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May 3, 2010

VIA ELECTRONIC FILING

Honorable Kimberly D. Bose
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

Re: ISO New England Inc. and New England Power Pool, Docket No. ER10-942-000; Motion for Leave to Answer and Answer of ISO New England Inc.

Dear Ms. Bose:

Transmitted electronically for filing is the Motion for Leave to Answer and Answer of ISO New England Inc. in the above-captioned docket.

If there are any questions concerning this filing, please call me at (202) 661-2205.

Very truly yours,

/s/ Howard H. Shafferman

Howard H. Shafferman
Counsel for
ISO New England Inc.

Enclosure

I. BACKGROUND

On March 26, 2010, the ISO and the New England Power Pool Participants Committee (“NEPOOL”) filed amendments (“Amendments”) to the ISO New England Financial Assurance Policy (the “Financial Assurance Policy”) and the ISO New England Billing Policy (the “Billing Policy” and together with the Financial Assurance Policy, the “Policies”).³ The Amendments are a package of revisions intended to increase the efficiency of the New England energy markets by further limiting the Pool’s exposure in case of payment default by a Market Participant and by making other changes, including: (i) providing for twice-weekly, rather than weekly, settlement for certain charges; (ii) eliminating the use of unsecured credit for Market Participants that do not serve retail load at government-established rates; (iii) reallocating the costs of defaults where unsecured credit is still used; (iv) segregating the billing and collateralization of transmission charges from other ISO charges; and (v) improving the quality of security that is provided.

II. MOTION FOR LEAVE TO ANSWER

The ISO hereby moves, pursuant to Rule 212 of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.212 (2009), for leave to file this Answer.

The Commission has the authority to waive the prohibition against answers to protests for good cause.⁴ The Commission has found good cause to permit answers where they are otherwise prohibited in various circumstances, including where the answer would assure a complete record in the proceeding,⁵ provide information helpful to the disposition of an issue,⁶ permit the issues

³ The Financial Assurance Policy and the Billing Policy are Exhibits IA and ID, respectively, to Section I of the ISO Tariff.

⁴ See 18 C.F.R. § 385.101(e) (2009).

⁵ See, e.g., *Pacific Interstate Transmission Co.*, 85 FERC ¶ 61,378, at 62,443 (1998), *reh’g denied*, 89 FERC ¶ 61,246 (1999).

⁶ See, e.g., *CNG Transmission Corp.*, 89 FERC ¶ 61,100, at 61,287 n.11 (1999).

to be narrowed or clarified,⁷ or aid the Commission in understanding and resolving issues.⁸ The ISO believes that this Answer will assure a more complete record in this proceeding and otherwise assist the Commission in understanding and resolving the issues presented.

III. EXECUTIVE SUMMARY OF ANSWER

The Coalition Protest (which attaches the affidavit of Scott Carr, Ph.D.⁹) and the other Supporting Protests go to great lengths in arguing that the Coalition Members, and similar entities, should continue to enjoy the use of unsecured credit in the New England markets. The Coalition Protest raises various arguments, including that: Commission action should be postponed until final action in the Commission’s credit rulemaking proceeding (the “Credit NOPR Proceeding”)¹⁰ is implemented, adoption of the Amendments will result in undue discrimination, adoption of the amendments will increase costs, and reducing the billing cycle from weekly to twice weekly is inappropriate. These arguments are summarized below and, for the reasons explained in the remainder of this answer, should be rejected. The core argument put forth by the Coalition Members, however, is far more troubling and, indeed, highlights one of the primary reasons for adopting the Amendments. The Coalition Protest’s arguments rest heavily on “the fact that the Coalition Members and other comparable entities receiving unsecured credit from ISO-NE are large, sophisticated firms that are capable of minimizing credit and default risks through forward trading, hedging, and other risk-management techniques.” This core argument suffers from two significant flaws.

⁷ See, e.g., *PJM Interconnection, LLC*, 84 FERC ¶ 61,224, at 62,078 (1998); *New Energy Ventures, Inc. v. Southern California Edison Co.*, 82 FERC ¶ 61,335, at 62,323 n.1 (1998).

⁸ See, e.g., *Tennessee Gas Pipeline Co.*, 92 FERC ¶ 61,009, at 61,016 (2000).

⁹ Hereinafter, the “Carr Affidavit.”

¹⁰ *Credit Reforms in Organized Wholesale Electric Markets*, FERC Stats. & Regs. ¶ 32,651 (2010) (“Credit NOPR”).

First, the Coalition Members and the other protestors who seek to continue relying upon unsecured credit do not receive that credit “*from ISO-NE.*” The unsecured credit that the Protestors use today is involuntarily extended to them, via the rules administered by the ISO, by their fellow Market Participants. The ISO is not a counterparty that extends unsecured credit based upon its assessment of potential risk and costs. Rather, pursuant to the current market rules, other Market Participants are required to bear the risks and costs of the use of unsecured credit by the Protestors.

Second, as countless headlines over the past nineteen months have made all too clear, there is simply no reason to accept the premise that large size or “sophistication” magically minimizes the risk of default. Reminiscent of Enron’s collapse in 2001, many well-known large and complex firms have recently gone bankrupt, or nearly so, despite their “sophistication” and despite their use of the hedging and risk-management techniques lauded by the Coalition Members. Indeed, the upstream parent of two of the Coalition Members itself came dangerously close to bankruptcy just over one year ago, despite its size, sophistication, and risk-management.¹¹ Nonetheless, the Coalition Members essentially say “trust us” to the Commission, the ISO, and to other Market Participants that subsidize the use of unsecured credit by the Protestors. It is precisely this problem that the ISO is seeking to minimize through the proposed Amendments – the risk of failure is real and other participants in the marketplace should not be unwillingly forced to underwrite the risk of a market default by a large, sophisticated player.

More generally, the Protests urge the Commission to dismiss the Amendments without prejudice pending the issuance of a final rule in the Credit NOPR Proceeding. The Coalition Protest requests the Commission, if it nevertheless proceeds to consider the Amendments at this

¹¹ See discussion in Section IV.C.3 below.

time, to reject the Amendments' elimination of the use of unsecured credit for Market Participants that do not serve retail load at government-established rates. The Supporting Protests concur in that request and, in addition, oppose the Amendments' shift to twice-weekly settlement for certain charges.

The Commission should reject the Protests, and accept the Amendments without suspension or hearing at this time, for the following reasons.

A. A Deferral of Consideration of the Amendments Pending Issuance of a Final Rule in Credit NOPR Proceeding Would Be Inappropriate

The Protests argue that the Commission's consideration of the Amendments should be deferred pending the issuance of a final rule in the Credit NOPR Proceeding. The ISO believes there is no compelling reason to do so, because:

- The Amendments are consistent with the Credit NOPR. Many of the standards proposed in the Credit NOPR are expressed as outer limits or minimums, rather than as specifically prescribed amounts. The corresponding provisions of the Amendments fall within these limits or exceed these minimums. The remainder of the standards proposed in the Credit NOPR reflect policies that are consistent with the remaining provisions of the Amendments. Ultimately, though, if the Credit NOPR Proceeding results in final rules that are at odds with the changes filed here – or with any other previously existing rules in New England – the ISO will work with its stakeholders to develop and file any required changes.
- The preparation and consideration of the Amendments began long before the issuance of the Credit NOPR, followed the normal NEPOOL stakeholder process, and the Amendments were supported by a majority of NEPOOL Participants. Current consideration by the Commission is therefore appropriate.
- The Coalition Protest mischaracterizes Commission precedent regarding deferral of action on individual tariff filings where a rulemaking has been initiated.

B. The Amendments' Modifications to the Use of Unsecured Credit Are Consistent With Commission Policy

The Coalition Protest argues that eliminating the use of all unsecured credit for an entity is contrary to Commission policy. This argument is incorrect and should be rejected, for the following reasons.

- The Coalition Protest relies, as an expression of Commission “policy,” on statements – made by the Commission in a policy statement¹² issued almost six years ago – that do not account for interim credit policy reforms that make the underlying assumptions for those statements outdated in the New England context. In fact, the Creditworthiness Policy Statement noted that requiring full collateralization would have the salutary effect of eliminating mutualized credit risk, but declined to pursue that as a goal at that time because the costs would be too high. Because of intervening reforms in New England, the cost of achieving the benefits of full collateralization is very manageable (and the Amendments’ move to twice-weekly settlement makes it even more so).
- The orders cited in the Coalition Protest do not in fact state a Commission policy in opposition to a market operator’s elimination of the use of unsecured credit.
- The survey in the Coalition Protest of the unsecured credit policies of other regions has no probative value as to the acceptability of the unsecured credit modifications reflected in the Amendments. The Commission has long recognized the acceptability of regional differences among RTOs and ISOs, and New England has often taken a leading role on credit issues.

C. The Retention of a Limited Amount of Unsecured Credit Use Is Not Unduly Discriminatory

The Coalition Protest argues that preserving a limited use of unsecured credit by certain types of Market Participants, while eliminating its use by other Market Participants that are allegedly equally creditworthy, is unduly discriminatory. This argument should be rejected, for the following reasons:

- Contrary to the assertions in the Coalition Protest, the Commission has never prohibited application of credit policies that distinguish between various classes of market participants based on objective distinctions. Indeed, the Financial Assurance Policy has long imposed differing requirements on different classes of entities.
- The Coalition Protest inappropriately characterizes the risk of organized market defaults by investment-grade entities as low, and self-identifies the Coalition Members as “large, sophisticated firms that are capable of minimizing credit and default risks.” This type of assertion flies in the face of the string of recent bankruptcies of entities once thought of as “too big to fail.” Statements by the Coalition’s witness regarding New England market activity levels of financially strapped Market Participants are necessarily speculative, and are grossly

¹² *Policy Statement on Electric Creditworthiness*, 109 FERC ¶ 61,186 (2004) (the “Creditworthiness Policy Statement”).

inaccurate: simply stated, the fact that New England was lucky enough to avoid serious harm during the most recent period of economic upheaval is no reason to neglect prudent reforms to protect against future defaults.

- The Coalition Protest inappropriately disputes that the types of Market Participants being permitted to continue to use limited amounts of unsecured credit present a lower risk of default. In light of the relative prevalence of defaults by “unregulated” entities in the energy industry, this is no more than wishful thinking. Indeed, public filings with the United States Securities and Exchange Commission (“SEC”) demonstrate that the upstream parent of two of the Coalition Members was itself quite close to bankruptcy in the recent past. Market Participants with state-regulated rate recovery for the costs of the provision of service tend to decline in strength due to financial difficulty more slowly than “unregulated” entities (which can fail with little notice), and in a manner that can be accommodated by the markets by imposing more security requirements as strength decreases. Moreover, many municipal utilities are subject to state law requirements that protect their financial health.

D. The Coalition Protest Vastly Overstates the Costs and Vastly Understates the Expected Financial Risk Avoidance of Reducing Unsecured Credit Use; this Reduction Will Not Increase Consumer Costs, Hurt Competition or Reduce Market Efficiency

The Coalition Protest makes a number of assertions regarding the adverse economic impacts of the Amendments’ reduction in the use of unsecured credit. These assertions are ill-founded and should be rejected, for the following reasons:

- The Coalition Protest vastly overstates the costs of the reduction in unsecured credit.
- The Coalition Protest’s estimate of the expected financial risk-avoidance benefit of eliminating unsecured credit is vastly understated and based on a series of unreasonable assumptions.
- The Coalition Protest’s arguments about adverse impacts on liquidity are unfounded. The modest cost of additional collateralization is not substantial relative to the overall financial volume of transactions in the New England markets.

E. The Amendments’ Transition to Twice-Weekly Settlement Poses None of the Ills Asserted in the Supporting Protests

The Supporting Protests object to the Amendments’ provisions that would transition the New England region to twice-weekly settlement of certain charges. The three concerns

commonly raised in the Supporting Protests, generally in the form of conclusory assertions, are groundless:

- The concern that twice-weekly settlements pose an increased danger of payment defaults¹³ is unfounded, since the settlements will in each case be smaller (*i.e.*, no larger amount of payments is collected in a given full week than previously).
- The concern that there will not be time for the ISO to validate and reconcile data before billing and payment¹⁴ is unfounded, because data have been, and under the Amendments will continue to be, validated and reconciled on a day-by-day basis after the end of each day.
- The concern that the time to dispute possible billing inaccuracies will be shortened¹⁵ is incorrect, since the Amendments do not alter the time limits governing Market Participants' submission of billing disputes.

IV. ANSWER

A. **Consideration of the Amendments Should Not Be Deferred Pending Issuance of a Final Rule in the Credit NOPR Proceeding**

The Protests argue that the Commission's consideration of the Amendments should be deferred pending the issuance of a final rule in the Credit NOPR Proceeding.¹⁶ As discussed below, there is no justification or need to do so.

1. The Amendments are Consistent with the Credit NOPR

Deferral of consideration and acceptance of the Amendments should be rejected by the Commission, as the Amendments' provisions are consistent with the Credit NOPR in all pertinent respects. In particular, many of the standards proposed in the Credit NOPR are expressed as outer limits or minimums, rather than as specifically prescribed amounts. For example, Section 35.47(a) of the proposed rule would "[l]imit the amount of unsecured credit extended to any market participant to no more than \$50 million." The Amendments conform to

¹³ See, e.g., BP Energy Protest at 4.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ See, e.g., Coalition Protest at 8 *et seq.*

this standard by limiting the market credit limit to \$50 million for those entities that may continue to use unsecured credit to satisfy their native load obligations, and “exceed” this standard by reducing the use of unsecured credit to zero for all other participants.

Similarly, Section 35.47(b) of the proposed rule would require adoption of “a settlement period of no more than seven days and allow[ing] no more than an additional seven days to receive payment.” The Amendments conform to this standard, and exceed it, by adopting a twice-weekly settlement period.

The remainder of the standards proposed in the Credit NOPR reflect policies that are consistent with the other provisions of the Amendments, or are not addressed one way or the other in the Amendments. This means, in sum, that the ISO and its stakeholders should not be facing a need to backtrack and extensively revise provisions included in the Amendments, even after issuance of the final rule in the Credit NOPR proceeding.

Of course, if after the Commission acts on the Amendments, the Credit NOPR Proceeding ultimately results in final rules that are at odds with the Amendments filed here – or with any other previously existing rules in New England – the ISO will work with its stakeholders to develop and file any required changes.

2. The Preparation and Consideration of the Amendments Has Followed the Normal NEPOOL Stakeholder Process, and Began Long Before the Issuance of the Credit NOPR; Current Consideration is Therefore Appropriate

The preparation and consideration of the Amendments began long before the issuance of the Credit NOPR. Indeed, as described in Section V of the filing letter accompanying the Amendments, the discussions leading to the filing of the Amendments began in early 2008. The formulation and consideration followed the normal NEPOOL stakeholder process, and indeed, if anything, received more concerted attention over a long period of time than many similar tariff

amendment packages. Ultimately, the Amendments were supported by a majority of NEPOOL Participants.

Importantly, the Amendments could have been filed following their acceptance at the June 5, 2009 Participants Committee meeting (seven months before the Credit NOPR was even issued), had the ISO and NEPOOL not taken steps in the interim to first consolidate the three existing Financial Assurance Policies in Section I of the ISO Tariff so that a more coherent single policy could more clearly reflect the Amendments, and to make other changes in the consolidated Financial Assurance Policy to facilitate the commencement of the initial Capacity Commitment Period for the Forward Capacity Market.¹⁷ Given the extent of consultation reflected in the Amendments, it is reasonable to respectfully request the Commission to consider the Amendments now, so that their benefits to the region will not be delayed pending the issuance of a final rule.

3. The Coalition Protest Mischaracterizes Commission Precedent Regarding Deferral of Action on Individual Tariff Filings

The Coalition Protest¹⁸ suggests that there is a general Commission policy to defer action on individual tariff filings where the matters raised are likely to be affected by the outcome of a

¹⁷ *ISO New England Inc. and New England Power Pool*, Consolidation of Financial Assurance Policies, Docket No. ER09-1470-000 (July 17, 2009); *accepted in* Letter Order dated August 21, 2009 in the same docket. *ISO New England Inc. and New England Power Pool*, Filing Implementing the Transition Provisions of the FCM Settlement Agreement, Docket No. ER06-1465-000 (September 1, 2006), *accepted in* *ISO New England Inc. and New England Power Pool*, 117 FERC ¶ 61,132 (2006), *rehearing denied in* 119 FERC ¶ 61,044 (2007). *ISO New England Inc.*, Filing Containing Revisions to Market Rules Implementing FCM Settlement Agreement, Docket Nos. ER07-546-000, et al. (February 15, 2007), *accepted in* *ISO New England, Inc.*, 119 FERC ¶ 61,045 (2007), *ISO New England, Inc.*, 119 FERC ¶ 61,239 (2007), *rehearing granted and denied* 120 FERC ¶ 61,087 (2007), *ISO New England Inc. and New England Power Pool*, 121 FERC ¶ 61,070 (2007).

¹⁸ Coalition Protest at 11-12, and fn. 15.

pending rulemaking. In fact, the Commission has often cited its judicially upheld and broad discretion to act in a case-by-case manner rather than through a rulemaking process.¹⁹

Further, in the *Pacific Gas and Electric Co.* order²⁰ cited in the Coalition Protest, the Commission found significant that “it is likely that a final rule will be issued before a hearing can be held and a final order issued in this proceeding.”²¹ The Coalition has neither alleged nor shown that a final rule in the Credit NOPR proceeding would issue before a final order in this proceeding. In fact, the Coalition concedes that “if adopted, the . . . Amendments would be in effect . . . before . . . the Final Rule that ultimately results from the Credit NOPR proceeding.”²²

In light of these factors, the Commission should exercise its discretion to act on the Amendments now rather than await the issuance of a final rule.

B. There is No General Commission Policy Prohibiting the Elimination of Unsecured Credit

The Coalition Protest argues that eliminating the use of all unsecured credit is contrary to Commission policy. This argument is incorrect and should be rejected, as explained below.

¹⁹ See, e.g., *California Indep. System Operator Corporation*, 123 FERC ¶ 61,288 at P 40 and n. 34 (2008), citing *Mobil Oil Exploration v. United Distrib. Cos.*, 498 U.S. 211, 230 (1991) (“An agency enjoys broad discretion in determining how to handle related, yet discrete, issues in terms of procedures . . . [such as] where a different proceeding would generate more appropriate information and where the agency was addressing the question.”) (citations omitted). See also *Tennessee Gas Pipeline Co v. FERC*, 972 F.2d 376, 381 (D.C. Cir. 1992) (“The agency is entitled to make reasonable decisions about when and in what type of proceeding it will deal with an actual problem”); *Nader v. FCC*, 520 F.2d 182, 195 (D.C. Cir. 1975) (“[T]his court has upheld in the strongest terms the discretion of regulatory agencies to control the disposition of their caseload.”).

²⁰ 72 FERC ¶ 61,217 at p. 61,991 (1995) (cited in Coalition Protest at fn. 15).

²¹ *Id.*

²² Coalition Protest at 10.

1. The Commission “Policy” To Which the Coalition Protest Refers Is Six Years Old and Does Not Reflect Interim Reforms

To support its claim that there is a Commission “policy” against the elimination of unsecured credit, the Coalition Protest relies on a statement made by the Commission almost six years ago.²³ In the Creditworthiness Policy Statement, the Commission stated that

While 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. . . . [T]he Commission believes that there are less burdensome ways to reduce credit exposure and minimize the mutualized default risk in ISO/RTO markets and encourages them to adopt such measures.²⁴

The Coalition Members’ reliance on this statement for the proposition that the Commission has – as a policy – prohibited the elimination of the use of unsecured credit suffers from several interrelated flaws. On its face, the statement recognizes the *benefits* of requiring full collateralization (namely, eliminating mutualized credit risk), and expressly states that the only reason not to impose such a requirement is that the costs of doing so appeared to be excessive at that time. So instead, the Commission at that time urged regions to shorten settlement periods and take similar measures to reduce default risk.

The New England region took the Commission’s encouragement to heart, and adopted a series of reforms – with Commission support – designed to shorten the settlement periods and reduce the risk of default, as detailed in footnote 6 of the filing letter accompanying the Amendments. These intervening reforms have reduced greatly the cost of achieving the benefits – recognized in the Creditworthiness Policy Statement – to a very manageable level. The Amendments’ move to twice-weekly settlement will make it even more manageable.

²³ Coalition Protest at 15.

²⁴ See Creditworthiness Policy Statement at P 19.

In other words, the statement that the Coalition Protest relies on is dated and does not account for the significant credit policy reforms made since that time in New England, which will allow the region to realize the benefits of full collateralization that the Commission *did* recognize at that time.

2. The Orders Cited in the Coalition Protest Do Not State a Commission Policy in Opposition to a Market Operator's Elimination of the Use of Unsecured Credit

The Coalition Protest furthermore cites to the Commission's 2009 order in *Midwest Independent Transmission System Operator, Inc.*²⁵ for the proposition that the Commission is opposed, *substantively*, to the elimination of unsecured credit. However, in that case, the Commission rejected a proposal to eliminate the use of unsecured credit on purely *procedural* grounds; namely, because it was not made through a Section 205 or Section 206 filing, but in a protest that constituted a collateral attack on earlier orders. The Commission stated:

The Commission has previously accepted for filing Midwest ISO's Tariff provisions that provide for the use of unsecured credit, and Midwest ISO does not propose to change those provisions in the instant filing. Accordingly, we reject Financial Marketers' request to eliminate Midwest ISO's use of unsecured credit, and their alternative request that we direct Midwest ISO to socialize default costs entirely among the Market Participants using unsecured credit, *as a collateral attack* on the Commission's previous orders approving the use of unsecured credit by Midwest ISO. Financial Marketers' requests would be more appropriately raised in a complaint under section 206 of the Federal Power Act.²⁶

Thus, the cited order does not suggest that Commission precedent substantively rejects an elimination of unsecured credit when properly included in a tariff filing or a complaint.

²⁵ 128 FERC ¶ 61,093 at P 19 (2009) (emphasis added) (cited in fn. 24 of the Coalition Protest).

²⁶ *Id.* (emphasis added).

The other Commission order (involving the California ISO) cited in footnote 24 of the Coalition Protest similarly involved the Commission’s rejection of a protest (primarily as a collateral attack), rather than a proposal by a market operator to eliminate unsecured credit.²⁷

3. The Survey in the Coalition Protest of the Unsecured Credit Policies of Other Regions Has No Probative Value as to the Acceptability of the Amendments

The Coalition Protest²⁸ “surveys” the unsecured credit policies of other regions. This survey has no probative value as to the acceptability of the unsecured credit modifications reflected in the Amendments. The Commission has long recognized the acceptability of regional differences among RTOs and ISOs,²⁹ and New England has often taken a leading role on credit issues.³⁰ New England should be permitted to continue its development of innovative and cost-effective credit policies.

C. The Retention of a Limited Amount of Unsecured Credit Use Is Not Unduly Discriminatory

The Coalition Protest argues that preserving a limited use of unsecured credit by certain types of Market Participants, while eliminating its use by other Market Participants that are allegedly equally creditworthy, is unduly discriminatory. This argument should be rejected, as discussed below.

²⁷ *Calif. Indep. System Operator Corp.*, 126 FERC ¶ 61,285 (2009).

²⁸ Coalition Protest at 15-19.

²⁹ *See, e.g., Southwest Power Pool, Inc.*, 128 FERC ¶ 61,114 at P 5 (2009) *citing Interconnection Queuing Practices*, 122 FERC ¶ 61,252, at P 15 (2008) (“if an RTO or ISO concludes that the options already identified in Order No. 2003 are inadequate to address its queue problems, that RTO or ISO may consider proposing variations from Order No. 2003”).

³⁰ *See, e.g., New England Power Pool*, 107 FERC ¶ 61,201 at P 1 (2004) (finding that implementation of weekly billing in New England “benefits customers by reducing the amount of collateral required from market participants and the exposure of NEPOOL to a default by one of those participants”); *ISO New England Inc.*, 115 FERC ¶ 61,054 at P 9 (2006) (“proposed revisions are consistent with our Policy Statement and improve the transparency of credit procedures, reduce collateral requirements, and better align ISO-NE’s financial assurance requirements with its risks”).

1. Contrary to the Assertions in the Coalition Protest, the Commission Has Not Prohibited Application of Credit Policies That Distinguish Between Various Classes of Market Participants Based on Objective Distinctions

The Coalition Protest misstates Commission precedent by stating that:

The Commission has consistently held that extending or denying access to unsecured credit or allocating responsibility for default risks based on a market participant's status is unjust and unreasonable and unduly discriminatory, particularly where, as is the case here, there is no link between creditworthiness and the cited characteristics.³¹

The Coalition Protest relies, as authority for that proposition, on a quotation from the Commission's Creditworthiness Policy Statement "that a credit policy should be transparent and fairly and uniformly applied."³² This reliance is misplaced, for the Creditworthiness Policy Statement did not address in any sense, the acceptability of a credit policy that objectively distinguishes among classes of market participants based on their collective characteristics.

The excerpt by the Coalition Members says no more than that the unsecured credit policies should be applied transparently, fairly and uniformly to the members of the classes of Market Participants that are still permitted to use a limited amount of unsecured credit. The Coalition Protest does not demonstrate any risk that this principle will be violated by the ISO in the implementation of the Amendments.³³

³¹ See Coalition Protest at 20.

³² See Creditworthiness Policy Statement at P 12.

³³ The related assertion on page 21 of the Coalition Protest – that "[t]he Commission has expressly found that it is not just and reasonable to adopt a credit policy that addresses only a subset of market participants, nor is it appropriate for a credit policy to discriminate against entities seeking credit based on their corporate form" – similarly distorts the actual holdings of the cases cited in footnote 44 of the accompanying text. Again, the Coalition cites cases in which the outcomes turned on procedural and evidentiary shortcomings, rather than stating the desired substantive principles.

Specifically, the rationale in the cited order involving PJM for the Commission's decision "that it is not just and reasonable to adopt a provision that will address only a subset of the entities" was that "PJM [had] not established that its risks are limited to companies with affiliates" and that "PJM fail[ed] to explain why, if its proposed collateral requirements are sufficient in these situations, it should be entitled to an offset if it happens that an affiliate makes profits rather than incurs losses." See *PJM Interconnection, L.L.C.*, 122 FERC ¶ 61,279 at P 57 (2008). Thus, the Commission's decision is not a condemnation of the application of different credit standards to subsets of participants when such application is properly explained and supported.

(continued...)

Indeed, the Coalition’s point is an odd one, in that the Financial Assurance Policy has long imposed differing requirements on different classes of entities.³⁴

2. The Coalition Members’ Argument that the Amendments are Not Necessary Because the Default Risk is Not Significant Enough is Entirely Unpersuasive

In attacking the Amendments’ elimination of unsecured credit for its members, the Coalition Protest argues that there simply is not a high enough risk of default to warrant implementing the Amendments,³⁵ and self-identifies the Coalition Members as “large, sophisticated firms that are capable of minimizing credit and default risks.”³⁶ Regrettably, the Coalition’s minimization of the risk of default flies in the face of the string of recent collapses of investment-rated entities thought “too big to fail,” such as Lehman Brothers, Merrill Lynch, Bear Stearns, and AIG.³⁷

In a similar vein, the Carr Affidavit seeks to minimize the need for reduction in unsecured credit in New England by discussing two FTR-related defaults in PJM and defaults by investment-grade Lehman Brothers Commodity Services (“LBCS”) in NYISO, MISO and

(...continued)

The Coalition Protest also cites *Southwest Power Pool, Inc.*, 116 FERC ¶ 61,162 at P 18 (2006) for the same proposition. This order does not support the sweeping statement on page 21, and is no more apposite to the Amendments than the PJM order, since the Commission was reacting, not to a filing of an RTO, but to a protest by certain market participants seeking special review and treatment by the RTO. The basis for the Commission’s rejection of the request was that the market participants’ proposal would “introduce subjectivity into the process.” The Coalition has neither alleged nor shown that the Amendments’ limited retention of the use of unsecured credit for certain classes of market participants is based on anything but objective standards.

³⁴ For example, FTR Only and DRP Only participants are not permitted to use unsecured credit under the current Financial Assurance Policy.

³⁵ Coalition Protest at 22 *et seq.*

³⁶ Coalition Protest at 29.

³⁷ It should be noted that all of the foregoing entities were at one point Market Participants in New England.

PJM,³⁸ which affected energy markets as well as FTR markets. The witness views the LBCS defaults dismissively, in terms of impacts of the default on the New England markets, stating:

The Lehman defaults are particularly interesting because LBCS was, *I understand, very active in ISO-NE markets*, yet there were no uncollateralized Lehman-related defaults in ISO-NE.³⁹

The witness's statements are necessarily speculative, and in fact his "understanding" is grossly inaccurate. LBCS in fact conducted no settled activity in ISO-NE's markets during the 12 months preceding its bankruptcy in September 2008.⁴⁰

In sum, the witness's attempts, there and elsewhere, to dismiss the region's concerns – as exemplified in the reform measures taken in the Amendments – ring hollow. But the Carr Affidavit does highlight an important fact: LBCS *was* very active nationally in wholesale energy trading prior to its bankruptcy.⁴¹ LBCS was qualified to use the maximum \$75 million amount of unsecured credit allowed under the existing Financial Assurance Policy. Had LBCS chosen to employ a different business strategy and settled its market transactions through the ISO, serious dislocations could have occurred through an LBCS default.

Simply stated, that New England was lucky enough to avoid serious problems during the recent period of economic upheaval is no reason to neglect prudent reforms – such as those reflected in the Amendments – to protect against the potentially significant adverse impact of future defaults.

³⁸ Carr Affidavit at 7-9.

³⁹ *Id.* at 8 (emphasis added).

⁴⁰ LBCS's only financial obligations to NEPOOL were in the form of monthly NEPOOL Participant expenses, which amounted to less than \$2,000/month.

⁴¹ In September 2008, Platts reported that Lehman ranked as the 38th largest wholesale power seller, called it a "rising star," tallying an estimated 13,332,088 MWh of physical power sales for delivery through the second quarter of 2008. See Alan Kovski, *Constellation Energy, banks keep Q2 lively*, Platts Megawatt Daily at 11 (Sept. 29, 2008).

The Coalition Protest also asserts that the Filing Parties must show actual harm to the energy markets – a series of actual market defaults in other regions is apparently not good enough – before proposing tariff changes (such as those reflected in the Amendments) that are designed to *prevent* harm.⁴² Most importantly, this assertion is contrary to the long-established Section 205 standard⁴³ that simply requires that the filing utility’s proposal is just and reasonable. Furthermore, the Commission has approved countless filings made pursuant to Section 205 of the FPA to improve regional markets in various ways without requiring a showing of actual harm, and potential harm has been sufficient support for a preventive tariff change.⁴⁴ Moreover, the Coalition Protest is internally inconsistent: it chastises the Filing Parties for offering up defaults solely in the FTR markets (rather than in the energy markets) as justification for the unsecured credit limitations, but elsewhere⁴⁵ its witness notes that *energy* market defaults have involved previously well-rated entities (*i.e.*, LBCS).

3. The Coalition Protest Inappropriately Disputes That the Types of Market Participants Being Permitted to Continue to Use Limited Amounts of Unsecured Credit Present a Lower Risk of Default

The Coalition Protest disputes that the types of Market Participants being permitted to continue to use limited amounts of unsecured credit present a lower risk of default than those that would no longer be permitted to use unsecured credit. This is wishful thinking, in light of the relative prevalence of defaults by “unregulated” entities in the energy industry.

Indeed, a public filing demonstrates that the upstream parent of two of the Coalition Members was itself quite close to bankruptcy in the recent past. In proxy materials filed by

⁴² Coalition Protest at 27.

⁴³ See filing letter for the Amendments, at 8-9.

⁴⁴ See, e.g., *ISO New England Inc. and New England Power Pool*, 125 FERC ¶ 61,355 at P 33 (2008) (Commission approving tariff revisions to eliminate Reserve Margin Gross-Up because the use thereof could have had the potential to harm New England).

⁴⁵ Carr Affidavit at 8.

Constellation Energy Group, Inc. (“Constellation Energy”) with the SEC in December 2008, Constellation Energy stated: “Without MidAmerican’s \$1 billion investment in Constellation Energy preferred stock on September 22, 2008, bankruptcy filing by Constellation Energy was likely imminent.”⁴⁶ Constellation Energy’s subsequently filed Annual Report on Form 10-K for the year ended December 31, 2008 provided the following explanation of how Constellation Energy’s unregulated energy trading business contributed to the liquidity crisis that nearly led to Constellation’s Energy’s bankruptcy:

In September 2008, a rapid and extreme increase in volatility of U.S. and global credit and capital markets caused us to face severe, near-term uncertainty about our ability to maintain sufficient liquidity to continue operating our business. The rating agencies downgraded Constellation Energy's credit ratings because of concerns over our liquidity. The downgrades, in turn, required us to post additional collateral assurance to some of our counterparties, and, since we could not access the capital markets, this further reduced our available liquidity. At that time, we had not made significant progress with our strategic initiatives to generate substantial reductions in our collateral requirements or substantial improvements in our liquidity.⁴⁷

Load-serving Market Participants with state-regulated rates, if they begin to experience financial difficulty, tend to decline in strength more slowly and transparently than “unregulated” entities (which, as the above example demonstrates, can rapidly decline with little notice), and in a manner that be accommodated by the markets by imposing more security requirements as strength decreases.⁴⁸ The examples of regulated T&D utility defaults cited in the Carr Affidavit

⁴⁶ See slide 7 of the proxy materials filed with the SEC, which are available at http://www.sec.gov/Archives/edgar/data/1004440/000110465908074040/a08-29384_3defa14a.htm.

⁴⁷ See p. 2 of Constellation Energy’s Annual Report on Form 10-K for the year ended December 31, 2008, which is available at <http://www.sec.gov/Archives/edgar/data/9466/000104746909002000/a2190570z10-k.htm>.

⁴⁸ The deliberate pace and process involved with the decision for a municipal entity to file for bankruptcy (which, as discussed below in the body of this Answer, happens exceedingly rarely) permits the ISO an opportunity to take steps to mitigate the credit risk (*i.e.*, declare a material adverse change and request the posting of collateral). This pace and transparency stands in stark contrast to the sequence that occurred

(continued...)

go back 9 years (PG&E) and 22 years (PSNH). Certainly, such entities are not immune from default, but they are far less likely to default than “unregulated” LSEs: the Carr Affidavit points out⁴⁹ that Moody’s one-year corporate default rate forecast for “Utilities: Electric” is 0.4 percent, compared with the average across all industries of 2.2 percent. However, Exhibit 12 of the Moody’s document cited in the Carr Affidavit makes a more telling comparison, that the 0.4 percent default rate forecast for the “Utilities: Electric” category (which consists mostly of regulated public utilities) compares with a 2.0 percent default rate forecast for the “Energy: Electricity” category (which consists predominantly of unregulated electric producers/marketers). That is, the latter category has a forecasted default rate *five times higher*.

With respect to the continuing ability of investment-grade municipal utilities⁵⁰ to use a limited amount of unsecured credit, in the current economic climate, an investment-grade rating for a municipal entity may be more reassuring than for other types of entities. Again, municipal entities are not immune from default, but since 1934, only 614 cases have been filed by municipal entities under the provisions of the Bankruptcy Code (Chapter 9) addressing municipal bankruptcies,⁵¹ versus more than 60,000 business bankruptcy filings overall in 2009 alone.⁵² A recent Fitch “special report” explains:

The hallmark of the municipal market has been the strong security structures afforded to bondholders and the issuers’ demonstrated willingness to pay. Bankruptcy has rarely been used by full-service municipal entities. In nearly all

(...continued)

recently with an unregulated entity such as Lehman Brothers that is A-rated on a Friday, and declares bankruptcy on Sunday.

⁴⁹ Carr Affidavit at fn. 20.

⁵⁰ It bears emphasis that in order to qualify for continuing use of unsecured credit under the Amendments, municipal and T&D entities must still maintain investment grade ratings.

⁵¹ See “States Aren’t About to Default on Debt,” *Wall Street Journal Financial Adviser* (March 29, 2010).

⁵² The foregoing statistics are available on the American Bankruptcy Institute's web site. See <http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=60229&TEMPLATE=/CM/ContentDisplay.cfm>.

cases, municipalities have taken the difficult measures required to maintain fiscal solvency and avoid bankruptcy....⁵³

Moreover, many municipal utilities are subject to state law requirements that protect their financial health.⁵⁴

For all of the reasons stated above, the differentiation in credit requirements between unregulated energy market participants and regulated T&D companies and municipal entities is well justified and does not constitute undue discrimination.

D. The Coalition Protest Vastly Overstates the Costs and Vastly Understates the Benefits of Reducing Unsecured Credit Use; this Reduction Will Not Increase Consumer Costs, Hurt Competition or Reduce Market Efficiency

The Coalition Protest makes a number of assertions regarding the adverse economic impacts of the Amendments' reduction in the use of unsecured credit. These assertions are ill-founded and should be rejected, for the reasons discussed below.

1. The Coalition Protest Vastly Overstates the Costs of the Reduction in Unsecured Credit

The Coalition Protest, based on the Carr Affidavit, estimates that the additional collateral that would need to be posted due to the Amendments would be approximately \$256 million, with an annual cost of \$7.7 million.⁵⁵ As explained below, the estimate used in the Carr Affidavit for additional collateral postings vastly overstates the amount of additional required collateral by assuming that Market Participants would be posting collateral at significantly inflated amounts

⁵³ See *Perils of Considering Municipal Bankruptcy*, Fitch Ratings Ltd. (January 27, 2010). The Coalition Protest (at 31-32), in a paragraph questioning the financial strength of municipal entities, cites the bankruptcies of five cooperative utilities: Eastern Maine Electric Cooperative, Big Rivers Electric Corporation, Colorado-Ute Electric Association, Inc., Wabash Valley Power Association and Cajun Electric Power Cooperative. These bankruptcies are not pertinent to this argument, as an electric cooperative is not treated as a Municipal Market Participant under the existing Financial Assurance Policy or the Amendments. See Financial Assurance Policy at Section II.

⁵⁴ For example, Massachusetts Municipal Light Plants are required by law to set rates to cover expenses associated with operating the plant, which includes contracts for supplies executed by the MLPs. Mass. G.L. c. 164, § 58.

⁵⁵ Coalition Protest at 33; Carr Affidavit at 11-13.

compared to peak unsecured credit usage, for which the Carr Affidavit provides little explanation for his assumed adjustment.⁵⁶ Further, as explained below, the Carr Affidavit substantially overstates the cost of additional collateral postings, even when utilizing Dr. Carr's higher estimate of the costs of replacing the use of unsecured credit.⁵⁷

The elimination of the use of unsecured credit as described in the Amendments would have affected only 30 Market Participants during 2009, which is approximately 7 percent of the total number of Market Participants. Of the 30 Market Participants to be affected by the Amendments, only 8 had average daily amounts of greater than \$1 million. The total average daily unsecured credit for all 30 Market Participants for 2009 was approximately \$79.8 million, with the vast majority of that (\$77.2 million) being from the 8 participants having average daily amounts over \$1 million. By comparison, the sum for all Market Participants of their average daily posting of collateral throughout 2009 was \$589 million. Based on its own market research, the ISO understands that issuance fees for a standby letter of credit (for entities with an investment grade rating) were in the range of approximately 75 to 125 basis points (with pricing being based on strength of the rating of the entity, banking relationship, and other factors)

⁵⁶ The contortions necessary to reach this high an estimate are extensive, and reveal significant inconsistencies between cost and benefit estimates. On one hand, the Carr Affidavit analysis measures the costs of the additional collateral posting requirements required under the Amendments in terms of a significantly grossed-up *non-coincident peak* annual value; on the other hand, when estimating the expected financial risk-avoidance benefit (see discussion in Section IV.D.2 below), the Carr Affidavit analysis chooses to utilize an expected financial risk-avoidance benefit value based upon *annual averages*. In other words, the Carr Affidavit analysis presumes that Market Participants will post an additional \$256 million of collateral even though Dr. Carr estimates their annual average requirement to be only \$89.6 million. In short, when developing his measurement of the cost of the proposal Dr. Carr utilizes the highest possible collateral posting requirement (based upon annual peak-day requirements further increased as described below) but when estimating the benefit of full collateralization he presumes a default exposure based on annual averages. In another significant inconsistency, the analysis in the Carr Affidavit employs a 35 percent gross-up on the non-coincident peak usage of credit (from \$189 million to \$256 million), but inexplicably employs only an 8 percent gross-up on the average default exposure (from \$83 million to \$89.6 million).

⁵⁷ The Coalition Protest also argues (at 35-36) that the Amendments' unsecured credit modifications will increase consumer costs. However, those voting in favor of the Amendments included the state consumer advocates from Connecticut, Massachusetts and New Hampshire.

multiplied by the principal amount of the letter of credit. Accordingly, the issuance fees for standby letters of credit to replace \$79.8 million of unsecured credit would be in the range of approximately \$600,000 to \$1,000,000.

In New England, this equates to an average cost of \$0.0000063 per kWh, representing a cost for an efficiency-enhancing measure that is relatively low compared with the average day-ahead energy clearing price of \$0.04152 per kWh⁵⁸ at the New England Hub during 2009. Even using Dr. Carr's higher estimate of the costs of replacing the use of unsecured credit (*i.e.*, 3.0%), the total annual cost of standby letters of credit to replace an average of \$79.8 million of unsecured credit would be approximately \$2.4 million (or \$0.0000189/kWh), still a small amount relative to the efficiency benefits accruing to the markets from the elimination of unsecured credit proposed in the Amendments. Under either set of assumptions, the cost is far less than the \$7.7 million estimated in the Carr Affidavit.

2. The Coalition Protest's Estimate of the Expected Financial Risk-Avoidance Benefit of Eliminating Unsecured Credit Is Vastly Understated and Based on a Series of Unreasonable Assumptions

The Coalition Protest asserts that the expected financial risk-avoidance benefit from eliminating unsecured credit as provided in the Amendments, in terms of reduced credit default risk, is small, approximately \$50,000.⁵⁹ The assumptions required to arrive at that number are clearly unreasonable.

For example, the Carr Affidavit assumes a Credit Loss Rate of 0.06 percent per year, based upon Moody's forecasted 2010 one-year Credit Loss Rate for investment grade corporate debt.⁶⁰ However, the average rating for those Market Participants that stand to lose the benefit of

⁵⁸ Day-ahead LMP data can be found at: http://www.iso-ne.com/markets/hstdata/znl_info/monthly/smd_monthly.xls.

⁵⁹ Coalition Protest at 33; Carr Affidavit at 12-13.

⁶⁰ Carr Affidavit at 12.

unsecured credit pursuant to the Amendments more closely align with the Baa category rather than “investment grade.” Investment grade includes the following broad ratings categories; Aaa, Aa, A, as well as Baa. Most of the affected Market Participants fall within the lowest category of Baa. According to the Moody’s table cited in the affidavit, this ratings category has an average annual Credit Loss Rate of 0.11 over the same period of 1982 to 2009 – nearly twice the value utilized in the Carr Affidavit analysis. Over the past two years, this rate averaged an even-higher 0.397 percent. Also, as explained in footnote 56 above, another questionable assumption is reflected in the significant inconsistency in the gross-ups used for the costs versus the benefits: the analysis in the Carr Affidavit employs a 35 percent gross-up on the non-coincident peak usage of credit (from \$189 million to \$256 million), but inexplicably employs only an 8 percent gross-up on the average default exposure (from \$83 million to \$89.6 million).

Perhaps the best indication that the estimate of the expected financial risk-avoidance benefit presented in the Carr Affidavit is deeply flawed is the fact that the ISO’s existing competitively-bid credit insurance policy (which could be eliminated once the Amendments become effective) carries with it annual premiums many times greater than the \$50,000 in expected financial risk-avoidance benefit claimed in the Carr Affidavit in order to cover a similar level of risk exposure. Importantly, this policy does not provide reimbursement for losses stemming from FTR markets activity nor a payment defaults by affiliate guarantors. In addition, the policy only covers losses incurred due to payment defaults by Market Participants that maintain investment grade ratings. Thus, either the ISO and NEPOOL have for years grossly overpaid for competitively bid credit insurance, or the Carr Affidavit fails to recognize the heavy costs of existing risks in the New England wholesale energy marketplace.

Finally, it is noteworthy that the Carr Affidavit ignores the hard-to-estimate, but very significant, costs of the damage to market efficiency and confidence that a major default would

entail. The ISO has the responsibility to manage efficient energy markets, and a hallmark of efficiency is the ability to clear transactions in a timely fashion. While experts may differ on the correct assumptions to be utilized in calculating the value of the expected financial risk-avoidance benefit of the elimination of unsecured credit, these calculations do not account for the substantial adverse impact on market efficiency that can occur from just one substantial unsecured payment default such as the \$17 to \$18 million default by LBCS in the PJM markets, which is cited in the Carr Affidavit.⁶¹

3. The Coalition Protest’s Arguments About Adverse Impacts on Liquidity are Unfounded

The Coalition Protest argues that the increased costs of collateral posting would “reduce liquidity by increasing trading costs and ... increase entry barriers.”⁶² Again, even a casual examination of this argument shows its error. As explained in Section IV.D.1 above, the additional cost of collateralization for Coalition Members collectively is not substantial relative to the billions of dollars of overall financial volume of transactions in the New England markets. These small amounts do not represent meaningful increases in trading costs that could hurt liquidity or constitute barriers to entry.

E. The Amendments’ Transition to Twice-Weekly Settlement Poses None of the Ills Asserted in the Supporting Protests

The Supporting Protests object to the Amendments’ provisions that would transition the New England region to twice-weekly settlement of certain charges. The three concerns commonly raised in the Supporting Protests, generally in the form of conclusory assertions, are groundless, as explained below.

⁶¹ Carr Affidavit at 8.

⁶² Coalition Protest at 36; Carr Affidavit at 14-16.

The concern that twice-weekly settlements pose an increased danger of payment defaults⁶³ is unfounded, since the settlements will in each case be smaller (*i.e.*, no larger amount of payments is collected in a given full week than previously). Further, the grace period between bill issuance and payment due date has not been changed, so Market Participants will be entitled to the same amount of time to remit payment to the ISO.

The concern that there will not be time for the ISO to validate and reconcile data before billing and payment⁶⁴ is unfounded, because data have been, and under the Amendments will continue to be, validated and reconciled on a day-by-day basis after the end of each day. Taking three to four days of validated and reconciled data and billing based on those days' data, versus taking a full seven days of validated and reconciled data and billing based on those days' data, does not short-change the time needed to perform these processes.

The concern that the time to dispute possible billing inaccuracies will be shortened⁶⁵ is incorrect, since the Amendments do not alter the time limits governing Market Participants' submission of billing disputes.

⁶³ See, *e.g.*, BP Energy Protest at 4.

⁶⁴ *Id.*

⁶⁵ *Id.*

V. CONCLUSION

For the foregoing reasons, ISO-NE respectfully requests that the Commission grant the motion for leave to answer and reject the Protests.

Respectfully submitted,

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Dated: May 3, 2010

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C. this 3rd day of May, 2010.

/s/ Pamela S. Higgins

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