UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Credit Reforms in Organized Wholesale Electric Markets	**)** **)** **)**	**Docket No. RM10-13-000**

SUPPLEMENTAL COMMENTS OF THE
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION
ON NOTICE OF PROPOSED RULEMAKING

The California Independent System Operator Corporation (California ISO) submits these supplemental written comments in response to the Notice of Proposed Rulemaking, issued by the Federal Energy Regulatory Commission on January 21, 2010, to address the proposal that ISOs and RTOs should become central counterparties to the transactions in their markets. The California ISO respectfully requests that the Commission not implement such a rule because its predicted costs would outweigh any benefits. This was explained in the California ISO's earlier written comments, which it will avoid repeating here.

I. Overview of the Record After the Technical Conference

The testimony at the May 11 technical conference discussed the proposed rule in terms of "insurance" to eliminate a possible risk that ISOs and RTOs might not be able to enforce setoff contract rights against a bankrupt market participant.[1] The California

[1] Transcript of May 11, 2010 Technical Conference in this Docket ("Transcript"), pp. 15-16.

ISO takes seriously any perceived credit risk that could negatively impact its market participants. But 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.

In 2004, the Commission considered the closely related issue of whether the value of netting is worth the "possible risk that the netting arrangement may be unwound if a customer becomes insolvent."[2] Weighing the same risk that is at issue here, the Commission concluded that it did "not believe that these potential costs outweigh the benefits of netting."[3] The California ISO submits that there is nothing in either the written record or the testimony at the technical conference that should alter this conclusion or justify the proposed rule. No new information about the scope or likelihood of the risk has emerged from this proceeding. To the contrary, even the parties advocating for the rule continue to assess the risk that setoff could not be effected in the bankruptcy context as "remote." Moreover, there is no evidence to dispute the California ISO's explanation why it would have to incur substantial expense to become a central counterparty. And altogether there has been no showing that any benefits of reducing that risk are worth the significant expense of the proposed rule.

To the extent the Commission finds that the scope and likelihood of the risk justify adopting some rule, it should require ISOs and RTOs to work with their stakeholders to identify alternative approaches to mitigating any risks, including but not limited to market participants granting a security interest in their receivables to ISOs and RTOs, the approach employed successfully and with minimal cost by the Midwest ISO.

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[2] *Policy Statement on Electric Creditworthiness*, 109 FERC ¶ 61,186 (2004) n. 26.

[3] *Id.* at P. 29

This approach would be much less burdensome and costly than requiring ISOs and RTOs to become a central counterparty, and there was general agreement at the technical conference that a security interest, once granted, would address the perceived risk.

II. Evidence about Benefits of the Proposed Rule

A. There is no Evidence about the Scope of the Risk to be Avoided

If the mutuality argument were raised and litigated successfully, how much money could market participants lose? Although concerns were expressed that a loss could be high, the record contains no evidence on this point. There was discussion at the technical conference about potential losses in the range of a hundred million dollars, but this was a reference to the approximate stakes in the Mirant litigation, which Mirant dropped before any decision by the court. Moreover, the ISO explained, this litigation arose from unique circumstances and did not concern ordinary course settlements,[4] which is the concern posed in Wachtell memorandum cited in the NOPR.[5]

Evidence about the overall size of ISO and RTO markets does not show the scope of the risk. For one thing, the California ISO and the Midwest ISO both explained that only certain kinds of market participants would consider raising the mutuality issue.[6] For these entities, the Commission should gather historical data about the difference between their net position and gross credits. This figure would theoretically represent

[4] Transcript at 26-27. Mirant's large receivable arose only because of the default of the California Power Exchange which, due to the unique structure of the initial California ISO market, constituted more than 80% of the ISO's market. The California ISO no longer has a single market participant that represents this large a share of the market, and is not aware of a similar concentration in any other market.

[5] Wachtell memorandum at 11.

[6] Transcript at 25-26, 46-47.

the amount those entities would be under-secured, assuming ordinary monthly netting were determined to be unenforceable for lack of mutuality. The average monthly figure, or perhaps the highest portion of average figures, should represent the potential loss if one of these entities were to challenge netting and succeed. Without this type of data, the Commission would simply be speculating about the scope of the risk.

B. The Only Evidence about Likelihood of the Risk Shows it is "Remote"

In addition, the Commission should also consider the likelihood of the risk – i.e., the chances that a bankrupt market participant would choose to litigate the issue and ultimately succeed. The testimony of the parties advocating the counterparty rule was that this risk is "remote" and "weak."[7] Accordingly, a significant discount must be applied to the benefits of the proposed rule. Put another way, if the ten percent of market participants who pose the greatest risk historically have, for example, an average monthly difference of $12 million between their net and gross positions, the risk would not justify incurring $12 million in costs, but only a small fraction of that amount.

In addition, two points about the technical conference testimony are worth noting. First, there is some confusion in the testimony about the significance of assuming executory contracts.[8] The reality is that a bankrupt market participant that wishes to stay in the energy business post-reorganization, such as Mirant, has no choice but to continue to rely on the ISOs and RTOs in the markets where it operates. As such, that market participant will be reluctant to do anything but assume its executory contracts

[7] Transcript at 15 & 32 (PJM), 85 & 86 (Committee of Chief Risk Officers).

[8] Transcript at 64-65.

with the ISOs and RTOs, which assumption, in turn, under the Bankruptcy Code, requires the cure of all defaults. Thus, the market participant will have to pay in full the amounts it owes the ISOs and RTOs and any setoff arguments will be moot. The Wachtell memorandum acknowledged this reality.[9]

Second, the final panel at the technical conference focused on setoff and the identity of the parties, without any discussion of recoupment. As the Wachtell Memo recognized, however, recoupment, unlike setoff, does not require mutuality.[10] To accurately assess the risk that ISO and RTO contractual netting rights will not be enforced, the Commission must weigh the likelihood that an ISO or RTO would prevail on its recoupment defense, again rendering any consideration of the setoff issue moot. Similarly, the panel did not discuss any of the long-standing and established legal principles that give force to tariffs and contracts approved by this Commission.

To be sure, to the extent there is a risk that a bankruptcy court, as a court of equity with a "hostility" to setoff,[11] will not honor the terms of a FERC-approved tariff, then it follows that there is a risk that the same court, motivated by the same "hostility," may look behind the form of the central counterparty structure. A debtor market participant could argue, for example, that while the ISO is, in form, the counterparty, it takes only “flash title” and mutualizes bad debt losses. As such, in substance, the ISO would be acting as an agent for the pool.[12] Such a finding would pose a risk similar to

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[9] Wachtell memorandum at 9.

[10] *Id.* at 11.

[11] Transcript at 66.

[12] *See, e.g.*, *Liona Corp. v. PCH Assocs. (In re PCH Assocs.)*, 949 F.2d 585, 597 (2d Cir. 1991) ("It is well established that a bankruptcy court, as a court of equity, may look through form to substance when determining the true nature of a transaction as it relates to the rights of parties against a bankrupt's

the current structure. Thus, while the proposed new PJM structure reduces some risk for PJM participants, it does not eliminate it entirely, something the Commission must consider when deciding whether the costs of the proposal outweigh its benefits.

III. Evidence about Costs of the Proposed Rule

A. The Only evidence About Cost Show They will Be Significant and Ongoing

In its written comments, the California ISO explained why becoming a central counterparty would require it to expend additional resources. Besides the initial work to set up new legal structure and modify software, the accounting and auditing costs would be significant. These costs would continue past initial implementation. Nothing was presented to the contrary, either in written comments or at the technical conference. Without more information about costs – in particular, information that the costs should be less than the expected value of the credit risks avoided – the Commission should not consider ordering a wholesale restructuring of ISO and RTO markets.

B. There is a Less Costly Alternative

The Midwest ISO has chosen to address any risk posed by the mutuality requirement through creating security interests.[13] There was general agreement at the technical conference that this approach addresses any risk just as well as the central counterparty approach.[14] The California ISO concurs in this assessment. It has also

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estate. It is the economic substance of a transaction that should determine the rights and obligations of interested parties."); *see also Pepper v. Litton*, 308 U.S. 295, 304-05 (1939) (explaining that bankruptcy courts are courts of equity and use their powers to ensure that "substance will not give way to form").

[13] 128 FERC ¶ 61,093.

[14] Transcript at 50, 72-73.

reviewed the Midwest ISO approach and concluded that it would be relatively simple to implement, at least for the ISO. Stakeholder acceptance is less certain, depending on the details of the rule, because of potential conflicts with market participants' lending documents. But the Midwest ISO testified that their stakeholders did not resist their rule, which was voluntary in the sense that participants who did not grant the security interest could instead accept a higher cost of credit by securing their gross rather than net market participation.[15] In addition, stakeholder concerns might be addressed by allowing a long lead time before the rule takes effect to facilitate discussions between market participants and lender. Given the general agreement that any risk is remote, a long lead time should be acceptable to all parties.

IV. Conclusion

While PJM should be free to pursue its central counterparty proposal, there is no basis to impose it nationwide. The evidence in the record does not show that the benefits of the proposed rule in terms of reducing credit risk to market participants outweigh the costs, which ultimately will be borne by those same market participants.

It is noteworthy that most of the California ISO stakeholders that filed written comments on this issue were opposed to a central counterparty requirement. If the Commission determines that some action must be taken, it should begin by requiring a formal stakeholder process to weigh options, including the security interest approach of the Midwest ISO, and whether a national clearinghouse could be established without requiring ISOs and RTOs to be counterparties.

[15] Transcript at 47-48.

Beyond that, if the Commission were to determine that some rule must be adopted, it should allow ISOs and RTOs to adopt the approach of the Midwest ISO.

June 8, 2010

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing document upon the parties listed on the official service list in the captioned proceedings, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated at Folsom, California this 8th day of June, 2010.

/s/ Jane Ostapovich

Jane Ostapovich