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

- <u>CPWG meetings:</u>
  - *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*

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

- <u>"Credit Contacts" and "Billing Contacts" (as designated by each Market Participant):</u>
  - *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.*

- <u>BIC meeting:</u>
  - *Summary of implementation plan – 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).

<u>NYISO Software Automation Required:</u> 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	Complete (reviewed at 3/25 CPWG)
2. Use of Unsecured Credit – Individual Market Participant Cap	Complete (reviewed at 3/25 CPWG)
3. Use of Unsecured Credit – Aggregate Corporate Family Cap	Complete (reviewed 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	Final Review June 20 CPWG
7. Use of "Material Adverse Change"	Complete (reviewed 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 <u>and</u> 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 April 30 each year.*
    - Initial certification due October 1, 2011.

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 maintains current written risk management policies and procedures that address those risks that could materially and adversely affect the Market Participant's ability to pay its NYISO invoices when due, including, but not limited to, credit risks, liquidity risks and market risks.*
  - *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.*
  - *Market Participant has appropriate personnel and technical abilities to promptly and effectively respond to all communications and directions from the NYISO related to settlements, billing, credit requirements, and other financial matters.*
  - *Market Participant is in compliance with the NYISO's minimum capitalization requirements.*

Proposed Credit Requirements

- Adequate expertise to transact in ISO market
  - *Each Market Participant must certify that each of its NYISO traders/users (e.g. persons authorized to bid and/or offer in the NYISO markets) have adequate expertise to transact in the NYISO markets.*
  - *Each Market Participant approved in the TCC market or Virtual Transactions must have each of its NYISO traders/users complete training specific to those products.*
    - Free training will be offered continuously on-line beginning September 1, 2011. Both training courses will conclude with a test to evaluate user understanding.
    - Required once per trader/user.
  - *The NYISO is no longer planning to require each trader/user to take NYMOC, although Market Participants may opt to use this and other courses as a part of their basis for certifying adequate expertise to transact in the NYISO market.*

Proposed Credit Requirements

- Ability to respond to ISO direction
  - *Market Participant has appropriate personnel resources, and technical abilities to promptly and effectively respond to all communications and directions from the NYISO related to settlements, billing, credit requirements, and other financial matters.*

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 satisfy the minimum capitalization requirement.
    - For those Market Participants approved for the TCC market, provide $500,000 to satisfy 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 netting 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).*

Summary of Options

Option	Points of Consideration
1. Central Counterparty	• Of the four options provided by FERC, Market Participants appear to support this option. • NYISO researching implications on accounting treatment, debt covenants, insurance, taxes & others (see next slide). • Potential tax exposure is currently largest concern. • The CFTC has expressed a preference for this option.
2. Obtain Security Interest in MP Receivables	• Many Market Participants are prohibited from providing such a security interest (either by law or existing financing arrangements). • Some additional NYISO administrative and legal costs.
3. Develop Another Option	• To date, NYISO and Market Participants have not identified another viable option that meets FERC Order 741.
4. Collateralize Based on Gross Obligations	• Some Market Participants could incur potentially significant increases in creditworthiness requirements.

Establish a Central Counterparty

- *What is a Central Counterparty?*
  - *Acts as the counterparty to all participants in the market.*
    - Explicitly taking title to transactions further supports a finding of mutuality in those transactions, thereby permitting setoff in a bankruptcy proceeding.

- *Implementation Requirements:*
  - *Amendments to NYISO tariffs noting that NYISO is a counterparty to all Market Participant transactions.*
  - *No software development or process changes are anticipated.*

Establish a Central Counterparty

- Risks and Implications
  - *Accounting Treatment*
    - NYISO's independent auditors have agreed that the NYISO's financial statements can continue to be recorded on a net basis.
    - NYISO's independent auditors are continuing to review the NYISO's financials for purposes of tax treatment.
  - *Debt Covenants*
    - NYISO's legal counsel indicates there are no prohibitions to becoming a central counterparty.
  - *Insurance*
    - NYISO's insurance broker confirms there are no impacts to NYISO's insurance policies / coverage / etc.

Establish a Central Counterparty

- Risks and Implications
  - *Tax Concerns*
    - The NYISO is a 501(c)(3) and New York not-for-profit entity.
    - Legal counsel does not believe that becoming a central counterparty to market transactions changes the substance of NYISO's operations, and therefore, should not alter NYISO's tax-exempt status.
    - Legal counsel has advised that the NYISO should notify the IRS and NYS of this potential change and obtain confirmation of the continuation of NYISO's existing tax treatment.
    - NYISO would not likely obtain advisory opinions from the IRS or NYS prior to September 30, the due date of the compliance filing for Order 741-A.

Next Steps

- NYISO staff is pursuing the Central Counterparty option to comply with FERC Orders 741/741-A.
  - *Recommendation is dependent on the results of the tax discussions with the IRS and NYS.*
  - *NYISO and certain other ISOs/RTOs have initiated discussions with FERC to obtain additional time to comply with Order 741-A.*
  - *NYISO and other ISOs/RTOs are developing a strategy to approach the IRS in Q2 2011.*
  - *NYISO is also planning to initiate discussions with New York State.*

Next Steps

- NYISO staff is pursuing the Central Counterparty option to comply with FERC Orders 741/741-A.
  - *NYISO staff will provide regular updates to Market Participants and appropriate regulators, as needed.*
  - *In the event tax discussions reveal that becoming a central counterparty is not in the best interest of NYISO and its Market Participants, the NYISO will need to revisit remaining options.*

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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