says. "We've developed strong relationships with many of the bigger, more global power or integrated energy companies who participate in our markets here in the US. So, if we go international, we might already have the basis or support to operate elsewhere." He said that like ICE, the distributed model would probably work best for power. "Local is best," he says. Unlike stock or equity exchanges, the local population has a far different relationship with commodities, whether it's power or grain we're talking about. "Power markets are very unique, they are all very different.

There are social and cultural aspects, environmental aspects, liquidity, the needs of market participants vary widely. You need to truly understand the local market, to assume nothing." So, think global, buy local? Something like that.

"For example, when ICE looks abroad, they may look and implement local but also leverage centralized knowledge, leveraging staff capabilities and technology, for example, from the US or elsewhere. To me this makes a lot of sense … "

It was clear in our discussion that Cusenza's response to the question on international expansion wasn't off the top of his head, although he demurred on confirming that some plan was already in the works. In his previous life at CapitalOne, he noted, global expansion was part of his role.

"We've always stayed abreast of international policies and regs that might impact us here … and we've always viewed ourselves as an organization with great long-term potential. Today, you can't ignore international environments when you think about broadening your market scope. We are always focused on our core markets, but we're also aware of opportunities that may become our core markets in the future."

Beyond the Henry Hub contract that was added this year, he says that the next big addition to the mix will be basis options in early 2017. Makes sense. In our discussions with CME's Derek Sammann, options have been somewhat of a saving grace for energy markets operators during these few years of painfully low prices. Nothing like options for smoothing out energy price volatility.

"Options weren't relevant when we started, but now we view options as a key leg of this multi-leg stool we're building. First the exchange, then clearing, futures, and now, options. In the beginning, trading was thin on many of the zones, so options weren't really necessary. It's different now. Look at Henry Hub, half of the open interest today is in options," he says. "Considering all the uncertainty we've already discussed, looking to 2017, we think our options business will be very well positioned, it should be a very strong play," he says. "We're looking forward to an exciting 2017 and 2018 for some longer-term projects. I think we have a lot of momentum going forward."