

The Electric House

BY JEREMY D. WEINSTEIN AND NOEL TRASK¹

In his brilliant 1922 short film, *The Electric House*, Buster Keaton fumbles around at his graduation ceremony, and in the confusion his diploma in botanical sciences is exchanged for the electrical engineering diploma of the man next to him. Following graduation, Buster, rather than the engineer, is hired to design a wealthy man's new house, to have all the latest electric modern conveniences. As one would expect, when it is finished and the switch thrown, the house goes berserk and literally eats its inhabitants alive.

Increasingly, our nation's wholesale energy transactions are written on the ISDA standard form documents, often including power, gas, coal and emissions annexes for transactions in physical energy commodities. There are substantial benefits to energy transactions that are purely financial derivatives. Liquidity in financial energy markets is often better than in the physical markets, and because purely financial transactions can be structured to be financially identical to their physical counterparts, the financial markets can help reduce a utility's cost of hedging the price risk associated with serving its native load. For utilities with obligations to serve native load in traditionally regulated states, and "provider-of-last resort" load in states that have unbundled their rates and established retail competition, this brand of financial hedging can yield substantial benefits for ratepayers, assuming the utility's hedge counterparties perform under their contracts.

Of potentially equivalent importance is that using a standard master agreement like the ISDA with standard annexes that link all derivative and physical transactions together into one single agreement, enables a utility to reduce its credit risk associated with its transactions with its hedge counterparties. A financial master agreement with annexes for physical commodities enables a utility to net in-the-money and out-of-the-money positions on *all* of its transactions with individual hedge counterparties, which necessarily means a reduction in credit risk. Standardized documentation also helps expedite transaction consummation, and increases fungibility of products documented on such paper.

The irony is that therein lies a trap for the unwary. Indeed, eerily mindful of the lesson of *The Electric House*, we can see a potentially sinister dialectic at work in our present day world of highly volatile energy prices. The availability of the risk-reducing ISDA agreement and its linked physical annexes can tempt traditional, risk-averse utilities to expand their use of, and reliance upon them to a degree that brings them right back to the edges of their previous risk appetite. That this risk is a very real one is not in question, as utilities have in fact begun to rely on purely derivative fi-

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financial transactions done under an ISDA to hedge the price risk associated with obtaining power in the wholesale markets. For example, in 2007, the State of Illinois amended its retail restructuring law to allow its public utilities to enter into significantly-sized derivative transactions, without any need for approval by the state's commission, as one means to serve their provider-of-last resort loads. Commonwealth Edison Company, the utility that serves Chicago and has more than five million customers, took advantage of the new law and entered into a five year derivative contract in which the MW amount purchases by the end of its terms reaches 3,000 MW.

It is not only the ISDA's attractiveness as a credit risk reducer that has and will continue to make it a preferred choice for energy transactions. It is also that it is the first choice of an increasingly large proportion of counterparties in the energy markets, which are the commercial banks. The ISDA first came into being in the early 1980s as a result of the need of banks and other large dealers in derivatives for a standard trading agreement. As such, it is not only utilities in the restructured states that deal increasingly with banks under ISDA agreements. It will likely also be traditionally integrated utilities, because they may have no choice but to enter into some volume of financial, rather than physical, transactions to hedge their load obligations. In any construct, whether in a restructured state or in a traditionally regulated state, if a utility is exposed to a floating price risk, a purely financial fixed-for-floating swap under an ISDA will serve the same purpose as an economically identical physical transaction scheduled with control areas and transmission providers. The banks will prefer purely financial swap transactions, and they will require use of the ISDA Agreement to document and govern these transactions.²

And how might this state of affairs make the Electric House go haywire? We can see at least three possible concerns, all of which have become evident in the last few turbulent weeks and months.

First, the way the ISDA Agreement collateralizes transactions could put utilities at risk of being under-collateralized with respect to their bank

counterparties. Under the ISDA, parties must provide collateral as a function of the mark-to-market value of their positions. After a trade, the market will move, and the trade will be profitable, or not. For a utility buyer of a financial swap, if the market price increases after the purchase, the trade will be profitable, and if the market price decreases it will not be. But the more profitable a purchase is for a utility, the more credit-related exposure it creates, for if the utility's counterparty defaults, the utility must cover in a higher-priced market. Therefore, the higher market prices go, the greater the utility's exposure.

Under the ISDA, however, parties typically allow each other some leeway with respect to the amount of collateral they must provide to each other, requiring that margin be posted only if exposure exceeds a set "collateral threshold." The collateral threshold amount is really a free, unsecured line of credit provided by the exposed party to its counterparty. Under the ISDA's Credit Support Annex and also the Collateral Annex to the EEI Master Power Purchase and Sale Agreement,³ parties typically set collateral thresholds at levels tied to their respective credit ratings. For example, an agreement could provide that a party with a rating of AA need only post collateral to the extent that the value of the position to its counterparty exceeded a \$50,000,000 collateral threshold against it, with that threshold declining to \$15,000,000 for a party with an S&P rating of BBB+. Most in the industry set the collateral threshold to zero for a counterparty at or below BBB-, or Baa3 from Moody's, both of which are the lowest "investment grade" ratings. Herein lies the rub.

Even after the bankruptcy of Lehman Brothers, the big banks are likely to have ratings that are much higher than their utility counterparties, meaning that they will be required to post much less collateral than their utility counterparties when the utilities are exposed to them than would be required in the opposite situation. However, the big banks are not necessarily proportionately more creditworthy. They are also less likely to own physical generating assets that will be there at the end of the day to support transactions. As the financial system continues to teeter, it is very

possible that exposed utilities will therefore be under-collateralized with respect to their big bank counterparties.

The second risk utilities face is the indirect impact of increasing pressures on liquidity that are the result of the combination of another core feature of the ISDA Agreement's collateralization scheme with the current crisis in confidence in the credit markets, and the resulting redoubled emphasis on the view that "cash is king." Under the ISDA, as well as the EEI Agreement, counterparties with investment grade ratings can use cash collateral posted to them by their counterparties for any purpose; they are not required to segregate the cash, or place it with a third party bank subject to an escrow arrangement. Accordingly, a party holding cash margin can post it to other counterparties to whom they owe margin. In the case of government securities given as collateral, this is called "rehypothecation." If, however, a party provides a letter of credit rather than cash, the other party does not have liquid collateral to meet its obligations to provide margin to its other counterparties, and must use other sources of cash as margin. Parties might provide a letter of credit instead of cash if they are concerned about the return of that cash: a claim for return of posted margin that was not help by a third party is generally merely an unsecured claim in a bankruptcy proceeding.

If the market suspects that a particular large bank, or banks in general, could go bankrupt, every entity in a position to learn from the experience of those who posted cash collateral to Lehman Brothers would no longer post margin in the form of cash, but rather instead provide letters of credit⁴ or perhaps pledged certificates of deposits⁵ or a custodial bank account. As this attitude and practice spreads through the market, the cash and collateral that were available for brokers and dealers to re-post or rehypothecate to their counterparties would dry up.

It is not a stretch to hypothesize that *this* liquidity crisis – the risk of the marketplace at large learning the lesson of what can happen to posted cash collateral – is part of the reasoning behind the Federal Reserve's statement at the time of its arranged bailout of Bear Stearns that it was "too

interconnected to fail"⁶ and part of the very real drop in liquidity in the energy markets in the aftermath of Lehman's bankruptcy. This crisis could easily get worse, as it is likely that the ratings agencies may begin to determine the raw exposure of companies taking into account the real risk that because more market participants will no longer provide collateral in a form that can be reposted or rehypothecated, they will therefore have to rely on their other cash resources to enable them to meet margin calls.⁷

The third risk lurking in the Electric House is systemic, and is the natural result of the loss of liquidity in the markets and the increasing risk of bankruptcies it and many other factors pose. It is that unsecured creditors in these bankruptcies will be even less likely than they will be in the Lehman bankruptcy to recover any of their value lost. Derivative energy contracts almost always contain two-way, or "no fault" termination clause, which provide that regardless of which party has defaulted, the party that is out-of-the-money pays the equity in the contract to the party that is in-the-money.⁸ The larger the volume of derivative transactions, the greater the risk that the entire system will have to come to terms with what could well be a major semi-delusion, which is that derivative positions that are in-the-money for a declining enterprise are really part of their capital, and that their value will be available to creditors in their bankruptcies.

Why is this assumption potentially delusional? The answer is that non-defaulting parties with out-of-the-money positions are far less likely to pay the bankrupt estate, at least not without a fight. Most people like to keep their money, and most attorneys like to help people keep their money. Human nature being what it is, in the next major bank counterparty meltdown, lawyers advising non-defaulting counterparties will not be likely to say "sure, just go ahead and cut the check, your agreement, after all, requires payment." Rather, they will propose extensive review of all available defenses, including fraud in the inducement, and the use of all available tactics for delay, including the reliable standby, "come and get it."⁹

Just as an expert in botanical sciences could not design a safe Electric House, the latest in finan-

cial engineering may not always provide the safest path for utility ratepayers. How do we keep the Electric House from going haywire? Much of what we discuss above may be beyond the reach of parties or the market to control with respect to contracts and arrangements already in place. It is very likely that new, or at least reformed, views of these instruments and their optimal use will form in the immediate future as the current financial markets crisis works its way through the system. But for now we can offer, perhaps, a word to the wise utility – tread softly in the world of financial derivatives, because if you don't, you could end up getting clobbered with a very big stick.

NOTES

1. Jeremy D. Weinstein is an attorney in Walnut Creek, California. He can be reached at jweinstein@prodigy.net. Noel Trask is Lead Counsel of The Exelon Power Team, the wholesale power marketing division of Exelon Corporation, and is located in Kennett Square, Pennsylvania. He can be reached at noel.trask@exeloncorp.com.
2. Notwithstanding the recent financial crisis, there will likely be no shortage of potential counterparties to derivative transactions for utilities. Many major US commercial banks, hedge funds, and their international counterparts are likely to stay in the energy trading business, and they will usually prefer derivative transactions, as they are either more comfortable with them or unable to enter into physical transactions as a consequence of US banking and other laws.
3. The EEI Master Power Purchase and Sale Agreement is the standard enabling agreement for physical electricity transactions. The Power Annex to the ISDA Agreement is based on the EEI Agreement. See Weinstein, *Practical Considerations Regarding Electricity and its Regulation When Using the ISDA/EEI Power Annex*, Futures & Derivatives Law Report, Jul./Aug. 2006.
4. And it is these very same banks to whom counterparties seeking to borrow money to post letters of credit to their trading partners could be turning- and be turned away from.
5. Typically, pledged certificates of deposit are not accepted as collateral for energy trades, whether financial or physical.
6. It was apparently not a factor in the case of Lehman Brothers. Lehman was still rated A by Standard & Poor's at the time of its collapse. See Standard & Poor's, *Why Was Lehman Brothers Rated 'A'?* (Sep. 24, 2008), available at http://www2.standardandpoors.com/spf/pdf/fixedincome/Lehman_Brothers.pdf
7. In the aftermath of being caught asleep at the switch (or perhaps also because they were wink-wink lied to) in the case of Enron, the major credit rating agencies suddenly woke up to the concept of credit cliffs - the immediate cash needs of a company for margin in the event of a downgrade, as it descended a stair step or two in the credit ratings matrix of all their collateral support arrangements with all of their counterparties. See, e.g., Standard and Poor's, *Credit Policy Update: Changes to Ratings Process Address Economic Conditions and Market Needs* (Jan. 25, 2002).
8. Largely due to the banks' influence, one-way termination has become a thing of the past. Banks typically refused to agree to it in their ISDA agreements, because banking regulators had long denied them netting benefits to hedges entered into under ISDAs with one-way termination. Then, largely due to the banks' influence, an express option for one-way termination called "First Method" was eliminated by ISDA when it issued the 2002 form of ISDA Agreement. Then, to completely eliminate the possibility of one-way termination for bank ISDAs, in the Netting Improvement Acts of 2006, Congress rendered one-way termination clauses unenforceable against federally chartered banks.
9. Litigated defaults requiring judicial review of ISDA contracts have been few and far between, as cases have typically settled. This leaves the field open for creative lawyers to develop new arguments to enable them to help their clients avoid or delay paying a bankrupt party the out-of-the-money value (see, e.g., Weinstein, MacIntyre & Henze, *Escape from the Island of the One-Way Termination: Expectations and Enron v. TXU*, Futures & Derivatives Law Report, Nov. 2004), and for potentially surprising judicial decisions to come from those cases, with attendant market reaction as they hit the advance sheets.