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BEFORE THE

FEDERAL ENERGY REGULATORY COMMISSION

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IN THE MATTER OF: :

TECHNICAL CONFERENCE ON PROPOSED : Docket RM10-13

RULEMAKING ON CREDIT REFORMS IN :

ORGANIZED ELECTRIC MARKETS :

- - - - - x

Hearing Room 2C

Federal Energy Regulatory Commission

888 First Street, N.E.

Washington, D. C. 20426

Tuesday, May 11, 2010

The above-entitled matter came on for technical
conference, pursuant to notice, at 9:00 a.m.

BEFORE:

SCOTT MILLER, Senior Market Advisor, Division of
Economic Policy & Analysis, OEPI

J. ARNOLD QUINN, Director, Division of Economic
Analysis, Office of Energy Policy Innovation

BRYAN K. CRAIG, Director and Chief Accountant,
Division of Audits, Office of Enforcement.

1 BEFORE (Continued):

2 GREGORY BERSON, East Group 3 Manager, Division
3 of Tariffs and Market Development-East, OEMR
4 MICHAEL BARDEE, Principal Deputy General Counsel
5 Office of General Counsel
6 LAWRENCE R. GREENFIELD, Associate General
7 Counsel, Energy Markets-1, OGC.
8 CHRISTINA HAYES, Office of General Counsel

9

10 Also Present:

11 COMMISSIONER JOHN NORRIS

12

13 PANELISTS:

14 PANEL I:

15 VINCENT DUANE, General Counsel and Vice
16 President, PJM Interconnection L.L.C.
17 MICHAEL HOLSTEIN, Chief Financial Officer,
18 Midwest Independent Transmission
19 System Operator, Inc.
20 DANIEL J. SHONKWILER, Senior Counsel, California
21 Independent System Operator Corporation
22 ANANDA K. RADHAKRISHNAN, Director, Division of
23 Clearing and Intermediary Oversight,
24 Commodities Futures Trading Commission

25

1 PANELISTS (Continued):

2 PANEL II:

3 ISKENDER H. CATTO, ESQUIRE, Kirkland & Ellis,
4 LLP, on behalf of the Committee of Chief
5 Risk Officers

6 HAROLD S. NOVIKOFF, ESQUIRE,
7 Wachtell, Lipton, Rosen & Katz

8 STEPHEN J. DUTTON, ESQUIRE
9 Barnes & Thornburg

10 TODD BRICKHOUSE, Vice President - Treasurer,
11 Old Dominion Electric Cooperative

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P R O C E E D I N G S

(9:00 a.m.)

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3 MR. MILLER: Thank you all for coming for this
4 technical conference related to the Commission's proposals
5 in RM10-13. Specifically we are going to be discussing the
6 Commission's proposal for the ISOs and RTOs to clarify their
7 positions as central counterparties in their markets.

8 We are having two panels here today to discuss
9 the various merits of that proposal, and any other proposals
10 listed in the comments. I wanted to let everyone know who
11 may be listening in on the Web that the Commission yesterday
12 posted a further notice concerning the technical conference
13 in which we noted this public conference may address matters
14 in the following Commission proceedings: Docket ER10-942,
15 ISO New England and NEPOOL; Docket ER10-1190, also ISO New
16 England and NEPOOL; and Docket ER10-1196, PJM
17 Interconnection.

18 I got a couple of anxious phone calls from
19 participants who were going to be listening from afar and
20 said, oh, my gosh, why are--you know, wondering if we were
21 expanding the breadth of the conference.

22 I assured the parties who called that the intent
23 is for this to be narrowly focused on the Commission's
24 proposal to clarify the central counterparty issue.
25 However, we in a fit of completeness needed to notice things

1 that were before the Commission related to credit generally
2 speaking.

3 Given the nature of this conference, we may be
4 discussing the PJM Docket, but we also through the ISO New
5 England Dockets, just in case.

6 We are going to have one panel that generally we
7 refer to as our Market Administrator Panel, although we are
8 very pleased to have senior staff member from a sister
9 regulatory agency. And, Ananda, I have never tried to
10 pronounce your last name in public, nor will I do that here
11 because I'm afraid of butchering it, but we have the
12 Director of Clearing from the Commodities Future Trading
13 Commission here to discuss their comments on this particular
14 aspect of the Commission's proposal; as well as Vincent
15 Duane from PJM, Michael Holstein from Midwest ISO, and
16 Daniel Shonkwiler from California ISO.

17 We will have a break after this panel, and then
18 we will have a second panel that is composed of legal
19 experts and market participants to give a different
20 perspective on our proposal in the NOPR.

21 We have Commission staff here. Do any of them
22 want to say anything before we get going?

23 (No response.)

24 MR. MILLER: Okay, great. With that, why don't
25 we start off with our distinguished colleague from the CFTC,

1 Ananda, and then you can fill in the blank with your last
2 name because I'm anxious to try it.

3 (Laughter.)

4 MR. RADHAKRISHNAN: Thank you, Scott, and I thank
5 the Commission for inviting me to participate in this panel
6 this morning.

7 Before I give you my remarks, I just want to
8 clarify that whatever I say does not reflect the views of
9 the Commodities Futures Trading Commission, but just
10 reflects my views and that of my staff.

11 Having said that, what I would like to do is to
12 summarize the comments that the staff at the CFTC provided
13 in response to the Notice of Proposed Rulemaking that the
14 FERC issued on January 21st. We submitted these comments in
15 response to an invitation from Chairman Jon Wellinghoff to
16 our Chairman to provide some comments.

17 Generally we are very supportive, the staff is
18 very supportive of the proposal as reflected in the Notice
19 of Proposed Rulemaking as we believe that it constitutes an
20 important step towards the goal of ensuring that the credit
21 policies of RTOs and ISOs are sufficient to protect
22 consumers against the adverse effects of default.

23 Having said that, let me get into the specifics
24 of our comments. With respect to the FERC proposal to
25 require a shorter settlement cycle, we recommended that the

1 FERC require daily settlement in the FTR market--oh, I'm
2 sorry, I forgot to mention that our comments are focused on
3 the markets for Financial Transmission Rights, FTRs, and I
4 will limit my comments to that.

5 So we had recommended that FERC require daily
6 settlement in the FTR markets, and the collection of
7 settlement amounts related to FTRs as soon as possible. We
8 suggested within hours, or the same business day after
9 they're determined.

10 With respect to the proposal to require minimum
11 RTO or ISO participation criteria, we recommended that there
12 be a limitation on participation in the FTR markets to
13 entities with adequate capitalization and the capacity or
14 capability to manage FTR risks.

15 With respect to the proposal for greater
16 specification of the term "material adverse change," the
17 staff recommended that FERC permit each RTO or ISO to retain
18 broad discretion to call for additional collateral to
19 support FTR transactions.

20 And then finally with respect to the proposal to
21 limit the time period in which participants must post
22 additional collateral, we recommended that FERC require a
23 time period shorter than two days.

24 We also submitted additional proposals or
25 recommendations for the consideration of this Commission,

1 several of which are corollaries to the proposals in the
2 NOPR. These recommendations reflect our approach to
3 addressing financial risk in the clearing and settlement
4 systems for the markets that the CFTC regulates.

5 First, we recommended that FERC require each RTO
6 or ISO to adopt a methodology for calculating credit
7 requirements that adequately covers the potential future
8 exposure of FTR positions on a portfolio basis. And
9 sometimes due to portfolio nearing, such a requirement may
10 lead to substantial reductions in current credit
11 requirements for entities that participate in both the Day
12 Ahead Markets and the FTR Markets.

13 Next we recommended that FERC require each RTO or
14 ISO to impose a limit on the risks that any one participant
15 may accumulate relative to its size. And size could be
16 calculated by looking at the net capital of the participant
17 in the FTR Market.

18 Next we recommended that there be a requirement
19 that each RTO or ISO adopt rules governing the default of a
20 participant on an FTR obligation. We understand that a
21 number of RTOs or ISOs have adopted such rules, but we
22 believe that the adoption of such rules should be mandatory
23 rather than voluntary.

24 And also the other thing that we wanted to talk
25 about what the clarification of the status of each RTO/ISO

1 as a party to each FTR transaction, which would enable the
2 RTO/ISO to offset in the event of a bankruptcy of the
3 participant the obligations owed to such participant against
4 the obligations owed by such participant.

5 What you want to avoid we think in the event of
6 an insolvency is the--you know, if there is no right to net
7 up obligations, we don't think it would be helpful for the
8 ISO to have to pay money to an entity that's insolvent
9 without being able to net off sums of money that the
10 participant owes to the ISO/RTO.

11 Now the issue of course is whether the RTO or ISO
12 is acting as the party that has the obligation. In other
13 words, you must act in the same capacity. And I believe
14 there were some questions raised in the Mirant bankruptcy as
15 to whether the party acting in the middle--I won't call it a
16 central counterparty because I know that's kind of a
17 controversial term for some of my fellow panelists--but the
18 party acting as in the middle, if you are making payments it
19 doesn't make a lot of sense if the defaulting party owes you
20 some money for you not to be able to net that off.

21 So I will restrict my comments to the summary of,
22 you know, the proposals--the recommendations that we made,
23 and I will be pleased to answer any questions that you have.

24 MR. MILLER: Thanks. And I think our general
25 practice is to wait for questions until after everyone has

1 spoken. And exhibiting an East Coast bias, but I will move
2 from East to West and we'll begin with Vince Duane from PJM
3 on the RTO/ISO proposals.

4 MR. DUANE: Thank you, and good morning, too. I
5 am very delighted and appreciate the Commission staff and
6 Commissioner Norris for having me here today.

7 I think what this Technical Conference represents
8 is picking up on some unfinished business that was
9 identified quite clearly back in 2004 when the Commission
10 issued its Policy Statement on Credit Practices In The
11 Organized Electricity Markets.

12 Picking up on the question of the enforceability
13 of setoff, I would like to just speak from the RTO's
14 perspective in two broad areas.

15 First, just to say what is this problem, identify
16 that and discuss that a little bit;

17 And secondly, to try and address what I believe
18 are some of the purported negative consequences of the
19 solution that's being suggested by the Commission in its
20 rulemaking.

21 So turning to the first, I would respectfully
22 submit that the problem that we are facing today is really
23 somewhat broader than merely the enforceability of the
24 netting practices that has been quite understandably the
25 focus of this particular subject.

1 In PJM in 2008, some \$35 billion of transaction
2 volume took place. And it frankly befuddles me that we are
3 unable to answer with clarity, when you're talking about
4 volumes of that size, just who is doing business with whom
5 and what the role of the RTO/ISO is vis-a-vis those
6 transactions.

7 It's I think concededly awkward and
8 uncomfortable, but we sort of live with that when we're
9 talking to this Commission. We all understand that an
10 ISO/RTO is a market administrator and we don't really feel
11 the need to go much further.

12 That may be fine, but I think that ambiguity
13 becomes intolerable once we leave the confines of this
14 Commission and get out there in the rest of the world, and
15 particularly when we find ourselves trying to enforce rights
16 that we have contractually--and by that I mean in our
17 tariffs, in our business rules, in our operations
18 agreements, we have rights that purportedly inure to the
19 benefit of the ISO/RTO when we seek to enforce those in
20 civil courts, in bankruptcy courts, when we try and explain
21 ourselves to taxing authorities, when I try to explain our
22 function to other regulatory authorities like the CFTC, the
23 inability to answer the basic question of: When a seller is
24 selling into the pool, who is it selling to? You know, I
25 think it has come to a point where we need to be able to

1 answer a pretty simple question there.

2 Because if we can't, the rights we think we have
3 are going to be challenged by assertions that the ISO does
4 not have judicial standing to enforce a claim against an
5 individual party; it doesn't have privity of contract. And
6 in the case of netting, it is lacking the requisite
7 mutuality to have enforceable netting.

8 That is an important right. Just focus on the
9 right that the ISO has to net off obligations against
10 credits. In PJM, approximately--it's approximately a four
11 times ratio, 4 to 1 ratio, on average between the gross
12 exposure versus the net exposure.

13 So if you--and I don't have this number at my
14 fingertips, but if you look at the total credit support that
15 we do take, without netting, if we were to abandon the
16 netting construct, we would be looking on average at a
17 requirement of 4 times more, and in some companies' cases,
18 those that are very active in various different markets,
19 that could be as high as 7 times more. So we are talking
20 about real costs here.

21 Nobody I think on either of these panels would
22 suggest that we want to abandon setting off a netting
23 because of the efficiency that brings. But it is elementary
24 that if you are engaged in that activity you have to have
25 mutuality or the capacity--I'm going to leave to the lawyers

1 later on in the second panel to explain in more detail what
2 that really means, the concept of mutuality--but I think all
3 would agree that if you're engaged in netting you need to
4 have mutuality.

5 I think most would agree that the obvious and
6 direct way to establish mutuality is simply to be a contract
7 party to the transactions that you're setting up. There is
8 at least one other way that I'm aware of, and that is the
9 establishment of a security interest in receivables to
10 provide mutuality. That's not a path that we have
11 recommended to our stakeholders.

12 And the rest I would characterize as falling in
13 the context of sort of arguments. Well, this transaction is
14 really not a setoff or netting, it's something different.
15 And I think some of those arguments can even be clever, but
16 speaking from experience 10 years ago when I was the chair
17 of the Unsecured Creditors Committee for the bankrupt PCA,
18 it is never a pleasant place to be when you are making
19 arguments on behalf of an individual creditor in a
20 bankruptcy context. It is very much a tilted slope and it
21 tilts against you.

22 So having arguments as opposed to a rock-solid
23 predicate upon which you ground your setoff practices I
24 think is essential.

25 Shifting quickly to some of the consequences,

1 some have suggested that the establishment of the RTO as a
2 counterparty to pool transactions would represent a radical
3 change. I don't see it that way. In fact, I really see it
4 as simply conforming explicitly in the rules the functions
5 that we already provide today, and that we already perform
6 today, and conforming practice to form, conforming the rules
7 to what we do.

8 Perhaps the best way to understand this is to
9 look at an example. If at PJM we did face a situation where
10 we had a bankrupt or insolvent market participant that
11 asserted that we lacked mutuality and tried to undo the
12 setoff in a bankruptcy context, our argument would be, no,
13 we do have mutuality. We are the counterparty. We have all
14 this indicia that demonstrate that. We are the party on the
15 billing statement. We are the designated beneficiary on a
16 letter of credit. We collect in our name. We bill in our
17 name. We clearly have that privity.

18 We would like to one step further and actually
19 establish that unequivocally so as to remove any ambiguity
20 or any defense to the contrary.

21 Some have suggested, well, to do that would
22 really compromise the RTO's independence, and I think that
23 rests on a very technical understanding of what it means to
24 be a counterparty. And when you explore that a little
25 further, you understand that the RTO is not purporting to

1 take any price risk; it's not making offers into the market;
2 it will have a neutral, flat book at all time.

3 The markets are going to clear as they do today.
4 They will clear as they do tomorrow. Nothing here is
5 changing other than really some wording. In the interests
6 of time, I won't address some of the concerns that have been
7 raised about liability, and taxes, other than to say we have
8 explored those in the comments in this docket.

9 I think there is a tendency for people to sort of
10 say, well, if it ain't broke don't fix it. The risk here
11 appears remote. And I'm not going to take issue with that.
12 I think it is something that isn't--hasn't happened, and
13 doesn't happen every day, but I commend the Commission for
14 looking proactively at this question.

15 To me it's a little bit like saying, well, I
16 haven't died so why should I buy life insurance? You know,
17 and you don't die every day--

18 (Laughter.)

19 MR. DUANE: --but I think it's a good idea when
20 you do that you're prepared for it. Maybe a better analogy
21 would be a car accident, because I'm not suggesting that
22 necessarily this would be the end of the world, but why not
23 take prudent steps to address a known concern and a known
24 risk?

25 So in conclusion, I would say I would regard the

1 Commission's initiative here as overdue. It's a necessary
2 step in maturing these large markets. It brings basic
3 definitional clarity that's attendant to all markets,
4 whether it's your neighborhood garage sale or the trillions
5 of dollars that are settled and cleared every day in the
6 U.S. equities markets. Everybody knows who is doing what in
7 a market, what role they perform, whether they're a broker,
8 whether they're a principal, whether they're an agent,
9 whether they're a counterparty. These definitions are
10 basic, and they should apply to RTO/ISO markets as they
11 apply to every other market.

12 It's not merely an academic question. I think
13 the proposal here would remove a real disability that is a
14 cloud over the enforcement of a broad set of rights that the
15 RTOs have in outside forums, particularly beyond this
16 Commission.

17 So with that, I would close and again thank the
18 Commission staff and make myself available for questions.
19 Thanks.

20 MR. MILLER: Thanks, Vince. Next we will go to
21 Michael Holstein from the Midwest ISO.

22 MR. HOLSTEIN: Thank you for the opportunity to
23 appear before you. We are going to take the opposite
24 position of PJM in this particular matter.

25 Really the Commission is intending through this

1 proposal to help address one issue, which is the potential
2 risk--and let me highlight the word "potential risk"--that
3 netting might not be allowed in a bankruptcy proceeding.

4 To date that has not occurred. There has been no
5 loss to an RTO and there has been no loss to a market
6 participant due to netting not being allowed in a bankruptcy
7 proceeding. So we have a potential risk as opposed to an
8 actual occurring risk.

9 The Commission correctly asked: Are there
10 ramifications beyond addressing the risk by what they
11 propose to do? I submit that the answer is: Yes. The
12 potential to the proposed cure for netting will in fact have
13 the potential to create greater harm, which could be
14 catastrophic to an RTO, and I will address that in a minute.

15 As such, our position really is that the
16 Commission should not order all RTOs to take title to
17 transactions. Instead, if an RTO wishes to do so for
18 reasons that it believes are valid, it has the ability to
19 submit that to the Commission and the Commission can take
20 action on that individual case, as opposed to broadly being
21 applicable to all RTOs.

22 So what harm could be caused by a Commission
23 directive for RTOs to take title to transactions?

24 Simply put, the directive would create a risk to
25 one of the primary safeguards that's relied upon by

1 investors when they loan money to the Midwest ISO. And that
2 safeguard is the fact that the Midwest ISO is revenue
3 neutral in all transactions.

4 So what do we mean by "revenue neutral"? If a
5 counterparty doesn't pay--or, excuse me, if a market
6 participant doesn't pay a charge that's owed, which is the
7 net charge on the invoice, we simply short-pay all of the
8 other market participants who are net-owed funds in that
9 billing cycle. So the ISO remains revenue neutral.

10 So if we will \$100 collectively, we receive \$90
11 in total, we short-pay everybody their share of the \$10 that
12 was missing from somebody not paying in full. So that's
13 what we call short-pay.

14 Now later we make that up by basically uplifting
15 the default to all market participants, taking the proceeds
16 from that and then redistributing that to those who were
17 initially short-paid. So there's the two-step mechanism for
18 making somebody who was short-paid whole.

19 First we do the short-pay; then we do the uplift,
20 from that point of view. However, the Midwest ISO is not
21 involved and has no risk in those particular transactions
22 because again we remain revenue neutral.

23 The requirement to become a counterparty or take
24 title to transactions in our opinion introduced new legal
25 risks which are greater than the ones that we're facing

1 right now in terms of the netting issue.

2 A court could treat each transaction as a true
3 purchaser sale and require the Midwest ISO to pay in full in
4 the event of a shortfall. In other words, the argument that
5 I'm just administrating the market, I only pass through what
6 I receive, the court could say, no, you're the counterparty
7 to the transaction, you must pay in full.

8 The problem with that is we have no means to do
9 so, because we don't have a cushion or any sort of reserve
10 that would allow us to pay in full pending the outcome of
11 the bankruptcy proceeding. And even if the bankruptcy
12 proceeding were to come out adversely to us, we didn't get
13 100 percent collection, we have no means to make somebody
14 whole.

15 In short, we would become insolvent and have to
16 file for bankruptcy protection.

17 There is a derivative form of that risk: That
18 somebody who was allocated the share of the loss, through
19 the uplift procedure could go to court and argue that they
20 have no means--they have no--that it's not their obligation
21 to pay; it's the Midwest ISO's obligation to pay. They're
22 not the counterparty, the Midwest ISO is the counterparty.

23 So an adverse legal ruling in that case could
24 say: Midwest ISO, pay in full.

25 Again, we have no means for doing so, and

1 therefore it leads us to being insolvent and filing for
2 bankruptcy protection.

3 In our opinion, the presence of these new risks,
4 which is introduced or magnified by the requirement to take
5 title to transactions, could also lead to one or more of our
6 investors who loaned us money to declare a Material Adverse
7 Event under the terms of the loan agreement and demand
8 payment in full of the outstanding loan balance.

9 Again, we would have no means to pay that. Such
10 a demand could make the Midwest ISO insolvent and again
11 force us into bankruptcy.

12 So of the two risks that we're worried about
13 here, both of them in the legal realm, one risk is that
14 netting might not be allowed, in which case we didn't have
15 enough collateral on hand. The other case is we've become
16 the counterparty but we're not allowed to--we have to pay in
17 full; we can't follow the short-pay/uplift procedure; or
18 there's a Material Adverse Event on our loan documents.
19 Those could cause us to be insolvent. We view those as
20 being catastrophic risk. And of those two, we prefer the
21 netting risk, which we think is minimal, to the catastrophic
22 risk of bankruptcy from those two actions.

23 So in summary, it is our view that each RTO has
24 the capability to come to the Commission, voluntarily seek
25 to take title to a transaction, and proceed down that path

1 that they choose to.

2 What we are asking the Commission to do is to do
3 that on a case-by-case basis, as opposed to requiring all
4 RTOs to be in that same position. And thank you very much.

5 MR. MILLER: Thanks. Daniel Shonkwiler from
6 California ISO. I merely do that for people who are
7 listening by phone. Dan?

8 MR. SHONKWILER: Thank you, Scott. I appreciate
9 the opportunity to address this issue which is important to
10 the California ISO, and we think to the entire industry,
11 because we do think this would involve a fundamental
12 restructuring of all ISOs and RTOs at significant expense.

13 In terms of the legal issue discussed in the NOPR
14 about the right of ISOs and RTOs to set off against the
15 bankrupt market participant, the California ISO understands
16 this issue and we agree that there's some legal risk.

17 Where I think we depart from PJM and from the
18 proposal for mandatory counterparty status is in our
19 assessment of whether the legal risk, or the legal issue
20 ultimately becomes a credit risk to our market participant
21 as it plays out in our market and under our market rules.

22 We don't perceive a credit risk. We also think
23 that the expenses of becoming a central counterparty are
24 quite significant, and it would also lose us a legal status
25 that saw us--that we like. It saw us through the crisis and

1 the following litigation, which is still going on, so it has
2 worked well for us.

3 So we oppose a rule at least as it's mandatory
4 for all ISOs and RTOs, and we would urge the Commission, if
5 they perceive a credit risk to market participants, to seek
6 less costly alternatives.

7 Currently the principals in our market
8 transactions are the market participants, and this has been
9 as found in litigation both in courts and before the
10 Commission, the ISO is an agent for parties in the energy
11 transactions and ancillary services transactions, and we
12 are--but we are not a principal in the financial
13 transactions, and we do not have privity of contract, or
14 we're not--I should say this another way.

15 Parties have tried to bring us into litigation,
16 our market participants, in cases where they're litigating
17 against each other, have tried to bring in the ISO saying
18 their privity of contract is with the ISO and not the other
19 market participants. That has been attempted a couple of
20 times and so far it has been unsuccessful. That is in civil
21 litigation.

22 We--the NOPR would propose to sort of turn this
23 on its head and make every ISO, including the California
24 ISO, a central counterparty. So we would be a buyer to
25 every seller and vice versa. And the concern is that, is

1 that would be a way of alleviating the risk about an ISO's
2 possible inability to set off.

3 There's not enough time here to explain what set
4 off is, but--and I'm not sure I'm the right person to do
5 that; that may be the second panel--but let's give an
6 illustration, because the setoff--at least we don't believe
7 the setoff involves every financial transaction in our
8 market.

9 So let's say you've got a landlord and a tenant
10 and the rent is \$1000 a month under the lease. And then the
11 landlord offers the tenant, who happens to be a painter,
12 well I'll pay you \$300 to paint the apartment. So the
13 painter does that. The tenant paints the apartment. And
14 before rent is due, he hasn't been paid so he says, instead
15 of writing a \$1000 check he writes a \$700 check and says I
16 forgive the painting bill. That's clearly a set-off, or
17 that's one example of a set-off.

18 And the reason is it involves two different debts
19 running in both directions that are offsetting, two
20 offsetting obligations.

21 The main reason we don't see a risk, in addition
22 to what Mr. Holstein mentioned, there's been no--despite
23 billions of dollars in transactions and 15 years of
24 experience, there have been no losses due to an inability to
25 set off.

1 We also don't see a risk because we don't believe
2 that ordinary monthly settlements, at least in the
3 California ISO market, involve a setoff. They certainly
4 involve net invoices. The debtors in the market pay in
5 their net obligation, and the creditors receive their net
6 payment. But there is only--under our tariff, there's no
7 right to receive any payment other than the net. In other
8 words, there aren't competing claims and obligations.

9 So we've spent a great deal of time working with
10 our outside advisors on this, but we don't see--and for a
11 variety of reasons--they don't see a material risk that the
12 ordinary monthly settlements can be torn apart through, or
13 upset due to the legal issue.

14 Where the legal issue arises in our market is
15 where a market participant would fail to pay one monthly, or
16 at this point bimonthly invoice, and they don't have
17 adequate security, and then in a subsequent month they have
18 a payment due back to them.

19 Our tariff says we have to set off or recoup that
20 payment to pay the previous default. And this can
21 happen--this can happen in a number of circumstances,
22 including refunds, or other re-runs, or retroactive
23 settlement adjustments. It's happened a number of times
24 with bankrupt market participants in our market.

25 For these transactions, or this set of

1 transactions, the reason we don't see a material credit risk
2 from a legal issue is that we don't assume a right to set
3 off when we are calculating the amount of financial security
4 required.

5 In other words, the setoff would be extra
6 protection. So if there's a risk to set off, or a chance
7 that we might not be allowed to set off, that we might lose
8 the extra protection possibly, but it doesn't represent an
9 exposure to the market because financial security, or the
10 amount of security to post is calculated without assuming a
11 right to do the setoff, or what we understand to be setoff.

12 In other words, to put it one more time, it's a
13 lost opportunity possibly for extra protection but nothing
14 else.

15 In addition to all this, there are practical
16 reasons we think why the setoff issue hasn't been fully
17 litigated to a bankruptcy court yet, and it has only been
18 raised once. You know, I mentioned financial security
19 already. The party is adequately secured. The mutuality,
20 the argument that mutuality, or that there's no mutuality
21 sufficient to allow setoff becomes academic.

22 Two, many market participants are exclusively
23 buyers or sellers on their invoices, and if you have
24 obligations running only in one direction you are less
25 likely to have a setoff situation.

1 Third, the issue is legally complicated and
2 expensive to litigate, so there is probably below a certain
3 threshold where legal fees could eat up any benefits that a
4 market participant or a bankrupt market participant might
5 gain from the argument. And so that is another reason they
6 might not raise it.

7 Fourth, after you have narrowed the pool this
8 much, and we have 120 market participants in our market, I
9 assume we've narrowed it down from these three criteria to a
10 smaller set, you have to realize that even in the entire
11 market a bankruptcy, at least so far, it happens only every
12 couple of years. So we're not talking about something that
13 happens every day.

14 Now one time, as far as I understand, in the
15 entire history of ISOs and RTOs, you had these four factors
16 come together, and that's the Mirant litigation that's
17 mentioned in the NOPR. And you have to understand how
18 unlikely that was.

19 There were two different things, two different
20 catastrophic events, that happened that resulted in the
21 setoff situation. You have Mirant's large, unsecured
22 obligation that arose through the California crisis
23 litigation, the EL00-95 docket.

24 Then you have the large receivable that arose
25 only because of the default and bankruptcy of the California

1 Power Exchange.

2 Now everybody in this building has been working
3 ten years to make sure that none of those things ever happen
4 again. And if only one of them had happened, there wouldn't
5 be both a large receivable and a large payable. I think
6 we're talking about amounts over \$100 million, if I remember
7 correctly, in both directions. If you didn't have both of
8 those, we wouldn't be here talking about the Mirant
9 litigation.

10 In any event, there was another factor there
11 that's mentioned in the Wachtell memo, which is: Mirant
12 wanted to reorganize, not liquidate, and continue with--and
13 continue to participate in energy markets. And what's
14 suggested is, if an energy company wants to do that they
15 have to assume their contracts and pay all their prepetition
16 obligations, which would make the mutuality and setoff
17 obligation not something--there'd be no benefit in raising
18 it.

19 And that's--there may be many reasons why
20 ultimately Mirant settled, and that's not something I'm--you
21 know, I don't know why they did that, but the Wachtell memo
22 suggests a number of reasons why they might have done it,
23 and that was one of the reasons suggested in the memo.

24 To wrap up the risks then, I think all these
25 factors explain why there hasn't been--no one has lost money

1 based on the setoff issue to date.

2 When you flip over to the cost side, the simplest
3 way to look at the cost issue is that becoming a
4 counterparty in our transactions would make the California
5 ISO, or would take it from being a \$200 million company, a
6 nice small utility, to an \$8 billion company, and that
7 transformation is not simply achieved.

8 A couple of the high points are related to
9 accounting an auditing costs and a legal status that has
10 worked for us through the crisis litigation.

11 In terms of the accounting and auditing costs, I
12 think we agree with PJM, or at least with their written
13 comments, that all the revenue and all the costs of the
14 market transactions would have to be put on our financial
15 statement, and that is not simply a matter of taking
16 transactions from market software and adding them to the
17 numbers. Everything has to be presented in conformance with
18 GAAP, and that would be quite a significant project because
19 that's not where it stands right now.

20 In addition, everything on a continuing basis,
21 all the transactions we understand would have to be
22 validated. This is something that our market transactions
23 do currently because the market transactions appear on their
24 balance sheet, but we don't do, and we would have to
25 duplicate or perhaps be large than the validation department

1 of all of our market transactions, and that would represent
2 a redundancy.

3 It is our understanding that our auditing costs
4 would increase significantly, and we explained this in our
5 written comments, it's both due to external fees that we
6 expect would increase and also because of increased staff
7 time necessary to work with the audits.

8 We would also lose a legal status that has worked
9 well for us. It is complex, but at the right times it has
10 come through with the right answers to the questions in the
11 litigation following the energy crisis.

12 The ISO again is an agent only, which is why the
13 transactions don't appear on our books, or the market
14 transactions. More importantly, and I think this may be a
15 difference between California and some of the other ISOs and
16 RTOs, we don't ohv a collection responsibility. If a market
17 participant declares bankruptcy, our market participants
18 have to go in and file claims and pursue collection. And
19 that is how there's been civil litigation after the crisis,
20 and we haven't had to be a party.

21 After the crisis, we had I think it was \$2.5
22 billion in defaults in our markets, and thank goodness that
23 wasn't on our books. The number has been reduced over the
24 years to, if I understand it correctly, it's just south of a
25 billion dollars right now, and not withstanding that over

1 that period we have had multiple bond offerings. And the
2 reason we can do that is because it's easy to explain.
3 Look, the market transactions are separate from our company.
4 Just look at our numbers, and we explain that--it takes a
5 while to explain why it is separate, but that is relatively
6 simple.

7 One of our concerns is if we had \$8 billion in
8 transactions on our books, things become more convoluted.
9 It becomes harder to explain to investors--not impossible,
10 but much more challenging--where the appealing small utility
11 is amid all those transactions.

12 So for all these reasons, including the--
13 especially the reluctance to lose the structure that's
14 worked for us--we are concerned about the costs of the
15 proposal, or at least of a mandatory rule, for all ISOs and
16 RTOs.

17 So the ISO is not opposed to national netting,
18 but we are opposed to becoming a counterparty in the
19 transactions in our markets. And so the current structure
20 has worked for us, and because it's hard to see a serious
21 credit risk here to our market participants, we would ask
22 the Commission not to adopt a mandatory rule for all ISOs.

23 I would be available to answer questions.

24 MR. MILLER: Thanks, Dan. By the way, what we
25 will do is staff will ask questions first, and we will

1 entertain some questions from the audience via written form,
2 if we have time, at the conclusion of this panel. And so if
3 anyone has written questions, and if we have time, could
4 they just deposit them on the corner over there and if we
5 have time we will get to them.

6 Let me lead off a question before I get to the
7 other staff's questions, and I will first direct it to Vince
8 Duane from PJM.

9 One of the things that we have heard has been the
10 nature--the minute risk of the confluence of situations
11 occurring that could lead to this legal clarification being
12 useful.

13 Once again, everyone has invoked that popular
14 phrase that I think first came up during the California
15 crisis, which is perfect storm, and of course we have seen a
16 number of subsequent perfect storms. The question that I'll
17 ask is: Take yourself back to the Fall of 2008. Could you
18 imagine--oh, I'm glad somebody caught me on this. I forgot
19 that we had Commissioner Norris here.

20 Commissioner, do you have any questions before
21 the staff directs them?

22 COMMISSIONER NORRIS: No, go ahead. Don't take
23 it personally but I have to leave here pretty soon. It's
24 not reflective your comments, but I appreciate reading your
25 comments and hearing what you had to say orally. So go

1 ahead, Bryan--or Scott, sorry.

2 MR. MILLER: Thank you, Commissioner.

3 If you take yourself back to the Fall of 2008,
4 and Dan you were talking about defaults in the nature of
5 \$100 million, you used I think that sort of threshold issue,
6 Vince, could you imagine the default of an entity in your
7 markets in that time frame, given everything else that was
8 going on, of a default of that size and magnitude just in
9 the PJM market?

10 MR. DUANE: Scott, not only could we imagine it,
11 I think we felt we were 24 hours away from having that
12 transpire and be put on our doorstep. So we took that
13 experience very seriously.

14 I mean, I don't think this is a situation that
15 happens every day. Clearly it doesn't. I would agree that
16 the risk is remote, and certain factors have to come into
17 being before it materializes as a real risk. But I think
18 the consequences of that risk can be extraordinarily dire.
19 So it may be a low probability but high magnitude type of
20 risk.

21 You know, one of the points raised is, well, if a
22 company--and most utilities don't go out of business even if
23 they're insolvent; they reorganize. And the point is well
24 made that if they do reorganize, they have to address their
25 prepetition obligations.

1 Fair enough. But when you have, particularly in
2 the competitive energy markets that we engage in today,
3 retail competitive suppliers in particular, that yet
4 establish--these are subsidiary organizations; there is
5 behind those organizations a provider of last resort--what
6 we faced was a very real fear that a substantial amount of
7 load from a particular market participant might leave its
8 default insolvent competitive retail provider, go back to
9 the traditional utility; our relationship, the transacting
10 party with the pool, was this competitive supplier; that may
11 fold its tent and not reorganize. That's not to say that
12 the larger utility company wouldn't continue in some
13 fashion, but any setoffs involving this load housed in the
14 competitive supply subsidiary of the organization we felt
15 were very much at risk of being undone and wouldn't have to
16 be satisfied because this particular subsidiary wouldn't be
17 reorganized. It would be liquidated. And we felt we were
18 facing hundreds of millions of dollars of potential
19 exposure.

20 It didn't happen. We're thankful about that.
21 But why not take prudent steps to ensure that it doesn't
22 happen, or that if it does happen we're well protected.

23 MR. HOLSTEIN: We had a different perspective
24 during that same time frame. Even though the Midwest ISO
25 and PJM are very comparable in terms of their service

1 offerings and are very comparable in terms of their
2 size--for instance, you mentioned \$38 billion in
3 transactions; ours was \$42 billion during a comparable time
4 frame.

5 The makeup of our market is very different. From
6 the most recent weekly invoicing cycle, if we look at who
7 our counterparties are, basically vertically integrated
8 utilities, cooperatives, municipalities, to a much lesser
9 extent generators, a very much lesser extent, and even other
10 ISOs, RTOs. Roughly 80 percent of the charges, just gross
11 charges setting aside net credit amounts, 80 percent of the
12 gross charges were due from utilities, coops, and
13 municipalities, people who are very likely to not reject
14 their executory contracts. And therefore if they were to
15 fall into bankruptcy they would basically have to take up
16 the obligation in order to come out of it on the
17 restructuring side of the thing.

18 So our market is different. We don't have quite
19 the level of activity that is present in other markets from
20 retail choice providers and for financial players. It's
21 much more dominated by bilateral transactions and on the
22 margin vertically integrated utilities.

23 It doesn't look like New England, and it doesn't
24 look like New York, and it doesn't look like PJM, because of
25 the lack of retail choice in the Midwest for the most part.

1 MR. SHONKWILER: So the question is about where
2 were we and how did things look in 2008?

3 First, our finance department was making every
4 effort to make sure that market participants were adequately
5 secured. And I don't disagree. Even then I'd like to think
6 we, at the time would put it the way Mr. Duane did. You
7 have a low probability of a high-impact event, but I think
8 that's how we looked at it.

9 But we accept that kind of risk anyway in RTOs.
10 Another way to look at the point about California not
11 factoring in a right to set off in calculating in collateral
12 requirements is that the risk from this legal issue is lower
13 than the residual risk we all accept in setting collateral
14 requirements.

15 You can--you know, it's always possible, at least
16 under our market it remains possible for market
17 participants, due to unusual market circumstances or changes
18 in their activity, to run up obligations that exceed the
19 collateral they've posted. And the only way to prevent that
20 is to raise collateral requirements, and that is not
21 something, you know--people talk about fine-tuning it, but
22 there are limits, because imposing too high a collateral
23 requirement is too high a cost on business. And our
24 position here is that, while there is a risk from the legal
25 issue, it is lower than risks we accept.

1 MR. MILLER: Do other staff have questions? I've
2 got some others, but I wanted to give others an opportunity
3 to ask their questions.

4 (No response.)

5 MR. MILLER: Vince, it has been posited both in
6 the comments and by some of your sister organizations that
7 there are additional costs associated with clarifying your
8 position as the central counterparty; and that it can affect
9 your--it can affect auditing costs, and in fact lead to, you
10 know, to possible downgrades in your credit.

11 Yet PJM has indicated that this clarification
12 that PJM and the stakeholders have agreed to pursue, and
13 which is similar to the proposal in the proposed rule, that
14 these are minimal, or not material. Could you elaborate as
15 to why that might be for you and not for others?

16 MR. DUANE: Thanks. Let me try and do that. But
17 I can't resist keying off of a point that Mr. Holstein made
18 just a few moments ago when he described who his
19 counterparties are. I mean, that really gets to the heart
20 of it.

21 I mean, we naturally regard the people doing
22 business with the pool as doing business with the RTO.
23 These are the people who are my counterparties. And that I
24 think leads into your question, Scott.

25 When you look at what are the costs, I think you

1 have to start by asking the question: Well, what is
2 changing? Functionally, nothing is changing. We're not
3 doing any more. We're not doing any less than what we have
4 done previously. We are just putting a name on it, and a
5 name that many would already implicitly assume--namely, that
6 we are a counterparty and that our market participants are
7 counterparties to us.

8 So there are consequences in terms of financial
9 reporting. We have discussed that. And we have discussed
10 it at length with our auditors and our financial advisors.
11 We run a pretty tight ship at PJM. We understand our
12 transactions pretty well already. We make distinctions
13 between transactions that are pool transactions,
14 transactions that are bilateral transactions that are
15 tracked and accounted for appropriately in our systems
16 already. Our systems are audited. We pass FAS 70s on
17 these.

18 So from our perspective, and in doing the due
19 diligence that we have done, we do not see any added costs
20 from an auditing standpoint, or any other standpoint, any
21 material additional costs associated with really putting a
22 definition around a function that is going to remain the
23 same tomorrow as it has today.

24 MR. QUINN: Just to follow up on that, if you
25 legally acknowledge that you are a counterparty to those

1 transactions, do you have any fear that that would have
2 negative credit rating implications if you had even a
3 moderate sized default, and that it took you some time to go
4 to your stakeholders and through the socialization process
5 rectify that default?

6 MR. DUANE: No. That hasn't been a concern for
7 us. I mean, we certainly wouldn't be waiting for the
8 outcome of a bankruptcy before we would engage in a
9 mutualization of the default across all suppliers. That
10 would happen within one billing cycle or the next billing
11 cycle, and these billing cycles in PJM have been reduced
12 considerably over the last 18 months, as you're well aware.

13 The essence of our credit rating, and I would
14 submit it's true for our brethren as well, is the fact that
15 the exposures we may face due to the insolvency of a market
16 participant, or the failure, the bad debt of a market
17 participant, is passed on to the members. That is not going
18 to change in PJM by establishing ourselves as a counterparty
19 to the pool transactions.

20 Again, it is already implicit and in many
21 instances assumed. We have had these discussions with our
22 credit rating agencies. They understand the structure.
23 They understand the change to the structure. And they rely
24 most heavily on the default allocation. That's the driver
25 to the credit support that they afford to us.

1 MR. GREENFIELD: Let me put a question to
2 Mr. Holstein and Mr. Shonkwiler that picks up on a point
3 that Mr. Duane makes, which is both orally here and in his
4 comments, which is PJM to some degree starts from the
5 premise of saying somebody is going to ask in these markets.
6 There are buyers and there are sellers. Who are the buyers
7 buying from? Who are the sellers buying--or selling to?
8 And therefore from there we go to, you know, a series of
9 conclusions and analysis.

10 For your two respective markets, MISO and CAISO,
11 if somebody were to say to you in court, or here, you know,
12 who are sellers selling to, and who are buyers buying from,
13 what is the answer to that question in your markets? Or how
14 do you perceive them?

15 MR. HOLSTEIN: I'll give you two answers to that.
16 The short, brief answer is that the market is the
17 counterparty. If I'm a buyer, I am buying from the market.
18 If I'm a seller, I'm selling to the market. That is the
19 short, brief answer from that particular point of view.

20 What you're really doing is selling at a price
21 set by the marketplace through a bid-offer clearing
22 mechanism. And so what you're really getting is I'm selling
23 to the marketplace at a price set to the market mechanism.

24 Who the counterparty is is not necessarily the
25 issue. It's basically how much money am I owed? Or how

1 much money do I have to pay for whether I bought or whether
2 I sold.

3 MR. GREENFIELD: Could I do a follow-up question?
4 Why is who the counterparty is, why is that not an issue?

5 MR. HOLSTEIN: Because under the tariff the
6 obligation to pay the net amount of the invoice is
7 established. And so the counterparty really isn't the issue
8 from that particular point of view.

9 You've entered into what amounts to a contract by
10 signing our registration forms, Attachment W to the tariff,
11 that says I agree to be bound by the terms of the tariff.
12 Under the terms of the tariff, you are obligated to pay your
13 net invoice when it becomes due.

14 Our tariff is similar to the California ISO. We
15 make it clear that you have no right to an individual charge
16 for any given transaction. Only the net amount is something
17 that you have a particular right to, and only if you are in
18 good standing within all terms and conditions of the tariff.
19 So the counterparty issue really doesn't come up within that
20 transaction.

21 MR. MILLER: Mike--if I could just jump in for a
22 second--the issue, as has been posed by PJM, is that it is
23 not the tariff, per se, which takes care of your FERC
24 obligations; but when exit the FERC universe into the
25 broader universe of legal standing, that that becomes an

1 issue.

2 To put it more fundamentally, the issue of
3 property right under pending commercial activity is, you
4 know, kind of fundamental. And so therefore this detail
5 outside the FERC construct could become important.

6 MR. HOLSTEIN: But I think the key phrase there,
7 though, Scott, is "could" become important, but to date it
8 has not. And there have been numerous bankruptcy
9 proceedings involving entities that have RTO participation.
10 We ourself experienced a bankruptcy with Calpine. We
11 haven't had an issue with that particular situation.
12 Mirant hasn't had a situation there.

13 So again what we're talking about is the
14 potential, could, risk, might, those kinds of things. Then
15 we get into probability and impact. And at this particular
16 point in time, we think the probability is fairly small that
17 someone could prevail on an issue that they don't owe--that
18 they're owed--that the netting issue doesn't apply; that
19 they would be owed in full without having an obligation to
20 pay what is due from them.

21 You actually have to go into the bankruptcy court
22 and deal with that particular issue, but it comes down to
23 it's a probability issue. It's a matter of risk.

24 MR. SHONKWILER: If I'm hearing the question
25 right, there are two--what's our answer to somebody who says

1 who are your counterparties, what's your status?

2 Then also in particular how does that play out
3 once you get outside the FERC arena, and the question of
4 standing to collect in bankruptcy.

5 And our answer is similar to Mr. Holstein's. In
6 the California ISO--actually we've answered this question at
7 length, as I understand it, in the depositions in the EL00-
8 95 Docket and other proceedings related to the crisis.

9 The gist of that, if I understand it correctly,
10 and I wasn't involved in these proceedings at the time, is
11 we had to explain that the counterparty at the transaction
12 time is the market. Your seller is selling in and selling
13 to all the load, and load is buying from everyone who is
14 supplying, and the obligation doesn't become sort of
15 bilateralized unless and until you get to the settlement and
16 financial clearing phase and one of the debtors defaults.

17 At that point, California ISO tells the
18 creditors: Go collect from the debtors. It's your
19 obligation. We've had to litigate this a couple of times.
20 The parties tried to bring us in in civil litigation between
21 the investor-owned utilities and some of the suppliers
22 during the crisis, and that hasn't been successful to date
23 because we've been able to explain, look, we're just an
24 agent in these transactions not a principal.

25 The question of who has the obligation to collect

1 from bankrupt debtors has also been litigated at the
2 Commission and also litigated but not to conclusion in
3 bankruptcy court. Enron raised that challenge to some of
4 the claims by the investor-owned utilities, and they raised
5 it and it was briefed and I believe argued, but after that
6 point they settled.

7 MR. MILLER: Perhaps we can--one of the reasons
8 we had each of you here is that you sort of represented
9 somewhat different solutions to the issue of setoff, and I
10 understand, Dan, the distinction that you've sort of made
11 that quite frankly you're not setting off.

12 I don't know if I necessarily know that everybody
13 would view it that way, but, Michael, you have--MISO has
14 been before the Commission several times, and in fact your
15 organization identified this issue early on and you
16 identified several solutions, the final of which was that
17 you had taken a security interest as the solution.

18 Could you just say--this wasn't the first time
19 you came to the Commission, and in fact the final solution
20 you came to was a considerably smaller portion of market
21 participants taking advantage of this solution. And could
22 you just discuss to what extent there are--how many parties,
23 and what percentage of the market represents a security
24 interest in your market?

25 MR. HOLSTEIN: Thanks, Scott. I anticipated that

1 you might ask me that question. So looking at--

2 MR. MILLER: You're a smart guy.

3 (Laughter.)

4 MR. HOLSTEIN: No, it's a logical question. And
5 I would say, by the way, it's not our final solution; it's
6 at least an incremental solution, one more step down that
7 particular path.

8 But if you look at the most recent billing cycle,
9 and just dealing with invoice charges, really we've reduced
10 the potential for somebody arguing that netting is not
11 permissible within category versus across categories. And
12 let me stop real quick to talk about what I mean by
13 categories.

14 We've basically said netting within the category
15 in which they had real-time and congestion and losses
16 charges is all one type of transaction, and the odds of
17 somebody arguing that they weren't mutual or the same kind,
18 the same type, is very, very slim because my Day Ahead
19 transaction, one of them, I owe money, one of them you owe
20 money, in the market from that particular point of view, the
21 idea that you could prevail in saying those are not the same
22 type of transactions is in our opinion very, very slim.

23 So we were more concerned with somebody saying I
24 can't net a Day Ahead charge or credit against an FTR charge
25 or credit against a transmission charge or credit. So our

1 provision right now is we won't net across categories unless
2 you give us a security interest.

3 The amount of reduction in risk associated with
4 somebody making that argument was 8 percent based upon the
5 most recent billing. So it took it from \$230 million down
6 to \$210 million, not a large number, but again that's
7 netting across categories. We believe we are completely
8 covered for anybody making an argument of not permitting
9 netting across categories because either we require more
10 collateral--we don't allow you to net; or, you've given us
11 the security interest taking it away.

12 So where our residual risk right now is is within
13 the category, somebody arguing that you can't net Day Ahead
14 charges against Day Ahead credits, or Real Time charges
15 against Real Time credit. Against we think the argument
16 there is very, very weak in terms of saying it's not the
17 same type of transactions.

18 I do have one potential additional solution to
19 bring to the Commission once it goes through our particular
20 stakeholder process. Right now the security interest issue
21 is voluntary. You can choose to elect or not elect. If you
22 don't give us the security interest, then you have to give
23 us potentially more collateral, depending upon the nature of
24 your transactions.

25 We do--in my opinion, and I've been the CFO for

1 10 years now--over that 10-year period of time I've become
2 more comfortable with the risk of a co-op, or a muni, or a
3 vertically integrated utility basically not rejecting the
4 executory contract, reemerging from bankruptcy and having to
5 pay its prepetition obligations.

6 So what I have left is those people who aren't
7 dependent upon transmission service who are likely to
8 liquidate, or more likely to liquidate, and therefore maybe
9 the solution is to come back to the Commission one more time
10 and say security interest is mandatory, not optional; if
11 your business model doesn't depend upon transmission service
12 and therefore you are a higher probability of liquidating,
13 rather than re-emerging and restructuring and reorganizing
14 coming out of bankruptcy.

15 That would take that residual risk down even
16 further from that particular category, but keep in mind the
17 earlier statistic I gave you, 80 percent of those charges
18 were among co-ops, munis, and utilities. Only 20 percent
19 are among the category of people I would say who are not
20 dependent upon transmission service and might liquidate
21 rather than re-emerge from bankruptcy.

22 So really I think I'm dealing with 20 percent of
23 \$200 million in a billing cycle as opposed to a \$200 million
24 risk. I think I'm dealing with a \$40 million risk in the
25 universe if everybody simultaneously were to default and

1 then make the argument and prevail.

2 MR. QUINN: Can I follow up on that question, or
3 that statement--and I'm outside of my depth when I ask
4 this--so is it your belief that within category those set of
5 transactions are eligible for recoupment?

6 MR. HOLSTEIN: We believe anybody who tried to
7 make the argument that mutuality doesn't exist is not there.

8 MR. QUINN: Okay. Can you talk a little bit
9 about why, as you went through this process your
10 stakeholders initially decided to go with voluntary
11 acceptance of the security priority rather than move
12 directly to mandatory? Or what were the concerns about
13 being forced to give the ISO the first security?

14 MR. HOLSTEIN: Setting aside the issue of certain
15 public power entities that have a difficult time, if not an
16 impossible time, doing that--and again, they were granted an
17 exception under the Commission Order which we proposed and
18 we believe is appropriate.

19 It's really a matter of, you know, it's an
20 inconvenience in terms of having to go through the process
21 of getting security interest, but it's not something that's
22 insurmountable. Those who elected not to give it to us
23 basically looked at the additional collateral required by
24 not netting and determined it was de minimis and therefore
25 wasn't worth the effort of pursuing, because essentially

1 they were doing all their business within one category and
2 weren't going across categories anyway.

3 So it didn't really impact them. There was no
4 reason. There was no motivation. There was no additional
5 collateral required by not giving us the security interests.
6 They elected not to do it.

7 MR. QUINN: Can you give us an idea of what
8 percentage of your market participants have elected to
9 become your, I guess they call them "Category A"
10 creditors?

11 MR. HOLSTEIN: It's roughly 10 percent. But
12 that's accounting a number not a volume. I gave you a head
13 count rather than a transaction volume count.

14 MR. MILLER: Let me ask Dan, first of all, let's
15 say that the Commission decided in a final rule to say that
16 we either require a solution similar to MISO's--and that is,
17 that anybody not relying on transmission service has to take
18 a security interest, or post a security interest, or the ISO
19 has to take title, how would you view that? Or would you
20 view that as, as--either solution as being something that
21 would be acceptable in your markets?

22 MR. SHONKWILER: This is where I have to say I
23 haven't had a chance to discuss the--review the MISO
24 procedures with my clients, so I'm speaking only for myself
25 and not for the ISO, but I would--

1 MR. MILLER: When you say "your clients," do you
2 mean the ISO, or the market participants?

3 MR. SHONKWILER: My finance department.

4 MR. MILLER: Okay. Good.

5 MR. SHONKWILER: The people who would have to
6 implement the rule.

7 MR. MILLER: Okay.

8 MR. SHONKWILER: But I would recommend that they
9 consider the MISO solution. I think, to the extent that
10 there is a risk under our solution, and you suggested you
11 thought there was, I think--I believe the MISO solution is
12 preferable for the reasons I explained, and I would ask them
13 to look into it. We could certainly follow up on this issue
14 with written comments.

15 MR. MILLER: Vince, in your filed comments you
16 indicated that the MISO solution, if it were fully
17 implemented--and I think you characterized it as fully
18 implemented--might represent a sufficient safeguard in the
19 event of a bankruptcy and a default, that it would be
20 sufficient, and perhaps almost as good as the solution that
21 PJM is proposing.

22 Could you, if the Commission decided to go in
23 that direction, say how you would regard that solution? In
24 other words, do you view it as equal to--let me clarify--do
25 you view it as equal to the solution that you have put

1 forth?

2 MR. DUANE: I think in terms of establishing
3 mutuality it does the job. It does the job as well as
4 establishing the RTO as a contract party to pool
5 transactions.

6 There's a few big caveats, though. I would not
7 agree with Mr. Holstein that there's no argument, or a very
8 de minimis argument about mutuality within a product class.
9 In his example, the Day Ahead market. Yes, they are the
10 same product, but that doesn't begin to address the question
11 of mutuality, which is: Is the setting off party acting in
12 the same legal capacity with respect to those transactions?
13 Yes, the transactions are the same market class, but that
14 doesn't begin to answer the question, in my opinion, of
15 mutuality.

16 So I think implementing the security, the
17 perfected security interest approach comprehensively as the
18 Midwest ISO sought to do originally back in 2004, I think
19 would do the trick.

20 The reason, I would submit, that it is very
21 difficult to implement it comprehensively is because it is
22 burdensome both from the RTO's perspective and from the
23 market participants' perspective. From the market
24 participants' perspective, you have to grant a security
25 interest and you have to worry about whether that is

1 offending any covenants, or whether you've got priority
2 leans that have been granted to lenders, or whether you have
3 regulatory authority to do that.

4 In the case of municipals, as has been mentioned,
5 whether you have the legal authority to do that.

6 And then in the case of the ISO, you have to
7 administer a complicated process of perfecting UCC Form 1
8 financial statements in all these jurisdictions, and the
9 potential for a mistake to me made on that end I think is
10 too great. To me, it seems a very elaborate and intrusive,
11 and I mean this is really illustrating the difference of
12 opinion I'm afraid, but a very costly approach to resolve
13 the problem, as opposed to just saying let's admit what we
14 are, let's concede what we are, which is the counterparty.

15 And to Mr. Greenfield's question, claiming that,
16 well, the market is the counterparty, to me conceptually
17 that sounds fine, but legally that doesn't make sense to me.
18 The market isn't an entity. The market is not a legal--in
19 fact, if there is a legal embodiment of the market it is the
20 ISO/RTO.

21 So we all sort of say the same things but we're
22 just dancing around the words with this somewhat emotional,
23 and I would submit, irrational fear that putting a
24 particular word on something--i.e., we're a contract party
25 or a counterparty to a transaction--is going to lead to all

1 these changes.

2 So I think the approach by the Midwest ISO
3 conceptually is sound. In practical--putting it into
4 practice, however, I think is very burdensome, difficult,
5 and why go to those lengths when you can address the problem
6 more directly?

7 MR. HOLSTEIN: Actually I want to build a little
8 bit on the costly issue that was referenced right here. I'm
9 going to make reference to--I don't know if you have it in
10 front of you, but slides 7 and 8 in the material that was
11 part of the briefing book which I obviously didn't cover
12 here.

13 Let me state that the Midwest ISO would not be
14 comfortable being a counterparty, establishing a limited
15 liability corporation, and becoming a clearinghouse, absent
16 additional safety net to make sure that if I am the
17 counterparty I have to pay in full.

18 And so the reference I gave you was to what
19 actually NYMEX, which I now believe is called ClearPoint,
20 they simply have a safety net in place. I believe all
21 clearinghouses have safety nets in place to make sure that
22 they are able to honor the transactions that they are the
23 counterparty to at all times.

24 And that safety net for ClearPoint includes what
25 I call a prefunded loss pool of \$200 million. And that

1 money did not come from NYMEX, it came from the members
2 participating in the marketplace. So basically to be part
3 of the clearing function they had to contribute capital, if
4 you will, to this prefunded loss pool.

5 Now we have talked about that with our market
6 participants and our stakeholders and they did not like that
7 idea at all. They much preferred to be allocated the share
8 of the default after it happened than have to prefund it and
9 have it sit there and never be needed, from that particular
10 point of view.

11 So there are costs to market participants as well
12 as costs to the ISOs and RTOs of basically going to being a
13 central counterparty. I myself would not be comfortable
14 simply saying that the shortfall uplift provisions in the
15 tariff that apply now will apply going forward and putting
16 no additional safety net in place.

17 We would have to come to the Commission and ask
18 for things such as prefunded loss pools to cover the cost of
19 default insurance, and other things of that nature. So it
20 is not a cost-free situation to simply make us a
21 counterparty to the transaction. There would be additional
22 mechanisms, protections that we would ask for in order to
23 protect ourselves against insolvency because we do believe
24 we are obligated to pay in full as the counterparty to the
25 transaction.

1 MR. QUINN: Could I ask two follow ups on that?

2 First, on the requirement you have the
3 responsibility to pay in full as the counterparty, do you
4 feel that there wouldn't be a tariff fix to that, that you
5 couldn't add something either to your tariff or your
6 participants' agreement that said that they acknowledged
7 that there won't be a payment in full in the event of a
8 default?

9 MR. HOLSTEIN: Our concern is someone could then
10 challenge that. Much like the earlier question, we would
11 leave the land of FERC world where we all understand what
12 the tariff is, and we would go into the commercial world,
13 bankruptcy courts and those natures. Whether anybody then
14 would mount an argument and prevail on that particular
15 world.

16 So my concern is, I don't want to put all my eggs
17 in one basket and count on the tariff protection without
18 putting the other safety net in provision which every other
19 clearinghouse does have right now.

20 MR. QUINN: And the second follow up is, could
21 you talk a little bit about--Mr. Duane was concerned about
22 the cost and the burden of perfecting the security.
23 Presumably you've had to do that with your Category A
24 customers, or market participants. Can you talk about the
25 cost and the burden of perfecting the security?

1 MR. HOLSTEIN: It's been neither costly nor
2 burdensome in our case. It's de minimis. I can't speak to
3 how costly or burdensome it was to the counterparty who gave
4 it to us, but again it happened pretty speedily between the
5 time we got the FERC Order and the time we asked the bills
6 to be in place. Within 40 to 45 days they were all done for
7 those that were motivated because it would have required
8 more collateral if they didn't give us the security
9 interest.

10 MR. MILLER: So in other words, it is not costly
11 or burdensome from your angle even though it's not a
12 mandatory. If you were talking about that scale of
13 participants, you would still feel it wasn't burdensome for
14 anybody? And you're feeling that if it were mandatory
15 across all the participants, then the possibility for a UCC
16 Form 1 mistake with a jurisdiction is a low, low risk?

17 MR. HOLSTEIN: I believe administratively we
18 could handle it, Scott. I'd much prefer that solution to
19 being placed in what the counterproposal is, which is take
20 title of the transactions and all the attendant risk that
21 comes with that.

22 One I can manage; the other one I would have to
23 take some action to take care of, not the least of which
24 again is to come back to you with a proposal to put in place
25 a safety net that extends beyond just tariff protection that

1 says I short-pay and then I uplift.

2 MR. MILLER: Vince, do you want to respond to the
3 safety net requirement issue that Michael has raised?

4 MR. DUANE: I only have--I don't have very much
5 to say to it. I don't think it's an issue. I'd like to
6 understand more. But the way I see that, and having had
7 some discussions along the same lines both internally and
8 with others, it's just a timing question of funding.

9 I mean, do you prefund it? The loss is the loss,
10 and the members are responsible for the loss under the
11 mutualized structures that we all share. Are you going to
12 seek that the members fund in advance a pool of money to
13 cover those potential losses? Or are you going to allocate
14 them afterwards?

15 To me, it's not all that critical. I mean, I can
16 see the potential I guess that there would be some liquidity
17 issue, or cash flow issue, in making a payment if you're not
18 able to assert your default allocation immediately, but
19 we've never had that.

20 When we have a default, we have a default
21 allocation, and it's one/two.

22 MR. MILLER: By the way, Ananda, if you've had
23 anything to say I would assume that you would have jumped in
24 at this point. I don't mean to completely ignore you.

25 MR. RADHAKRISHNAN: No, I wanted to make an

1 observation. I think all of my colleagues have raised
2 critical points, but the way to look at it is: What is your
3 desired outcome? If your desired outcome is the least
4 amount of shock to the markets, then you want to make sure
5 that the possibility of that happening is minimized.

6 And what do I mean by that? One of the
7 suggestions--as I understand right now, if somebody doesn't
8 pay you tell the rest of the people you're off \$10. So
9 that's your sort of loss mutualization that you have. And
10 some comments were made about, well, what is the potential
11 for loss and so on, and I agree with you. You know, the
12 potential for the occurrence of a loss may not be that high,
13 but what you don't know is when a loss does take place what
14 the magnitude of the loss will be.

15 And so what you don't want to happen, I suspect,
16 is let's say there's a shortfall. You can't net. You don't
17 have a security interest. So you tell the other
18 participants this is it. You know, instead of getting \$100,
19 you're going to get \$50. What is the impact on that person?

20 I don't know. Unless you guys know for certain
21 that that impact is not going to be devastating on the other
22 party, this is the uncertainty that I guess, you know, the
23 FERC is trying to address and Vince is trying to address.

24 In our markets, and they're different, all
25 transactions and exchanges have to be cleared. There's no

1 exception. All of them have to be cleared by a central
2 counterparty, and there's a structure around central
3 counterparties.

4 Central counterparties collect margin, and they
5 do have this prefunded guarantee fund, or default fund,
6 whatever you want to call it. There is also the attendant
7 bankruptcy protection. In fact, the protection is codified
8 in Subchapter 4 of Chapter 7 of the Bankruptcy Code, which
9 we found to be very helpful particularly in the context of
10 the last two bankruptcies we had to deal with, one being
11 Lehman and the other being Refco.

12 So I guess I would ask what you need to consider
13 as FERC is: Are you willing to take the chance that a
14 default will not have a significant impact on the market?
15 Are you willing to take that chance?

16 If you are, that's fine. But I suspect, you
17 know, you have certain responsibilities as a regulatory
18 agency, and I suspect one of them is that the markets
19 function orderly. So it's a tradeoff, but you may be asking
20 the wrong guy. I don't like taking chances. We don't like
21 taking chances. And the clearing system has been structured
22 so that the negative impact is minimized.

23 So far we have never had a situation where
24 whatever defaults take place--and they don't take place that
25 often--has had a negative impact on the market. So I think

1 that's what people need to think about.

2 I'm not blind to the costs that people need to
3 engage in, but I would urge the three ISOs here to think
4 very carefully about negative impacts, and encourage my
5 colleagues at FERC to think about it as well.

6 MR. MILLER: Any further questions from staff?

7 (No response.)

8 MR. MILLER: Did we get any questions from the
9 audience? Do we see anything there?

10 (No response.)

11 MR. MILLER: Okay. There were some people who
12 were threatening to have some questions. Okay, very good.
13 Then we have finished a little bit early on this panel, and
14 that is not a bad thing, and so I thank the panelists for
15 their participation.

16 We will take a 25-minute break for refreshment
17 and relief, and we will meet back here at 10 of the hour,
18 Eastern Time, and we will begin the second panel then.

19 Thank you.

20 (Whereupon, a recess was taken.)

21 MR. MILLER: Okay, great. We are going to begin
22 Panel Two. Let me just say, before we begin panel two
23 something that I want to make note of before so that I don't
24 forget it at the end.

25 The Commission will be accepting comments

1 regarding issues raised in this Technical Conference
2 relating to this issue only, and we will accept those
3 comments up till June 8th, I believe, which will be four
4 weeks from today. So anyone wishing to file comments--and
5 we will issue a notice I think subsequent to this to let
6 everyone know that we will be accepting comments on this
7 Technical Conference up to June 8th.

8 Okay, with that I would like to begin the second
9 panel, which initially was what I would call legal experts
10 and market participants. We do have one market participant
11 here. Unfortunately we ran into some scheduling issues
12 which perhaps relate to other meetings that have occurred
13 that we don't have some of the other market participants who
14 had filed comments in this regard.

15 But we do have Alex Catto, who is speaking on
16 behalf of the Committee of Chief Risk Officers; Hal Novikoff
17 from the Law Firm of Wachtell, Lipton, Rosen & Katz; Stephen
18 Dutton from Barnes & Thornburg; and Todd Brickhouse, who is
19 the Vice President and Treasurer of Old Dominion Electric
20 Cooperative.

21 Why don't we go ahead and begin with Alex, with
22 your viewpoints on behalf of the CCRO.

23 MR. CATTO: As you mentioned, my name is Iskender
24 Catto. I am an attorney with Kirkland & Ellis, LLP, in the
25 New York office. I am here on behalf of the Committee of

1 Chief Risk Officers, not as their attorney but as a
2 participant in one of their many subcommittees, which we
3 will get into in a moment.

4 In response to market activity and one of the
5 Commission's prior technical conferences, the Committee of
6 Chief Risk Officers convened a panel of experts back in
7 September of 2009 in what they called their Power Market
8 Credit Panel. And that Power Market Credit Panel split into
9 four subcommittees dealing with specific issues, one of
10 which was netting.

11 The Netting Subcommittee produced a report, after
12 looking at and identifying best practices currently used in
13 the ISO and RTO markets. The full report of the Netting
14 Subcommittee was submitted with the CCRO's comments back on
15 March 29th, I believe, and we will get into some of those.

16 Now, more specifically, the instant issue. One
17 of the things the Subcommittee did was identify, as we
18 mentioned, some of the best practices that are going on
19 there, and that basically meant enhancing the status quo.
20 And we've heard some of those things in the earlier panel,
21 some of which was maybe taking a security interest. That
22 doesn't work in every instance.

23 While it is a good practice, it doesn't work in
24 every instance because in markets where security interest
25 wasn't already established as a criteria the market

1 participants financings that are in place may not allow for
2 them to grant security interest to other entities. So that
3 is just something to consider in that area.

4 Of course daily netting or shorter netting
5 periods were an important consideration, because again that
6 reduces liquidity requirements, and anything that reduces
7 liquidity requirements is good for all market participants.

8 The Subcommittee did look at this particular
9 issue of the ISO being a central counterparty and identified
10 PJM's proposed change, or adoption of a central counterparty
11 entity as an emerging best practice.

12 So looking at from a best practices perspective,
13 it gets kind of to be an easy decision. When we look at--
14 and we have heard the phrase used many times today that, you
15 know, low risk, substantial hit with respect to business,
16 variations on that phrase, but basically the low risk of
17 this bankruptcy attempt to eliminate mutuality or challenge
18 the mutuality with respect to an attempted setoff, while the
19 risk of it I agree is low, the impact is extremely high.

20 And from a best practices standpoint, if you can
21 eliminate that risk, any circumstance that does is better.
22 So one is substantially better than the other from a risk
23 perspective.

24 Some of the things that we did hear today, I just
25 wanted to clarify some issues. There was some distinction

1 made between netting and setoff, and that is not really
2 clear. One is a product of the other. Netting is
3 accomplished through setoff.

4 So, you know, when we're talking about the
5 prebankruptcy period, we just call it netting. Setoff is a
6 term that's used in bankruptcy and has a very specific
7 meaning, and I know there are others who will address more
8 on the bankruptcy specifics, but generally speaking when we
9 get into the risk associated with bankruptcy, setoff is an
10 equitable remedy. The Bankruptcy Code doesn't grant you a
11 right to set off. It allows you to effect a setoff with
12 respect to a right that you might already have. And there
13 are a few ways you can get that right. You can either have
14 a contractual right to set off. You can have a statutory
15 right to set off. There could be a common law right to set
16 off. Bankruptcy courts are courts of equity, so they'll
17 allow you to do this.

18 But the confusion at least that I heard was some
19 people were talking about categories of contracts. That
20 doesn't mean anything. The basic equitable right of a
21 setoff is one person should not be required to pay somebody
22 something when the other person is not going to pay them.
23 So you are setting off obligations.

24 So the mutuality that we're talking about is
25 between the parties in the same right and capacity. And as

1 long as that is there, the character of the contract, what
2 it's for, what it does, is essentially meaningless.

3 There are some types of contracts that might have
4 other rights in bankruptcy, but that is a different
5 circumstance. What we're talking about here is netting. So
6 when--and I don't think this was intended by the speaker
7 because it didn't--I really don't think it was intended, but
8 when I hear that, well, our netting scheme, or our
9 collateralization requirements don't take into account the
10 potential of setoff, what I'm hearing is that, well, then
11 you're not fully netting everything.

12 So my collateralization requirements are not
13 being fully reduced because, if there is that mutuality
14 there and you could set those things off in theory, then my
15 obligation for collateralization should be reduced because
16 there should be less exposure associated with our
17 relationship, regardless of what transactions they might
18 entail.

19 There was a question also, or an issue raised
20 with respect to prepetition debts. My takeaway from that
21 was--and again this is just for clarity--that all
22 prepetition debts are cured. That's not necessarily the
23 case. If the contracts are rejected, you wind up with a
24 claim. So there isn't always a cure just because the entity
25 is going to emerge from bankruptcy. The contracts that are

1 associated with that obligation could be rejected. So there
2 is that.

3 Going back to the primary premise, which was that
4 having a central counterparty from a risk perspective is
5 better than not having a central counterparty, the CCRO sees
6 that, as we mentioned, as an emerging best practice.
7 Whether it's done through the PJM standard or a different
8 standard, that might be put forward. Having that one entity
9 will probably allow more effective netting, from our
10 perspective, both within and without bankruptcy.

11 MR. MILLER: Thank you, Alex.

12 Harold Novikoff, please.

13 MR. NOVIKOFF: Good morning. Thank you for the
14 opportunity to appear on this panel. My name is Harold
15 Novikoff, Wachtell, Rosen, Rosen & Katz, in New York.

16 I am here as a bankruptcy lawyer. I am acutely
17 aware of the fact, sitting in this room at FERC, that I am
18 probably the least knowledgeable person in this room about
19 the energy markets.

20 On the other hand, I do spend a lot of time
21 dealing with bankruptcy issues in the bankruptcy courts. If
22 I can be of any use today I think it is to explain to this
23 group why it is that the bankruptcy courts are quite hostile
24 to setoff, which on its face I think to most of the energy
25 professionals in this room would view--you know, from the

1 perspective of an energy professional, as being a perfectly
2 fair and equitable practice.

3 So first, what you have heard is that in order
4 for setoff to be applied, the debt and obligation to be set
5 off must be mutual. That means it's, each side of the
6 transaction with the same parties acting in the same right
7 and in the same capacity.

8 As Alex has just said, it is not transaction-
9 driven. The two amounts to be offset can arise from totally
10 different transactions. They can be transactions of totally
11 different types. We are looking at the identity of parties.
12 Are they the same? And parent, subsidiary, or not the same
13 entities under common control are not the same? Legal
14 entities have to be the same, and they have to be acting in
15 the same capacity. If one is acting as a trustee and the
16 other is acting in its own right, that is also not the
17 same.

18 So why is it that the bankruptcy courts are
19 hostile to this? And are they in fact that hostile? Well I
20 want to read an example. One of the cases that many of you
21 have heard that is key in this area is the SemCrude decision
22 which came out of the bankruptcy court in Delaware, and in
23 the bankruptcy world Delaware is a very important
24 jurisdiction.

25 On April 30th, just 12 days ago, that case was

1 affirmed by the District Court. I want to read a quote from
2 that, and this is the words now not of a bankruptcy judge
3 but a Federal District Court Judge, Judge Joseph Farnan in
4 the District of Delaware, and I quote:

5 As the bankruptcy court correctly recognized, the
6 mutuality required by Section 553, quotes, "cannot be
7 supplied by a multi-party agreement contemplating a
8 triangular setoff," closed quotes, and then he cites the
9 bankruptcy court decision.

10 This conclusion is not only consistent under the
11 facts and applicable case law, but also with general
12 bankruptcy principles concerning the strict construction of
13 mutuality against the party seeking setoff.

14 In addition, the court concludes that the
15 bankruptcy court correctly determined that a contract
16 exception to the mutuality requirement does not exist based
17 upon the plain language of Section 553.

18 As the bankruptcy court recognized, this
19 conclusion is also consistent with the primary goal of the
20 Bankruptcy Code to ensure equal and fair treatment among
21 similarly situated creditors. He then cites again to the
22 bankruptcy court decision, and that is going to be the close
23 of my quote.

24 But here you have the Federal District Court
25 Judge saying you can't contract around mutuality, and the

1 courts correctly view setoff issues and mutuality issues
2 strictly, and strictly construe them against the party who
3 wants a setoff.

4 Why does that happen? Essentially there's two
5 basic principles of the law, one from bankruptcy and really
6 one from state law, that setoff offends, even though I think
7 the energy professionals view it as something perfectly
8 fair. Under the circumstance, why should I be paying in
9 full to somebody who is paying me back at a discount?

10 Two things. One is, as Judge Farnan mentioned, a
11 basic tenet of bankruptcy is quality of distribution among
12 creditors. That is, that similarly situated creditors
13 should get the same treatment.

14 Therefore, when courts view special priorities
15 established under the Bankruptcy Code, security given to a
16 party in bankruptcy, and setoffs, those are strictly
17 construed because it means that a creditor who is getting
18 the benefit of one of those things is getting better
19 treatment than other creditors. And basic notion of
20 fairness in bankruptcy on its face is that similarly
21 situated creditors should get similar treatment.

22

23

24

25

1 And the Bankruptcy Code itself, the statutory
2 language, is not helpful because Section 553, which is the
3 section of the Bankruptcy Code dealing with set-offs, says
4 that setoffs which are valid under state law will be given
5 effect in bankruptcy, but the only ones which are given
6 effect are mutual set-offs. It uses the word "mutual" in
7 the statute.

8 Reason number two that you have courts looking
9 restrictively at setoff is something that those of us who
10 have gone to law school will all remember if you were ever
11 in a commercial transactions or secured transactions course,
12 which is that the law does not like secret liens.

13 You know, it's the old notion of if you walk
14 into--if a prospective creditor walks into a business and
15 sees a lot of inventory on the shelves, the creditor does it
16 with the expectation that if it advances credit to that
17 business that inventory will be available to it and all
18 creditors to satisfy their claims. So in order that people
19 not be surprised and find out that somebody else actually
20 has a security interest in that inventory we now require
21 public filings.

22 You know, so you can perfect a security interest,
23 therefore making it effective as against third parties,
24 through essentially a couple of means. One is the secured
25 party can take possession of it, in which case the creditor

1 isn't going to walk in and see it on the shelves, or it can
2 file. It can file a UCC registration statement under the
3 Uniform Commercial Code; it can file a mortgage against real
4 estate under state laws.

5 And there's a number of separate federal statutes
6 providing for filing against, you know, rolling stock or
7 aircraft or patent rights. So the law is based around the
8 notion of not honoring -- or not allowing creditors to be
9 trapped by secret liens.

10 Set-offs are an exception to that because a set-
11 off is the economic equivalent of the assignment of a
12 receivable. And to the extent that you are honoring a set-
13 off -- meaning that the counterparty whose receivable is not
14 now going to be collected by the debtor because that
15 counterparty is going to set it off -- effectively has
16 created a security interest for its own benefit in that
17 receivable without filing. So it effectively offends the
18 Uniform Commercial Code.

19 But the common law developed this exception so
20 that any creditor seeing that there is a receivable on the
21 debtor's books should have to take into consideration the
22 fact that that particular counterparty, the account obligor,
23 might have reasons to reduce that. He might have claims
24 that go in the opposite direction. And the common law gives
25 that exception to the basic filing requirement. But that

1 common law exception is limited to the mutual situation.

2 The creditor should not -- you know, other
3 creditors should not have to worry about secret liens where
4 an account obligor now has the ability to set off against
5 other non-recorded obligations.

6 And without getting into it further, there could
7 also be fraudulent transfer issues in honoring a set-off
8 right.

9 So while, again from the perspective of an energy
10 professional, set-off seems a perfectly fair, equitable
11 thing to do, when you move into the context of a bankruptcy
12 court you have to understand that the bankruptcy courts are
13 going to be hostile to it. We now have the decisions in Sim
14 Crude, where the court has ruled -- and it very well could
15 go up on appeal now to the Third Circuit, but at least the
16 decision so far at the bankruptcy court affirmed by the
17 District Court are you cannot contractually get around
18 mutuality requirements.

19 And we can point to other decisions where courts
20 have been very, very strict in mutuality: a very recent
21 decision -- actually May 5, not directly on point here, but
22 a May 5 by Judge Peck in the Lehman case again construing
23 safe harbors, which were arguably protecting set-off rights
24 and construing them in a very restrictive way.

25 So we've identified essentially three solutions

1 to deal with the issues confronted by the ISOs here. One,
2 as discussed, is to create mutuality by using a central
3 counterparty and have that counterparty deal with all of the
4 participants.

5 This is a common way of dealing with it in the
6 securities, commodities and certain other markets. You
7 create a central clearing corporation, clear the
8 transactions through that clearing corporation acting as a
9 central counterparty. That clearing corporation holds the
10 necessary collateral -- usually calculated on a net basis
11 usually with some margin for the exposures -- and typically
12 it would have some ability to assess its members if there
13 were a loss beyond the collateral levels obtained. And
14 those have satisfied even restrictive views on mutuality. I
15 think Alex called it a best practice. I would consider that
16 a best practice.

17 You can get -- so that's one way.

18 Another way is a collateral arrangement. You can
19 in theory get to the same economic result through the use of
20 collateral. Among other things, you know, as I mentioned,
21 you know, set-off is the economic equivalent of taking a
22 security interest in receivable. So actually take the
23 security interest in the receivable as part of the
24 collateral package. Perfect against it by filing a UCC-1 or
25 other measures. Make sure you're perfected on the other

1 collateral. If you set up the documentation properly and
2 you administer it property, you can get to the same economic
3 result.

4 I think as has been pointed out, this can be
5 difficult in the sense that there may be issues as to
6 whether certain participants have the authority or the power
7 to grant a security interest. Some entities -- for example,
8 municipalities -- may not be able to do that. Others may be
9 constrained by covenants in lending agreements or other
10 agreements from granting security interests. So that is a
11 practical damper on using that type of solution. But in
12 theory you can get to the result through a collateral pool.

13 One other way that we have -- and obviously you
14 can reduce just as a general matter credit exposure through
15 quicker cycling of settlements, et cetera.

16 The other way we have looked at doing it is our -
17 - rewriting tariffs so they are written in the form of a net
18 obligation rather than a gross obligation. However, I think
19 the concern is without a clear identification of the role of
20 the ISO of truly being the counterparty in all respects a
21 hostile court may not give effect to that type of netting.

22 With that -- that finishes my comments and I'm
23 available for questions at the end.

24 MR. MILLER: Thank you. As we did with the
25 previous panel, we'll save questions until the end of the

1 panel.

2 Stephen Dutton from Barnes and Thornburg.

3 MR. DUTTON: Good morning. Thank you for having
4 me to participate with this distinguished group.

5 I am Steve Dutton, a partner in the Indianapolis
6 office of Barnes and Thornburg. My comments here are my
7 own; they don't necessarily reflect the opinions of my firm
8 or my partners. I hope they do, but they may not.

9 We have worked with the Midwest ISO on credit and
10 finance matters for most of its history. And so we've had
11 occasion to watch this issue develop and grow here at the
12 Commission.

13 I want to address two issues. One is the risk
14 assessment of the current -- of the situation as it
15 currently stands. And the other is the -- I guess what I'd
16 characterize as the necessary prerequisites for an
17 appropriate central counterparty solution.

18 So first to the existing risk. And obviously the
19 risk is different or may be different among the various ISOs
20 depending on their tariffs. I'm most familiar with the
21 Midwest ISO's tariff so I'm going to use that as an example.
22 But other tariffs could be different and could be more risky
23 or less risky, just depending.

24 The first hurdle that someone who wants to avoid
25 netting -- a market participant who wants to avoid netting

1 is to -- they've got to raise the set-off issue as an issue.
2 And to do that they've got to find two claims -- or more
3 than one claim.

4 In the case of the Midwest ISO its tariff is
5 written so that a participant has no right to any funds
6 other than a net amount and only when the invoice is issued
7 so that a market participant who wants to say no, you can't
8 net has to first of all break this obligation which exists
9 only at the time when the invoice is issued into constituent
10 parts that you can then net against.

11 If the market participant can persuade a court
12 that it can disaggregate this one net amount then the market
13 participant has to deal with the issue that the tariff
14 amounts to a contract among the parties permitting netting.

15 As Harold said, that argument is less strong this
16 year than it was last year. But when the Third Circuit
17 acts, if it is appealed, it may be stronger. So we'll wait
18 and see what the bankruptcy court does with that.

19 Then if a market participant gets past that
20 hurdle then they need to address the netting, the set-off
21 issue. And to do that they have to determine that the
22 Midwest ISO is acting in a different capacity with respect
23 to amounts that they owe the market participant than with
24 respect to amounts the market participant owes them.

25 I guess I view the way the ISOs serve here is

1 they are agents for the market. And in that capacity
2 they're in the same capacity with respect to both the amount
3 owed and the amount owing.

4 Now there are arguments that, well, with respect
5 to one class of charges -- say the real time day ahead
6 charges -- the Midwest ISO's capacity could be different
7 than with respect to another kind of charges -- say FTR
8 rights. That's an argument that is more plausible than the
9 argument that the Midwest ISO, for example with respect to
10 the day ahead market, is not acting in the same capacity on
11 both sides of the transaction. We think that's a hard
12 argument to win. But no one has every done it and it's
13 never been tried. So we don't know the answer.

14 So to the extent the -- And so the Midwest ISO
15 saw this risk of netting across buckets as being problematic
16 or at least more risky and put in place a security interest
17 solution for that, which is sort of where we get to.

18 The prior panel already talked about the
19 practical limitations on a market participant's ability to
20 assert these arguments. And essentially the practical
21 ability is if they want to stay in the business of selling
22 energy in that market and transmitting energy in that market
23 they're going to have to assume the contract they have with
24 the Midwest ISO, and that brings all the netting into place.

25 Now with respect to central counter-parties.

1 Obviously words and documents are important. As
2 lawyers, we think that that's kind of an important thing.
3 But the words don't always make the facts different.

4 And if an ISO implements a central counterparty
5 proposal by simply becoming a central counterparty and not
6 eliminating the short-pay feature that has been talked about
7 -- which is essentially that if enough money isn't collected
8 the market participants are short-paid an amount.

9 If it doesn't eliminate that short-pay feature
10 then this creates the ability for an argument to be created
11 that there's some sort of a -- this cloud liability feature
12 which the Locktoe memo that sort of initiated all of this
13 discussion referred to as a factor -- that suggests that
14 mutuality may not be present. That if this cloud liability
15 feature isn't eliminated then there is the argument that
16 could be made, that Mirant made -- whether it would be
17 successful or not we won't know -- but essentially the
18 argument that mutuality is lacking, even though the ISO is
19 characterized as a counterparty.

20 The other -- Well, to solve this issue obviously
21 the counterparty, the ISO, could become a true buyer, a true
22 seller, become obligated to pay, which raises the issues on
23 the need for protections that among, other people, Mike
24 Holstein spoke about -- and being able to be assured that if
25 there's a credit mistake made and a participant goes under,

1 and it's under-collateralized, that that does not render the
2 ISO insolvent; that there is enough cushion to protect
3 against that.

4 So those are the two issues that I really wanted
5 to address. The practical risk and sort of how implementing
6 a central counterparty structure I think would need to be
7 done unless the decision is made to accept the risk that the
8 argument -- essentially the same argument that can be made
9 with respect to set-off could be made with respect to a
10 central counterparty structure.

11 Thank you.

12 MR. MILLER: Thank you, Steve.

13 Todd Brickhouse from Old Dominion Electric.

14 MR. BRICKHOUSE: Thanks, Scott.

15 Again, my name is Todd Brickhouse. I am the
16 treasurer of Old Dominion Electric Cooperative. I
17 appreciate the opportunity to offer remarks today.

18 I've been inspired by the lawyers to my right.
19 So my disclaimer is that my comments are on behalf of myself
20 and Old Dominion and may or may not reflect the opinions of
21 other cooperatives and market participants.

22 Old Dominion Electric Cooperative, or ODEC, is a
23 not-for-profit generation and transmission cooperative. We
24 serve the power supply needs of eleven distribution
25 cooperatives that are located in Virginia, Maryland and

1 Delaware. The distribution cooperatives are also the owners
2 of Old Dominion, which is an important point that I'll come
3 back to in a little bit.

4 As a not-for-profit generation and transmission
5 cooperative ODEC is exempt from federal income taxation.
6 For a little more background, we are rate-regulated at the
7 federal level by the Commission and we are not regulated at
8 the state level.

9 Our entire service territory falls within the PJM
10 footprint. We have been very active in the PJM stakeholder
11 discussions regarding credit issues and counterparty
12 clarity. Our interests and our active involvement in the
13 PJM stakeholder process concerning counterparty clarity and
14 credit issues is really driven by two factors.

15 First, the credit defaults experienced in PJM's
16 FTR market in late 2007 resulted in ODEC again as a member
17 of PJM absorbing costs related to those defaults that were
18 not insignificant. Thus we had a vested interest in PJM
19 enhancing its credit procedures.

20 Second, and specific to the counterparty clarity
21 initiative, as a tax-exempt electric cooperative, ODEC must
22 receive 85 percent of its gross revenue from its member-
23 owners. And I emphasize its member-owners again.

24 Said a little bit differently, no more than 15
25 percent of the tax-exempt electric cooperative's gross

1 revenue can come from sales to non-members.

2 As first discussed going back to April 2008 with
3 PJM's counterparty clarity initiative, that would involve
4 the way PJM first described it was PJM taking title to
5 transactions within the pool. And that was in order to
6 establish mutuality for set-off for the purposes under the
7 bankruptcy code.

8 Taking title involves a purchase and a sale. And
9 in ODEC's case with all of our generating assets and again
10 all of our customers in the PJM footprint, this initial
11 concept would have had us sell all of our output to PJM for
12 further transfer to our customers. That sounds rather
13 benign on the face of it until you recognize that PJM is not
14 one of ODEC's owners. Thus, sales of this magnitude would
15 immediately violate our tax-exempt status. So it was very
16 important to -- it was a very important issue to us just as
17 proposed by PJM for really maintaining our business model.

18 To PJM's credit, they worked to develop a
19 solution that would satisfy both their concerns under the
20 bankruptcy code and the cooperative's concerns under the tax
21 code, which reconciling those two is certainly no easy feat.

22 Ultimately I believe that the tools that PJM
23 developed to reconcile the issues -- namely bilateral
24 scheduling and self-supply scheduling -- also proved to be
25 compelling solutions in other respects for the broader

1 membership as well. And I would just point out that the
2 bilateral scheduling and self-scheduling are ways within the
3 PJM marketplace that PJM will not take title to all of the
4 transactions within its footprint.

5 I bring this to your attention and really had the
6 discussion about the PJM process not as a broad endorsement
7 for a FERC-initiated counterparty initiative, but hopefully
8 to demonstrate the unique needs of every constituency and
9 more likely every constituent within an ISO or an RTO.

10 In the PJM stakeholder process, which took well
11 over a year and which I would describe as being
12 unconstrained by FERC mandates, parties were able to
13 identify potential unintended consequences like the tax
14 discussion I just went through. And we were able to work
15 through those unintended consequences in what I would
16 describe as a sense of mutual purpose.

17 If FERC were to mandate some form of counterparty
18 clarity my concern would be that constituents in other RTOs
19 might be disadvantaged by a stakeholder process that was
20 somewhat imposed, for lack of a better term.

21 That's not to suggest that the PJM stakeholder
22 process satisfied all constituents' concerns. For example,
23 there are PJM members that have larger geographic footprints
24 than ODEC that believe counterparty clarity gives rise to
25 taxation issues at potentially the state and local level.

1 Those concerns may or may not prove to be valid
2 in the PJM region. I do think it's conceivable that state
3 law outside the PJM region could prove to be less
4 hospitable, if you will, or that states suffering some form
5 of financial stress may look for what might be creative
6 additions to their revenue base.

7 I don't want to further belabor my comments with
8 more hypotheticals. But since no one has implemented a
9 counterparty clarity initiative the question of cost is
10 still a hypothetical of significant importance to market
11 participants. Not only is cost important at the individual
12 RTO or ISO level, but I would encourage the Commission to
13 look at the aggregate costs of implementing counterparty
14 clarity across all of these entities.

15 Given my previous comments regarding each
16 constituent's unique needs within an RTO or an ISO, I would
17 suggest that a solution that might satisfy one RTO or ISO
18 may not fit another. Thus leverage costs from duplicating
19 the effort of PJM, for instance, and MISO, those costs may
20 not be leveraged based on lessons learned as one might
21 expect.

22 I'd just point out that the cooperative economic
23 model is based on cost avoidance as opposed to EPF's gross
24 return on invested capital or return on equity metrics. So
25 we are especially attuned to circumstances that may create

1 further burdens of costs for us and ultimately the end
2 consumer, who again is our owner.

3 We respectfully requests that the Commission and
4 Staff carefully consider the aggregate costs of implementing
5 counterparty clarity across the entirety of FERC's
6 jurisdiction, as well as carefully vetting the cost
7 assumptions of both explicit costs that are proposed by ISOs
8 and potential unintended costs that wouldn't be in their pro
9 formas or their filings that RTOs and ISOs submit as a basis
10 for implementing the counterparty clarity initiatives that
11 FERC may or may not require.

12 In closing, I thank you for the opportunity to
13 offer my comments. And I'll look forward to your questions.

14 MR. MILLER: Thank you very much, Todd.

15 And thanks to the other panelists.

16 We now have an opportunity to ask a few questions
17 of the panelists. And if it's all right with everyone else,
18 I've got a couple before we go to the others.

19 Alex, I notice that you put -- you tried to
20 distinguish certain solutions, other solutions that people
21 have posited to the ability to net. And you said that the
22 other solutions that didn't encompass central counterparty
23 clarity would not allow for more effective netting.

24 Can you clarify that, what you meant by that?

25 MR. CATTO: I'm not sure which part of my remarks

1 that related to.

2 MR. MILLER: It was at the very end when you were
3 distinguishing the, for instance, security interests versus
4 central counterparty.

5 MR. CATTO: Oh, sure. Yes.

6 The security interests won't work across the
7 board. As I think I mentioned, there will be -- while it is
8 a good thing to have a security interest because mutuality
9 isn't really an issue there, you're talking about a secured
10 transaction essentially. You're going to run into I suspect
11 difficulty in implementing that across the board because of
12 the restrictions placed on parties by their lenders.

13 In areas where security interests are required
14 under -- to the extent they exist and are required under
15 some of the organized markets, the financings that were
16 entered into or the lender agreements that were entered into
17 already provided for that. In other words, they were trying
18 to meet a market requirement.

19 So making a change in a new market will take some
20 time before someone will be able to meet that requirement.
21 So you won't necessarily get the full benefit of it. And we
22 don't necessarily know if the security interests will cover
23 all of the exposures that we're talking about.

24 So if what we're trying to do is, one, eliminate
25 a specific risk with respect to this mutuality issue -- and

1 let me just say my involvement with the Committee, the
2 Netting Committee, was because I am an energy lawyer and a
3 bankruptcy lawyer. I have the odd distinction of playing in
4 both worlds. And I don't really know which type of lawyer I
5 am on any particular day.

6 (Laughter.)

7 MR. CATTO: I've been through the NRG bankruptcy
8 and represented Calpine in Calpine's bankruptcy. So I've
9 seen the different types of arguments that people can raise.

10 And Harold raised two different cases that were
11 just decided both last week on different levels, both trying
12 to come up with arguments that I thought were not very
13 strong on attacking, you know setoff in various ways and the
14 establish rules for setoff. And I think both were decided
15 rightly, at least in my view.

16 But there's no question in my mind that the door
17 has been opened with respect to the Mirant issue. And if
18 the facts wind up in the right circumstances where a debtor
19 has an opportunity to raise that issue, it's really a
20 question of when will the issue come up.

21 And even though I still believe it's a weak
22 argument, you know, the Mirant argument, it will come up.
23 And then it becomes a question of, well, if you can get into
24 court now you've created risk. Maybe you're low risk, but
25 it's risk. And risk always leads to either someone

1 following it through to the end over a long and costly trial
2 or a quick and easy settlement.

3 So risk creates leverage. And creating the
4 central counterparty effectively takes the gun out of
5 somebody's hands and eliminates the potential leverage that
6 they might have.

7 So again, while I see the outcome as low risk, I
8 think the fact that the issue will come up is a more
9 significant risk some day. Yes, it didn't come up in the
10 multiple bankruptcies because the facts didn't really allow
11 for it. It hadn't come up prior to Mirant because the facts
12 didn't really provide for it.

13 And, you know, what we all know is -- I've made a
14 career out of one crisis after another. So crises have just
15 continued to pop up. And there will be another one of some
16 sort. And maybe that one might not have the right facts,
17 but the following one will.

18 So one way or another we've got to figure out how
19 to eliminate this thing, or deal with it.

20 MR. QUINN: A follow-up question for Mr. Dutton.

21 Can you comment, then, on the question about how
22 difficult or how long it will take to establish the right to
23 give the ISO the security interest needed to do something
24 other than central counterparty, whether that was an
25 impediment as MISO moved forward with exclusion, whether you

1 think that would be an impediment if it attempted to do
2 something that was more mandatory.

3 MR.DUTTON: I think the -- correctly -- Alex
4 mentioned the issues that a participant would have with
5 respect to their existing lending agreements.

6 Most lending agreements prohibit granting liens
7 to anybody for anything. And so the market participant
8 would either have to go back to the lender and get a
9 waiver--it's really a pretty innocuous kind of lien. But in
10 the markets as they existed last year you probably couldn't
11 have gotten a lender to say 'hello.'

12 (Laughter.)

13 MR. DUTTON: But some time over the future the
14 markets will change and something like that may be feasible.
15 But I think it would take time to implement. Not everybody
16 could take advantage of it immediately.

17 And some entities such as the munis may not be
18 able to do that anyway. They've got a different risk
19 profile all together because they're so often funded with
20 revenue bonds, which really mitigate the risk significantly.

21 MR. QUINN: Was this an element of the
22 stakeholders' decision not to move forward with something
23 that's like more mandatory than voluntary?

24 MR. DUTTON: I believe it was.

25 I believe that the original attempt by the

1 Midwest ISO in 2004 for a broader security interest
2 requirement, some of the stakeholders resisted it pretty
3 strongly. And after evaluating the risk and what could be
4 done feasibly, the Midwest ISO concluded that the risk of
5 not being able to set off within a category of charges was
6 low enough that it could live with calculating credit
7 exposure within a category on a net basis.

8 MR. MILLER: Hal, I wanted to go to one of the
9 three solutions for the ISO/RTOs that you laid out. The
10 third one, as I think you put it, was rewriting tariffs to
11 reflect net rather than gross obligations.

12 One of the problems that we seem to be wrestling
13 here with is again the risk once we exit the FERC world into
14 the broader world. And the fear that a tariff, which is
15 something that's just approved by our Commission -- Let me
16 rephrase that because I don't want any Commissioner to think
17 that what they do is something that's "just" -- that our
18 Commission does after consideration may not be something
19 that is -- holds as much weight once we get into a
20 bankruptcy proceeding. Is that correct?

21 MR. NOVIKOFF: Yes, notwithstanding the stature
22 and wisdom of the Commission.

23 (Laughter.)

24 MR. MILLER: Thank you for bailing me out on
25 that.

1 MR. NOVIKOFF: I would view that as creating a
2 weaker argument for mutuality than the central counterparty,
3 and also weaker than collateral. Collateral doesn't really
4 require mutuality. It's essentially a way of taking you out
5 of the issue. But I think it's a weaker argument than the
6 central counterparty.

7 And I would also point out that, as I said, I'm a
8 bankruptcy lawyer learning about the energy markets. I
9 really heard two ways today of actually approaching the
10 tariff. And I think one is stronger than the other in the
11 sense that one way of approaching the tariff is to write it
12 on a net basis, and then if there is a default the ISO
13 continues as the party that pursues the claim into
14 bankruptcy or post-default.

15 I think that model has a better chance of
16 succeeding on mutuality than a model in which, once there's
17 a default, the ISO essentially immediately distributes the
18 risk out and says, 'Participants, you now go try to pursue
19 it.'

20 If a bankruptcy court is seeing multiple
21 participants coming to collect it, I don't know that it's
22 going to take at that point very much credence to the fact
23 that the -- a tariff in essence created mutuality I think
24 has a better shot if the ISO continues in place.

25 But as I pointed out, you know, because of the

1 issues I described where you're going to be in a somewhat
2 hostile forum on this where a creditors committee is going
3 to be supporting a debtor potentially in attacking the set-
4 off right, you would prefer in an ideal work to not create
5 the foothold for the debtor to try to upset the set-off
6 rights. And I think, you know, it's a weaker model.

7 Is it possible that it ultimately does prevail on
8 the basis of the tariff? Sure. But I just don't think it's
9 as strong as either going with the central counterparty
10 model or a collateral model.

11 MR. MILLER: Todd, I'd like to direct a question
12 to one of your--the issues that you raised, which was that
13 you wanted us to consider the aggregate cost of solutions
14 versus--and I guess against their benefit. The question I
15 have is:

16 Are you particularly worried with what is being
17 proposed in terms of the solution that you've worked through
18 in PJM? And if so, how do you measure that against the
19 benefit?

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1 I guess, you know, the benefit of there not being
2 a calamity, and what would you suggest the Commission--how
3 would the Commission view that? I mean, would we use some
4 sort of scenario to say, you know, a calamitous default of
5 \$100 million which has been raised sort of as a threshold
6 here a couple of times, I mean are you worried about the
7 cost in the solution you've been working through?

8 And, two, are you--how would you calculate the
9 benefit? Because obviously we're talking about something
10 that's akin to insurance.

11 MR. BRICKHOUSE: Sure. Specifically in terms of
12 the solution that we've worked through through the PJM
13 stakeholder process, I am not overly concerned about
14 exorbitant costs being passed along to the membership.

15 In preparing for my remarks today, I did go and
16 read a number of the comments that have been filed in
17 response to FERC's NOPR, and it stood out to me the comments
18 that CALISO had made with respect to the administrative
19 costs that they expected to incur, but I will let those
20 comments stand on their own.

21 In terms of measuring it against the solution
22 that PJM has put forth and what might be a calamitous event,
23 I've listened to the discussion today and I guess the
24 question in the back of my mind is: Is PJM's solution the
25 most efficient and cost-effective?

1 And hearing the first panel and the comments of
2 these gentlemen, I would say the answer to that is: Maybe.
3 It seems to be that there is not legal certainty on some of
4 these issues, and whether you come to a hundred million
5 dollars default in the market, whether you can't have a real
6 stake in the bankruptcy claim, it seems to me that that
7 legal issue is uncertain but I'll let the lawyers speak to
8 that. And I think they have.

9 MR. MILLER: Further questions from the staff?
10 Larry?

11 MR. GREENFIELD: I have a couple of questions,
12 but let me start with one for Mr. Dutton. It probably
13 reveals more about my lack of understanding of bankruptcy
14 law since it's been many years since I've had occasion to
15 ever look at bankruptcy law.

16 That is, the sense I got from your comments was
17 that in contrast to Mr. Novikoff and Mr. Catto who make the
18 point that being successful in a setoff argument in
19 bankruptcy court is no easy thing, I drew some sense from
20 your comments, Mr. Dutton, that you didn't think it was
21 quite that difficult.

22 Am I misunderstanding, or misreading that?

23 MR. DUTTON: Well I too read the SemCrude case
24 that Harold mentioned. It reflects a very serious distaste
25 for setoff. But I think that the issues are: Is there

1 anything to set off?

2 In other words, are there two claims, or more
3 than one claim so that you have to even approach the Setoff
4 Doctrine? And then if there are multiple claims, is the
5 Midwest ISO, or the relevant ISO, acting in the same
6 capacity with respect to the amounts owed and the amounts
7 owing?

8 And I think the argument is strongest that they
9 are acting in the same capacity when they're essentially
10 representing the same market. And the "same market" would
11 be, for example, the Day Ahead Market compared to the RTFs.
12 And an argument can be made that the Midwest ISO or an ISO
13 would not be acting in the same capacity and wouldn't be the
14 agent for the same people with respect to one market as
15 opposed to another, which is why we went to the security
16 interest.

17 MR. GREENFIELD: And could I ask Mr. Novikoff and
18 Mr. Catto to respond, if they have a different view of the
19 world on that, or indeed the same view?

20 MR. NOVIKOFF: Yes. I think the substantial the
21 court is going to look at is a different issue than the one
22 that Mr. Dutton just identified. I think the question is
23 going to be: Who is the party? Is the ISO the party at
24 all? Or are the ultimate market participants the party? Or
25 even if you view the ISO as the party, at most it is acting

1 as an agent and it could be acting as agent for different
2 people depending on the particular transaction.

3 So I think that a court that is going to be
4 looking at setoffs restrictively is not necessarily going to
5 look at it as a capacity issue, but much more may look at it
6 as an identity issue. Who is the party?

7 It is going to be difficult to argue that it's
8 the ISO acting as a principal in the transaction. I'm not
9 hearing Mr. Dutton even use that term. He's using an
10 "agent" term for the market, but you can say the market, and
11 if that's not something that a bankruptcy court, or a
12 district court is familiar with it's going to say, well,
13 it's a number of participants and maybe those participants
14 are different for each transaction.

15 That is where the--in my view--the tariff-type of
16 proposal can really run afoul in a court that's looking to
17 be restrictive could jump to that characterization.

18 Now, yes, it is certainly possible that a court
19 says, okay, I'm either going to view the ISO as the
20 principal, or view it as an agent for a market that doesn't
21 change, but we don't have cases that say that right now.
22 And I'm quite concerned that in a hostile forum that could
23 very well not be the result that comes out.

24 MR. CATTO: Yes, I think I tend to agree with
25 what Hal is saying. The issue of capacity goes to identity.

1 So it's identity first, and then in what capacity.

2 What I would hate to have to argue to a
3 bankruptcy judge is, you know, the identity of the
4 counterparty is the market, without identifying specifics.
5 I mean, that is just one that I would never want to be on
6 that side of that argument; I'd rather take the difficult
7 side of the fight. But I think if I was in that instance I
8 would be arguing that the ISO is the counterparty, despite
9 what the tariff says, and everything else. If want to
10 effect that setoff, I'm arguing that that's the
11 counterparty.

12 MR. MILLER: Todd, let me--and I don't to put you
13 in this position, since you mentioned it, but you didn't
14 necessarily say it reflects the ODEC position, but I'm
15 curious with regard to the state tax issue.

16 There were a number of parties that raised this
17 generally speaking as an issue to be wary of, but then did
18 not put any specifics around it that I could see. And I'm
19 wondering, since we're talking about transactions that are,
20 you know, fundamentally the same, the volumes are the same
21 and you're just putting a different name on it, the volumes
22 aren't going to change, you know, Utility X is still going
23 to be transacting the same way in the same volumes as long
24 as there is, you know, whether it's a central counterparty
25 or this issue is left amorphous, so do you--I guess what I'm

1 looking for perhaps, Todd, is if you have any clarity to
2 offer in that regard?

3 Of if not, I would just ask any parties that are
4 going to be filing comments in this regard to give some
5 meat, some specifics to that concern that's raised.

6 Do you have anything to offer on that, Todd?

7 MR. BRICKHOUSE: Well I would say I think one of
8 the overriding reasons that we're here is because there's
9 not clarity of what a bankruptcy court does in each of these
10 situations. So I think it's fair to say that if it's not
11 clear necessarily what a bankruptcy court is going to do in
12 each situation, it is probably not clear what a tax court or
13 tax jurisdiction is going to do in each case or situation.

14 We are having I think trouble getting to what the
15 meaning of taking title, and mutuality, and setoff all mean.
16 If you're a taxing jurisdiction, or in the case of a
17 co-operative, the way we look at it is if you take title,
18 that is a sale that we have made to you.

19 So that is where--you know, you say, well, the
20 market is not doing anything different. I think it is doing
21 something different. It's taking title to a transaction
22 that previously it did not take title to. And then thereby
23 you get the benefits in the Bankruptcy Code which may lead
24 to exposure within the Tax Code.

25 I would just also add that we are no different

1 than other people in the marketplace, or companies in the
2 marketplace. We don't necessarily want to go public with
3 our tax positions and where we think we have a potential
4 liability and risk. So it is not unique that people don't
5 want to, either in their comments on a NOPR or up here
6 specifically, say this is a specific concern that we have
7 and why.

8 MR. MILLER: But then they are difficult for the
9 Commission to take into consideration, aren't they?

10 MR. BRICKHOUSE: It most certainly is, and it is
11 also difficult for taxing authorities to take into
12 consideration, as well.

13 (Laughter.)

14 MR. MILLER: Larry?

15 MR. GREENFIELD: Mr. Brickhouse, let me do a
16 question for you also, but from a slightly different
17 perspective on a slightly different topic.

18 You had commented earlier that you were able,
19 fortunately from your perspective, to sort of work out your
20 issues with PJM through a voluntary process, and you were
21 concerned that the Commission imposition of something,
22 whatever the Commission does, could inhibit that voluntary
23 back-and-forth and working out the process.

24 And I was curious why you think that if we were
25 to impose something, whatever that something might be, would

1 make it more difficult for you within that structure to
2 still voluntarily work out the details with either PJM as
3 the case may be, or another co-op with another RTO.

4 I'm not quite drawing the connection between an
5 umbrella, broad Commission directive to do something, and
6 then not being able to work out the details, and I'm
7 interested in that.

8 MR. BRICKHOUSE: One advantage that I think the
9 PJM process offered was it was relatively open-ended. And
10 maybe there's a workaround for that, that you say there's
11 not a time constraint, or there is a very generous time
12 constraint provided to the various organizations to
13 implement a counterparty clarity initiative.

14 But we were not working against the clock, so we
15 had time for a considerable amount of discussion, and we
16 were able to reach a solution that I would describe as
17 certainly amicable and very workable for the co-operative
18 community. And the voting record within the PJM's broader
19 membership community I think would suggest that it was very
20 workable for them, as well.

21 I would just be concerned that, again that the
22 Commission comes out and says we want to have a counterparty
23 clarity initiative, and somehow that is used as a way to
24 force people into decisions or compromises that aren't in
25 their long-term best interest, whether it's a co-operative,

1 a municipal, another entity within a RTO or an ISO.

2 And I'm not implying that would be the case, I'm
3 just saying that that is a risk of putting the mandate out
4 there.

5 MR. MILLER: Arnie?

6 MR. QUINN: Mr. Dutton, I would like to follow up
7 on something you said earlier, and we might have covered
8 this but I want to make sure that we've got it in the
9 record.

10 You mentioned when talking about the central
11 counterparty solution that in order to make that become
12 fully effective we would have to somehow address the issue
13 of the ISO making a short payment to market participants in
14 the event of a default.

15 Can you elaborate on that statement a little bit?
16 And then I guess I would ask the rest of the panel to
17 comment on that.

18 MR. DUTTON: Yes. The risk that I see that
19 creating--and of course we're talking about a case where no
20 court has ever ruled--the risk that that would create is the
21 risk of the transactions being characterized as involving
22 some sort of a cloud liability that was referred to. And,
23 that the transaction really isn't with this person that's
24 named as the counterparty, because that person isn't
25 obligated to pay the sales price, or the purchase price.

1 The transaction is really with these fuzzy market
2 participants. So the same argument that would be made with
3 respect to mutuality and setoff would be made with respect
4 to the person identified as a counterparty in the--but who
5 doesn't have the obligation pay. It's not really a seller
6 or a purchaser; it's someone who pays if they can.

7 And if you read the extract from the Mirant
8 argument that's in the memo that Harold's firm put together,
9 it isn't hard to just read that argument with those facts in
10 mind and make the same argument.

11 So I am not saying that argument is right, but I
12 am saying that argument is available.

13 MR. NOVIKOFF: Well I can't say the argument
14 isn't available, but I will say I don't think it's right.
15 There are plenty of instances in which parties to agreements
16 are backed up by guarantors, can get support from corporate
17 parents, have other sources of access for their obligations,
18 but here the central counterparty would be obligated to pay.

19 The obligation exists, regardless of whether it's
20 able to pay or not able to pay. The obligation exists, and
21 the concern was stated rightly in the prior panel that,
22 yeah, that's an obligation that exists and you have to make
23 sure that the central counterparty pretty much under all
24 circumstances has the ability either through recourse at the
25 collateral, recourse to participants, to make good on its

1 obligations, but it has to be clear that the central
2 counterparty is in fact obligated, is the party.

3 Just like a clearing corporation in the
4 securities industry, or in the commodities industry, it has
5 to be the real counterparty.

6 I think it would be a major change from the case
7 law to say that because that central counterparty has access
8 to others for credit support that somehow it makes that
9 entity go away. I don't think that's correct, as long as
10 it's got the obligation in its own right to pay, it's not a
11 pure agent, it's not just a pure conduit, it's a real entity
12 and I think it should stand up.

13 MR. MILLER: Well with that I think that we've
14 reached our conclusion. I want to thank the panel and the
15 previous panel for appearing here. I think this has been
16 very useful to the staff as we work through a hopeful final
17 rule for the Commission to vote on.

18 I will just remind everybody once again that if
19 anybody wants to submit comments on this particular issue
20 raised in the Technical Conference, we welcome them up till
21 June 8th. So thank you, very much.

22 (Whereupon, at 11:59 a.m., Tuesday, May 11, 2010,
23 the technical conference in the above-entitled matter was
24 adjourned.)