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UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Creditworthiness Standards for Interstate Natural Gas Pipelines	**)** **)**	**Docket No. RM04-4-000**

COMMENTS OF THE
NEW YORK INDEPENDENT SYSTEM OPERATOR, INC.

Pursuant to the Notice of Proposed Rulemaking issued February 12, 2004, in the above-captioned proceeding,[1] the New York Independent System Operator, Inc. ("NYISO") hereby respectfully submits these comments on creditworthiness standards for interstate natural gas pipelines.

The NYISO is a not-for-profit corporation responsible for providing open access transmission service, maintaining transmission system reliability, and administering competitive wholesale electricity markets in New York State. The NYISO acts as the settlement agent between buyers and sellers for transactions; those transactions totaled nearly $6.7 billion last year. The NYISO administers credit requirements pursuant to which each of its customers' risk profiles are determined and necessary collateral is collected and held to protect against defaults. The NYISO's evaluation includes an analysis of both the financial wherewithal of the customer and the nature and extent of the customer's participation in the NYISO-administered markets.

[1] *Creditworthiness Standards for Interstate Natural Gas Pipelines*, 106 FERC ¶ 61,123 (2004) ("NOPR").

Without the proper credit protections in place, any bad debt resulting from a default would be allocated among the remaining market participants.

Given the many similarities between the gas and electric industries, the Commission has a logical and long-standing precedent of sharing polices between the industries. Moreover, the Commission has statements in the record indicating that it intends to establish similar creditworthiness standards for the electricity industry. The recent credit downgrades for many energy companies pose the nearly identical concern of increased risk profiles for both the gas and electric industry. In response to increased credit risk, the NYISO, working through its stakeholder process for nearly three years,[2] created a comprehensive credit policy that has been largely accepted by the Commission and is currently being implemented.[3] Thus, the NYISO is well-situated to assist the Commission by submitting these comments in the instant docket.

[2] The NYISO stakeholder process requires that at least 58% of the market participants approve tariff modifications before such modifications can be filed with the Commission under section 205 of the Federal Power Act. The NYISO's credit policy filed with the Commission exceeded this threshold of support by market participants and was filed under section 205.

[3] The Commission is currently evaluating the aspects of the NYISO's credit policy dealing with prepayment provisions and improving billing cycles.

I. COMMUNICATIONS

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II. COMMENTS

A. <u>Executive Summary</u>

The NYISO strongly supports the Commission's initiative to develop creditworthiness standards for the natural gas industry and certain aspects of the electric industry. The NYISO submits that successful creditworthiness standards should be based on accepted business practices and trade credit principles. Rooting standards in this already familiar framework will help assure adequate collateral requirements to protect the market from defaults. This concept is critical because in many ISO / RTO situations market participants bear the burden of bad debts caused byinadequate collateral. The NYISO urges the Commission not to allow its commitment to reduce barriers to entry overshadow the need for adequate collateral to protect the market. To do otherwise would effectively force more creditworthy market participants to subsidize the less creditworthy market participants.

Further, NYISO believes that standardization is generally beneficial, but urges the Commission to continue to recognize the need for credit and security differences among the RTO/ISO markets as it has with other "regional" variations. Standardizing theevaluati on of a company's financial health and consequently its unsecured credit is completely logical. Current industrial rating mechanisms (*e.g.*, S&P, Moody's ratings) recognize that for purposes of determining a company's overall financial health, geography is largely irrelevant. However, applying generic financial or risk indices to specific electricity markets and products is a more complex task. Thus, the Commission should recognize that different geographic areas have very different electricity markets and that "generic" creditworthiness standards will need to be tailored to markets and products of varying stages of development and complexity.

Accordingly, the NYISO strongly urges the Commission to accommodate the existing Commission-approved credit policies that some ISOs / RTOs have developed when it considers generic standards for the electricity industry. To the extent the Commission intends to impose creditworthiness standards in the existing competitive electricity markets, the NYISO submits that its recently-approved comprehensive credit policy would serve as a rational, workable model.

B. Discussion

1. Overall Policy Comments

(a) Successful Credit Policies Must Be Based On Accepted Business Practices And Established Trade Credit Principles

The NYISO's extensive efforts in developing its creditworthiness policy have revealed the need for creditworthiness rules to be based upon accepted business practices and drawn from principles already in place for trade credit. The concept of managing risk is fundamental to nearly any business transaction and reliance on accepted business practices and established principles avoids reinventing the wheel. One good example of this is the established concept of treating different types of companies differently based upon the risk profile they present.

The credit industry has developed extensive rating systems that speak to the different risk profiles and default rates that different companies present. Based on these ratings, companies are classified into gross categories such as "investment grade" rated and "non-investment grade". It is proper, therefore, to treat different categories of customers differently based upon very real differences in their risk profiles. The Commission has recognized the legitimacy of treating different categories of customers in several places throughout the NOPR and the NYISO strongly supports this approach.[4]

(b) Collateral Requirements Should Be Commensurate With Risk Exposure To Adequately Protect The Market From Defaults

The NYISO understands and respects the Commission's commitment to reducing barriers to entry into the market but strongly urges the Commission not to let this objective overshadow the need to require adequate collateral to protect the market. In many areas, including the New York Control Area, bad debts created by inadequately collateralized market participants are allocated among the remaining solvent market participants. As such, leaning too heavily on the side of eliminating barriers to entry by reducing collateral requirements will inappropriately shift

[4] NOPR at PP. 15, 20 & 21.

the risks of bad debts to the remaining market participants. Such an approach would effectively subsidize less creditworthy market participants at the expense of "healthier" players – a result that appears to be at odds with competition.

Collateral requirements should be commensurate with risk exposure. The two broad variables that need to be assessed are (i) the financial risk profile of the customer and (ii) the nature and extent of the customer's transactions as a counterparty to the organization with which it is transacting. Classes of market participants that pose greater credit risk and / or have a greater volume of transactions in a market should logically post more collateral than a lower risk, lower volume market participant. As recognized by the Commission, a non-creditworthy market participant represents a higher risk profile and consequently should post greater collateral compared to a creditworthy market participant.[5]

It is imperative that all facets of risk be analyzed to assure that market participants post adequate collateral. Two examples help illustrate this point. First, if regulatory approvals are a precondition to termination, the time required to ascertain those approvals must been viewed as additional time that a party may continue accruing financial obligations while operating in default. As such, that additional time period during which exposure exists must be collateralized. Second, if there are billing and settlement issues that require an iterative billing process, subsequent re-bills (*e.g.*, "true-ups") may result in additional financial liability. Then, "true-up" liability represents a risk that may require additional collateral.

Moreover, assessing market participant's collateral requirements should be a dynamic process where the risk posed is periodically evaluated. When risk decreases an appropriate amount of collateral should be released. Conversely, when risk increases, the market participant

[5] NOPR at P. 20.

should be called upon to post additional collateral. In addition, while collateral is useful for an initial default, the NYISO strongly supports the view that termination may under certain circumstances be an appropriate remedy for default or failure to post collateral.

(c) Alternative Forms Of Collateral Provide Useful Flexibility For Market Participants

The NYISO supports the concept of allowing alternative forms of collateral to provide flexibility for customers that must provide security. The NYISO's credit policy allows market participants to post cash collateral, letters of credit, affiliate guarantees and surety bonds,[6] as well as netting of account receivables, and pay-down agreements. The NYISO developed these options to assure that customers had a number of avenues to fulfill NYISO's credit requirements and to reduce barriers to entry.

(d) Standardization Is Beneficial To The Extent Real Regional Differences Are Considered

The Commission's current initiative to standardize creditworthiness requirements generally makes sense, but the NYISO respectfully cautions that one size may not fit all industries. The gas and electric industries have notable differences that must be taken into account. Moreover, one size may well not fit all in areas even within the electric industry because many of the markets, and within different control areas, are either not the same or at different stages of evolution. Not all electric control areas even have markets, of the areas that do, some areas are highly congested, and some areas have very little congestion. Some ISOs run multiple markets (such as energy and ancillary services, installed capacity, virtual bidding,

[6] The NYISO requires "pay now, fight later" surety bonds where the surety must make payment immediately upon demand without prior demonstration of the validity of the demand.

transmission congestion contracts markets) while other ISOs run only energy markets. Consequently, standardization of creditworthiness requirements will have to take these very real market differences into account.

The NYISO strongly supports the standardized criteria for determining the financial wherewithal of a company without regard to the area in which the company is operating. These standards should be closely tied to the senior long-term unsecured debt ratings and default probability ratings of the major industry rating agencies such as Moodys, Fitch, and Standard and Poors or alternative substitutes for companies that do not have such ratings. The ultimate result of that consideration should be arriving at an amount, if any, of unsecured credit a company should be granted. This determination should be independent of the control area in which the company desires to operate.[7]

The determination of a company's collateral requirement will be more difficult to standardize based upon the different markets in a particular control area. Any policy imposed by the Commission will have to include all the components for the most complex markets and utilize only those components necessary for other less robustmarkets. For example, the policy would need to include how to calculate collateral requirements for a Transmission Congestion Contract ("TCC") market, but such component would not be used in a control area that did not run a TCC market. Moreover, the policy must allow for differences within markets that are similar, but not exactly the same. In short, some level of standardization is possible, but real differences need to be recognized.

[7] Under the NYISO's credit policy a transmission customer's unsecured credit is not allowed to exceed a specified threshold of the NYISO's total accounts receivables based on a historic period to guard against other market participants absorbing a fatal loss in the event of a default.

(e) The Progress Already Achieved Should Not Be Lost In A Haste To Adopt A Generic Standard

The NYISO has been working with its market participants and the Commission for nearly three years to develop its current comprehensive credit policy. Other ISOs have invested substantial effort as well to address default risks in their markets. The NYISO respectfully requests that the Commission carefully consider the intricacies of these different credit policies and allow them to largely remain in tact. Simply adopting generic and inflexible standards without recognizing the progress that has been made as a result of tremendous effort would place form over substance. Such an approach would likely be a backslide in sacrificing the progress made to date in the name of a "standard" policy that would not perform as well. To the extent that the Commission is interested in adopting a generic standard, the NYISO respectfully recommends that its recently-approved comprehensive credit policy would serve as arational, workable model.

2. Comments on Specific NOPR Provisions

(a) Adoption of the North American Energy Standards Board Standards (P. 6)

In addition to adopting the 10 consensus standards promulgated by the Wholesale Gas Quadrant of the North American Energy Standards Board Standards ("NAESB") regarding exchange of information between pipeline owners and shippers, the Commission also proposes to adopt additional standards. The NAESB standards, while useful, simply address the standards for information flow between a pipeline owner and shipper. The NYISO commends the

Commission for going beyond these procedural standards and proposing additional substantive standards.

While the Commission has noted the strong policy in favor of consensus standards,[8] the NYISO's experience has shown consensus standards are very difficult when dealing with diverse groups with opposed financial interests. Such situations require a central authority to ultimately impose standards as the Commission is in the process of doing in the instant docket.

(b) Adoption Of An Exclusive List Of Criteria To Evaluate Creditworthiness (PP. 18 & 19)

The Commission is proposing that the tariffs disclose the "objective criteria to be used in evaluating a shipper's creditworthiness" but also states that it will ensure the "basic standards a pipeline will apply in determining creditworthiness status."[9] The Commission seeks comment on whether it should adopt a defined set of criteria for determining creditworthiness, along with a list of criteria from those who support such an approach.

The NYISO believes the tariff should establish the basic standards, but it should not include an exclusive list or a rigid formula whereby credit determinations are mechanistically made. Taken to its extreme, such an approach would simply require inputs to a computer algorithm to make such determinations without human intervention. The NYISO urges the Commission to adopt a balanced approach of requiring the broad standards in the tariff, but also recognizing the expertise necessary in making these decisions. To adopt a rigid set of standards would preclude consideration of other factors that may be highly relevant in assessing a particular market participant's creditworthiness.

[8] NOPR at P. 13.

[9] NOPR at P. 18.

In the case of an ISO / RTO in the electricity industry, there are no financial motivations as with a pipeline owner in the gas industry. The very different financially disinterested and independent aspect of an ISO / RTO provides comfort in allowing more discretion in determining creditworthiness. Moreover, in most ISO / RTO situations, any bad debt resulting from a defaulting party that does not have adequate collateral is absorbed by the other solvent market participants. Such a situation argues heavily in favor of aggressive collateral requirements from an equitable perspective.

C. Conclusion

WHEREFORE, the New York Independent System Operator, Inc. respectfully requests that the Commission consider these comments and issue a final rule consistent as discussed above.

Respectfully submitted,

NEW YORK INDEPENDENT
SYSTEM OPERATOR, INC.

By *____/s/ Andrew S. Antinori____*
Andrew S. Antinori

April 2, 2004

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in Docket No. RM04-4-000 in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure 18 C.F.R. § 2010 (2003).

Dated at Albany, N.Y. this 2nd day of April, 2004.

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