

109 FERC ¶ 61,186  
UNITED STATES OF AMERICA  
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;  
Nora Mead Brownell, Joseph T. Kelliher,  
and Suedeem G. Kelly.

Policy Statement on Electric Creditworthiness

Docket No. PL05-3-000

POLICY STATEMENT ON CREDIT-RELATED ISSUES FOR  
ELECTRIC OATT TRANSMISSION PROVIDERS, INDEPENDENT SYSTEM  
OPERATORS AND REGIONAL TRANSMISSION ORGANIZATIONS

(Issued November 19, 2004)

1. While credit policies of regulated utilities have always been a component of the Commission's regulatory agenda, recent changes in the electric industry have caused credit-related issues to become increasingly significant. In response to these changes, the Commission believes that its policy with regard to certain credit-related issues requires clarification in order to increase transparency and competitiveness in electricity markets. In particular, this policy statement clarifies the Commission's policy with regard to the need for Open Access Transmission Tariff (OATT) Transmission Providers<sup>1</sup> and, to a lesser extent, independent system operators (ISO) and regional transmission organizations (RTOs) to: (1) make their credit-related procedures and standards more transparent; and (2) consider both quantitative and qualitative factors in assessing transmission customers' creditworthiness. In addition, the order clarifies certain actions (namely, shortening settlement periods and netting) that the Commission expects ISOs/RTOs to take to reduce the risk and impact of a default by a market participant on individual market participants and the market as a whole.

2. Due to the significant differences between the electric and gas industries in their respective development and inherent nature, the Commission finds it necessary at this time to issue this policy statement concerning creditworthiness standards and procedures for electric transmission providers, rather than initiate a rulemaking proceeding. We note that the level of transparency for creditworthiness and collateral requirements has been

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<sup>1</sup> For the purposes of this guidance order, an OATT Transmission Provider is defined as an entity that provides electric transmission service that is neither an ISO nor an RTO (i.e., a traditional utility).

less developed for OATT Transmission Providers, than for the more mature gas markets.<sup>2</sup> Specifically, with respect to ISOs/RTOs, the established creditworthiness and collateral requirements cover a wider range of services and commodities - including energy, transmission rights and ancillary services - whose value is more variable than that for either gas or OATT transmission service alone. The Commission believes that the development of creditworthiness requirements specific to each ISO/RTO through a stakeholder process is appropriate because of the greater variability and difficulty required to measure the credit exposure of providing these additional services. This policy statement will provide enhanced transparency to electric market participants and to the Commission and could be used as a model to create additional requirements for standardization if such requirements prove to be necessary.

3. This policy statement benefits the public by providing a more transparent credit process and reducing risk.

## **I. Background**

### **A. Notice of the July Technical Conference**

4. In the Notice of the July Technical Conference,<sup>3</sup> the Commission stated that due to market conditions and price volatility recently experienced within the industry, many participants in competitive energy markets have been subject to downgrades by credit rating agencies, often below investment grade levels. In fact, the notice pointed out that some have been forced to seek bankruptcy protection from creditors. The Commission explained that these credit downgrades have raised the level of concern regarding credit-related risks. At the same time, the notice noted that certain market participants have alleged that OATT Transmission Providers and ISOs/RTOs have sought excessive levels of credit support and therefore, in effect, foreclosed full market participation by competitive entities.

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<sup>2</sup> For example, the Commission instituted the standards for gas pipeline creditworthiness contained in its recent Notice of Proposed Rulemaking after two years of public notice and comments procedures, which involved a wide range of market participants, including the North American Energy Standards Board. *Creditworthiness Standards for Interstate Natural Gas Pipelines*, 69 Fed. Reg. 8,587 (Feb. 25, 2004), FERC Stats. & Regs., Proposed Regulations ¶ 32,573 (2004).

<sup>3</sup> Electric Creditworthiness Standards, Notice of Technical Conference and Request for Written Comments on Credit-Related Issues for Electric OATT Transmission Providers, Independent System Operators, and Regional Transmission Organizations, Docket No. AD04-8-000 (May 28, 2004) (Notice of July Technical Conference).

5. In addition, the Commission stated that it believes that there are ways for ISOs/RTOs to reduce credit/default exposure and, in turn, to minimize the mutualized default risk in their markets. As the notice explained, ISOs/RTOs are typically non-profit entities that administer the market on behalf of market participants. In such markets, credit is collectively extended by market participants to each individual market participant. As a result, if one market participant defaults, it falls upon the remaining participants to make up the shortfall (i.e., the default risk is mutualized).

6. In order to address those concerns, the Commission stated in the notice that it would hold a technical conference to consider credit-related issues for service provided by OATT Transmission Providers, ISOs, and RTOs in the electric industry. To assist the Commission in its preparation for that conference, the Commission invited all interested persons to submit written comments on the various questions posed in the notice or any other issues related to credit requirements for the electric industry, including whether it was appropriate for the Commission to consider a similar course for the electric industry as the one it proposed in relation to the gas industry (i.e., standardized, transparent and comprehensive tariff-based creditworthiness procedures).<sup>4</sup> On July 13, 2004, Commission staff held the technical conference (July Technical Conference).

**B. Creditworthiness Issues for OATT Transmission Providers and ISOs/RTOs**

7. Although the Commission recognizes that there is some overlap, the credit concerns facing OATT Transmission Providers and ISOs/RTOs differ in important ways due to the nature of those entities. In general, OATT Transmission Providers develop their own credit policies and do not receive input from their customers through a stakeholder process. On the other hand, most ISOs and RTOs establish their credit policies through a stakeholder process that includes all market participants. While OATT Transmission Providers' credit policies apply only to transmission services, ISOs' and RTOs' credit policies apply to both transmission services and purchases and sales in the markets they administer for energy, capacity, and other products. Accordingly, as the Commission has noted in the past, the differences between traditional utilities and ISOs and RTOs often warrant different approaches to creditworthiness requirements.<sup>5</sup>

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<sup>4</sup> See *Creditworthiness Standards for Interstate Natural Gas Pipelines*, 69 Fed. Reg. 8,587 (Feb. 25, 2004), FERC Stats. & Regs., Proposed Regulations ¶ 32,573 (2004) (Gas Credit NOPR). In the Gas Credit NOPR, the Commission stated that standardized creditworthiness provisions in the gas industry promote consistent practices across markets and utilities and provide customers with an objective and transparent creditworthiness evaluation.

<sup>5</sup> See *Duquesne Light Co.*, 103 FERC ¶ 61,227 at P 17 (2003).

Recognizing these differences and the problems they pose, in this policy statement the Commission will discuss credit concerns for OATT Transmission Providers and ISOs/RTOs separately.

## II. Discussion

### A. Transparency and Content of Credit Policies under the Pro Forma OATT

8. In Order No. 888,<sup>6</sup> the Commission issued its pro forma OATT for the electric industry without prescribing specific credit standards and processes for OATT Transmission Providers. Instead, the pro forma OATT only contains generalized standards regarding credit policies. Specifically, it states that OATT Transmission Providers: “may require reasonable credit review procedures” and that such review shall be made “in accordance with standard commercial practices.”<sup>7</sup> These standards do not, on their face, require a transparent evaluation process and allow OATT Transmission Providers, ISOs, and RTOs significant discretion in the approach they take in assessing credit risk and determining how and to whom to apply such an assessment.

9. Unlike the majority of ISOs and RTOs that post their credit requirements on their websites or Open Access Same-Time Information System (OASIS) sites or incorporate them into their tariffs, OATT Transmission Providers, with some exceptions (most notably Carolina Power & Light),<sup>8</sup> have not incorporated their credit requirements into

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<sup>6</sup> See *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Service by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, FERC Stats. & Regs. ¶ 31,036 (1996), *order on reh’g*, Order No. 888-A, FERC Stats. & Regs. ¶ 31,048 (1996), *order on reh’g*, Order No. 888-B, 81 FERC ¶ 61,248 (1997), *order on reh’g*, Order No. 888-C, 82 FERC ¶ 61,036 (1998), *aff’d in relevant part, remanded in part on other grounds sub nom, Transmission Access Policy Group, et al. v. FERC*, 225 F.3d 667 (D.C. Cir. 2000), *aff’d sub nom, New York v. FERC*, 535 U.S. 1. (2002).

<sup>7</sup> See section 1 of the Pro Forma OATT, Common Service Provisions, subsection 11, Creditworthiness.

<sup>8</sup> See, e.g., *Carolina Power & Light Co. and Florida Power Corp.*, 103 FERC ¶ 61,159 (2003), *reh’g denied*, 106 FERC ¶ 61,141 (2004) (accepting in part and rejecting in part tariff sheets as modified); *Carolina Power & Light Co. and Florida Power Corp.*, Docket Nos. ER03-962-000 and ER03-962-001 (Aug. 15, 2003) (unpublished letter order); *Duquesne Light Co.*, 103 FERC ¶ 61,227 (2003) (rejecting filing); *Entergy Services, Inc.*, 104 FERC ¶ 61,329 (2003); *Entergy Services, Inc.*, 106 FERC ¶ 61,039 (2004).

their OATTs. Even among those that have done so, the Commission believes that the credit policies of OATT Transmission Providers and, to a lesser extent, some ISOs/RTOs may contain unclear credit requirements for customers and the manner in which those elements are considered is not clearly communicated to customers.<sup>9</sup>

10. At the July Technical Conference, the OATT Transmission Provider presenters generally explained that they employed relatively sophisticated processes to analyze customer credit using both qualitative and quantitative criteria.<sup>10</sup> However, they did not post such criteria on their websites, to OASIS or otherwise make the criteria publicly available.<sup>11</sup> Notwithstanding such presentations, some transmission customers asserted that they had been subject to very limited credit evaluations based solely on matters such as ratings.<sup>12</sup> The Commission believes that the credit criteria used by OATT Transmission Providers should be made available to customers and the Commission. It is only through the clear presentation of such criteria that customers and the Commission can determine whether credit analysis is being conducted in an appropriate and non-discriminatory manner.

11. In particular, the Commission believes that if credit processes are neither posted on an OASIS site nor incorporated into a tariff, transmission customers do not have the ability to judge whether the application of a transmission provider's credit procedures to them was done on a reasonable, comparable, and non-discriminatory basis. Furthermore, without such transparency, the Commission believes that transmission customers are unable to determine *ex ante* the general amount of security, if any, they need to provide an OATT Transmission Provider to receive transmission service or to participate in an ISO/RTO market. In addition, if standards are not made clear to transmission customers, it could serve to undermine certainty in markets and therefore could result in creditworthiness requirements (either intentionally or unintentionally) being turned into barriers to legitimate market activity, thus affecting market participation and liquidity levels in the markets.

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<sup>9</sup> The Commission acknowledges that this lack of transparency might be due in part to the fact that creditworthiness requirements in the pro forma OATT are general in nature.

<sup>10</sup> See, e.g., Remarks of Tommy Lee on behalf of Duke Energy Corporation, July 13<sup>th</sup> Conference Transcript at 7-14, Docket No. AD04-8-000; Remarks of Thomas Foster on behalf of MidAmerican Energy Company, *id.* at 15-21; Remarks of Dan Sarti on behalf of Arizona Public Service Company, *id.* at 22-30.

<sup>11</sup> See *id.* at 31-34.

<sup>12</sup> See, e.g., Remarks of Michael Thomas on behalf of Calpine Corporation, *id.* at 65-74.

12. In order to address those concerns, we clarify that we interpret the term “reasonable credit review procedures” in the pro forma OATT to include the posting by OATT Transmission Providers, ISOs, and RTOs on their OASIS sites, to the extent that they have not already done so or incorporated such requirements in their tariffs, the information used by them to evaluate a potential customer’s creditworthiness (including both quantitative and qualitative methodologies, as discussed further below, for determining the credit that a transmission provider will offer an applicant for transmission service). Thus, the Commission expects OATT Transmission Providers, ISOs, and RTOs to: (1) make their credit-related practices more transparent and comprehensive; (2) post on their websites the procedures that they use to do their credit analyses; and (3) provide a customer with a written analysis setting forth how that entity applied its credit standards to that customer, if that customer is required to provide security. These creditworthiness standards, security requirements, and the process for developing them should be transparent enough to enable customers to understand the information required to demonstrate creditworthiness and to determine for themselves the general amount and type of security they may need to provide in order to receive transmission service from OATT Transmission Providers and/or participate in the markets of ISOs/RTOs. In short, the methodology by which the credit analysis is conducted should be transparent and fairly and uniformly applied, and a written explanation should be required for any required security.

13. In addition, OATT Transmission Providers, ISOs, and RTOs must consider both qualitative<sup>13</sup> and quantitative<sup>14</sup> measures in their assessment of the credit risk of a party and post the criteria they use to determine these factors. In this regard, as discussed above, some customers have maintained that no qualitative elements are used at all (*e.g.*, no investment grade rating results in no credit). As a result, those customers have maintained that OATT Transmission Providers, ISOs, and RTOs could potentially discriminate against non-credit rated companies, because their review does not have to be based on whether those customers are truly non-creditworthy.

14. To help prevent such an occurrence, the Commission believes, as stated above, that qualitative factors should be considered in determining whether security should be provided for transmission service. Thus, OATT Transmission Providers and ISOs/RTOs

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<sup>13</sup> Qualitative factors to be considered include, among others: applicant’s history; nature of organization and operating environment; management; contractual obligations; governance policies, financial and accounting policies, risk management and credit policies; market risk including price exposures, credit exposures, and operational exposures; event risk; and the state or local regulatory environment.

<sup>14</sup> Quantitative factors to be considered include, among others: financial statements, in general, and profitability, capital structure, and cashflow, in particular.

should not automatically determine that an applicant is not creditworthy if it does not have a credit rating or that credit rating is below investment grade. For example, although municipalities and cooperatives may not be rated, they may still have strong credit for transmission service due to the nature of their businesses and their ability to charge their customer base for service. Similarly, stand-alone merchants may not have a strong balance sheet but may have strong credit for transmission service if they have a contract commitment with a creditworthy purchaser for the output of their unit that is dependent upon transmission to perform under the contract.

15. In conclusion, the Commission expects OATT Transmission Providers, ISOs, and RTOs to comply with these goals and will consider taking action on a case-by-case basis or entertain complaints to address significant problems if the goals of transparency and the consideration of qualitative, as well as quantitative, factors are not met. The Commission has stopped short of mandating standardized credit measurements in this policy statement. However, the Commission will consider standardizing credit procedures through a generic rulemaking if necessary to prevent undue discrimination. To the extent a transmission customer believes that an OATT Transmission Provider, ISO, or RTO has discriminated in the application of its creditworthiness standards, that customer may contact the Commission's enforcement hotline<sup>15</sup> or file a complaint pursuant to section 206 of the Federal Power Act.<sup>16</sup>

16. Finally, we reiterate here that Order No. 2004-B allows the sharing of risk management functions to assess corporate-wide risk, but prohibits the shared risk management employees from deciding "whether a transmission customer receives services, sets prices, or sets other rates, terms or conditions of transmission service, such as a specific amount of collateral a non-creditworthy shipper must post before receiving service."<sup>17</sup>

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<sup>15</sup> Transmission customers that believes that an OATT Transmission Provider, ISO, and/or RTO has discriminated against it may contact the Commission's enforcement hotline by phone at (888) 889-8030 or by e-mail at [hotline@ferc.gov](mailto:hotline@ferc.gov).

<sup>16</sup> 16 U.S.C. § 824e (2000).

<sup>17</sup> *Standards of Conduct for Transmission Providers*, Order No. 2004, 68 Fed. Reg. 69,134 (2003), FERC Stats. & Regs. ¶ 31,155 (2003) (the standards of conduct govern the relationships between OATT Transmission Providers and all of their marketing and energy affiliates), *order on reh'g*, Order No. 2004-A, FERC Stats. & Regs. ¶ 31,161 (2004), *order on reh'g*, Order No. 2004-B, 108 FERC ¶ 61,118 at P 68 (2004).

## **B. Mutualized Default Risk**

17. Since ISOs/RTOs are typically non-profit entities that administer the market on behalf of market participants and, in this capacity, serve as the clearing firm to every transaction, ISO/RTO members are exposed to the credit risk of other members. In addition, ISOs/RTOs are generally not capitalized sufficiently to absorb the impact of defaults by market participants on an outstanding obligation.<sup>18</sup> If collateral posted by a defaulting party is not sufficient to cover the amount of its default, the remaining credit risk exposure and costs are socialized across an ISO's/RTO's members. As such, the credit/default risk of undercapitalized market participants lies with the non-defaulting participants, not the ISO/RTO. In other words, due to the nature of ISO/RTO markets, credit is, in effect, collectively extended by market members to each individual market participant.

18. Furthermore, that exposure is not truly under a market participant's control because it is the ISO/RTO that serves as the gatekeeper for the integrity of the markets they administer. As a result, ISO/RTO market participants are exposed to risks based on an ISO's/RTO's determination of other market participants' creditworthiness, and they have little ability to mitigate that risk. Furthermore, market participants must trust ISOs/RTOs to implement their credit policies in a manner created to limit, as much as possible, the risk of credit defaults. As a result, the level of exposure faced by ISOs/RTOs can significantly affect market development by dampening the willingness of various entities to participate in ISO/RTO markets that inadequately mitigate mutualized risks through a clear, workable mechanism for minimizing the mutualized default risk.

19. Although the Commission believes that there is a consensus in the industry, as demonstrated at the July Technical Conference and the comments received prior to that conference, that the goal of reducing the mutualized default risk is an important one, there are differences in opinion among various entities regarding the question of what types of methods should be used to reduce that risk and what the achievable reductions are. While requiring all market participants in ISOs/RTOs to be fully collateralized would eliminate the mutualized credit risk, the Commission believes that such a goal

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<sup>18</sup> The following are some of the credit risks that an ISO/RTO and its membership face: (1) a market participant cannot or will not pay for energy, ancillary services, purchased ICAP requirement, FTRs purchased at auction, or transmission services; (2) a market participant cannot deliver energy, ancillary services, or capacity when scheduled to do so and does not purchase replacements; and (3) virtual bidders that cannot meet their obligations when their bids in the day-ahead market clear.



would impose significant costs on market participants and, in turn, would represent a serious barrier to entry into the markets. Short of that, the Commission believes that there are less burdensome ways to reduce credit exposure and minimize the mutualized default risk in ISO/RTO markets and encourages them to adopt such measures.

20. In particular, the Commission believes, as discussed in greater detail below, that shortened settlement periods and netting are cost-effective steps to reduce the exposure to risk among market participants (*e.g.*, from a default by one of the participants), the amount of collateral required from market participants, and barriers to entry by minimizing collateral requirements. Thus, these measures should improve market conditions and provide for greater market participation and improved market liquidity. Furthermore, these measures should serve to reduce the security requirements for both small and non-credit rated entities, thus significantly enhancing their access to ISO/RTO markets.

**i. Shortening Settlement Periods**

21. The size of credit risk exposure is, in large part, a function of the length of time between completion of the various parts of electricity transactions, *i.e.*, the provision of service, the billing for service, and the payment for service. Since the risk of default begins at the time the product or service is committed for delivery and continues until the account payable is ultimately extinguished, reductions in settlement periods would serve to: (1) lower the level of financial assurances required (*i.e.*, collateral requirement provided by individual participants); (2) reduce the quantity of the aggregate level of payables outstanding at any point in time, thereby reducing the potential exposure of a defaulting entity; (3) enable updated transaction prices and charges to be utilized in a timely manner in determining credit risk exposure; and (4) provide earlier identification of default situations by lessening the opportunity for an unrecognized default and its severity. Accordingly, the Commission believes that ISOs/RTOs can minimize the exposure period and significantly reduce the credit risk to all market participants by reducing the time between when a cost is incurred and when payment is ultimately received by an ISO/RTO (*i.e.*, shortening the settlement period).

22. For instance, ISO-NE recently revised its billing policies to implement a weekly billing period and a shortened settlement cycle in its hourly markets. These actions are predicted to reduce both the amount of collateral required from market participants and NEPOOL's exposure to a default by market participants.<sup>19</sup> NEPOOL's settlement cycle

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<sup>19</sup> See *New England Power Pool*, 107 FERC ¶ 61,201 (2004) (approving these changes). In addition, the Commission recently approved Midwest ISO's proposal to invoice and bill on a weekly schedule. See *Midwest Independent Transmission System Operator, Inc.*, 108 FERC ¶ 61,163 at P 473 (2004) ("We note that . . . the trend in energy markets is toward shortened settlement periods to reduce the potential exposure

up to May 2004 was approximately 55 days; however, upon replacement of monthly billing with weekly billing, the settlement cycle decreased to 13 days for all hourly market services. As a result of these changes, ISO-NE projects that the overall amount of financial assurance required in NEPOOL will be reduced by 67 percent from approximately \$176,791,000 to \$58,128,000.<sup>20</sup>

23. Currently, settlement cycles in other ISOs/RTOs are as high as 90 days.<sup>21</sup> The Commission believes that there is significant room for many ISOs/RTOs to significantly shorten these periods, reducing the credit risks and cost of collateral in their markets by shortening their billing cycles and implementing weekly billing.<sup>22</sup> Accordingly, the Commission asks ISOs/RTOs to initiate processes to reduce credit exposure and minimize the mutualized default risk in their markets by adopting shortened settlement periods.

24. The Commission acknowledges that some regulated load-serving entities have expressed a wish to remain on at least a monthly billing schedule due to cash flow concerns that could arise from a more frequent payment schedule.<sup>23</sup> However, the

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window and collateral requirements for all parties. . . . Accordingly, we find that the Midwest ISO's proposal to invoice and bill on a weekly schedule is just and reasonable."), *reh'g pending*.

<sup>20</sup> See Memorandum to NEPOOL Participants Committee re: Amendments to Billing Policy and Financial Assurance Policies to Implement Weekly Billing, Paul Belval and Scott Myers, NEPOOL Counsel, February 12, 2004.

<sup>21</sup> For example, in the CAISO, the portion of the settlement cycle up to the point of customer receipt of the preliminary invoice is approximately 83 days, *see* CAISO FERC Electric Tariff, section 11.24.1-2 (payment Calendar), and, in PJM, the settlement cycle (through standard payment terms) is approximately 50 days, *see* PJM FERC Electric Tariff, 2nd Rev. Sheet No 50 (section 7.1).

<sup>22</sup> By way of comparison, the financial markets (*e.g.*, NASDAQ, NYMEX) typically rely on a daily settlement process.

<sup>23</sup> That is, most load-serving entities are only allowed to bill on a monthly basis because they are tied to retail meter reading schedules that are billed on such a basis. Thus, those entities may be unable to collect payments from retail customers any more frequently, resulting in a larger gap between payments made to the ISO/RTO and payments received from customers and, in turn, increasing working capital requirements to serve those customers.

Commission notes that it appears that all of the load-serving entities in ISO-NE were supportive of NEPOOL's move to a weekly billing cycle and thus encourages other ISOs/RTOs to work through their stakeholder processes to resolve this issue.

**ii. Netting**

25. Another method of minimizing the size of the credit risk exposure in ISOs/RTOs is to net obligations owed by and to individual market participants whenever possible. Under netting, obligations for transactions with a given counterparty are offset against revenues for other transactions with that counterparty.<sup>24</sup> Thus, a market participant's payment obligation to an ISO/RTO would be offset, or netted against, what the market participant is owed from ISO/RTO.<sup>25</sup> As a result, exposure will usually be considerably smaller than if the obligations were not netted. The amount of collateral a company must post would also be reduced because the collateral determination would often be based on a lower overall outstanding or potential obligation to an ISO/RTO.

26. Specifically, the Commission believes that three basic types of netting should be adopted, to the extent practicable, by ISOs/RTOs: (1) netting accounts payable and accounts receivable within one product class (e.g., energy); (2) netting accounts payable and receivable across products (e.g., energy and ICAP); and (3) netting internal bilateral energy contracts.

27. First, the netting of accounts receivable and accounts payable within one product class could lower the credit exposure rate of ISOs/RTOs. Furthermore, if a customer holds a positive position in one geographic market and a negative position in another, allowing it to net its positions across geographic markets could also reduce its

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<sup>24</sup> Under netting, if A defaults on obligations to B, and B has separate, offsetting obligations to A, then B is exposed only up to the net amount of the mutual obligations.

<sup>25</sup> In the context of an ISO/RTO, if a generator/marketer provides an ISO/RTO \$1,000 worth of energy, and the ISO/RTO sells \$1,500 of ancillary service to the marketer/generator, the ISO/RTO can simply secure the difference of \$500 in the event that the generator defaults on its obligation. As a result, the marketer/generator has less money (\$500 vs. \$1,500) as a liability and thus would need less collateral to participate in the ISO's/RTO's market. Furthermore, netting out obligations means that if a market participant defaults on its obligations, the ISO/RTO is assured of receiving the obligation's net worth if it has collateral equal to the net amount of the obligations. Accordingly, through netting, credit exposure is determined as the net overall exposure, resulting in collateral needs being reduced in an ISO/RTO and minimizing the risk of a default by a market participant.

creditworthiness requirement. However, the Commission recognizes that certain bankruptcy issues may be raised with regard to netting accounts receivable and accounts payable.<sup>26</sup>

28. Second, netting across ISO/RTO product markets could achieve credit reductions through the same mechanism as described above for accounts receivable but does so for more transactions. Therefore, it adds to the flexibility a company can exercise to reduce its risk exposure. For example, an ISO/RTO could net financial obligations for energy, capacity, and transmission. However, netting across products might also present the same bankruptcy issues as netting of accounts receivable and accounts payable within a single market.<sup>27</sup>

29. As stated above, the Commission recognizes that netting may impact creditors' rights in a case where a market participant seeks bankruptcy protection. Nevertheless, we do not believe that these potential costs outweigh the benefits of netting, which would reduce the likelihood of defaults by market participants and the magnitude of the impact of such defaults on other market participants. Furthermore, we clarify that the Commission is not here directing or encouraging ISOs/RTOs to take any measures that disregard the requirements of the Bankruptcy Code.

30. Third, netting internal bilateral energy contracts, as opposed to ISO/RTO products, could also serve to reduce default costs and risk. For instance, in PJM, the software system known as *eSchedules* allows market participants to net internal bilateral contracts (by allowing them to use schedules to subtract or net the bilateral transactions) against their short-load obligations. As a result, this system allows market participants to net collateral for firm, liquidated damages contracts against the payments that would be due from purchasing energy to meet a load obligation, if it has a counterparty willing to accept its load obligation, without posting collateral with the ISO. Furthermore, this type of netting could result in less cash moving through an ISO/RTO and thus lower market participants' risk. In addition, net settlement could provide incentives for load-serving entities to purchase long-term bilateral contracts from wholesale suppliers in order to

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<sup>26</sup> Specifically, some parties have stated that the laws affecting creditors' rights create a possible risk that the netting arrangement may be unwound if a customer becomes insolvent. For instance, according to the Midwest Independent Transmission System Operator, while bankruptcy law generally permits the setoff of obligations due a debtor against amounts due the creditor, it imposes requirements that may make it difficult to net fees with respect to a market participant who enters bankruptcy. *See, e.g.*, Comments of Midwest Independent Transmission System Operator, Inc. at 3-4, Docket No. AD04-8-000.

<sup>27</sup> *See id.*

lower their collateral costs, thereby increasing market liquidity.<sup>28</sup> In short, internal bilateral energy contracts are a financial hedging tool; netting them adds value to this tool.

**iii. Other Measures for Reducing the Mutualized Default Risk**

31. The Commission also encourages ISOs/RTOs to consider other means that they believe would be cost-effective measures to reduce the mutualized default risk. For instance, credit insurance might allow ISOs/RTOs to remove any residual mutualized credit risk, and these insurance policies could be tailored to the unique needs of each ISO/RTO.<sup>29</sup> Credit clearing might also provide a platform to net obligations and could possibly serve to transfer credit risk to entities that are better able to manage such risk. Specifically, clearing services could encompass a central counterparty, such as a clearinghouse, that would assume and manage the default risk that would otherwise be borne by an ISO's/RTO's market participants on a mutualized basis.

**iv. Request for Reporting**

32. The Commission recognizes that not all ISOs/RTOs are at the same stage of evolution, and, therefore, that they should be able to determine for themselves at what point these measures to reduce the mutualized default risk would be cost effective and compatible with their markets and therefore should be implemented.<sup>30</sup> Furthermore, because the risk of default in ISOs/RTOs involves each member sharing a portion of a default, the Commission encourages, to the extent practicable, each ISO/RTO to improve its credit practices through its stakeholder processes (assuming it uses such a process), allowing its members to determine what practices are the most cost-effective for reducing the credit risk that the members ultimately bear.

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<sup>28</sup> For instance, according to Strategic Energy, NYISO, which does not permit netting of collateral requirements for firm liquidated damages purchases, has collateral costs that are four times higher than PJM, which as noted, permits such netting. *See* Francis Pullaro's Remarks on Behalf of Strategic Energy, July 13<sup>th</sup> Conference Transcript at 138, Docket No. AD04-8-000.

<sup>29</sup> We note that there has been some concern that these policies are relatively expensive and therefore not cost effective. However, assuming the implementation of measures such as shortened settlement periods and netting reduces the mutualized default risk in ISOs/RTOs, it might make credit insurance a more viable option (i.e., its costs would be reduced as the level of insured risk decreased).

<sup>30</sup> For instance, an ISO/RTO might decide that moving directly to credit clearing is more cost-effective than shortening settlement periods.

33. In addition, the Commission expects that each ISO/RTO report back to us within 90 days of the issuance of this order on their progress toward implementing shortened settlement periods, netting, or any other measure that they determine might serve to reduce the mutualized default risk in their markets or their reasons for not yet adopting such measures. That report should also detail any future plans that that ISO/RTO has, at that time, for reducing the mutualized default risk in its market.

By the Commission. Commissioner Brownell dissenting with a separate statement attached

Magalie R. Salas,  
Secretary.

UNITED STATES OF AMERICA  
FEDERAL ENERGY REGULATORY COMMISSION

Policy Statement on Electric Creditworthiness

Docket No. PL05-3-000

(Issued November 19, 2004)

BROWNELL, Commissioner, dissenting:

Today's order clearly articulates that recent changes in the electric industry have caused credit-related issues to become increasingly significant. I agree. However, I believe a policy statement intended to simply provide clarification falls dreadfully short of the regulatory agenda this Commission is advancing. Instead, I believe the more appropriate action is the issuance of a proposed rule consistent with our efforts in the natural gas creditworthy proceeding; thus allowing all market participants an opportunity to comment and shape an ultimate rule. As the Commission has harmonized standards of conduct, accounting rules, and other business operational functions between the natural gas and electric industries, I see the issue of creditworthiness equally linked.

When addressing the natural gas creditworthiness proposed rulemaking in February, my colleagues and I unanimously agreed that additional regulations pertaining to creditworthiness were needed to promote consistent practices among the pipelines and provide shippers with an objective and transparent creditworthiness determination.<sup>31</sup> The electric industry is no different than the natural gas industry when it comes to needing stability, predictability, and assurance that the right protections are in place.

The Technical Conference held July 13, 2004 raised issues which underscore the seriousness of the problem. One panelist representing cooperatives characterized the lack of appropriate credit policies as "pos[ing] the risk of basically making the cooperatives unable to meaningfully participate in some of the transmission services which are supposed to be part of the open access that the FERC is trying to create."<sup>32</sup> Another participant representing generators noted that after eight years handling credit issues, he "still had no idea what [the "reasonable credit review procedures" language in the pro forma OATT] truly means or obligates a regulatory body to undertake."<sup>33</sup> I am concerned the existing credit policies continue to build barriers to entry.

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<sup>31</sup> See transcript from the Feb. 11, 2004 Commission Meeting, pp. 14-16.

<sup>32</sup> Transcript of the technical conference in the matter of Electric Creditworthiness Standards, Docket No. AD04-8-000, p. 77.

<sup>33</sup> *Id.* at p. 65.

Today's order expresses the "expectation" that transmission providers will voluntarily agree to start posting explanations of their credit review processes on their OASIS. I hope I am wrong, but I fear this expectation will not be met in the absence of a direct order. When asked about the willingness to post their creditworthy processes on their OASIS with granularity, the panelists resisted. Instead, they stated they would not oppose posting general or high level information.<sup>34</sup> When describing their reluctance to post more detailed information, one panelist stated:

The problem with posting a specific methodology is, first, I don't know if there's enough paper to print it all on, given how many scenarios there are and how many different variables we take into account. But the problem also is that the industry changes, the industry changes constantly, and sometimes we change the models; sometimes we change the weightings, based on the way the industry is going.<sup>35</sup>

This response alone illustrates the veil under which transmission owners and providers could avoid consistency and uniformity in applying their respective creditworthy provisions.

As I have stated previously and often, I believe establishing mandatory electric creditworthiness principles will promote consistent practices across markets and utilities and provide customers with an objective and transparent creditworthiness evaluation. Such an approach would lessen the opportunity for applying these provisions in an unduly discriminatory manner. Opponents of mandatory principles seem to fear they will lead to institutionalizing a "one-size-fits-all" approach. Let me be clear, I agree that such an approach is hazardous and I would not support it. What I am saying is that electric creditworthy provisions need to be more systematic, transparent, and non-discriminatory with sufficient flexibility to adapt to specific situations but with customer safeguards such as written explanations.

This is also the approach most transmission customers voiced during the July 2004 technical conference. As one panelist stated:

Not all OATT providers have demonstrated ... flexibility, and in many cases, it seems to be a black box in terms of the credit.... We believe that it would be much preferable to have, not necessarily standardized, but transparent credit requirements, transparent credit procedures so that transmission service obtainers

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<sup>34</sup> *Id.* at p. 31-34.

<sup>35</sup> *Id.* at p. 33-34.



will know in advance, what's going to be required of them, how often that information needs to be updated, in what form it can be furnished, so there's less risk for surprise.<sup>36</sup>

Therefore, I would propose rules requiring transmission owners and providers to include their respective quantitative and qualitative creditworthy provisions in their OATTs and to post these standards on their OASIS websites.

Additionally, this policy statement lacks other forward-thinking policies proposed in the currently pending natural gas creditworthy rulemaking. The instant proceeding neglects to provide transmission owners, providers and customers any guidance on the consequences of not achieving or sustaining good creditworthy standing. The policy statement expects Transmission Providers' processes to be transparent enough for customers to determine for themselves the general amount and type of security they may need. However, that does not attend to one of the fundamental concerns transmission customers raise. As one panelist at the technical conference explained, "the biggest concern that we've had is going through all that we went through, there was a lot of disparity between companies. Every company required something different. Some would ask for collateral for one amount. Some would ask for collateral for ten times as much for the exact same type of exposure."<sup>37</sup> Without specifying collateral/security requirements for service and without specifying timelines for the suspension and termination of service, I firmly believe this policy statement does not adequately clarify the rules of the road or reassure financially comparable customers that they are entitled to, and in fact are, receiving equitable treatment.

Finally, I agree with the order's observation that ISO/RTO creditworthiness and collateral requirements cover a wider range of services and commodities. However, again, I believe the policy statement falls short by merely "requesting" rather than directing the ISOs/RTOs to evaluate their current processes and standards, and determine the sufficiency and adequacy of the terms and conditions, and report back to the Commission on actions each ISO/RTO would be taking.

The non-binding effect of this policy statement seems to result in a known problem still wanting a remedy, and therefore, I dissent.

Respectfully,

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<sup>36</sup> *Id.* at p. 77-78.

<sup>37</sup> *Id.* at p. 95.

