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.

NYISO Implementation Plan

- IRC:
  - *The ISOs/RTOs are discussing implementation options for certain aspects of Order 741 to determine if consistent approaches can be adopted.*
- Governance Process:
  - *Initial meetings on November 15 (BOD) and November 19 (Market Participants).*
  - *Ongoing discussions with the BOD and Market Participants will continue between November 2010 and June 2011.*
- Software Enhancements:
  - *Consolidated Invoice Redesign project will modify NYISO billing software to permit invoicing more frequently than monthly – targeted deployment in August 2011.*
  - *Additional automation required by Order 741 will be evaluated and incorporated into 2011 project planning activities.*

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, 4/25, 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>
  - *To be copied on meeting notices & materials for all CPWG and BAWG (if applicable) meetings from November 2010 – October 2011.*
  - *To be provided proposed calendar of 2011 settlements cycle dates & invoicing elements.*
  - *To be encouraged to participate in NYISO Market Trials for weekly invoicing transition.*
  - *Other ad hoc communications by NYISO Finance and/or Customer Relations, as necessary.*

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.

<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

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). 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: Impact on NYISO systems & processes is dependent upon adoption of specific compliance approach.

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).

<u>NYISO Software Automation Required:</u> 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

Overview

Credit Reform	Status
1. Shortening the Settlement Cycle	Limited items for discussion at 2/22 CPWG • Frequency of invoicing certain settlements
2. Use of Unsecured Credit – Individual Market Participant Cap	Tariff language pending for 2/22 CPWG
3. Use of Unsecured Credit – Aggregate Corporate Family Cap	Tariff language pending for 2/22 CPWG
4. Elimination of Unsecured Credit in FTR Markets	Tariff language pending for 2/22 CPWG
5. Ability to Offset Market Obligations	Submitted comments to FERC for clarification and rehearing - pending
6. Minimum Criteria for Market Participation	Discussion at 1/25 CPWG
7. Use of “Material Adverse Change”	Discussion at 1/25 CPWG
8. Grace Period to “Cure” Collateral Posting	Tariff language pending for 2/22 CPWG

Proposed Schedule for Tariff Language

Credit Reform	Status
1. Shortening the Settlement Cycle	March 25 or April 25 CPWG
2. Use of Unsecured Credit – Individual Market Participant Cap	February 22 CPWG
3. Use of Unsecured Credit – Aggregate Corporate Family Cap	February 22 CPWG
4. Elimination of Unsecured Credit in FTR Markets	February 22 CPWG
5. Ability to Offset Market Obligations	Dependent upon FERC response to NYISO request seeking clarification and rehearing
6. Minimum Criteria for Market Participation	March 25 CPWG
7. Use of “Material Adverse Change”	March 25 CPWG
8. Grace Period to “Cure” Collateral Posting	February 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.*

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

- 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
  - *Market Participant must submit its risk management policies and procedures within 10 days of a NYISO request.*

Proposed Credit Requirements

- Adequate expertise to transact in ISO market
  - *Each Market Participant must have each of its NYISO traders/users (e.g. persons authorized to bid and/or offer in the NYISO markets) complete NYMOC (NY Market Orientation Course) and receive ongoing training via an online course each year thereafter.*
    - NYMOC currently offered four (4) times per year.
    - 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.
  - *Each Market Participant active in the TCC market or Virtual Transactions must have each of its NYISO traders/users attend training specific to those products annually.*
    - Training offered on-line. Beginning January 1, 2012 these training courses will 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.*
  - *Market Participant must submit its operating procedures within 10 days of a NYISO request.*

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, OR*
  - *Post collateral (e.g. cash, letter of credit, surety bond) of $200,000 to meet the minimum participation criteria requirement.*
  - *If Market Participant does not qualify for $1 million TNW or $10 million in assets and participates in the TCC and/or Virtual Transactions market, provide additional $500,000 to meet minimum participation criteria requirement.*

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.*

Use of
“Material Adverse Change”

Summary of FERC Order

- FERC requires each ISO/RTO to specify the conditions under which they will request additional collateral due to a material adverse change.
  - *This list should not be exhaustive and the tariff provisions should allow the ISOs and RTOs to use their discretion to request additional collateral in response to unusual or unforeseen circumstances.*
  - *Market Participants should receive a written explanation explaining the invocation of the material adverse change clause (¶147, pages 68-69).*

  - Tariffs should clarify when a market administrator may invoke a "material adverse change" clause to compel a market participant to post additional collateral, cease one or more transactions, or take other measures to restore confidence in the participant's ability to safely transact *(¶149, page 69)*.

Summary of FERC Order

- The tariff revisions should state examples of which circumstances entitle a market administrator to invoke a “material adverse change” clause, but this list should be illustrative, rather than exhaustive *(¶149, page 69)*.

- The tools used to determine “material adverse change” should be sufficiently forward looking to allow the market administrator to take action prior to any adverse effect on the market, but provide market participants with notice as to what events could trigger a collateral call or a change in activity in the market *(¶149, pages 69-70)*.

Current NYISO Tariff Provisions

- Current MAC tariff language (Section 26.10 in Attachment K of the Market Services Tariff):
  - *The amount of Unsecured Credit granted to a Customer, if any, and the amount of the Customer's Operating Requirement shall be subject to change, at the discretion of the ISO, in the event that there is a material adverse change affecting the risk of nonpayment by the Customer.*

Options for Consideration

- In comments submitted to FERC's NOPR, the IRC jointly agreed that certain criteria should be considered in the context of potential "Material Adverse Change" usage:
  - *Downgrade by a ratings agency*
  - *Placed on credit watch with negative implication by any rating agency*
  - *Bankruptcy or other insolvency*
  - *Significant quarterly loss or decline of earnings*
  - *Resignation of key officer(s)*
  - *Filing of a material lawsuit that could materially adversely impact current or future financial results*

Proposed Credit Requirements

- NYISO will modify the existing material adverse change provision in Section 26.10 of Attachment K in the Market Services Tariff to define "material adverse change" to include a "material change in financial status," as described in Section 26.1.1.4.

- Section 26.1.1.4 currently requires Market Participants to inform the NYISO of material changes in financial status within five (5) business days, including, but not limited to:
  - *(a*) a downgrade of a long- or short-term debt rating by any ISO-approved rating agency;*
  - *(b) placement on a negative credit watch by any ISO approved rating agency;*
  - *(c) a bankruptcy filing, insolvency, or a default under any financing agreement;*
  - *(d) resignation or termination of a key officer;*
  - *(e) initiation of a lawsuit that could materially and adversely impact current or future financial performance; or*
  - *(f) restatement of prior financial statements.*

** Language will be added to include a reference to the equivalency rating.*

Proposed Credit Requirements

- The NYISO also proposes to add the following forward looking examples to Section 26.1.1.4:
  - *Significant change in Expected Default Frequency (EDF) as determined by Moodys KMV CreditEdge*
  - *Significant variation in NYISO Credit Assessment process*
  - *Significant increase in Credit Default Swap (CDS)*
  - *Significant decline in Market Capitalization*

- Section 26.1.1.4 is an illustrative, but not exhaustive, list of material adverse change examples.

- NYISO will add tariff language stating that it will provide the affected Market Participant with written notice explaining NYISO's invocation of the material adverse change clause.

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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