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LEGAL ALERT

October 25, 2010

FERC Adopts New Rules Addressing Credit Support Requirements in the Organized Energy Markets

On October 21, 2010, the Federal Energy Regulatory Commission (FERC) announced rules that reform certain credit practices in the wholesale energy markets operated by regional transmission operators and independent system operators (together the Markets). FERC observed that the following credit rule changes will bring greater stability to the Markets:

- Shortening the Markets' billing period and payment period to no more than seven days each.
- Capping unsecured credit in each Market to no more than $50 million per market participant and no more than $100 million per corporate family.
- Eliminating unsecured credit for financial transmission rights (FTR).
- Implementing minimum credit criteria, such as adequate capitalization and risk management controls, that entities must meet to participate in the Markets.
- Clarifying the circumstances when a Market may invoke rights under a material adverse change (MAC) clause.
- Establishing a uniform two-day grace period for meeting collateral calls.

The credit rules will become effective 30 days after publication in the Federal Register. The implementation details associated with the new rules will become more apparent when the Markets submit their compliance tariff filings on June 30, 2011 and with the tariff revisions in each Market that will go into effect by October 1, 2011.

Shortened Settlement Cycle: FERC directed the Markets to revise their tariffs to establish billing periods of no more than seven days and settlement periods of no more than seven days after issuance of bills. FERC explained that shortening the periods will reduce the size and resulting impacts of any default and decrease the amount of collateral that market participants must post. The agency declined to impose daily billing at this time.

Unsecured Credit: FERC required the Markets to revise their tariffs to reduce the amount of unsecured credit available in each Market to no more than $50 million per market participant and $100 million for all entities within a corporate family. The Markets retain discretion to impose lower limits. The agency considered arguments that reducing unsecured credit is not needed because the Markets perform a thorough credit analysis before allowing an entity to participate, but ultimately concluded that limiting unsecured credit is required because the assumptions underlying credit assessments can change rapidly.

FERC rejected requests to make exceptions to the aggregate cap limit for corporate families that include regulated utilities. The agency explained that utilities with cost-of-service rates still raise default risks because their rates may not cover their wholesale transaction costs. FERC also directed the Markets not to treat parent guarantees like cash or letters of credit when establishing the appropriate level of unsecured credit because guarantees are a form of unsecured credit.

Unsecured Credit for FTRs: FERC ordered the Markets not to grant unsecured credit for FTR positions. FERC understands FTRs are an important risk management tool and does not intend to discourage their use, but the risk and effects of FTR defaults warrant full credit support. For comparable reasons, FERC declined to allow the Markets to extend unsecured credit to load serving entities (LSE) when they are using FTRs to hedge congestion, noting that LSEs still can default. Additionally, there are no exceptions

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to the prohibition on the use of unsecured credit for holders of “fixed price TCCs” or other comparable products because they are still subject to default.

Commenters noted that the proper valuation of FTRs is important to protecting market participants from default risk. FERC acknowledged the challenges associated with valuing FTRs, but declined to address FTR valuation issues because they are beyond the scope of the credit rulemaking.

FERC rejected requests to permit Markets to net credit requirements between FTR and non-FTR activity, explaining that intermingling credit between different markets (including those where unsecured credit is permitted) would defeat the goal of reducing market risk from FTRs.

Creation of a Central Counterparty: FERC had asked whether it should require the Markets to become central counterparties in order to establish the mutuality of contract that a bankruptcy court demands in order to set off obligations between the Market and the defaulting market participant. Commenters argued that FERC does not have enough information to mandate each Market to become a central counterparty and that the benefits of doing so have not been proven. For example, some commenters noted that a bankruptcy court that is hostile to set-off could question whether the Market is the central counterparty in form only, thus eradicating any perceived benefits from moving to a central counterparty structure.

FERC rejected CAISO arguments that it does not need to become the central counterparty because its “net invoicing” provides sufficient bankruptcy protection. More specifically, CAISO treats all items on a market participant’s monthly invoice as one transaction. FERC is concerned that a bankruptcy court may not recognize CAISO’s net invoicing solution even though it is covered in CAISO’s FERC tariff. Such invoice netting thus could pose a risk to the Markets in the event of a bankruptcy. The fact that there is a low probability that a market participant would file for bankruptcy and challenge a Market’s ability to net does not supplant the high cost to market participants and the Market if it does occur. In contrast, FERC believes that MISO’s decision to allow market participants to grant a security interest in their transactions to MISO provides a basis for the Market to net market obligations, although an incomplete one because not all participants are permitted to grant such interests (*e.g.,* governmental sellers).

Some suggested that FERC should direct that all Market tariffs have explicit tariff authority to perform netting and set-off to provide legal cover if a market participant declares bankruptcy. FERC declined, noting that bankruptcy courts might not find such terms sufficient and thus could leave the Market unable to protect itself or its participants through netting and set-off.

FERC expressed qualms on whether a bankruptcy court might not allow a Market to take advantage of set-off and other rights if the Market is not the central counterparty. However, due to a variety of views in the record, FERC will consider other solutions and directed the Markets to submit tariff revisions that include one of the following options:

- Establishing a central counterparty.
- Requiring market participants to provide a security interest in their transactions in order to establish collateral requirements based on net exposure.
- Proposing another alternative that provides the same degree of protection as the two above.
- Establishing credit requirements for market participants based on their gross obligations.

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Minimum Criteria for Market Participation: FERC found that the Markets should specify the minimum participation criteria to be eligible to participate in the Markets (*i.e.*, the ability to engage in or out-source hedging, adequate risk management capabilities and capital to engage in trading with minimal risk to the Market). FERC rejected arguments that minimum criteria are not necessary if Markets apply vigorous credit review standards, noting that a credit review may identify whether the market participant has adequate capital but not other risks that participation criteria would identify. Rather than impose specific criteria, FERC ordered each Market to develop these criteria through their stakeholder processes.

MAC Clauses: As part of its credit proposal, FERC raised concerns that it was not always clear when a Market could invoke a material adverse change, or "MAC," clause and that this lack of clarity could impede the ability of the Markets to manage risks. To address these concerns, FERC required the Markets to provide in their tariffs an illustrative (rather than exhaustive) list of conditions under which they may invoke a MAC clause to compel a market participant to post additional collateral, cease transactions, or take other measures to ensure that a participant can transact without jeopardizing other participants. The Markets also can retain discretion to request additional collateral in response to unusual or unforeseen circumstances.

Moreover, FERC stated that MAC clauses need to be sufficiently forward-looking to allow the Markets to request additional collateral before a crisis starts. For example, credit ratings may be one factor, but they change slowly and can lag events that constitute a MAC. Thus, FERC ordered Markets to look for criteria that may be prior indicators of default, such as large changes in the price for a collateralized debt security.

FERC directed the Markets to provide reasonable advance notice to a market participant, if feasible, when they invoke a MAC clause. The notice should be in writing, contain the rationale for invoking the MAC clause, and be signed by a person with authority to represent the Market. FERC requires each Market to revise its tariff to establish a two-day limit to post additional collateral in response to the invocation of a MAC clause or other provision of the tariff.

General Applicability: When FERC issued the NOPR, it sought comment on whether the credit practices set out in the proposal should be applied in the same way to all market participants. In the rules it adopted, FERC declined to adopt generic waivers and exceptions for any market segment. However, FERC recognized that the Markets may seek specific exemptions based on their experience and appropriate evidence, including where the facts indicate that a default would not raise significant market disruptions.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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