UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

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

JOINT COMMENTS OF
THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION AND MIDWEST INDEPENDENT TRANSMISSION SYSTEM OPERATOR, INC.

I. INTRODUCTION

The California Independent System Operator (California ISO) and the Midwest Independent Transmission System Operator (Midwest ISO) jointly submit these early comments limited to the issue of setoff in bankruptcy – Section III(D) of the January 21, 2010 Notice of Proposed Rulemaking (the "NOPR").

The NOPR would require ISOs and RTOs (collectively "ISOs") to become parties to each financial transaction. See ¶¶ 24-25. This proposal is motivated by a concern that ISOs may have difficulty netting debits against credits for bankrupt market participants because of a possible lack of "mutuality," leading to a risk of loss for other market participants. 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. California ISO and Midwest ISO intend to address this issue in more detail in their respective comments to be filed later.

The purpose of this early filing is to encourage commenting parties to examine whether the proposed rule would materially reduce market credit risk for ISOs and their customers and, if so, whether less costly alternatives are available. These questions are not raised in the NOPR, and California ISO and Midwest ISO want to avoid a situation where positions are formed based on a less than complete picture of the costs and benefits.

II. COMMENTS

A. Completing the Picture on Risk – The Risk of Loss is Theoretical Only

The NOPR leaves the impression that there is a definite problem to address by citing a legal memorandum[1] about the risk that bankrupt market participants could challenge all ISO netting going back 90 days before a bankruptcy petition based on a lack of mutuality. California ISO and Midwest ISO urge commenting parties to evaluate this issue for themselves in light of two points.

First, the risk of loss is theoretical only. Although there have been billions of dollars of transactions, no ISO market participant has lost money due to the risk described in section III(D) of the NOPR. The Mirant case discussed in the NOPR is apparently the only occasion when ISO netting has even been challenged for lack of mutuality. Despite many other opportunities,[2] the argument has not been raised before or since. Indeed, the Wachtell memo mentions practical reasons why a bankrupt market participant might decide not to raise the argument, including a desire to continue its relationships with other market participants post-bankruptcy. *See* Wachtell Memo at 9-10, 11 n. 44. In addition, bankrupt market participants may be unlikely to challenge ISO netting when their payables within the 90 days before their bankruptcy petitions are insufficient to justify litigation. *Id.* at 11 n. 44.

As the NOPR accurately noted, Mirant filed complaints in its bankruptcy case against the California ISO and several other parties seeking declarations that the defendants would not be permitted to set off certain debts that Mirant owed to the California investor-owned utilities in FERC refund proceedings stemming from the California electricity crisis of 2000-01. Ultimately, however, Mirant walked away from the litigation and settled its refund

[1] Memorandum by Wachtell, Lipton, Rosen & Katz to PJM regarding Setoff and Credit Risk of PJM in Member Bankruptcies at 7, 10-11 (March 17, 2008), cited in NOPR p. 15 n. 28 (the "Wachtell Memo").

[2] After Mirant filed for bankruptcy, three more companies that participated widely in ISO markets also filed for bankruptcy – PG&E Energy Trading, Calpine, and Lehman Brothers. Nor was the argument raised in the Enron bankruptcy. Although Enron filed for bankruptcy before Mirant, it took longer to resolve and Enron could have copied the arguments that Mirant had already raised.

obligations, leaving the argument as just that – an argument. *See* Wachtell Memo at 11; Order on Settlement Agreement, 111 FERC ¶61,017 (April 13, 2005). It seems that FERC did not intend to suggest that any market participant had actually incurred losses, but rather that, "*had there been a ruling in favor of Mirant*, the market participants in that litigation could have incurred losses."

Second, the mutuality argument has never been raised to challenge ordinary ISO netting. The Mirant litigation involved unique circumstances arising from the California energy crisis – *i.e.*, both a large receivable due to Mirant ($285 million) due to the bankruptcy of the California Power Exchange and a large refund obligation due from Mirant as a result of the high spot market prices. These circumstances are not likely to recur given the changes instituted by FERC, ISOs, state regulators, and other stakeholders since the California crisis. The Mirant litigation did not challenge California ISO's right to have netted debits and credits in ordinary course settlements, which is the risk contemplated by the Wachtell Memo. Specifically, the Wachtell Memo contemplates the possibility that a bankrupt market participant could use the "mutuality" argument to challenge netting going back 90 days before its bankruptcy petition. *See* Wachtell Memo at 6-7, 12-13. In contrast, Mirant conceded California ISO's right to net in the ordinary course.[3]

In short, when formulating their positions on Section III(D), commenters should consider the facts that the mutuality argument has been raised only once in unique

[3] See *Order Regarding Motion of the Debtors for an Order Enforcing the Automatic Stay and Directing the Turnover of Property of the Estate and California Independent System Operator Corporation's Motion for Determination of Recoupment Rights, or in the Alternative, for Relief from the Automatic Stay*, In re Mirant Corporation, Case No. 03-46590 (DML), November 26, 2003 (N.D. Tex. Bankr.). By agreement of the parties, this order was not precedential. *Cf.* Wachtell Memo p. 11 n. 44 (stating that, according to Mirant's counsel, a factor in limiting Mirant's setoff challenge to just its "exceptional refund" claims was "that Mirant was in a very large net credit position on ordinary course operations and the ordinary course setoffs were relatively immaterial").

circumstances that are unlikely to recur, and has not caused market participants to incur losses.[4]

B. <u>Completing the Picture on Solutions – Any Problem Can be Mitigated Through Less Costly Tariff Revisions</u>

To the extent that there is a risk to address, commenting parties also should consider less burdensome solutions as alternatives to the proposed rule. As noted above, it would be quite costly to revise the California ISO and Midwest ISO tariffs to become central counterparties in all transactions. As an alternative, the Wachtell Memo suggests "shortening settlement periods" as a possible solution. Wachtell Memo at 14. Commenting parties should consider whether this solution may be adequate.

In addition, each ISO believes that its tariff mitigates the risk of being unable to net debits and credits to market participants. The California ISO tariff mitigates the risk by providing that charges and credits will be netted in preparing invoices and obligates the market participant to pay, or to be paid, a net amount. This netting of discrete line items in a single transaction is akin to a restaurant tab with a discount applied, and involves "recoupment" for which mutuality is not a requirement. The California ISO took this position in the Mirant bankruptcy.

The Midwest ISO tariff similarly provides for net invoices in the various service categories and explicitly provides that any payments to a market participant are subject to prior payment of all amounts due from the market participant. In addition, to mitigate any risk that netting would not be permitted across service categories, the Midwest ISO tariff requires market participants to grant a security interest in the receivables due from the Midwest ISO as a condition necessary for netting credit exposure. This was done to further minimize the hypothetical risk that netting could be undone in a bankruptcy proceeding.

[4] Furthermore, ISOs may have substantial defenses to challenges from bankrupt market participants, see Wachtell Memo at 11 n. 46, as California ISO and Midwest ISO will explain later in their separate comments.

The PJM Operating Agreement, which is analyzed in the Wachtell Memo, does not appear to adopt either of these approaches. Nor did the Wachtell Memo analyze how the scope of the risk it identified would be affected if the PJM Operating Agreement were revised to explicitly state, among other things, that there is no right of payment until all netting is complete. Such changes could mitigate the scope of any risk considerably and would be much less costly to implement.

III. CONCLUSION

The California ISO and the Midwest ISO acknowledge that the legal issues presented in and resulting from the NOPR are complex and cannot be addressed adequately in this short pleading. California ISO and Midwest ISO both intend to address these issues in more detail in their final comments. In the meantime, California ISO and Midwest ISO encourage all commenting parties to independently evaluate the risk to ISO market participants posed by the "mutuality" argument and, assuming they conclude there is a substantial risk, whether less obtrusive solutions would mitigate it effectively.

Respectfully submitted,

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