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Credit Solutions, Round 2

The Market is Improving, No One Can Argue the Point Any Longer. *New entrants are announced on an almost weekly basis, and liquidity is up all around. While the idea of independent clearing operations never really took off a couple years ago – when it seemed the market needed it most – the current thinking is that such clearing operations may well have a better go of it this time, now that the desperation thing has mostly subsided among the big players. We look at ICE and NYMEX and note that cleared OTC transactions are at an all-time high. This and other indicators bode well for start-up clearing operations like North American Energy Credit and Clearing Corporation (NECC). We invited NECC exec Becky Kilbourne to present a short commentary on how the process works, and why the NECC offering is now critical for the market's ongoing recovery. –the editor*

A Clearinghouse Solution for 'Physical' Power Markets

By Becky Kilbourne, North American Energy Credit and Clearing Corporation (NECC)

Power traders are sorely lacking the liquidity and credit protections they need, despite returning liquidity in financial energy markets. Why? It's simple: Power marketers can't use the conventional clearinghouse approaches because ultimate credit risk continues to migrate to pooled delivery markets and because they just don't fit with the physical market for power. It is only through a comprehensive solution that their needs can be fully addressed – meaning a clearinghouse that manages credit risk through the power delivery process, including at the Independent Transmission Operator (ISO or RTO). Noting the failures of traditional approaches and energy market credit management, the North American Energy Credit and Clearing Corporation (NECC) has adapted the standard credit clearing model so that it could fit the physical power market, while building upon the robustness of the standard clearing approach. Its value proposition centers on the notion that a real clearing solution for physical power markets must start with a comprehensive platform rooted in ISO/RTO delivery markets, while overcoming the barriers imposed by conventional exchanges and clearinghouses for forward or "futures" markets.

The NECC solution accommodates the unique needs of physical power market participants in several ways:

- It removes credit risk through the entire process of forward contracting to delivery in ISO/RTO markets;
- It allows direct participation because market participants can transact without the FCM required under conventional clearinghouse mechanisms;
- It accomplishes unprecedented multilateral netting across OTC and ISO/RTO markets;[1]
- It accomplishes further netting by incorporating the value of physical assets in its determination of collateral requirements;[2]
- It accelerates payment to sellers while providing certain financing provisions to buyers to maintain their traditional payment cycles (monthly or longer); and
- It removes the pooled risk in ISO/RTO markets.

Why Clear ISO/RTO Markets?

In today's energy markets, default risk is managed differently in different markets. As a result, the pooled delivery markets of the ISOs and RTOs increasingly bear the entire default risk of any entity going to delivery – either buyer or seller. The only way to stem market-wide ramifications of a serious default event is to clear the ISO/RTO markets as part of a comprehensive clearing platform.

For example, in OTC markets where significant collateral may be required as prices move, a default may occur in the posting of collateral well before physical delivery. In the absence of a comprehensive clearinghouse solution, such a default would automatically cause a participant to be "cut off" in the forward markets, despite the value of its delivery position, which could potentially offset the collateral requirement in the first place.

Having been cut off in the forward markets, the participant's ongoing obligations would be thrust into the ISO or RTO markets. In the case of a buyer, that would mean that the entire load obligation would be met in the more volatile delivery markets at the ISO. In the case of a generator that has been cut off from forward gas markets, its ongoing delivery obligations would be fulfilled by the ISO creating a large receivable with high probability of default.

Since the ISO and RTO delivery markets are the last to recognize a default (in the absence of other information) and slower to react given the difficulty in discontinuing the transaction flow of physical power, their pooled markets bear the brunt of the entire default potential of physical market participants. History shows that the volatility in physical markets can exacerbate this default risk, causing overall market disruptions when a large default occurs.

Similarly, any participant that has difficulty securing a forward position, which is frequently the case when poor credit quality is involved, will tend to increasingly transact in the more volatile near-term markets, thereby increasing its overall risk profile and default potential. Given the precipitous decline in credit quality in today's energy markets, this phenomenon continues to drain liquidity in forward markets for physical players. Naturally, in the absence of a comprehensive clearing solution rooted in ISO/RTO markets, they are most vulnerable to credit risk migration and resultant socialization of the risk.[3]

NECC as a Comprehensive Clearing Solution

In the previous example, NECC, as a comprehensive clearinghouse, would absorb all credit risk for each participant as a central counterparty as it migrates from OTC to ISO/RTO delivery markets. Given roots in ISO/RTO markets and in accommodating the needs of physical market participants, NECC would manage the risk it has assumed on several levels:

- It would have the advantage of early recognition of default in OTC markets.
- Due to its information link with the ISO/RTOs and access to payments outstanding in these markets, it would have a more complete view of and access to each participant's net exposure for appropriate collateralization.
- By virtue of its function as a forward contract merchant[4] and as a derivatives clearing organization (DCO), it would have special creditor protections under the Bankruptcy Code, including contractual rights of offset, relief from automatic stay provisions, protection from having to return prior margin and settlement payments, and the ability to enforce early contract termination rights.
- It would use a process to limit settlement cycles and accelerate payment to sellers in both OTC and ISO/RTO delivery markets as a way to reduce overall default risk, while at the same time transferring the risk and providing financing from A or better-rated banks and insurance providers to allow buyers to maintain their current monthly settlement cycles.

The comprehensive clearinghouse solution offered by NECC thus removes the pooled risk in ISO/RTO markets while providing a seamless clearing process that, by virtue of greater netting, will facilitate, not discourage, forward trading. It will also reduce the likelihood of a default being triggered due to excessive collateral requirements.

Overcoming Barriers to Conventional Clearing: Structured Finance Combined with Traditional Clearinghouse Practices

It is crucial for the provider of clearinghouse services to become the central counterparty to both buyers and sellers so that default risk is transferred to the clearinghouse. Over the past 80 years, conventional clearing has evolved to manage this risk based on a framework that, in addition to rigorous margin management and cash management procedures, incorporates a system of intermediaries who are members of the clearinghouse (futures commission merchants or “FCMs”)and backstop risk in the case of a default.

This conventional framework presents barriers to physical energy market participants for several reasons.

First, physical energy market participants do not want to transact through FCMs, which is required if they are not FCMs themselves (this is typically the case). Such an intermediary may selectively discriminate in fees that it would charge each participant to clear on their behalf, removing a level of transparency in energy markets.

Second, the settlement framework for conventional clearinghouses does not easily accommodate physical delivery. In accommodating delivery in power markets, a conventional clearinghouse would either match counterparties going to delivery, in which case they take on each other’s default risk, exchange the future contract for a delivered swap or require 100 percent cash collateral against the entire notional value of the position going to delivery, once it enters the delivery period. These delivery mechanisms expose the delivery position to market price volatility and/or extreme cash collateral requirements due to volatility and the granularity of physical power markets.

Third, to the extent conventional clearinghouses offer products around the spot markets, their systems and processes require cash settlement on a daily basis. This daily settlement creates difficulty for net buyers in physical markets where their net receipts are tied to a monthly settlement that typically transfers cash some 20 days after the end of a delivery month.

NECC’s approach overcomes these barriers by merging reliable clearinghouse risk-management practices with state-of-the-art structured finance. Like conventional clearinghouses, NECC will become the central counterparty between buyers and sellers in OTC and ISO/RTO markets. And NECC plans to use the framework for collateral management and funds transfer developed by the Clearing Corporation (formerly Board of Trade Clearing Corporation or BOTCC) to manage its exposure. But due to the advances in structured finance over the past 10 years,[5] NECC transfers the credit risk it assumes to the broader financial markets, which have the capital adequacy to absorb and manage it, rather than relying on the traditional FCM to absorb risk.

In essence NECC will transfer risk to large, highly rated banks and insurance companies as a means to eliminate the need for FCMs as a risk intermediary, and to provide the option for buyers to maintain a monthly settlement period. Further, because NECC will clear both OTC and delivery markets, it will be able to transition cleared OTC positions through delivery with minimal or no incremental cash collateral requirements and without requiring contract conversion.

Summary

Physical market participants need a comprehensive clearing solution that provides superior transaction management to conventional exchanges and clearinghouses while removing the pooled risk in ISO/RTO markets. The only way to stem systemic risk in physical markets is through a comprehensive clearing platform that clears ISO/RTO markets with a bridge to forward markets. This comprehensive approach facilitates physical market participants’ ability to truly protect their transactions through delivery. And, thanks to the development of liquid credit markets and modern finance conventions offered by banks and insurance companies, clearing of physical markets can be accomplished in a way that capitalizes on 80 years of clearinghouse experience, while employing a modern framework for risk transfer that better fits the needs of physical market participants in energy markets.

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Footnotes

[1] A patent pending Cash Flow Contract (CFC) converts physical energy market products into cash flows to accomplish netting across spot and forward markets with bankruptcy protection.

[2] This is accomplished through a ‘Real Option Credit’ determined by each participant’s physical profile.

[3] For both buyers and sellers in power markets, a default is recognized at the time of delivery in ISO/RTO markets. In the case of buyers, it is a failure to pay for purchases made and in the case of sellers, default would occur in the case of failure to pay for a failed delivery.
[4] NECC's patent pending Cash Flow Contract (CFC) qualifies as a forward contract that separates cash flows from underlying energy commodities and is managed by a separate division of NECC.
[5] In 2002, the market size for collateralized debt obligations (CDO) was estimated to be $250 billion, growing at a rate of $50 billion per year. "This explosive growth is due to the use of credit derivatives in the CDO market." "*Collateralized Debt Obligations & Structured Finance, New Developments in Cash and Synthetic Securitization*," Janet M. Tavakoli, John Wiley & Sons, Inc., 2003, p 11.