

**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. My name is Carol St. Clair and I am currently a Director and Senior Counsel with UBS Warburg Energy, LLC, whose business involves physical and financial gas and power trading. I have been handling energy trading matters for the past 4 years and have participated with the EEI drafting groups in the drafting of the EEI form of Collateral Annex and the EEI form of Master Netting Agreement. I also had a role in formulating the proposed “master netting legislation” to the bankruptcy code which I will talk about more fully in a few minutes. I am delighted to be here today with the other members of this panel to address the challenges facing all commercial energy traders, marketers and credit managers in today’s energy trading environment and to explore with you possible solutions to some of these challenges which may lead to a revival of the energy trading markets. During the next few minutes, I plan to address the following topics: (1) discussing the role of “credit” in the energy trading markets; (2) discussing the mechanics for posting collateral; (3) discussing the role of the Master Netting Agreement in managing credit risk; and (4) discussing what needs to be done in the near future to encourage use of the Master Netting Agreement.

A. The Role of Credit in the Energy Trading Markets

The role of credit in both the physical trading market and the financial trading market has changed dramatically during the past few years. For example, prior to the market downturn, in certain physical trading markets, it was not uncommon for trades between counterparties to be done on an “unmargined” or “uncollateralized” basis due in large part to the financial strength of the counterparties participating in such markets at such time. In addition, in certain physical markets, the customs of, and the course of dealing between, the players in such markets dictated and lead to a style of trading where

credit was not as much a focal point as it is now. Finally, in such physical markets where credit procedures were somewhat implemented, the credit terms between the parties was very simple and basic. As Ed Comer mentioned, it was only recently that the EEI Group set out to enhance and expand the collateral provisions of the EEI Master Agreement by coming up with a comprehensive EEI Collateral Annex which is similar to the credit support annex that goes with the ISDA Master Agreement for financial trades. This effort came about as a result of the recognition that posting margin or collateral is one of the primary ways that trading counterparties manage their credit risk to each other to a level that is acceptable and thus facilitates the execution of multiple trades between such counterparties. [Refer to Slide #1] As such, margining relationships must now be considered as part of the cost of doing business in both the physical and financial energy trading markets. With most counterparties, being capable of posting collateral is a prerequisite to being able to trade in such markets and the credit documentation between the parties is much more comprehensive and complex.

B. The Mechanics of Posting Collateral [Slides #2 and 3]

How does margining work in the energy trading markets? As a starting point, the primary types of collateral in the energy trading markets are cash and letters of credit. The concept of posting collateral to secure one's obligations under energy trading transactions is really no different from the concept of posting collateral to secure a loan from a bank which we are all familiar with. The primary difference really lies in the way that such energy trades are "valued" for margining purposes which is a bit more complicated than just looking at the principal amount of a loan. In the trading world, there is a concept of "exposure" which in simplest terms represents the "net" amount that would be payable to a party that is "in the money" on a net basis after taking into account and assigning a "value" to all trades that a party has done with its counterparty under a particular master agreement. Trade valuation is a complex concept but for purposes of our discussion here, what is important to understand is that all trades with a counterparty have a value and when such values are aggregated and netted against each other the result

will produce a “Net Exposure” amount that is similar to the outstanding principal and accrued interest owed on a loan at any given time.

A second key credit concept in the trading world is “Collateral Threshold” which represents the amount of “unsecured” credit that a party is willing to extend to its counterparty based on such counterparty’s financial strength and creditworthiness. In other words, this is the amount of “exposure” that a party is willing to have to its counterparty on an “unsecured” basis. The more creditworthy a party is, the higher its Collateral Threshold will be. A high Collateral Threshold results in less collateral or margin that will need to be posted by such party at any given time. This is because the amount of collateral or margin that a party would be required to post to its counterparty for trades done under a master agreement is calculated by subtracting the Collateral Threshold from such counterparty’s Exposure. [Go through example on Slide #3] For counterparties that have a credit rating, downward changes in such counterparty’s credit rating in most cases will lower its collateral threshold which will in turn, increase the amount of collateral that it will need to post. This is one of the reasons why a party experiences such a “liquidity” crunch and death spiral when its credit rating starts to fall – this sequence of events can be described as follows: credit rating drop; increased collateral calls from counterparties; more cash collateral sent to counterparties; and less cash to conduct business activities needed to restore credit rating.

C. Master Netting Agreement [Slides #4 and 5]

Are there any questions about the general concept of “posting collateral” for energy trades? As you can see, a party’s ability to post collateral is in large part affected by the amount of cash liquidity that such party has and whether such party has a means of accessing cash either through the sale of its assets or through lines of credit with its lenders. In the traditional financial and physical trading markets, parties trade different commodities under different Master Agreements. For example, gas trades may be done under a NAESB Master Agreement or a Master Firm Purchase/Sale Agreement and power trades may be done under an EEI or WSPP Master Agreement. In addition,

financial trades are often done under the ISDA Master Agreement or some other type of master agreement. In today's world, it would be commonplace for each such Master Agreement to have its own margining provisions. Thus, for a party that trades physical gas, physical power and financial derivatives, it would be subject to three (3) separate margining provisions under three (3) separate Master Agreements. This in turn produces three (3) separate and distinct collateral posting obligations from one party to another and vice versa. [Go through examples on Slide #5] As you can see from these 3 examples, posting margin separately under each Master Agreement ties up EACH party's cash resources significantly. For this reason, one of the credit solutions that is currently being pursued by some counterparties is entering into a "Master Netting Agreement" with its trading counterparties. I would now like to walk you briefly through how a master netting agreement works and why it is a possible partial solution to the credit and liquidity crisis experienced by energy trading counterparties. I will also explain the key legislative obstacle that needs to be overcome to clear the path fully for its use in the energy trading markets.

As Ed mentioned, in the Spring of 2002, EEI sponsored the development of a Master Netting Agreement and in October, 2002, the EEI form of Master Netting Agreement was posted on EEI's Website for public use. Accompanying the Master Netting Agreement was a comprehensive User's Guide as well as a Legal Landscape Memorandum that addresses certain important legal issues that one may need to consider in using a Master Netting Agreement. The EEI form of Master Netting Agreement has a form of Collateral Annex attached to it, as one of its primary purposes is to facilitate the posting of collateral on an aggregate, net exposure basis based on all of the trading relationships that a party may have with its counterparty such as physical power, physical gas and financial derivatives. [Refer to Slides #4 and 5] When parties agree to enter into a Master Netting Agreement and they put all of their energy trading relationships under such Master Netting Agreement, the end result is that only one (1) party posts collateral to the other party based again on the calculation of a "net aggregate exposure" which takes into account ALL of the outstanding trades between the parties. Thus, instead of posting collateral separately under each master agreement, the parties agree to

post collateral on a net, aggregate basis under the Master Netting Agreement. As you can see from the example on Slide #5, by posting collateral on a net, aggregate basis, both Party A and Party B each have an extra \$20 to use for other purposes other than for posting margin. As you can see from this example, the Master Netting Agreement is an important tool for credit risk mitigation and enhanced liquidity. I will now discuss what impediments currently exist with respect to a party's use of the Master Netting Agreement.

One of the areas that any credit manager needs certainty and clarity on is in the enforcement of its rights when its counterparty files bankruptcy. In the trading world, the Bankruptcy Code currently has various favorable, safe-harbor provisions that permit a party to a safe-harbored trading contract to terminate and enforce its rights under such trading contract upon the bankruptcy of its counterparty without having to obtain the bankruptcy court's permission. These enforcement rights include the ability to enforce rights with respect to collateral. These provisions were designed to promote continuity and certainty in the trading markets notwithstanding a party's bankruptcy.

Since most players in the trading world trade both physical and financial derivative products and would want to include all of such products under a Master Netting Agreement, one's use of a Master Netting Agreement is predicated on one's ability to safely enforce its "netting" rights in bankruptcy across ALL products, whether financial or physical. This is what is commonly referred to as "cross-product netting". The reason for this is that if a party is holding collateral based on a calculation of aggregate, "net" exposure, when it comes time to enforcing its collateral rights in bankruptcy, such party needs to know that it can "net" the exposure of all of its traded products in order to determine how much its bankrupt counterparty owes it or vice versa and in order to be certain that it is holding enough collateral to satisfy its bankrupt counterparty's obligations to it.

As currently written, the Bankruptcy Code is at best unclear as to whether all of the safe-harbor rights can be exercised across products. For this reason, as Ed mentioned

earlier, the current bankruptcy reform bill contains some critical amendments to the portion of the Bankruptcy Code that affects trading contracts to introduce the concept of a “Master Netting Agreement”. The effect of this proposed legislation is that it makes absolutely clear that parties to a Master Netting Agreement can exercise the rights and remedies set forth therein even in bankruptcy without having to obtain the bankruptcy court’s permission. In other words, this Master Netting legislation would remove any of the uncertainty that currently exists with respect to the enforceability of cross-product netting rights in bankruptcy and would pave the way for a much wider use of the Master Netting Agreement.

Unfortunately, as I am sure you are aware, the passage of the current bankruptcy reform bill has been stalled time and time again by the continuing dispute over one of the bill’s consumer provisions. My hope is that given the importance of the master netting agreement bankruptcy legislation and the possible affect that its passage would have on partially solving the credit and liquidity crisis that currently exists in the energy trading markets, both FERC and the CFTC and their staffs can actively support and get behind some type of effort to assure the enactment of this legislation this year. Thank you.