FORTNIGHTLY'S

SPARK

Letter #78
June 2010

THE ON-LINE GATEWAY FOR READERS OF PUBLIC UTILITIES FORTNIGHTLY MAGAZINE.

FERC is proposing to reform credit practices that would require RTOs and ISOs to file tariff changes to their region-specific credit risk assessment methods. The FERC NOPR would move toward market standardization prompted by fears of bankruptcies, market fragmentation and recent general market turmoil. Andrea Chambers and Trevor Stiles examine the balancing act FERC is facing.

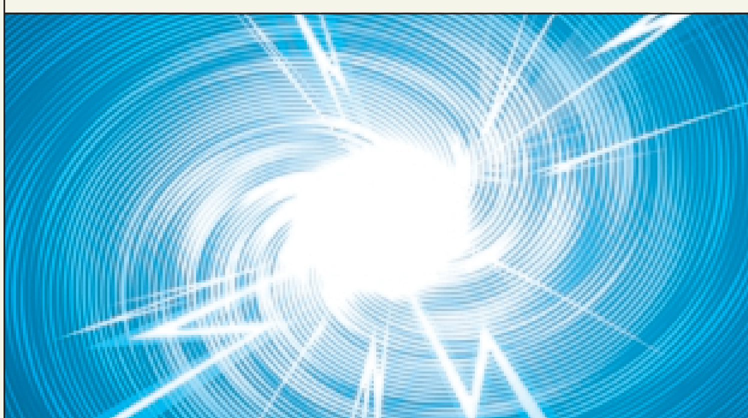
Also, Joel Hagan considers the importance of smart-grid customer participation, and Greg Imlay takes on the significance of utility payment remote deposits.

L. A. Burkhart
Editor

UTILITY REAL ESTATE INVESTMENT TRUSTS

Gazing Again into The Crystal Ball

By Timothy M. Toy and Ronald D. Brown



In *Fortnightly's SPARK*, Letter #60, published in December 2008, Timothy Toy and Dan Watkiss, in a piece entitled, *Electric Transmission Real Estate Investment Trusts: Grid in the Crystal Ball*,[1] explained how a real estate investment trust (REIT) structure might be employed to effect structural separation of electric transmission from distribution and generation, while producing tax savings and spurring investment resulting in needed grid modernization. This article addresses developments on the energy infrastructure REIT front since December 2008.

FERC & REITs

On March 18, 2010, the first REIT structure for FERC-jurisdictional assets[2] was filed with the Federal Energy Regulatory Commission (FERC), in Docket EC10-53-000. The FERC filing relates to the proposed combination of two smaller Electric Reliability Council of Texas (ERCOT) utilities presently up for approval by the Public Utility »

FERC'S PROPOSED CREDIT REFORMS

Will Market Standardization Allow Regional Flexibility?

By Andrea J. Chambers and Trevor D. Stiles

The Federal Energy Regulatory Commission (FERC) recently issued a *Notice of Proposed Rulemaking* (NOPR) in which it sought to reform credit practices in organized wholesale electric markets. In the NOPR, FERC sought comments on its credit reform proposals, which would require regional transmission operators (RTOs) and independent system operators (ISOs) to file changes to their tariffs to implement the new practices.

RTOs/ISOs are relatively recent developments in the electricity world, first created a little over a decade ago after FERC promulgated its landmark *Order No. 888*, which deregulated wholesale electricity markets. FERC originally addressed credit requirements for RTOs/ISOs in *Order No. 888*, but at that point, left it up to the individual transmission providers to create "reasonable credit review procedures." Traditionally, RTOs/ISOs have created their own credit policies tailored to meet the needs of their particular regional electricity market. These credit guidelines, implemented through the FERC tariff process, gave RTOs/ISOs great flexibility to try new policies, as long as those policies resulted in "just and reasonable" rates.

FERC reaffirmed this approach in a 2004 policy statement and required transmission providers to post their measures to assess credit risk on their OASIS Web sites or in their tariffs. Although these region-specific guidelines have worked fairly well over time, three recent developments in the energy markets raised FERC's concern about credit risk for market participants and the potential that the increased credit risk could drive up the cost of participation in the market, potentially leading to "unjust or unreasonable rates."

Reason for Concern

First, several bankruptcies in the last decade have revealed a potential problem regarding default risk in organized electricity markets. The principal difficulty created by these bankruptcies is that any default on an obligation in excess of the collateral requirements of an individual market participant is socialized among all market participants. The most notable example of this was associated with the bankruptcy of Enron in the early 2000s. Mirant's bankruptcy in CAISO and Exel/PowerEdge's defaults in PJM also raised awareness of the potential problems inherent in the socialization of risk. These bankruptcies create the possibility of a ripple effect, where a single bankruptcy in an RTO/ISO can trigger multiple bankruptcies without proper safeguards. If the RTO/ISO is not a counterparty to the transactions involving the bankrupt party, there is some risk that the credits and obligations of the bankrupt party would not be offset. That is, without mutuality, the bankruptcy court may not allow netting of the credits due to the bankrupt party from the RTO/ISO market to be offset by the obligations of the bankrupt party to pay into the RTO/ISO market. This could exacerbate the potential risks to the market as a whole.

Second, RTO/ISO variations have resulted in a fragmentation of the wholesale markets. Entities involved »

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across several wholesale markets can face a bewildering variety of inconsistent credit requirements.

Third, FERC warned that "the recent turmoil in financial markets has emphasized the importance of sound credit practices that provide competitive markets with adequate access to capital without excessive risk and without excessive cost." The credit crunch revealed potential problems with risk and cost that could result in unjust and unreasonable rates in the wholesale markets.

FERC's NOPR

In response to the perceived threat, FERC issued seven proposals aimed at increasing standardization, decreasing risk, and decreasing the cost of capital for the organized wholesale electric markets. The NOPR proposals included:

- shortening the settlement cycle to seven days to lower the level of financial assurances required and provide earlier identification of default situations, which lowers the overall credit risk exposure;
- reducing unsecured credit to no more than $50 million per market participant, with the possibility of an aggregate cap to cover an entire corporate family;
- eliminating unsecured credit in Financial Transmission Rights (FTR) markets because of the illiquidity of FTRs;
- clarifying that RTOs/ISOs are parties to each transaction, which would remove ambiguity about their ability to offset market obligations in the event of bankruptcy;
- establishing minimum criteria for market participation, such as the capability to engage in risk management/hedging;
- specifying what constitutes a "material adverse change" in a market participant's credit status such that the RTO/ISO can require additional collateral; and
- including in each RTO/ISO tariff language that limits the period in which a market participant may post additional collateral when the RTO/ISO requests collateral.

In large part, these proposals were well received by commentators, but some issues were identified. Market participants focused on three items in particular: (1) the cap on unsecured credit; (2) the minimum participation standards; and (3) the requirement that the RTO/ISO become a counterparty for netting purposes.

Commentators representing relatively small market participants tend to view the cap on unsecured debt as an opportunity to limit an advantage of regulated utilities and large corporate traders in the marketplace. Those representing larger participants would prefer that the RTOs/ISOs be permitted to set credit limits based on the individual financial characteristics of each market participant. They worry that, under the proposed limit, they will be forced to rely more often on collateral to support their larger transactions.

The Northeast ISOs (*e.g.*, ISO-New England, New York ISO, and PJM) stressed that "regional variations among the organized market operators —such as in the frequency of billing and the size of the particular market/region—make it important that any rule devising an aggregate cap for affiliated groups allow market operators a degree of flexibility in determining the appropriate dollar amount of the aggregate cap." Thus, while they supported the overall standardization pushed by FERC, they argued that regional differences might necessitate certain flexibility.

Several smaller market participants took issue with FERC's proposal to establish minimum criteria for market participation and argued that this proposal could prevent them from participating in the market altogether. The NOPR sought suggestions for the criteria, which "should allow most traditional market participants" to remain in the markets. Several commentators worried that the criteria will include some form of minimum size requirement, which could force small participants from the market and effectively prohibit the entry of new participants. One even lamented that the proposal was "anti-competitive." Until the actual criteria are revealed, it remains »

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impossible to judge the merit of these issues.

Market Participation

Though the RTOs/ISOs largely support the NOPR, they do not uniformly support the proposal to require the RTO/ISO to become a market participant. Because the RTOs/ISOs currently are not parties to the transactions between market participants, some questions have been raised about their ability to offset amounts owed to, and by, market participants in the event of bankruptcy. Bankruptcy courts generally treat all creditors the same. If transactions with bankrupt market parties cannot be offset because the RTO/ISO is not a counterparty, the RTO/ISO itself runs an increased risk of potentially catastrophic loss if a significant bankruptcy occurs.

Despite concerns about the inability to net debts in the event of bankruptcy, not all of the RTOs/ISOs are convinced that those concerns outweigh the expense and hassle of becoming counterparties. Both the Midwest ISO and California ISO (CAISO) questioned whether the risk was real or simply theoretical. They noted that "[t]he Mirant case discussed in the NOPR is apparently the only occasion when ISO netting has even been challenged for lack of mutuality[, d]espite many other opportunities . . ." They further stated, "The proposed rule would impose substantial costs on many ISOs, including but not necessarily limited to imposing additional tax liability, audit costs, and legal fees on ISOs, while also impairing access to capital."

CAISO opposes this part of the proposal and argued in its written comments after FERC's technical conference that "the mere existence of a risk is not the only factor to be considered in a careful analysis. The scope and likelihood of the risk has to be weighed, as well as the cost of mitigation and alternative uses of the required resources." The cost of mitigation, in CAISO's opinion, outweighs the potential risk to be mitigated. CAISO suggested that the Commission should consider less costly approaches, such as having market participants grant the RTO/ISO a security interest in the market participant's receivables, as was implemented by the Midwest ISO.

Additionally, the NYISO further clarified that while it "does not oppose other ISOs/RTOs adopting practices to take title in market transactions . . . [, It] is concerned that a Commission mandate could negatively affect the NYISO's non-profit tax status and potentially impose significant tax, accounting, regulatory and administrative costs, and reporting burdens, on the NYISO."

Although the RTOs/ISOs generally support increased standardization, they also appear to want to carve out some autonomy to allow region-specific differences in credit practices. If taken too far, of course, this could eviscerate the intention behind FERC's move to standardize credit practices. FERC faces a delicate balancing act of ensuring that the new rule acknowledges and permits legitimate differences to address valid concerns, while at the same time maintaining desired standardization to ease inter-market variance. However, an approach which, at a minimum, implements what are determined to be the best practices developed in the various RTOs and ISOs on a more uniform basis appears to have promise in increasing market participation and reducing credit risk for participants in such markets. ■

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