FERC Proposes Credit Policy Changes for Centralized Energy Markets

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On January 21, 2010, the Federal Energy Regulatory Commission ("FERC" or the "Commission") issued a Notice of Proposed Rulemaking, requesting comments regarding proposed reforms to credit practices in organized wholesale electric markets (the "NOPR"). *Credit Reforms in Organized Wholesale Electric Markets*, 130 FERC ¶ 61,055 (2010). Comments are due by March 29, 2010. Although the Commission has addressed credit policy issues before, the financial crisis and credit defaults in certain Regional Transmission Organization or Independent System Operator (collectively, "ISO") markets have brought credit policy issues to the fore. FERC recognizes that parties operating outside the organized markets typically use bilateral contracts and manage credit risk within the terms of those agreements, but also notes that the majority of transactions, based on quantity and volume, is in the organized wholesale electric markets. The Commission is particularly concerned about the potential for a large number of defaults in an ISO, because losses due to default in these markets are shared among market participants.

Each ISO has developed its own risk assessment, unsecured credit, and account settlement policies. But even before the financial crisis "began," the industry expressed concerns about the adequacy of the existing credit policies. The industry covered these issues and concerns at a January 2009 FERC technical conference on capital and credit issues. Also, both PJM Interconnection, LLC ("PJM") and the California Independent System Operator Corporation (the "CAISO") have recently revised their tariffs to modify their credit practices. The NOPR refers to these revisions with approval, but proposes that all ISOs be required to revise their tariff provisions regarding credit requirements and that the CAISO and PJM tariff revisions may not go far enough.

The Commission’s first proposal is a requirement that ISOs implement a settlement cycle of seven days or less, permitting another week for final payment. This may be an intermediate step prior to the implementation of daily settlement periods, which FERC suggests could be implemented a year after weekly settlement periods take effect. The Commission proposes shortening settlement periods because it believes that the degree of risk posed by credit exposure is largely "a function of the length of time between the completion of the various parts of electricity transactions, i.e. the provision of service, the billing for service, and the payment for service." FERC anticipates that shortening settlement periods

will lower the collateral requirements for individual participants, reduce the aggregate level of payables outstanding, enable the timely updating and use of transaction prices and charges, and allow for the earlier identification of default. However, the Commission is aware that shortening settlement periods may result in challenges for market participants. It will be necessary in many cases to update market software, which may delay other improvements and updates. In addition, market participants may need to implement new cash management facilities to handle the more frequent payments and to manage cash flow issues arising from a mismatch between the shortened settlement periods and the monthly payment cycle of retail buyers.

The Commission also proposes to limit the amount of unsecured credit that ISOs may extend to market participants. The Commission proposes a limit of $50 million per market participant. Recent CAISO tariff revisions reduced the level of unsecured credit that may be obtained by a market participant from $250 million to $150 million, and eventually to $50 million. FERC also asks for comments on whether or not there should be an aggregate cap for corporate families or different caps for markets of different sizes. The Commission notes that there will be less need for large amounts of unsecured credit if settlement periods are shortened and that it may be possible to eliminate the need for unsecured credit altogether by adopting daily settlement periods.

The Commission also proposes eliminating the use of unsecured credit in Financial Transmission Rights ("FTR") markets, because these rights are relatively illiquid and can quickly become unprofitable due to unforeseeable events such as unplanned outages and weather events. This proposal follows PJM's elimination of the use of unsecured credit in FTR markets following a default that it experienced in December 2007.

ISOs typically act as clearinghouses for the settlement and netting of transactions that occur in their markets; they do not "take title" to the underlying contract position by becoming a counterparty to the transactions. Citing problems that arose in the CAISO during the Mirant bankruptcy, the Commission proposes that ISOs be required to include in their tariffs a clarification of their status in a transaction. It appears that FERC is seeking such clarification to prevent the situation that arose during the Mirant bankruptcy where the CAISO was unable to net payments owed by Mirant against payments owed to Mirant because the CAISO had not "taken title" to the underlying contract position, with the result that the CAISO was junior to Mirant's other creditors in bankruptcy.

Another FERC proposal is for ISOs to include minimum criteria for market participation in their tariffs. The Commission does not intend for these criteria to be "onerous," as FERC does not want to exclude traditional market participants, such as cooperatives, small load serving entities, and

municipalities. However, the minimum criteria should assure that a market participant has adequate risk management capacity and adequate capital.

The NOPR also proposes that ISOs clarify which circumstances constitute a "material adverse change," justifying a demand for additional collateral. Although many FERC tariffs currently include a "material adverse change" clause, these terms can be ambiguous and create uncertainty regarding when additional collateral will be required. Ironically, a call for additional collateral at a late stage could result in the defaults that the additional collateral was intended to mitigate. Similarly, the Commission proposes a standardized timeframe for market participants to "cure" a changed credit position by posting additional collateral. The Commission suggests that two days would be a sufficient time period.

The Commission also requests comment about whether the new credit practices should be required of all market participants, since not all participants pose the same credit risks. Discussions with ISOs have revealed that municipalities, for example, are considered generally good credit risks.

Parties intending to comment in this proceeding may wish to consider:

- Potential cash flow problems due to the proposed shortened settlement periods for small entities engaged in retail sales;
- How "material adverse change" should be defined;
- Whether the new credit policies should apply equally to all markets and entities; and
- The implications of ISOs "taking title" to underlying contract positions; and other alternatives that may allow ISOs to reduce credit risk without "taking title," which could have other unintended consequences.

FERC wants tariff changes to implement its new credit policies to be filed by June 30, 2011 at the outside — to go into effect no later than 60 days after the filing — and also seeks comments on whether the proposed changes should be implemented sooner. The Commission has specifically requested that each of the ISOs submit comments.

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This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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