FERC Introduces Tougher Rules on Credit Practices in Organized Electric Markets

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On October 21, 2010, the Federal Energy Regulatory Commission (FERC) released a final rule reforming the credit practices of the organized electric markets, which include those energy transmission markets operated by independent system operators (ISOs) and regional transmission organizations (RTOs). Under the new regulations set forth in the final rule, ISOs and RTOs will have to revise their FERC transmission tariffs to provide for: (i) shortened and standardized billing and payment periods for market participants; (ii) caps on the amount of unsecured credit that may be held by individual and affiliated market participants; (iii) elimination of unsecured credit in financial transmission rights (FTRs) markets; (iv) an election among options as to how a wholesale power marketer may net transactions; (v) the establishment of minimum criteria for market participation; (vi) clarification of when a market administrator may require additional collateral of a market participant under a "material adverse change clause"; and (vii) the establishment of a maximum two-day grace period for curing calls for additional collateral.

The new regulations are designed to standardize certain credit practices among the various organized markets in response to FERC's concerns about the effects major defaults in a given market could have on others. The final rule makes specific reference to the various defaults in the nation's financial markets that occurred in the financial crises of the last several years, and notes that while it agrees with commenters' suggestions that the new uniformity sought by these regulations would have costs to the organized markets and to market participants alike, the new regulations would aim to achieve the appropriate balance between liquidity, risk management, and the continued ensuring of just and reasonable rates for retail customers. FERC notes in particular that defaults without collateral in the markets administered by the RTOs and ISOs are generally borne by all market participants, and a default by a major participant in one market could weaken others, since market activity is not confined to particular regions or markets.

New Regulations

Having identified a correlation between the settlement cycle for billings and payments and the costs attributable to eventual defaults, FERC has determined to end the current system where each ISO and RTO may have its own time period for billing and payment. Instead, the final rule introduces a standard cycle of no more than seven days for either a billing or a settlement period in all affected markets. Based on the premise that less outstanding debt at a given time means lower potential defaults, FERC will require each ISO and RTO to revise its tariff to provide for these standardized seven day billing and settlement periods. The final rule notes that several organized markets have already instituted and thereby proven the efficacy of this "weekly" billing.

The new regulations also impose uniform limits on the extension of unsecured credit; no more than $50 million may now be extended per market participant, and no more than $100 million for any particular corporate family. While any ISO or RTO remains free to establish lower limits as they see fit, FERC sees these ceiling limits as necessary to protect markets from disruption, particularly a scenario in which the bankruptcy of a single corporate family results in serious disruption to an organized electricity market. In adopting these new limits on unsecured credit, FERC rejected comments from market participants that urged the alternative requirement of parental guarantees to guard against defaults on unsecured credit. FERC brushed this idea aside as simply an argument for yet more unsecured credit, and directed ISOs and RTOs not to consider such parental guarantees in establishing appropriate levels of unsecured credit for a market participant.

Another aspect of the new regulations is the complete elimination of the allocation of unsecured credit in the FTR markets.[1] Although many commenters opposed this step, with one arguing that FERC should take into account market participants' business models and avoid applying a blanket prohibition on unsecured credit in the FTR markets, FERC determined that a prohibition was warranted, in part due to the relatively illiquid nature of FTRs and the resulting risk in valuation.

In the Notice of Proposed Rulemaking ("NOPR") that preceded the issuance of this final rule, FERC moved to address the perceived issue of ISO and RTO exposure where a market participant declares bankruptcy. FERC contends that if such a bankruptcy filing is made by a market participant, it might successfully contest the ability of the relevant RTO or ISO to offset amounts it owes against amounts owed the bankrupt party. This is because ordinarily, while RTOs and ISOs arrange for settlement and netting of transactions between market participants and the administrator, they do not take title to the underlying contractual position of the participant at settlement. Thus the NOPR proposed the creation of a legal basis to protect RTOs and ISOs by clarifying the RTO's/ISO's legal status to take title to transactions in the markets they administer. By doing so, the administrators could establish the mutuality in the transaction needed to support a set-off in bankruptcy.

FERC's proposal was opposed by many of the RTOs and ISOs that argued this approach would create harmful impacts in areas unrelated to member credit issues. In response to the various comments submitted regarding this proposal, the final rule sets forth several options that the ISOs and RTOs may take in order to address the issue presented: take title to transactions as proposed in the NOPR; require market participants to provide a security interest in their transactions to establish collateral based on net exposure; propose another alternative providing the same degree of protection as the previous options; or, establish credit requirements based on the gross obligations of market participants.

In another aspect of the final rule's reforms of the credit practices of the organized markets, FERC is requiring ISOs and RTOs to include in their tariffs language to specify the minimum participation criteria for eligibility to participate in the market. However, FERC is not proposing specific criteria in the final rule; rather, each ISO and RTO is directed to develop such criteria through its own stakeholder process and submit a compliance filing with the criteria.

The final two reforms set forth in the final rule pertain to the situation in which additional collateral is required to be posted by a participant in the markets administered by an RTO or ISO. The first of these relates to the invocation by a market administrator of a so-called "material adverse change" clause in its tariff, under which it may declare that such a change in the credit posture of a market participant has occurred to justify the posting of additional collateral. Arising from concern that the circumstances under which the market administrators may invoke such clauses are too ambiguous, the final rule requires ISOs and RTOs to specify in their tariffs the conditions under which they will request such additional collateral due to a material adverse change. The list need not be exhaustive, but illustrative, and the ISOs and RTOs will retain discretion to request additional collateral if unusual events arise. In addition, the final rule requires that ISOs and RTOs give market participants written explanations where these material adverse change clauses are invoked.

Finally, the final rule moves to standardize the "cure" period in which a market participant subject to an increased collateral posting obligation must post that collateral. Some organized market administrators currently allow up to three days for this posting of new collateral, while others require it to be done virtually overnight. Attempting to strike a balance among these practices, the final rule requires each ISO and RTO to allow no more than two days to cure a collateral call.

The final rule requires all RTOs and ISOs to submit compliance filings conforming their tariffs to the new regulatory requirements by June 30, 2011, with those new tariff provisions to be effective by October 1, 2011.

Conclusion

In issuing this final rule to significantly tighten and harmonize the credit practices and rules of the various organized electric markets, FERC has invoked the specter of the financial credit crises of recent years. Drawing on concerns that market participation across numerous regions and markets by large players risks a major default that could shake all the markets at once, FERC has moved to clamp down on the discretion of each ISO and RTO to set its own credit requirements and practices. The new regulations may introduce greater certainty and predictability across the organized markets, and FERC explicitly rejected suggestions of a graded approach to the applicability of the new rules, specifying instead that the credit practices in the final rule would apply to all market participants.

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[1] FERC defines an FTR as a "financial instrument[ ] used to hedge the risk of transmission congestion by entitling the holder[ ] . . . to compensation for transmission congestion charges." *PJM Interconnection, LLC*, 127 FERC ¶ 61,025 at P 2 (2010).

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