UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

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

POST-TECHNICAL CONFERENCE COMMENTS OF SOUTHWEST POWER POOL, INC.

Southwest Power Pool, Inc. ("SPP") submits these comments in response to the Federal Energy Regulatory Commission's ("FERC" or "Commission") Notice Establishing Date for Comments.[1] SPP submitted initial comments in this proceeding on March 29, 2010.[2]

The FERC NOPR "proposes to revise its regulations to require that each RTO and ISO include in the credit provisions of its tariff revisions to clarify their status as a party to each transaction so as to eliminate any ambiguity or question as to their ability to manage defaults and to offset market obligations. The Commission seeks comment on whether this clarification of status would have ramifications beyond addressing the risk *(of not being able to net payments or take set offs in a bankruptcy)* highlighted here." (para 25)

The actual risk of loss to ISOs/RTOs or their market participants due to a challenge of netting or set off in bankruptcy appears to be very small. One high profile case, Mirant, has been the only apparent challenge to mutuality and set off, and that case

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1 *Credit Reforms in Organized Wholesale Electric Markets*, Notice Establishing Date for Comments, Docket No. RM10-13-000 (May 12, 2010).

2 Comments of Southwest Power Pool, Inc., Docket No. RM10-13-000 (Mar. 29, 2010).

had several unique circumstances which were not in the ordinary course of business. The Mirant litigation did not raise an argument against mutuality in regard to netted debits and credits in ordinary course settlements of ISOs/RTOs. Ultimately, there was no bankruptcy ruling on the issue since the case was settled. There have been no successful challenges to RTO or ISO mutuality in bankruptcy.

Other reasons why the risk may be remote include:

- The bankrupt market participant may want to continue its relationships with the ISO/RTO and its other market participants post-bankruptcy.
- The nature of power pooling and the tariffs applied undermine the claim that there are two distinct debts as opposed to one net debt.
- Bankruptcy courts may be hesitant to set aside FERC approved tariffs that require payment netting or set off (filed rate doctrine.)
- Mutuality is not a requirement for "recoupment" (CAISO took this position in the Mirant bankruptcy.)

As an alternative to taking title to transactions, the Midwest ISO has required market participants to grant a security interest in the receivables due from MISO 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. However, as noted above, the risk is low to remote. In any event, this approach creates specific concerns:

- Many, if not most, market participants would not be able to supply such a security interest due to the terms and conditions of their existing financing arrangements.
- The burden of perfecting UCC filings for each security interest may be quite onerous and potentially costly.

If the ISO/RTO were to assume the role of central counterparty, several new risks would be introduced. For example, the nature of its business and that of its market

participants will be changed when the ISO/RTO takes ownership of transactions, with the following potential consequences:

- Negative effects on the Legal and tax reporting status of the market participants and the ISO/RTO.
- Additional accounting, audit and reporting requirements which would result in higher costs for the ISO/RTO.
- The opinions of the credit rating agencies could be adversely affected, resulting in materially higher financing costs for ISOs/RTOs.
- Performance measurements and other ratios deteriorating and result in an event of non-compliance with existing credit facilities.
- Additional regulatory oversight and compliance costs as a result of the ISOs/ RTOs becoming subject to the Commodity Futures Trading Commission.

By taking title to transactions, the ISO/RTO will also be expected to assume all the natural risks of ownership, including the following:

- Operational and delivery risk.
- Accounting risk (the increase in volume of purchase and sales transactions with associated mark-to-market reporting).
- Market risk.
- Credit risk. (Taking ownership of transactions will not reduce credit risk. The best way to avoid loss in bankruptcy is to minimize credit exposure before bankruptcy.)

The ISOs/RTOs have provisions to socialize defaults to all of the market participants. With the ISO/RTO taking ownership of all transactions, market participants may balk at the notion that they have any share in defaults. This could force the ISO/RTO itself into bankruptcy, which would be disruptive to the markets that the ISO/RTO administers.

The primary functions of ISOs/RTOs are to manage transmission systems to provide open access to markets and ensure reliability. If an ISO/RTO were to begin

taking title to transactions, there is a risk that the focus of the ISO/RTO, faced with all of the additional risks associated with assuming title of transactions, may inevitably shift toward the development of an economic interest in buying and selling power to the detriment of its primary functions. In addition, the ISO/RTO may not be able to avoid conflicts of interest or maintain the independence necessary to effectively administer transmission systems and markets.

It is worth noting that NYMEX and other large exchanges do not act as central counterparties. Instead, they utilize separate clearing houses which ensure the independent administration of the market.

If ISOs/RTOs were to assume the role of a clearing house, similar to the clearing houses of the large commodities exchanges, the impact to the markets they administer could be significant. Clearing houses, as counterparties to every trade, establish significant trading security requirements for their trading partners. CME Clearing, the clearing house affiliated with NYMEX, establishes and monitors financial requirements for clearing firms, such as:

- Deposits required from clearing firms to ensure that they can cover worst case potential losses in connection with their trading positions; and
- Segregation of customer funds.

In the event of default, CME Clearing will:

- First, apply assets (security deposits, performance bonds, etc.) of the defaulted firm to cover its payment obligation.
- Second, make a demand for payment pursuant to any applicable guarantee provided to the exchange by the parent company.

Thereafter, if the payment default remains unsatisfied, CME Clearing will use, in order:

- CME Clearing’s surplus funds;
- security deposits of other clearing firms; and
- funds collected through an assessment against all other solvent clearing firms to satisfy the deficit.

Rather than enabling market participants to extend credit collectively and pro-ratably to each other, the clearing house approach will concentrate all credit risk to the clearing house, with the result that many current market participants, such as cooperatives or municipalities, would not be able to meet the stringent credit requirements of a clearing house structure. Most ISOs/RTOs are not-for-profit entities or revenue neutral, and thus would have no "surplus funds" with which to satisfy a default. Those funds would have to be required from market participants. For those able to meet the requirements, the market participants would then be in a position of funding a potential loss in advance, most likely among a smaller pool of other qualified participants, rather than experiencing a loss, when or if one occurs, that is socialized among the wider pool of participants. In addition to funding a potential loss in advance, participants may still be subject to an additional assessment after the fact.

This approach is a significant departure from the current practices of the ISOs/RTOs. This could result in substantial new financial burdens on market participants and create additional overhead costs in order to effectively manage the market.

Much of the open access to markets inherent in the ISOs/RTOs primary functions would be lost due to these new funding barriers. Some of the better capitalized or more liquid market participants would, by necessity, emerge to fill the role of "clearing firm" to participate in the clearing house on behalf of smaller entities. This would expose those market participants acting as "clearing firm" to a series of new risks associated with the

maintenance of the smaller entities' positions, and segregation of funds. Such activities would also fundamentally change the nature of the participants business with all the resulting risks previously mentioned.

SPP has several serious concerns regarding the possibility of the ISO/RTO serving as the counterparty to the transactions in the various markets. Most importantly, it would seem to result in more potential risks than it mitigates. The current structure of the markets has performed acceptably through the bankruptcies of participants, which would seem to suggest an ability to manage the risks of mutuality and offset. On the other hand, the implementation of a counterparty requirement for the ISO/RTO would almost certainly result in materially higher costs to administer the markets and oversee its participants; create a high likelihood of negative effects (both legal and financial) on the existing and future credit facilities of the ISO/RTO and cause market losses to be absorbed by the ISO/RTO, even though its mission and financial condition are not designed for this purpose.

In summary, SPP and its stakeholders believe that the Commission should not mandate a requirement that each ISO/RTO become the counterparty to market transactions. Rather this decision should be left to the individual ISO/RTO and its members and stakeholders.

Respectfully submitted,

/s/ Thomas P. Dunn

Thomas P. Dunn
Vice President, Finance & Chief
Financial Officer
Southwest Power Pool, Inc.
415 North McKinley, #140 Plaza West
Little Rock, AR 72205

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