

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Electric Creditworthiness Standards

Docket No. AD04-8-000

TECHNICAL CONFERENCE ON CREDIT-RELATED ISSUES FOR
ELECTRIC TRANSMISSION PROVIDERS, INDEPENDENT SYSTEM
OPERATORS, AND REGIONAL TRANSMISSION ORGANIZATIONS
(July 13, 2004)

Opening Comments of

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Thank you for the opportunity to appear today. I would like to give you a little background on NECC – and then address key issues around credit in this conference. NECC's underlying theme is the importance of bridging the physical and financial markets – to insure that physical reliability and financial reliability reinforce each other. Since electricity is the most perishable of commodities, effective delivery via a Transmission Provider (TP), Independent System Operator (ISO) or Regional Transmission Operator (RTO) is a critical part of any successful commercial transaction. Hence, it is appropriate to consider the impact of the credit practices of these power delivery organizations in this conference.

Our comments today are based on our conversations with a number of ISO/RTOs and market participants during the past year as we have created a credit and clearing solution that a number of market participants have told us reflects the unique characteristics of the physical energy markets while at the same time providing at least the same level of accountability, oversight and transparency of the most liquid commodity and securities markets.

Overview / Mission of NECC

NECC's mission is to promote capital and market efficiency in energy markets, primarily through a clearing solution that integrates the physical and financial energy markets. In achieving that, we plan to become the central counterparty to buyers and sellers as a Derivatives Clearing Organization under the supervision of the CFTC. We are rooting ourselves in both RTO/ISO and OTC markets to insure that we can efficiently manage credit risk from transaction through delivery. We will provide credit and clearing services that, after novation and substantial netting across spot and forward markets, essentially operate to transfer energy market risk to experienced Wall Street entities that can properly assume and manage the risks at a low relative cost. We have developed a patent-pending Cash Flow ContractTM, that allows spot and forward market netting with maximum bankruptcy protection. We are using proven strategic suppliers, such as the IntercontinentalExchange (ICE) and The Clearing Corporation (CCorp). ICE is the largest electronic energy marketplace and would collect confirmed Over-The-Counter trades from any broker or trader for NECC to clear. CCorp (formerly BOTCC) has cleared commodity transactions for 75 years and would be the clearing engine behind NECC for netting and collateral management.

Bridging Physical and Financial Markets

NECC believes that the integration of the physical and financial energy markets will be the best sustainable way to a mature power market. We believe that integration is the main reason why NordPool today is the world's most successful power markets – with transacted volumes at 8x the underlying physical. NordPool has found a way to reduce seams between the physical and financial markets – between cash and forward markets. The clearing of both OTC and spot pool transactions was the feature that accelerated the trade volume growth in that market.

Figure 1 (on page 5) developed by FERC staff suggests that the netting and clearing across spot and forward markets for power and gas provides the greatest opportunity for capital efficiency and market liquidity. The Committee of Chief Risk Officers (CCRO) reinforces that perspective – “multi-lateral clearing has far and away the greatest potential

for advancement for the industry in terms of credit risk mitigation, improved liquidity and capital adequacy...” NECC agrees as long as the clearing bridges the physical and financial markets.

Key Issues in Bridging the Physical and Financial Worlds

1. *The difference in liquidity between physical and financial players.* The trade volumes have started increasing again on ICE and other platforms. Much of that trade volume comes from the introduction of new largely financial players (e.g., hedge funds, banks). Yet the physical players, who produce/manage electricity, are continually constrained or dropping out. An observation recently in The Desk was that “The market will continue to be less efficient as physical participants scale back or exit [due to credit collateral requirements.]” A credit/clearing solution that works for physical participants as well as financial participants is important so that new infrastructure will continue to be built to maintain physical reliability.

2. *The inefficiency of collateral/margin use.* A number of markets today operate as isolated credit silos. This leads to participants posting collateral in a number of places – RTOs/ISOs, physical OTC power, physical OTC gas, pipelines, financial power and gas. By using a clearinghouse entity that can net positions and margin requirements across all (many of) those markets, significant capital can be freed up for trading or infrastructure development.

3. *Risk transfer through differences in credit policies.* The differences in credit policies between RTOs/ISOs and certain over-the-counter markets is causing a shift in transactions and associated credit risk. For example, a net seller in most RTO markets posts no appreciable margin. Yet in many bilateral transactions (and on futures exchanges), lower credit quality entities can be required to post significant margin through delivery. This difference in policies is leading to an increase in volumes (and associated credit risk) in some RTO markets. A side benefit of clearinghouse netting across markets as described in 2 above is to levelize these differences in credit policies and neutralize any shifts in risk.

4. *Bankruptcy protection of netting.* Some commenters in this proceeding note the potential current danger of netting of spot and forward physical transactions under today's Bankruptcy Code. The Cash Flow ContractTM, developed by NECC, is one mechanism to bridge forward and RTO/ISO markets with bankruptcy protection.

5. *Physical collateral/positions.* Historically some clearinghouses (e.g., Cotton Exchange, Natural Gas Exchange) have used the commodity in readily-accessible storage as an alternative to cash collateral. Indeed, we note that FERC seems inclined in this way in the Gas Credit NOPR. We believe that a clearing platform that bridges the markets is needed to accomplish the use of power plant reserves committed to dispatch as an offset to cash collateral. And, these physical reserves not only reduce cash collateral requirements, but also enhance physical reliability.

6. *Understanding credit risk.* NECC has often seen a big discrepancy in how different firms value or recognize credit risk in power markets. Those more tied to financial markets are accustomed to following Basel (and now CCRO recommended) capital adequacy practices in reserving equity on the balance sheet to cover potential exposure. Until the real risk is fully recognized the industry will continue to have varying responses to manage it. Sarbanes-Oxley provides an environment to improve the identification and management of risk. FERC may help facilitate some common understanding of what the real risk is in RTO/ISO and potentially OTC markets as a way to expedite the value of managing such risk.

7. *Cash settlement cycles/FCMs.* While many financial traders are experienced in daily cash settlements and working through a Futures Commission Merchant (FCM), most physical players are used to monthly cycles (and currently receive cash from retail customers on such a basis) and not working through an FCM intermediary. Therefore, ISO/RTO accelerated settlements often bring resistance from natural buyers in the market. NECC believes that providing a mechanism to facilitate inherent financing, such

as in the Cash Flow Contract™, and allowing players to participate directly in a clearing entity, can remove resistance to such risk-reducing measures.

8. *Credit limits.* Conventional clearinghouses provide no unsecured credit limits – participants essentially must post cash-equivalent margin/collateral to cover all Value-At-Risk. Most higher credit quality physical players prefer some level of unsecured credit line, as several commenters noted. NECC believes that some level of unsecured, or alternatively backstopped, credit can be provided, based on credit quality and market positions that are monitored at least daily, and maintain credit integrity.

Summary

NECC agrees with the CCRO and seemingly with FERC staff that clearing across multiple markets is the best way to mitigate risk, improve capital efficiency and market liquidity. NECC is working to make available a credit and clearing solution bridges those physical and financial markets (see figure 2 on next page). An increasing number of market participants are coming to support that position.

Figure 1

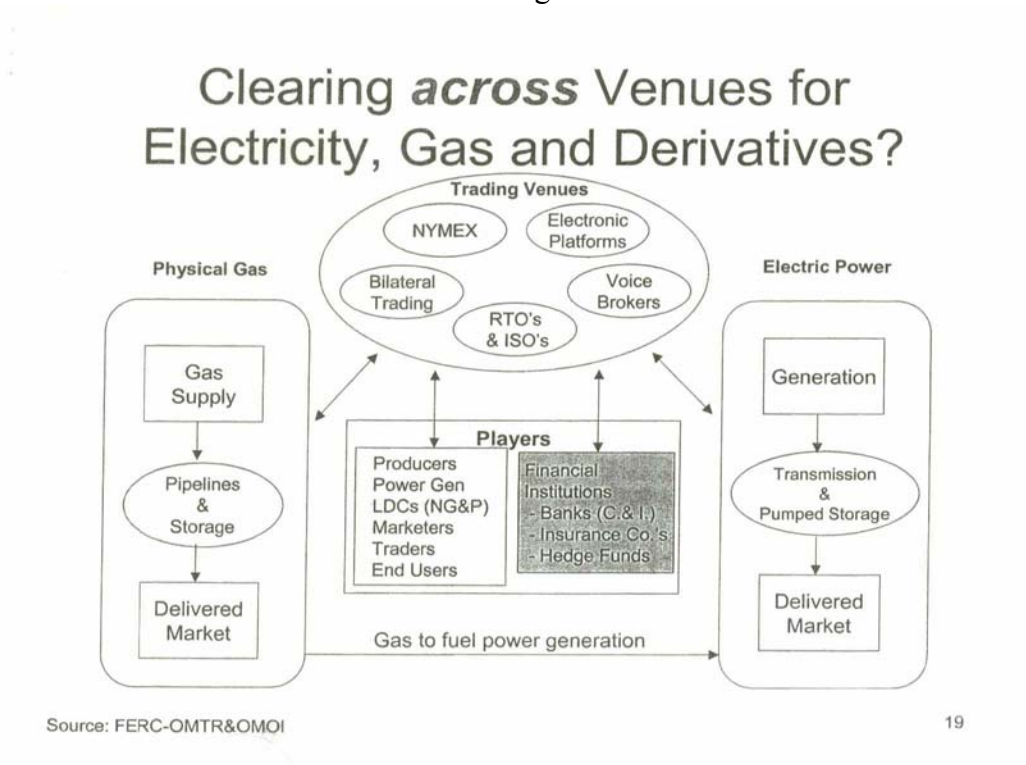


Figure 2

Comparison of Clearing Platforms

	ISO/RTO Markets		OTC (Forward) Markets				
	Pool risk reduction	Buyer payment optionality	Physical contracts thru delivery	Physical collateral	Multilateral netting	Direct, FCM not required	Physical / financial netting
ISO/RTO stand alone solution - accelerated settlements	Some from quicker settlement	maybe					
Physical – Financial clearing	99+%	Yes	Yes	Yes	Yes	Yes	Yes
Conventional clearing			Little Use: Requires High Collateral		Yes		