

July 3, 2008

Attachment A

EPIC Legal Analysis - Net Worth Requirements in ISONE

I. INTRODUCTION

ISONE's FTR Credit Working Group is currently discussing the establishment of a \$10 million net worth requirement. The approach would require market participants with a tangible net worth of less than \$10 million to post additional amounts of collateral and further stipulates limits to the amount of participation in the FTR market.

The following is a brief summary of the relevant legal precedent and statutory authority, which show that ISONE's proposed net worth requirements are inconsistent with established Federal Energy Regulatory Commission precedent and applicable law.

II. ARGUMENT

A. ISONE's Proposal is Unlawful under the APA and the Federal Power Act

Any ISONE proposal to impose net worth requirements would be a modification to ISONE's existing market rules and tariffs and therefore would have to be considered and approved by FERC. However, FERC can only approve ISONE's proposed net worth requirements if they satisfy the arbitrary and capricious standard delineated in the Administrative Procedures Act, 5 U.S.C. §§ 551 et seq., (APA), which requires reversal of any agency action

that is “arbitrary, capricious, an abuse of discretion or otherwise not in accordance with law.”¹

Thus, FERC can only adopt ISONE’s proposals if they are supported by substantial evidence and there is a rational connection between the facts and the choice made.² Similarly, Section 205 of the Federal Power Act states that a utility proposing a new tariff must bear the burden of demonstrating that its proposed rate is just and reasonable.³

EPIC believes ISONE’s net worth proposals violate these standards because it has provided no data or justification for its proposed net worth requirements and it is not rationally related to the harm it seeks to address.

- First, ISONE’s proposal is devoid of any rational basis or evidentiary support. ISONE’s proposals are spurred by Power Edge’s recent default in the PJM market; however, that default would not have been prevented by the proposed \$10 million requirement. Indeed, Enron and Bear Stearns certainly would have met the net worth requirements, which only provides further evidence that a net worth requirement has no relation to a company’s credit worthiness.
- Second, the proposed net worth requirements are particularly arbitrary since a company’s net worth may change by the day or even by the hour, meaning that a company’s authorization to participate would arbitrarily depend on which day they were required to

¹ See, e.g., *Knott v. FERC*, 286 F.3d 386, 372 (1st Cir. 2004 (quoting *Wis. Valley Improvement Co. v. FERC*, 236 F.3d 738, 742 (D.C. Cir. 2001)); see also *Alabama Rivers Alliance v. FERC*, 325 F.3d 290, 296 (D.C. Cir. 2003) (citing *State of North Carolina v. FERC*, 112 F.3d 1175, 1189 (D.C. Cir. 1997), cert. denied, 522 U.S. 1108 (1998); *Bangor Hydro-Elec. Co. v. FERC*, 78 F.3d 659, 663 n.3 (D.C. Cir. 1996)).

² *Wis. Valley Improvement Co.*, 236 F.3d at 742.

³ 16 U.S.C. § 824e(b).

file their net worth certification. Additionally, the net worth requirement has no rational relationship to participant trading activity, it treats market participants the same whether they make 1 trade per month or 10,000 trades per month.

- Third, there is no rational link between a net worth requirement and any legitimate credit concerns. ISONE has in place, and has the ability to propose changes as needed, credit and collateral posting requirements that are designed to protect the market from any potential defaults. Moreover, FTR financial participants are already required to post cash or cash equivalent credit well in excess of the value of their bids. Adding a net worth limitation serves no legitimate purpose because it is not needed to protect the market. To the contrary, it is anticompetitive and serves as a high barrier to market entry.

Accordingly, if the ISONE proposal to impose a net worth limitation is adopted it is unlikely to be approved by FERC or to survive judicial scrutiny.

B. ISONE’s Proposal Contravenes FERC Precedent and Policy With Regard to Trading

In March of this year, FERC declared that PJM must “correlate its collateral requirements with the risk exposure in the FTR market by more precisely matching a participant’s credit requirements with its actual FTR risks.”⁴ However, in the example of Power Edge, Bear Stearns and Enron, a net worth requirement does nothing to ensure that a participant’s credit requirements precisely match its actual FTR risk. Indeed, all that a net worth requirement appears to do is give a free ride to large, asset-based companies, while imposing impediments to small marketing firms. Thus, FERC has stated, “[e]ffective credit policies contain balance in their rules between participants large and small, balance between the need to ensure maximum

⁴ *PJM Interconnection, LLC*, 122 FERC ¶ 61,279, at ¶ 36 (2008).

participation through extension of credit and minimal amounts of uplift through default, and balance between the length of billing cycle and the amount of exposure in the market.”⁵

Therefore, the proper analysis is not based on the impossibly high standard of whether any risk of loss could ever theoretically arise, but based on actual market results and a reasonably balanced assessment of future market exposure. **A policy such as ISONE’s proposed net worth requirements, which attempts to eliminate all potential for even theoretical exposure is not reasonable when it also acts to inhibit, or even eliminate, access to the market for smaller companies and new market entrants.**

Similarly, FERC will not ratify anticompetitive requirements for market entry simply because they have been approved through ISONE’s stakeholder process. As the Commission has stated:

[w]hile we recognize that the RTOs and ISOs have approved these filings through their stakeholder processes and will give such approval due deference, we nevertheless must address each filing on its merits and be able to find the proposal just and reasonable. In reviewing these filings, we must balance the goals of allowing the ISOs and RTOs to reduce their risk of exposure in the event of default while at the same time ensuring that the credit or collateral requirements are not so stringent that they unnecessarily inhibit access to the marketplace. To permit the Commission to balance

⁵ *Midwest Independent Transmission System Operator, Inc.*, 108 FERC ¶ 61,163 at ¶ 430 (2004), (emphasis added).

these interests, it is incumbent for the ISOs and RTOs to include in their filings support for their proposals, including a full justification for their proposed credit or collateral provisions, including an explanation of why they reflect an appropriate balance. As discussed below, we find that PJM has not adequately provided such a justification here.⁶

The proposed net worth requirements are viewed as another unpermitted attempt to erect a barrier to market entry or to limit market participation by small marketing or financial marketing firms. No rationale has been provided, showing that these net worth requirements reflect an appropriate balance between reducing the risk of market exposure in the event of default while ensuring that ISONE's requirements for market entry do not unnecessarily inhibit the marketplace. In fact, there is no rational link between net worth requirements and market exposure because they do not consider the market participants' actual trading activity and ignores the fact that potential market exposure is already covered by ISONE's credit and collateral requirements.

Finally, ISONE's proposed net worth requirements are completely at odds with FERC's *Policy Statement On Credit-Related Issues For Electric OATT Transmission Providers, Independent System Operators And Regional Transmission Organizations*, 109 FERC ¶61,186 (Nov. 19, 2004) ("Policy Statement"). Through this Policy Statement the Commission has sought to remove unwarranted impediments to market entry. Thus, an ISO's criteria for market entry must be transparent and must not serve as a barrier to legitimate market activity.

⁶ *PJM Interconnection LLC*, 104 FERC ¶ 61,309 at ¶ 19 (2003).

Accordingly, an important goal in the Policy Statement is to keep market participation requirements from “being turned into barriers to legitimate market activity, thus affecting market participation and liquidity levels in the markets.”⁷ As FERC made clear in the Policy Statement,

[w]hile requiring all market participants in ISOs/RTOs to be fully collateralized would eliminate the mutualized credit risk, the Commission believes that such a goal would impose significant costs on market participants and, in turn, would represent a serious barrier to entry into the markets.⁸

ISONE’s net worth proposal clearly runs afoul of this policy, which seeks to remove unwarranted impediments to market entry, and for this reason is also unlikely to survive scrutiny by the Commission, much less an appellate court.

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⁷ See Policy Statement, at ¶ 11.

⁸ *Id.* at ¶ 19.