Testimony Before the Joint FERC/CFTC Technical Conference on Credit Issues in the Energy Markets: Clearing & Other Solutions

by
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Good Afternoon

I am Edward Comer, Vice President and General Counsel of Edison Electric Institute (EEI) and am appearing on behalf of EEI and its Alliance of Energy Suppliers. EEI is a trade association that represents the shareholder-owned electric utilities, affiliates, and associates. The Alliance of Energy Suppliers (The Alliance) is a division of EEI that specifically represents unbundled, bundled and independent power suppliers, as well as trading, marketing, and risk management activities.

I commend both FERC and CFTC for jointly addressing the very critical issue of credit and the need to alleviate the current liquidity problem. As was highlighted during the FERC January 16th technical conference on capital availability, the electric utility industry has been hard hit by a credit crunch and a lack of access to the capital markets. This crunch has resulted in, among many things, a sharp drop in trading liquidity across the board.

This afternoon I will address *EEI's role in facilitating development of standard contracts, needed changes to the bankruptcy code and the necessity of tight agency coordination.*

EEI was an early leader in developing a Standard Power Agreement to promote liquid markets.

Standard contracts are a fundamental building block to the development of a liquid competitive electric market and to any credit risk mitigation solution which relies on fungible transactions for efficiencies. The need for standardization became obvious after the wholesale market disruptions in the Mid-West in the late 1990s when parties trying to unwind transactions discovered how different their contracts were, even when they purported to sell the same product.

To address this problem, EEI began work on a standard form contract for wholesale electric transactions in early 1999. We convened a working group of representatives from our members, independent power providers, traders and marketers and members of National Energy Marketers Association. We made a special outreach effort to public power and cooperatives as well. The process was open to all interested participants and conducted very publicly, with many meetings in Washington and Houston. EEI identifies the key players and decisions points for this process on our website at http://www.eei.org/issues/contract/development.htm. The process was consensus driven. Where varying approaches could not be reconciled, the contract was drafted to provide alternatives as options.

The EEI/NEMA Master Contract standardizes the confirmation process, defines obligations and delivery, provides consistency in key terms, defines different electric products, defines remedies and articulates credit protection practices. Reaching consensus between those with a "physical" and a "financial" perspective was difficult at first, but was largely accomplished through development of different products and careful definition of "Force Majeure" to address these issues. The Master Agreement includes six precisely drafted common product definitions. Like any form agreement, the parties are free to customize it to meet their particularized business objectives.

EEI's role throughout the process was that of a neutral facilitator. We were helped by the fact that every company could use the agreement as either buyer or seller, so all had the incentive to develop a neutral, fair standard agreement.

The first Master Contract was released in the Spring of 2000. At that time we conducted a series of outreach sessions to inform the industry and regulators of the benefits and uses of the Contract. The contract is readily available for free on our website at http://www.eei.org/issues/contract.htm as well as NEMA's. We are very pleased that the Contract has been widely accepted throughout the industry, including many of the companies represented here today.

Following that effort, we developed a Collateral Annex as well as an agreement to transition from the "Into-Cinergy" product to a Mid-West product in response to the formation of the Mid-West ISO.

Last spring EEI sponsored the development of a Master Netting Agreement (MNA), in response to current credit issues. The MNA was issued last fall. We used the same very open and public process, and gained expanded representation from many financial institutions which have more recently become active in electricity trading. A fellow panelist, Carol St.Clair, was an active participant in this process and will explain netting and the agreement.

The MNA is a standardized bilateral contract that enables trading counterparties to agree to net collateral requirements: and in a closeout situation, settlement amounts related to underlying master trading contracts relating to sales and purchases of electricity, natural gas and related financial transactions. In other words, the MNA offsets positive balances of one transaction with negative balances of another.

EEI again conducted an education and outreach process and provided background information on critical legal issues to consider, in particular treatment of issues like netting in the bankruptcy process.

EEI is supporting NAESB's Wholesale Electric Quadrant contract standardization efforts.

Now that NAESB's Wholesale Electric Quadrant has been organized, we have had several discussions with NAESB that will enable our standard contract effort to continue under the umbrella of NAESB. EEI will continue to help facilitate this activity for NAESB. In fact, just last week, the NAESB Contract Subcommittee established a new Master Service Agreement Task Force, which an EEI lawyer will help co-chair along with fellow panelist Steve Bunkin and one other lawyer.

One of NAESB's top priorities is to further standardization of the Western System Power Pool agreement with the EEI agreement. This raises some unique issues because the WSPP Contract, unlike the EEI Master Contract, is actually a filed tariff at FERC.

EEI is commenting on ISDA's Power Annex.

The EEI Contract Drafting Committee is also participating in ISDA's efforts to develop a Power Annex to the ISDA commodity contract. Since ISDA is oriented to financial (not physical) transactions, it is very important to us that any ISDA Power Annex properly address the physical issues involved in electricity and be fully consistent with the EEI Master Contract to promote liquidity.

Commission Support for Bankruptcy Law Clarification is Essential

The Master Netting Agreement is a important tool for credit risk mitigation because it allows parties in a series of transaction involving multiple commodities, (e.g., gas, electricity and financial transactions) to net or offset their exposure across all these commodities, resulting in a lower overall credit risk exposure. Unfortunately, as is demonstrated in the Legal Landscape which EEI published to accompany the MNA, the protections offered by the agreement are ambiguous at best if a counterparty is bankrupt. A copy of the Legal Landscape is being provided to the Commissions as Appendix A. Others may obtain it from our website.

http://www.eei.org/issues/contract/mna/legal_landscape_10-25-O2.pdf

Last year, in Congress, House and Senate negotiators reached agreement on a bill to overhaul bankruptcy laws, including provisions that would have addressed netting concerns. H. R. 333. These provisions had strong bipartisan support, but were unfortunately, were never enacted because of totally unrelated issues. See. Congressional Quarterly Weekly, "2002 Legislative Summary: Bankruptcy Code Overhaul," December 7, 2002, p. 3201. Enactment of the agreed upon bankruptcy law provisions is still very important. Indeed, one of the most important steps both Commissions can take is to actively support enactment this year of the necessary revisions to the bankruptcy code to protect the value of cross-commodity netting.

Continued FERC-CFTC coordination is needed.

Finally, I would like to commend the members of FERC and the CFTC for holding this joint Technical Conference. EEI strongly encourages the CFTC and FERC to work together closely on credit and other trading issues. FERC has the unique ability to address the physical markets and system issues and implement rules that facilitates the use of the solutions reviewed today, recognizing the value of techniques developed in the financial markets. The CFTC has the unique ability of translating the lessons learned and techniques from the commodity future industry to the energy industry.

In conclusion, EEI is committed to continue to facilitate real commercial solutions to the credit crunch.

We urge FERC and the CFTC to add your strong support to the enactment of bankruptcy legislation to clarify the usefulness of the netting approach.

Thank you.