Testimony Before the Joint FERC/CFTC Technical Conference on Credit Issues in the Energy Markets

By

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February 5, 2003

Good afternoon.

My name is Steve Bunkin. I am a Vice President and Associate General Counsel at Goldman Sachs/J. Aron. Goldman, Sachs & Co. is a Futures Commission Merchant registered with the CFTC. J. Aron & Company is a certified power marketer registered with the FERC.

I am delighted to be here today to address issues of concern to the OTC energy market, particularly with the individuals on this panel, some of whom are my colleagues on various initiatives designed to address these concerns.

I would like to join in with the others in congratulating the FERC and the CFTC for organizing this conference. Having this conference is extremely helpful by focusing market participants and other interested groups on issues of importance to the energy markets today.

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I am appearing on this panel in my capacity as Co-Chair of ISDA's North American Energy and Developing Products Committee. As many of you know, ISDA, the International Swaps and Derivatives Association, has been in existence since the late 1980s. ISDA was organized by derivative market participants to create common standards and documentation for the developing swaps markets. Since its inception, ISDA has grown tremendously in both its size and its mission and has developed documentation standards for a range of markets. Of particular interest to this group is the fact that energy market participants are well represented in ISDA's membership. ISDA counts among its active members producers, IPPs, utilities, merchant energy companies, trading platforms, commercial and investment banks. The Energy and Developing Products Committee is focused on issues of importance to energy market participants.

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We heard from other panels about the possibilities that clearing may offer to improve the liquidity in the energy markets by having credit risk shared among market participants on a multilateral basis. Of course, bilateral trading continues to be an important aspect of the energy market. Bilateral trading offers market participants a means of negotiating transactions that may necessarily require customized solutions. Among the types of transactions that are better suited to a bilateral arrangements are those of significant duration and complexity, including transactions such as full service requirements for utilities.

And so, I would like to discuss some challenges that are currently confronting the bilateral trading arena and some of the initiatives that have been undertaken to address these challenges.

I want to spend a moment to describe some of the challenges currently confronting the OTC energy markets. Energy market participants trade a range of what I'll call products on various commodities. By products, I mean contracts such as fixed/floating swaps, physical forwards, financially and physically-settled options. The commodities in and in respect of which these products are traded include power, natural gas, crude oil and its constituent products.

Although these transactions may be classified as distinct “products”, they share the common characteristic of generating credit exposures whose size and volatility are a function of market forces. And yet, for historical reasons, many of these products are documented under product or commodity specific master agreements.

The reasons for creating product-specific documentation were quite legitimate at the time those documents were created. Many people felt that it was only by creating documentation specifically tailored to a sector of the market (such as the physical power sector) that it would be possible to address the issues that uniquely faced the particular sector.

For a long time, the fact that these products were traded under different forms of master documentation did not matter all that much. Firms managed their trading on a commodity and/or product specific basis. Many firms traded only one type of product or one type of commodity. However, increasingly there is a convergence of products/commodities and the entities that trade them. This convergence (which, with initiatives such as the SMD is expected by most to continue) has brought to light the limitations associated with the current multi-master agreement world.

The existence of multiple master agreements in markets and between trading counterparties creates a number of issues, many of which were highlighted in the Enron situation and other default scenarios. One commentator observed—in a different but analogous situation—that the existence of so many masters for products that share many essential common characteristics constitutes "Multiple Agreement Disorder" or "MAD". Indeed, our world is a veritable alphabet soup of documentation: ISDAs, EEIs, GISBs, NAESBs, WSPPs, etc.

The issues raised by this situation are (i) the different masters agreement forms are not bridged or linked to each other, (ii) any given master may not cover the full range of products that two parties desire to trade with each other, (iii) the strain on documentation negotiation resources associated with having a number of different agreements, (iv) potentially using credit lines less efficiently than would be possible in a world of streamlined documentation.

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Fortunately, this situation is getting the focus and attention that it deserves. I am confident that this conference, organized by the FERC and CFTC, will bring even greater momentum to some of the initiatives that I will be describing which are currently underway.

OK, so what needs to be done? What needs to be done is to come up with solutions that will reduce the strain on resources and promote greater credit efficiencies. These include solutions that will facilitate the ability of parties to close out a trading relationship in a default scenario across all exposures, regardless of whether those exposures arise from swaps or forwards on power or natural gas. These include solutions that will facilitate the ability of parties to net amounts arising in respect of various product and transaction types, in the manner that Carol described. These include solutions that will facilitate the ability of parties to margin across products and commodity types.

In crafting solutions, recognition must be given to the fact that a one-size fits all approach will not do. Solutions need to be available to enable parties to address their current situation.

This means (i) enabling parties that already have more than one product/commodity master agreement to create a bridge between those different masters and (ii) enabling parties that either have only one master or no master to expand or create a master agreement that will cover the full range of possible trading.

Allow me to spend a moment to describe some of the initiatives that will have been undertaken or are currently underway to provide these solutions.

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In 2002, ISDA published its Energy Agreement Bridge. This document was created to enabled parties who have more than one master agreement (one of which is an ISDA Master) to link those separate agreements together. The ISDA Bridge was created to facilitate the ability of such parties to terminate and net across products upon a default scenario. As such, the ISDA Bridge provides a foundation for a cross-product margining agreement. In developing the Bridge, ISDA sought to create a solution that was both easy to implement and one that would work within the existing framework of the relevant master documentation. Because the ISDA Bridge relies on the netting provisions in the ISDA Master Agreement, it benefits from the netting opinions delivered in relation to the ISDA Master Agreement.

Another initiative, which Ed has mentioned and Carol has described, was the great effort of EEI to develop a Master Netting Agreement. Like the ISDA Bridge, the EEI MNA (apologies for adding to the alphabet soup) facilitates the ability of parties to cross-product net. It also contains provisions for cross-product margining. The EEI Master Netting Agreement enables the parties to make certain various elections. Carol has already described the operation of the EEI MNA.

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The second type of solution that I mentioned is one that expands the scope of existing documentation to include a broader ranges of products and commodities. On that front, I'm delighted to describe the efforts currently underway between ISDA and the EEI to create a Power Annex for the ISDA Master Agreement. In pursuing this initiative we recognized (i) that the ISDA will provide the credit foundation for a multiproduct trading relationship while (ii) the commodity specific terms would have to come from and with the insights of the industry experts. We hope to have this finalized for publication by the end of the first quarter.

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A similar initiative, to produce a gas annex for the ISDA Master Agreement, has been recently undertaken by NAESB and ISDA.

In addition, representatives from EEI, NAESB, WSPP and ISDA are consulting to explore the common provisions in the various agreements.

Of course, our efforts are directed at addressing documentation concerns. As Ed and Carol mentioned, we will continue to seek clarification of the relevant Bankruptcy Code provisions to facilitate cross-product netting. Further, the solutions about which I have spoken are addressed specifically at bi-lateral rather than multilateral trading arrangements.

In conclusion, we do have challenges to improve our documentation for OTC energy trading but initiatives are underway to address them. With the help of the FERC and the CFTC in bringing greater attention to these issues, we will be well positioned to complete these efforts successfully.