FERC Order 741:
Credit Reforms in Organized Wholesale Electric Markets

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Background

Summary

- On January 21, 2010, FERC issued a Notice of Proposed Rulemaking (NOPR) to amend its regulations to reform credit practices in organized wholesale electric markets to ensure that credit practices in place in those markets reasonably protect consumers against the adverse effects of default.

- NYISO responded to the NOPR:

  a) in comments filed with the IRC,

  b) in comments filed with PJM and ISO-NE, and

  c) in a separate NYISO filing.

Summary

- On October 21, 2010, FERC issued a final rule in the NOPR proceeding: Order No. 741 – "Credit Reforms in Organized Wholesale Electric Markets."

- Order 741 requires each ISO/RTO to submit a compliance filing including proposed tariff revisions by June 30, 2011, with the tariff revisions to take effect on October 1, 2011.

Summary

- In November 2010, NYISO sought rehearing of Order No. 741 on one credit reform (ability to offset market obligations).

- On February 17, 2011, FERC issued Order No. 741-A denying all requests for rehearing on the ability to offset market obligations issue.
  - *FERC granted rehearing regarding the appropriate cap on the amount of unsecured credit extended to a corporate family, and reduced this cap from $100M to $50M.*

- FERC has extended the deadline for making a compliance filing with respect to the ability to offset market obligations to September 30, 2011, with tariff revisions to take effect January 1, 2012.

Communication Plan

- CPWG meetings:
  - *Monthly Status Updates – Progress toward NYISO compliance filing due June 2011*
  - *2011 Meetings currently scheduled for 1/25, 2/22, 3/25, 5/9, 5/23, 6/20*

- BAWG meetings:
  - *Monthly Status Updates – Con Invoice Redesign Project*
  - *2011 Meetings currently scheduled for 1/19, 2/16, 3/21, 4/12, 5/18, 6/17*

- "Credit Contacts" and "Billing Contacts" (as designated by each Market Participant):
  - *Copied on meeting notices & materials for all CPWG and BAWG (if applicable) meetings from November 2010 – October 2011.*
  - *Provided proposed calendar of 2011 settlements cycle dates & invoicing elements.*
  - *To be encouraged to participate in NYISO Market Trials for weekly invoicing.*
  - *Other ad hoc communications by NYISO as necessary.*

- BIC meeting:
  - *Summary of implementation plan – June/July*

Credit Reforms

Shortening the Settlement Cycle		
NOPR Proposal	**NYISO Comments**	**FERC Order**
Adopt a settlement period of no more than 7 days and allow no more than an additional 7 days to receive payment.	Summarize NYISO's governance process seeking to implement weekly invoicing. NYISO would require 9-12 months transition period to implement weekly invoicing. Consider limited carve-out for municipalities and state agencies.	Each ISO/RTO shall establish a billing period of no more than seven days and settlement periods of no more than seven days after issuance of bills (p. 17). FERC did not provide an exemption for municipalities and state agencies.

NYISO Software Automation Required: Market Information System, Billing and Settlement System, Credit Management System, Decision Support System, Con Invoice, Marketplace, Oracle Financials, Payment Application System (new)

Credit Reforms

Practicality of Daily Billing		
NOPR Proposal	**NYISO Comments**	**FERC Order**
Examine practicality of organized wholesale electric markets implementing daily billing periods within one year of implementation of weekly billing periods.	Do not believe that the Commission should mandate a movement to daily settlements at this time. Instead should allow each ISO/RTO to work with their stakeholders to research the proposal further.	Recognizing the benefits that will flow from requiring billing to be at least weekly, FERC will not require daily billing at this time (p. 19).

NYISO Software Automation Required: Not applicable at this time.

Credit Reforms

Use of Unsecured Credit – Individual Market Participant Cap		
NOPR Proposal	**NYISO Comments**	**FERC Order**
Limit the amount of unsecured credit extended to any market participant (upon migration to weekly invoicing) to no more than $50M.	Consistent with recent stakeholder discussions. Index fixed dollar amounts to current market prices, etc. Consider limited exception up to $85M for investment grade entities using unsecured credit to serve native load only.	Require each ISO/RTO to revise its tariff provisions to reduce the extension of unsecured credit to no more than $50M per market participant (p. 24). This limit is a ceiling, not a mandated amount (p. 26). FERC did not provide for exceptions to the cap or for indexing.

NYISO Software Automation Required: No new software development is required to implement this component of the rulemaking (can be accomplished in the Credit Management System by the Credit Department's adjustment of existing parameters).

Credit Reforms

Use of Unsecured Credit – Aggregate Corporate Family Cap		
NOPR Proposal	**NYISO Comments**	**FERC Order**
Examine whether there should be a further aggregate unsecured credit cap to cover an entire corporate family and whether the cap should be different for markets of different sizes.	NYISO supports the concept but asks that FERC allow each ISO/RTO a degree of flexibility in determining the appropriate dollar amount of the aggregate cap.	Require each ISO/RTO to revise its tariff provisions to account for a maximum level of $100M* in unsecured credit for all entities within a corporate family (p. 26). **Amount lowered to $50M per Order No. 741-A.* Parent guarantees are allowed, however, they are simply another form of unsecured credit and the amount utilized would be included in determining the appropriate level of unsecured credit for a market participant and corporate family cap (p. 28).

NYISO Software Automation Required: Software changes will be needed to Credit Management System to incorporate the concept of aggregated credit per corporate family.

Credit Reforms

Elimination of Unsecured Credit for FTR Markets		
NOPR Proposal	**NYISO Comments**	**FERC Order**
Eliminate unsecured credit in the FTR markets or their equivalent (i.e. TCC).	Recently included in NYISO's tariffs. NYISO would require limited carve-out to continue to exclude "Fixed Price TCCs" from this requirement.	Eliminate unsecured credit for FTR or equivalent (TCC) positions (p. 34). The Final Rule does not provide exemptions for holders of "fixed price TCCs," or other products, from the prohibition on the use of unsecured credit in this market as they may vary in value despite being called "fixed price" (p. 38).

NYISO Software Automation Required: No new software development is required to implement this component of the rulemaking (can be accomplished in the Credit Management System by the Credit Department's adjustment of existing parameters).

Credit Reforms

Ability to Offset Market Obligations		
NOPR Proposal	**NYISO Comments**	**FERC Order**
Market administrator clarify their status as a party to each transaction so as to eliminate any ambiguity or question as to their ability to manage defaults and offset market participant obligations.	The Commission's central counterparty proposal seeks to address a risk that is factually and legally remote. The NYISO's existing tariffs, agreements, and practices support a finding that the mutuality required to net through setoff in a bankruptcy context exists between the NYISO and its Market Participants. The benefit of becoming a central counterparty is unclear, but an increase in ISO/RTO costs is certain (e.g., increases in accounting, auditing, administrative, and regulatory compliance costs). Less disruptive means exist to address this perceived risk.	Require each ISO/RTO to include in its tariffs one of the following options: - Establish a central counterparty. - Require market participants to provide a security interest in their transactions. - Propose another alternative with the same degree of protection as the two above-mentioned methods. - Establish credit requirements for market participants based on their gross obligations (pp. 55-56).

<u>NYISO Software Automation Required:</u> Impact on NYISO systems & processes is dependent upon adoption of specific compliance approach.

Credit Reforms

Minimum Criteria for Market Participation		
NOPR Proposal	**NYISO Comments**	**FERC Order**
Each ISO/RTO should have language in their tariff to specify minimum participant criteria for all market participants.	Some minimum criteria for market participation could be beneficial, so long as the criteria are carefully crafted to ensure that they do not present an undue barrier to entry. Also, such minimum participation criteria must be recognized as just one component of aggregate credit risk management policies, and not viewed as a measure that prevents all potential defaults.	Require each ISO/RTO to include in its tariff, language to specify minimum participation criteria to be eligible to participate in the organized wholesale electric market (p. 62). Minimum criteria could include the capability to engage in risk management or hedging or to outsource this capability with periodic compliance verification to make sure each market participant has adequate risk management capabilities (p. 62). FERC directs each ISO/RTO to develop these criteria through their stakeholder process (p. 62).

NYISO Software Automation Required: Does not likely require any new software development.

Credit Reforms

Use of "Material Adverse Change"		
NOPR Proposal	**NYISO Comments**	**FERC Order**
Specify when a market administrator may invoke the material adverse change (MAC) as a justification for requiring more collateral.	Recommend that the list is not exhaustive and that each ISO/RTO are allowed to customize the list of material adverse changes to include in its tariff.	Require each ISO/RTO to specify in their tariffs the conditions under which they will request additional collateral due to a material adverse change. This list should be illustrative rather than exhaustive (pp. 68 – 69). Requires each ISO/RTO to provide reasonable advance notice to a market participant, when feasible, if invoking a material adverse change clause. It should be in writing, contain the reasoning and be signed by a person with authority to represent that ISO/RTO in such actions (p. 71).

NYISO Software Automation Required: Does not likely require any new software development.

Credit Reforms

Grace Period to "Cure" Collateral Posting		
NOPR Proposal	**NYISO Comments**	**FERC Order**
Limit to no more than 2 days the time period provided to post additional collateral when additional collateral is requested by the organized wholesale electric market.	Agree to establish an outer limit on the amount of time granted to post additional collateral.	Require each ISO/RTO to include in the credit provisions of its tariff, language to limit the time period allowed to post additional collateral to no more than two days (p. 76).

NYISO Software Automation Required: Does not likely require any new software development.

FERC Order 741 Implementation

Tariff Language Review

Credit Reform	Status
1. Shortening the Settlement Cycle	March 25 CPWG
2. Use of Unsecured Credit – Individual Market Participant Cap	Initial review at 2/22 CPWG; Final review at 3/25 CPWG
3. Use of Unsecured Credit – Aggregate Corporate Family Cap	Initial review at 2/22 CPWG; Final review at 3/25 CPWG
4. Elimination of Unsecured Credit in FTR Markets	Complete (reviewed at 2/22 CPWG)
5. Ability to Offset Market Obligations	TBD (Compliance filing due 9/30/11)
6. Minimum Criteria for Market Participation	May 9 CPWG
7. Use of "Material Adverse Change"	Initial review at 2/22 CPWG; Final review at 3/25 CPWG
8. Grace Period to "Cure" Collateral Posting	Complete (reviewed at 2/22 CPWG)

Minimum Criteria for Market Participation

Summary of FERC Order

- FERC directs each ISO to specify minimum participation criteria to be eligible to participate in the organized wholesale electric market, such as requirements related to adequate capitalization and risk management controls (¶131, page 62).

- FERC also directs each ISO to develop these criteria through their stakeholder processes and consider the minimum criteria that are most applicable to its market (¶132, page 62).

- Minimum participation criteria must apply to all Market Participants (¶133, page 63).

Summary of FERC Order

- FERC's suggested minimum participation criteria:
  - *Minimum criteria for market participation could include the capability to engage in risk management or hedging or to out-source this capability with periodic compliance verification, to make sure that each market participant has adequate risk management capabilities and adequate capital to engage in trading with minimal risk, and related costs, to the market as a whole* (¶131, page 62).
  - *Such standards might address adequate capitalization, the ability to respond to ISO/RTO direction, adequate expertise to transact in an ISO/RTO market and expertise in risk management* (¶133, page 63).

Proposed Credit Requirements

- FERC's order instructs the NYISO to consider:
  - *Expertise in risk management*
  - *Adequate expertise to transact in ISO market*
  - *Ability to respond to ISO direction*
  - *Adequate capitalization*

- It is expected that minimum participation criteria would apply to both current and future Market Participants.
  - *Failure to meet minimum participation criteria would constitute an event of default and could result in the suspension or termination of the Market Participant from the NYISO administered markets.*

  - *New applicants that do not meet the minimum participation criteria cannot become NYISO Market Participants until such criteria is met.*

Proposed Credit Requirements

- Each Market Participant will be required to provide a notarized officer certificate annually.
  - *One certificate will incorporate all minimum participation criteria.*
  - *An officer of the Market Participant, with signatory authority, will need to attest to the fact that the Market Participant meets all minimum participation criteria.*
  - *Notarized certificate must be received by January 31 each year.*

Proposed Credit Requirements

- Annual certificate must be in a form acceptable to the NYISO and will require attestation, at a minimum, to the following:
  - *Market Participant has written policies, procedures, and controls, approved by the Market Participant's governing body, which provide an appropriate, comprehensive risk management framework that at a minimum, clearly identifies and documents the range of risks to which the Market Participant is exposed, including, but not limited to, legal risk, credit risk, liquidity risk, custody and investment risk, concentration risk, default risk, operation risk, market risk, and business risk.*
  - *All employees or agents of the Market Participant with the right to bid or schedule in the NYISO-administered markets have adequate expertise to transact in such markets and have complied with the NYISO's training requirements. The certificate will need to include the names of its NYISO traders/users, the training courses attended, and dates taken.*
  - *Market Participant has established operating procedures and technical abilities that would allow the Market Participant to promptly respond to the NYISO's direction.*
  - *Market Participant is in compliance with the NYISO's minimum capitalization requirements.*

Proposed Credit Requirements

- Expertise in risk management
  - *Market Participant has established adequate risk management capabilities and policies after taking into consideration the following categories:*
    - Risk Management Culture And Governance
    - Risk Controls
    - Emerging Risks
    - Strategic Risk Management
  - *The NYISO is no longer planning to require submission of risk management policies and procedures, only certification by Market Participants that appropriate policies and procedures exist.*

Proposed Credit Requirements

- Adequate expertise to transact in ISO market
  - *Each Market Participant must have each of its NYISO traders/users (<u>e.g. persons authorized to bid and/or offer in the NYISO markets</u>) complete NYMOC (NY Market Orientation Course). Alternatively, the trader/user will have the option to complete a comprehensive exam in lieu of NYMOC.*
    - NYMOC currently offered four (4) times per year.
    - Traders/users would be considered grandfathered for this requirement if NYMOC has already been completed.
    - Comprehensive exam offered on-line beginning January 1, 2012 and trader/user must pass in order to be exempt from NYMOC.
    - Required once per trader/user.
  - *Each Market Participant active in the TCC market or Virtual Transactions must also have each of its NYISO traders/users complete training specific to those products.*
    - Training offered on-line. Beginning January 1, 2012, these training courses will conclude with a test to evaluate user understanding.
    - Required once per trader/user.

Proposed Credit Requirements

- Adequate expertise to transact in ISO market (continued)
  - *All traders/users must receive ongoing training via an on-line course each year thereafter.*
    - Annual training will be offered on-line beginning January 1, 2012. The course will include items such as market changes/issues, critical functions and conclude with a test to evaluate user understanding.
  - *Traders/users for new NYISO applicants, or for Market Participants new to the TCC market or Virtual Transactions, must complete training prior to the applicant becoming a NYISO Market Participant.*
  - *Current Market Participants will have twelve (12) months from October 1, 2011 to complete training.*

Proposed Credit Requirements

- Ability to respond to ISO direction
  - *Market Participant has established adequate operating procedures and appropriate technical abilities to effectively communicate and respond to NYISO requests.*
  - *The NYISO is no longer planning to require submission of operating procedures, only certification by Market Participants that appropriate procedures exist.*

Proposed Credit Requirements

- Adequate capitalization
  - *$1 million tangible net worth (TNW) based on that Market Participant/Guarantor's audited financial statements, OR*
  - *$10 million in assets based on that Market Participant/Guarantor's audited financial statements*
  - *Support for the above thresholds:*
    - The Commodities Exchange Act defines "eligible contract participant" to include business entities with assets in excess of $10M or net worth in excess of $1M. Transactions between eligible contract participants are exempt from many federal commodity and security regulations.
    - All other ISOs/RTOs are proposing similar requirements to both stated above.

Proposed Credit Requirements

- Adequate capitalization (continued)
  - *If a Market Participant cannot meet either of the two thresholds on the prior slide it must:*
    - Post $200,000 in security (e.g. cash, letter of credit, surety bond) to meet the minimum capitalization requirement.
    - For those Market Participants approved for the TCC market, provide $500,000 to meet the minimum capitalization requirement.
  - *Support for the above thresholds:*
    - Proposed levels provide a reasonable balance between demonstrating adequate capitalization to participate in the NYISO markets and potential barriers to market entry.
    - With limited exceptions, most NYISO bad debt losses have approximated $200,000, which include losses from each market (i.e. Energy, Capacity, TCC and Virtual Transactions).
    - TCC market risks are unique as they are difficult to quantify because of the longer duration and unforeseeable events such as outages and weather. Moreover, TCCs are relatively illiquid, which adds to the inherent risk in their valuation.
    - CAISO currently requires $500,000 for participation in its annual CRR auctions.
    - At least four other ISO/RTOs are proposing similar requirements.

Proposed Credit Requirements

- Adequate capitalization (continued)
  - *Example:*

MP	Energy and Other	TCC	Virtual Bidding	Capitalization Amount
1	x			$200k
2			x	$200k
3	x		x	$200k
4		x		$500k
5	x	x		$500k
6	x	x	x	$500k

Ability to Offset Market Obligations

Summary of FERC Order

- FERC directs each ISO/RTO to submit a compliance filing that includes tariff revisions to include one of the following options:
  - *Establish a central counterparty.*
  - *Require market participants to provide a security interest in their transactions in order to establish collateral requirements based on net exposure.*
  - *Propose another alternative, which provides the same degree of protection as the two above-mentioned methods.*
  - *Choose none of the three above alternatives, and instead establish credit requirements for market participants based on their gross obligations (¶ 117, pages 55-56).*

Request for Clarification

- On November 22, 2010, the NYISO submitted a request for clarification, or, in the alternative, for rehearing regarding the ability to offset market obligations:
  - *The NYISO sought clarification that, as used by FERC, the term "gross obligations" refers to a Market Participant's gross obligations across product or service categories (e.g., Energy, ICAP, TCCs, Virtual Transactions) and not its positions within product or service categories.*
  - *The NYISO sought confirmation that its existing credit practices satisfy the option to establish credit requirements based on gross obligations because the NYISO does not net across markets, but rather establishes separate credit requirements for each product and service category.*
  - *In the alternative, the NYISO requested rehearing on the basis that the equitable doctrine of recoupment provides an adequate basis to support the NYISO's current credit practices.*

Summary of FERC Order 741-A

- On February 17, 2011, FERC issued Order 741-A, which, among other things, denied rehearing on the issue of offsetting market obligations.
  - *In denying rehearing, the Commission remarked that in Order No. 741 it established requirements to minimize risk in the event of a market participant bankruptcy out of concern that the effect of a default could be exacerbated by a bankruptcy court decision that does not allow netting. The Commission commented that its concerns exist whether netting is performed within a market product category or across market categories (¶ 22, page 12).*
  - *The Commission also stated that it believes netting within product categories may put an RTO or an ISO at risk, were it not to adopt one of the remedies specified in Order No. 741 (¶ 23, page 13).*

Summary of FERC Order 741-A

- On February 17, 2011, FERC issued Order 741-A, which, among other things, denied rehearing on the issue of offsetting market obligations (continued).
  - *In response to Morgan Stanley's concern that establishing credit requirements based on gross obligations would be too costly and not commercially practicable, the Commission stated that such a requirement would apply only if the ISO/RTO did not take advantage of one of the other options given by the Commission (i.e., establishing a single counterparty or taking a security interest in receivables)(¶ 24, pages 13 - 14).*

Establish a Central Counterparty

- Description
  - *Establish a single counterparty to all Market Participant transactions.*
  - *For example, include language in tariff that NYISO takes title to all products bought and sold in its markets as the original counterparty to all market transactions*

- Points of Consideration
  - *May provide additional support that debts between the NYISO and the market participant are "mutual debts."*
    - Mutuality is required to net through setoff in the bankruptcy context.
    - Taking title as a central counterparty is a common mechanism for establishing mutuality.

Establish a Central Counterparty

- Risks and Implications
  - *Tax Concerns*
    - If the NYISO takes title to all products bought and sold in its markets, the NYISO may be subject to certain taxes.
    - Currently researching potential implications.
  - *Accounting Treatment*
    - Implications to NYISO financial statements are currently being reviewed by NYISO's auditors.
  - *Debt Covenants*
    - Approach likely does not affect the NYISO's debt covenants.
  - *Insurance*
    - Currently researching potential implications to insurance coverages.

MP Security Interests

- Description
  - *Require Market Participants to provide a security interest in the receivables of their NYISO transactions in order to establish collateral requirements based on net exposure.*

- Points of Consideration
  - *Under this option, the NYISO would not need to establish mutuality to protect its netting practices in the bankruptcy context.*
  - *The NYISO would become a secured creditor in the Market Participant's receivables from the NYISO.*
    - In the event the Market Participant files for bankruptcy protection, the NYISO would have a property interest in the Market Participant's receivables that it could use to satisfy the debt owed by the Market Participant to the NYISO.

MP Security Interests

- Points of Consideration *(continued)*
  - *May not be available to all Market Participants.*
    - Some Market Participants may be prohibited by law (e.g., municipalities), or pursuant to the terms of their existing lending arrangements from granting a security interest in its NYISO receivables.
    - *If a Market Participant cannot provide a first priority security interest in its receivables, it would be subject to credit requirements based on its gross obligations, which could substantially increase its costs.*
  - *Some increase in legal and administrative burdens and costs related to entering into Security Agreements with Market Participants and filing UCC-1 financing statements to secure the NYISO's interest in the receivables.*

MP Security Interests

- Potential Implementation Requirements
  - *The NYISO would need to develop a form Security Agreement for Market Participants to use to grant the NYISO a security interest in its NYISO accounts receivable.*
  - *A Market Participant with existing liens on its NYISO accounts receivable would need to obtain lien waivers from those lien holders prior to entering into a Security Agreement with the NYISO.*
  - *The NYISO would need to file a UCC-1 financing statement to perfect its interest in the Market Participant's NYISO accounts receivable and establish the priority of its security interest.*
    - The law in the jurisdiction where the debtor is located generally governs perfection and priority issues (e.g., the appropriate location for filing the UCC-1).

Another Alternative?

- Description
  - *FERC's order provides the opportunity for an ISO to propose another alternative, which provides the same degree of protection as the two above-mentioned methods (central counterparty or Market Participant security interests).*
- Points of Consideration
  - *The NYISO and Market Participants would need to develop an alternative that provides the same degree of protection for ISO/RTO netting practices as the central counterparty or security interest alternatives.*
  - *FERC must approve the proposed alternative, and as evidenced by its Order 741-A opinion, FERC may not agree that the proposed alternative provides the same level of protection as the above mentioned alternatives.*

Gross Obligations

- Description
  - *Establish credit requirements for Market Participants based on gross obligations.*

- Points of Consideration
  - *While "gross obligations" were not explicitly defined in Order No. 741-A, FERC implied in its statements that the NYISO cannot net a Market Participant's purchases and sales within a product or service category when establishing credit requirements.*
    - Cannot net at the transactional level (purchases vs. sales) in Energy and Virtual Transactions.
    - Credit requirements for Day Ahead and Real Time transactions would be based on purchases only.
    - Capacity sales cannot offset capacity purchases.
    - High positive TCCs creating "credit offsets" cannot be netted with credit requirements for negative TCCs (i.e. this essentially eliminates any portfolio effect).
  - *Overall credit requirements will substantially increase.*

The New York Independent System Operator (NYISO) is a not-for-profit corporation that began operations in 1999. The NYISO operates New York's bulk electricity grid, administers the state's wholesale electricity markets, and provides comprehensive reliability planning for the state's bulk electricity system.

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