UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

In the Matter of:	**)**	
Technical Conference on Proposed	**)**	**Docket No. RM10-13**
Rulemaking on Credit Reforms in	**)**	
Organized Electric Markets	**)**	

COMMENTS OF THE NEW YORK INDEPENDENT SYSTEM OPERATOR, INC.

The New York Independent System Operator, Inc. ("NYISO") hereby submits these comments in response to the Technical Conference on Proposed Rulemaking on Credit Reforms in Organized Electric Markets held by the Federal Energy Regulatory Commission ("Commission"), on May 11, 2010, in the above-captioned docket.[1]

The purpose of the Technical Conference was to discuss the Commission's proposal to require each Independent System Operator ("ISO") and Regional Transmission Organization ("RTO") to take title to the products bought and sold in its markets in an effort to "eliminate any ambiguity or question as to their ability to manage defaults and to offset market obligations."[2] The intent of the proposal is to ensure, in the event of a market participant bankruptcy, that ISOs/RTOs meet the mutuality requirement imposed by the Bankruptcy Code[3] to exercise setoff rights. If a bankruptcy court were to determine that an ISO/RTO lacks mutuality with a bankrupt market participant, then the court could order the ISO/RTO to pay the market participant in full for certain market sales without allowing the ISO/RTO to deduct the amount the market participant owes it for certain market purchases. While there is no clear precedent as to how a

[1] Capitalized terms that are not otherwise defined herein shall have the meanings specified in Article 1.0 of the NYISO's Open Access Transmission Tariff ("OATT") and Article 2 of the NYISO's Market Administration and Control Area Services Tariff ("Services Tariff").

[2] Notice of Proposed Rulemaking on Credit Reforms in Organized Wholesale Electric Markets, 130 FERC ¶ 61,055, Docket No. RM10-13-000, January 21, 2010 ("Credit NOPR").

[3] 11 U.S.C. §§ 101 et seq.

bankruptcy court would handle this issue in the context of ISO/RTO markets, parties for and against the Commission's proposal agree that the risk the Commission is seeking to address is limited.

The NYISO respectfully submits that the Commission should not impose a requirement that ISOs/RTOs take title to the products bought and sold in their markets. First, the risk that an ISO/RTO would incur financial losses as a result of being prevented from netting a market participant's purchases and sales in a bankruptcy proceeding is limited. Second, the proposed rule would not completely eliminate this risk because it does not definitively establish mutuality nor preclude challenges to an ISO's/RTO's exercise of setoff rights. Finally, there are less disruptive means by which ISOs/RTOs could address the concern raised by the Commission in the specific context of each of their respective markets that should be permitted as alternatives to this proposal.

For these reasons, as discussed below, the NYISO respectfully requests that the Commission allow each ISO/RTO to further examine this issue and propose such measures, if any, that it deems necessary and appropriate for its particular market structure, conditions, and practices. While the NYISO has no objection to other ISOs/RTOs taking title to the products bought and sold in their markets, the NYISO is concerned that a Commission mandate would, at least in the NYISO context, increase administrative costs and have other unintended consequences while failing to provide the benefit sought by the Commission.

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II. Setoff/Mutuality

The Bankruptcy Code preserves for a creditor any common law right "to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case … against a claim of such creditor against the debtor…."[5] The Bankruptcy Code does not define the term "mutual." When determining whether debts are mutual, courts frequently examine whether: (i) the debts are between the same parties, and (ii) the parties are acting in the same capacity.[6] Though there is a large body of case law examining the mutuality requirement under

[4] The NYISO respectfully requests waiver of 18 C.F.R. § 385.203(b)(3) (2009) to permit service on counsel for the NYISO in both Washington, D.C. and Richmond, VA.

[5] 11 U.S.C. § 553(a).

[6] *See In re Semcrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009) (finding that "[t]he authorities are also clear that debts are considered 'mutual' only when 'they are due to and from the same persons in the same capacity.' *Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 149 (2d Cir. 2002) (citing *In re Westchester Structures, Inc.* 181 B.R. 730, 740). Put another way, mutuality requires that 'each party must own his claim in his own right severally, with the right to collect in his own name against the debtor in his own right and severally.' *In re Garden Ridge*, 338 B.R. 627,633-34 (*quoting Braniff Airways, Inc. v. Exxon Co., U.S.A.*, 814 F.2d 1030, 1036 (5th Cir. 1987))").

§ 553 of the Bankruptcy Code in a number of contexts, there is no precedent that clearly addresses mutuality in the commercial relationships of ISOs/RTOs and their market participants.

III. NYISO Comments

A. The Proposed Rule Seeks to Address a Risk that is Factually and Legally Remote

The question of mutuality would only arise in limited circumstances, as several conditions must be present for the issue to come into play. First, a bankrupt market participant must engage in both purchases and sales in the ISO/RTO-administered markets such that the market participant has both payables and receivables with the ISO/RTO. Second, the ISO's/RTO's right to net those payables and receivables under the equitable defense of recoupment must be rejected. Third, the amount owed by the market participant must exceed the value of any collateral available to the ISO/RTO to secure the market participant's payment obligations. Finally, the court would need to find that, despite numerous factors indicating that the ISO/RTO is the counterparty to transactions with the market participant, the mutuality required for setoff is lacking.

1. The Need for Netting through Setoff Would Only Arise Where a Bankrupt Market Participant has Both Payables and Receivables with the ISO/RTO

The need for an ISO/RTO to reduce its credit exposure through setoff is only encountered if a market participant that files for bankruptcy has both payables and receivables with an ISO/RTO. Several factors affect the extent to which market participants in a given ISO/RTO may have both payables and receivables, including the design of a particular ISO's/RTO's markets and the products that it offers, as well as the extent to which the same market participants are active in multiple markets or both own generation and serve load. For example, the near-total divestiture of generation by the formerly vertically integrated utilities in New York substantially reduces the extent to which market participants are both buyers and sellers of

energy in the NYISO-administered markets. If a market participant only serves load, an ISO/RTO may have little or no need to reduce its credit exposure through setoff because it may owe little or nothing to the market participant.

2. The Alternative Remedy of Recoupment Would Be Available to Net Certain Transactions

Even if a bankrupt market participant has material payables and receivables with an ISO/RTO, the equitable defense of recoupment would likely allow the ISO/RTO to net those obligations. Unlike setoff, mutuality is not a statutory requirement for recoupment as recoupment by its nature requires that the countervailing obligations arise out of the same set of transactions.[7] The premise underlying recoupment is that it would be inequitable to permit a debtor to enjoy the benefits of a transaction without also meeting its obligations.[8] To the extent that a NYISO market participant's payables and receivables arise out of the same set of transactions, a bankruptcy court may permit recoupment, without the need to analyze the "mutuality" of the obligations.

Similarly, if a bankruptcy court were to determine that a market participant's activities in different NYISO-administered markets constitute separate sets of transactions such that the NYISO could not recoup a market participant's payables against its receivables across markets (for example, net payables in the energy market with receivables in the TCC market), the court would likely still uphold the NYISO's right to recoupment within each market because it would be inequitable for a market participant to benefit from its participation in a single market without also having to meet its obligations related to its transactions in that market.

[7] *See In re McMahon*, 129 F.3d 93, 96 (2d Cir. 1997) ("New York law requires recoupment to arise out of the same set of transactions as the claim.").

[8] *See e.g.*, *In re Peterson Distributing, Inc.*, 82 F.3d 956 (10th Cir. 1996).

3. NYISO's Credit Requirements Do Not Assume Cross-Market Netting

To the extent a bankruptcy court prohibited the NYISO from netting obligations across markets on the basis of recoupment, the NYISO would likely have sufficient collateral available to recover the market participant's payment obligations to the NYISO. The NYISO calculates distinct credit requirements for each of its markets without assuming the ability to net across markets in a bankruptcy proceeding. That is, the credit requirements for each market are calculated without regard to any payments owed to the market participant in other markets.[9] Accordingly, the NYISO's existing credit requirements should sufficiently protect against the risk of non-payment by a market participant in each of the NYISO-administered markets.

4. The NYISO's Tariffs, Agreements, and Practices Support a Finding that Mutuality Exists Between the NYISO and its Market Participants

The principal concern that appears to be driving the Commission is the potential ambiguity in the identity of the counterparty to a market participant's transactions rather than the exclusion of the ISO/RTO from the chain of title in the transaction. While taking title may provide an additional factor to support a bankruptcy court's finding that the debts owed between an ISO/RTO and its market participants are mutual, taking title is not likely to be determinative. The NYISO has found no case law supporting the proposition that a creditor must take title to goods or services in order to have the legal right to offset payment obligations. Rather, the key consideration in any analysis of whether mutuality exists is whether the parties are the same and are acting in the same capacity in each transaction.

The NYISO believes that its tariffs, agreements, and operating practices make it clear that it is the party to which market participants owe payments for their purchases in the NYISO-administered markets. Likewise, the tariffs provide that the NYISO is the party responsible for

[9] The limited exception is the ability of a NYISO market participant to treat the amount of its net receivable for the billing period as cash collateral. This potential exposure is reduced to the extent the NYISO's invoicing cycle is shortened from a monthly to a weekly invoicing cycle because the dollar amount of a market participant's net receivable that would be available as cash collateral is reduced.

paying monies owed to market participants.[10] Under the NYISO's tariffs and agreements, payment rights and obligations run between the NYISO and individual market participants.[11] In addition, it is the NYISO's practice to pay on time and in full any net monies owed regardless of the amount received by the NYISO from market participants for their purchases (i.e., the NYISO does not short-pay market participants). The NYISO is not acting merely as an agent on behalf of market participants, but rather is acting in its own capacity as a market administrator.

In the event of a payment default by a market participant, the NYISO's tariffs allow the NYISO to draw from its working capital fund to facilitate timely payment to market participants and maintain the liquidity of the NYISO-administered markets.[12] The NYISO's working capital fund operates as a loss reserve account that is pre-funded by market participants. The NYISO also maintains a bank line-of-credit that it may use to protect market liquidity and pay market participants on time. In general, the NYISO seeks to recover the amount of a bad debt loss from its market participants only after it has pursued remedies in its own name against a defaulting market participant. The NYISO will replenish its working capital fund with the monies it recovers through the exercise of its remedies, or, when necessary, from the mutualization of the loss.[13]

In addition, other factors indicate the NYISO is the counterparty to the transactions it conducts. The credit support provided by market participants is given in the name, and for the benefit of the NYISO. In the event a market participant defaults on a payment obligation, the

[10] *See Services Tariff, Section 7.2C* providing, in pertinent part, "the ISO shall pay all net monies owed to a Customer from the ISO Clearing Account by the first banking day common to all parties after the 19th day of the month that the invoice is rendered by the ISO...."

[11] *See Services Tariff, Section 7.2B* providing, in pertinent part, "[a] Customer owing payments on net shall make those payments to the ISO Clearing Account by the first banking day common to all parties after the 15th day of the month that the invoice is rendered by the ISO. "

[12] *See OATT, Attachment U, Section 3.0* providing, in pertinent part, "[w]henever all or any portions of any settlement invoices remain unpaid to the ISO after the invoice due date, the ISO, at its discretion, shall utilize the Working Capital Fund to maintain the liquidity of the New York wholesale energy markets and ensure that all [customers] who are owed monies in their settlement invoices [...] are paid in full."

[13] *See OATT, Attachment V, Section 5.2.*

NYISO is authorized by its tariffs to apply a market participant's collateral to reduce and/or recover its overdue payment obligation. The NYISO also is obligated by its tariffs to pursue available remedies to recover any further amount owed.[14] Finally, when then NYISO pursues a judgment against a market participant for a bad debt, the NYISO brings suit in its own name and right as the counterparty to the service agreement between the NYISO and the market participant.

The commercial relationship between the NYISO and its market participants, as described above, is distinguishable from the typical scenarios in which parties have successfully challenged setoff rights in a bankruptcy proceeding for lack of mutuality. In two common scenarios, courts have found a lack of mutuality on the basis that the debts are owed between different parties. In a third scenario, courts have found a lack of mutuality on the basis that the parties are acting in different capacities.

The first common scenario where mutuality has been determined to be lacking is known as a triangular setoff. In a triangular setoff, a creditor tries to offset an obligation that it owes to a bankrupt debtor against an obligation the bankrupt debtor owes to an affiliate of the creditor. Mutuality is lacking because the creditor and its affiliate, while related, are not the same parties.[15] The NYISO's netting practices are distinguishable from a triangular setoff because the NYISO, in issuing settlement invoices, only nets obligations owed directly between the NYISO and a specific market participant, and does not net obligations between the NYISO and affiliated market participants.

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[14] *See OATT, Attachment U, Section 1*, providing, in pertinent part, "[a]t such time that the ISO's Chief Financial Officer concludes that the ISO does not reasonably expect payment in full from a defaulting [customer] within an acceptable time period, then the ISO's Chief Financial Officer shall declare that such unpaid obligation is a bad debt loss [...] and the ISO shall pursue available remedies for customer defaults under the ISO Tariffs."

[15] *See, e.g., In re Semcrude, L.P.*, __ B.R. __, 2010 WL 1737103 (D. Del. April 30, 2010) (affirming the bankruptcy court's refusal to permit Chevron (A) to offset debt owed to SemCrude L.P. (B) against amounts owed to Chevron (A) by SemFuel, L.P. (C)). The court in *Semcrude* held that debts are mutual only when they are due to and from the same persons. *Id.* (citing *Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 149 (2d Cir. 2002)).

The next common scenario in which bankruptcy courts have found that mutuality is lacking is when a creditor attempts to setoff an obligation that it owes to a bankrupt debtor against an obligation the bankrupt debtor owes jointly to the creditor and a third party. In this case, mutuality is lacking because the money owed by the debtor is not owed only to the creditor but it is also owed to a different party (i.e., the third party).[16] The commercial relationship between an ISO/RTO and its market participants, at least in NYISO's case, is distinguishable from this scenario. While market participants ultimately share in any NYISO losses, a market participant's obligations to the NYISO for its purchases should not be characterized as joint obligations. Instead, this loss sharing mechanism is analogous to an indemnification obligation while the purchase and sale obligations that the NYISO would setoff in bankruptcy are owed directly between the NYISO and an individual market participant only.

A third common scenario in which bankruptcy courts have found that mutuality is lacking relates to the differing capacities in which a creditor may seek to effect a setoff. In such scenario, the transactions are between the same creditor and debtor, but the creditor or debtor acts in its individual capacity as a party to one of the transactions and in a different capacity (i.e., generally in a fiduciary capacity) as a party to the other transaction. The most common example of lack of capacity in this context arises when a debtor owes a loan to a bank and the same bank holds funds deposited by the debtor in a fiduciary capacity (e.g., as a trustee or escrow agent). When the debtor files for bankruptcy, the bank will often try to setoff the debtor's money that it holds as a fiduciary against the money the debtor owes the bank under its loan. In this scenario, mutuality is lacking because the bank is acting in its own capacity with respect to the loan with the debtor, but is acting in a fiduciary capacity with respect to the debtor's funds held by the

[16] *See, e.g.*, *Gray v. Rollo*, 85 U.S. 629 (1873) (holding that Gray and Gaylord (A and B) could not offset a debt owed to an insurance company ruined by the great fire in Chicago (C) against debt owed by the insurer to Gray and his brother (A and D)).

bank in trust.[17] This situation is distinguishable from the relationship between the NYISO and its market participants because the NYISO acts in the same capacity on both sides of market transactions whether it is acting as a principal on its own behalf or as an agent purchasing and selling on behalf of market participants.

B. Requiring ISOs/RTOs to Take Title in the Transactions they Administer will Not Definitively Establish Mutuality Nor Preclude Challenges to an ISO's/RTO's Rights to Exercise Setoff

The NYISO believes that the mutuality required to effect setoff likely exists under its current tariff provisions and would also likely exist under the tariff revisions proposed by PJM Interconnection, L.L.C. ("PJM") in Docket # ER10-1196. At the same time, the proposed rule will not eliminate potential challenges to an ISO's/RTO's ability to setoff market participant obligations in bankruptcy proceedings. Stated simply, the act of taking title to products sold in the markets does not, by itself, mean that an ISO/RTO is a counterparty or is acting in the same capacity in both transactions. Rather, taking title to transactions is another factor bankruptcy courts may consider in determining whether mutuality exists. PJM's proposal regarding the formation of a new entity is instructive in this regard.

PJM is proposing to modify its tariffs to create a new entity, PJMSettlement, that will take title to products purchased and sold in the PJM-administered markets. Under its proposal, PJM hopes to establish that PJMSettlement is the counterparty to each of PJM's market transactions by having PJMSettlement take title in those transactions. It is worth noting, however, that under the proposal PJMSettlement will be obligated to pay market sellers only to the extent of its collections from market buyers. If PJMSettlement does not receive sufficient

[17] *See, e.g.*, *In re Mastroeni*, 57 B.R. 191 (Bankr. S.D.N.Y. 1986) (holding that mutuality was lacking where a bank sought to setoff deposits of the debtor held in an Individual Retirement Account, with the bank as trustee pursuant to a custodian agreement, against unsecured loan payments owed to the bank by the debtor, where the bank acted as a lender, not a trustee).

funds from purchasers to cover its payment obligations to sellers, then it will not be required to pay those obligations in full at that time. While implementation of this proposal would allow PJMSettlement to assert that the obligations owed between PJMSettlement and a market participant are debts between the same parties, taking title would not insulate PJMSettlement from challenges that it lacks the requisite mutuality to effect setoff.

By short-paying market participants, a party opposing setoff could assert that PJMSettlement lacks mutuality because it is not truly taking on the debt obligation for market purchases but rather acting as an agent for many different buyers. The NYISO believes that the probability is low that a party would prevail on this assertion, but the fact remains, as is the case today, that a party could make this assertion to challenge an ISO's/RTO's right to exercise setoff. Accordingly, the risk a bankruptcy court would refuse to allow ISOs/RTOs to net market participant obligations is not eliminated by requiring ISOs/RTOs to take title to market transactions.

C. Less Disruptive Means Exist to Address the Perceived Risk

The benefit of taking title to the subject matter of market transactions is unclear, but an increase in ISO/RTO costs is certain. Some ISOs/RTOs will incur new and potentially significant costs if the Commission requires ISOs/RTOs to take title to the products bought and sold in its markets. These include costs for additional accounting, internal auditing, and administrative personnel, increases in external audit fees, additional legal costs to ensure compliance with any new or expanded regulatory requirements, and potential increases in regulatory fees.

In addition to the known costs, the unintended consequences could cause significant harm. Such consequences may include the imposition of state and local sales taxes on

ISOs/RTOs, implications regarding the independence of an ISO/RTO,[18] regulatory uncertainty resulting from potential multi-agency jurisdictional oversight of ISOs/RTOs, negative impacts on financing options, and increases in financing costs.

Finally, because of the diversity of administrative and credit practices among the various ISOs/RTOs, imposing a "one-size fits all" approach to addressing the perceived risk is fraught with the potential to have unintended consequences. As discussed above, the determination of whether mutuality exists between parties for a set of transactions is determined on the facts of each specific scenario. The NYISO believes that its tariffs, agreements, and practices all lend themselves to a determination that any obligations between it and market participants are mutual. The proposed changes may incrementally increase the likelihood that an ISO/RTO would be permitted to setoff obligations of one of its market participants in a bankruptcy proceeding; however, they could also result in additional costs and unintended consequences that are not justified by the remote risk presented.

Accordingly, NYISO submits that, to the extent the Commission believes it is necessary to act rather than simply allowing the various ISOs/RTOs to seek to address the risk in the manner they determine best in each of their specific factual situations, the Commission should allow ISOs/RTOs to use less disruptive means to address the potential risk identified in the NOPR, such as those outlined below.

1. Enhancement of ISO/RTO Tariff Provisions

Each ISO/RTO could carefully review their tariffs and propose revisions, as necessary, to address the concerns raised by the Commission by, for example, clarifying that the ISO/RTO is the counterparty to all market transactions, and establishing that amount due to or from a market

[18] For example, Section 3.04(g) of the ISO/TO Agreement prohibits the NYISO from having "a financial interest in any commercial transaction involving the use of the NYS Power System or any other electrical system . . . ." Under Section 6.14 of that Agreement, Section 3.04(g) may only be amended with the unanimous consent of the parties, i.e., the NYISO and its member transmission owners, or if the Commission were to make an express finding "that such change is required under the public interest standard under the Mobile-Sierra doctrine."

participant for all of the market participant's transactions during the specified time period is limited to the net obligation owed. As set forth in detail in Section III.A.4 above, the NYISO believes that much of this clarity is already contained in the NYISO's tariffs. While the risk is remote that an ISO/RTO would not have the right to net market participant obligations, either through recoupment or effecting a setoff of those obligations, to the extent any actual risk exists, the NYISO further believes that the credit requirements in its tariffs and its credit practices adequately address this risk.

2. ISO/RTO Security Interest in Market Participant's Accounts Receivable

Another potential alternative for addressing the identified risk, employed by the Midwest Independent System Operator, Inc., ("Midwest ISO") would be for ISOs/RTOs to take security interests where necessary to address potential challenges to mutuality. It should be noted, however, that as a mandatory requirement this may present more difficulties than have been observed in the Midwest ISO's voluntary program.

3. Amendment of the Bankruptcy Code

Appropriate revisions to the Bankruptcy Code could clearly establish ISO's/RTO's rights to exercise setoff. Congress has previously enacted laws to safeguard netting practices in certain circumstances to facilitate the smooth functioning of the economy, even when those netting practices may not provide the mutuality required to effect setoff under the Bankruptcy Code.[19] The same policy rationale is applicable to ISO/RTO-administered markets. Reasonable grounds exist to seek amendments to relevant federal laws and explicitly establish the legal soundness of ISO/RTO netting schemes. An ISO's/RTO's right to net the amount owed by a market participant to the ISO/RTO and the amount the ISO/RTO owes to the market participant helps

[19] *See, e.g., 12 U.S.C. § 4401, et seq.* (providing for the protection of the netting procedures between financial institutions as a result of Congress finding that netting between financial institutions reduces the systemic risk to the banking system, and determining that the effectiveness of the netting procedures can be assured only if they are recognized as valid and legally binding in the event of the closing of a financial institution that is participating in that netting).

prevent the destabilization of other market participants by facilitating the liquidity necessary to settle other market obligations, and by reducing the likelihood of a series of defaults by affected market participants that could undermine the overall operation of the wholesale electric markets.

IV. Conclusion

WHEREFORE, for the foregoing reasons, the New York Independent System Operator, Inc. respectfully requests the Commission to allow ISOs/RTOs to work through their stakeholder processes to appropriately address the identified risk based on each ISO's/RTO's unique market circumstances instead of imposing a one-size-fits-all solution to address a remote risk that varies by region.

Respectfully submitted,

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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 in accordance with the requirements of Rule 2010 of the Rules of Practice and Procedure, 18 C.F.R. § 385.2010 (2010).

Dated at Washington, DC this 8th day of June, 2010.

By: */s/ Ted J. Murphy*

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