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Practical Considerations Regarding Electricity and its Regulation When Using the ISDA/EEI Power Annex

by Jeremy D. Weinstein*

The ISDA/EEI North American Power Annex was published jointly by the International Swaps and Derivatives Association (ISDA) and the Edison Electric Institute (EEI) in 2003,¹ as a tool for parties to transact in wholesale physical energy under the umbrella of ISDA's Master Agreement. The Power Annex helps mitigate credit and liquidity risks by netting the financial ISDA and physical Power Annex transactions in a single document,² with ease of aggregated and netted margining through the ISDA Credit Support Annex. The Power Annex has succeeded in gaining wide market acceptance, and ISDA incorporated it into its 2005 Commodity Definitions.³

The ISDA Master Agreement traditionally operated as a financial, rather than commodity trading, contract. This article will focus on just a few of the many areas to which attention should be paid for effective contract drafting when using the Power Annex to trade physical wholesale energy from physical generating plants across physical transmission lines under market and asset jurisdiction exercised by the Federal Energy Regulatory Commission (FERC) and other regulators.

ARTICLE 2 OF THE UNIFORM COMMERCIAL CODE

Electricity as a "Good"

Contracts for sales of "goods" which fail to address certain specific matters will have terms doing so implied into them for the parties by application of Article 2 of the Uniform Commercial Code (UCC). In fact, the UCC can fill in all contract terms other than quantity.

A "good" is something "movable at the time of identification to the contract for sale other than the money in which the price is to be paid ..."⁴ Although electricity is a physical product of rotating metal moved from place to place over wires that with distance lose part of what they are carrying, states are split on whether or not electricity is a good.⁵ Recently, a New York bankruptcy court interpreting a contract governed by Utah law determined that although electricity was not a good under New York law, it was a good under Utah law and hence under the contract.⁶

Electricity has been found to be a good by courts in California.⁷ Courts in New York and Massachusetts have found that electricity is not a good. The Massachusetts court based its decision on public policy concerns over the implications of subjecting utilities to the UCC's implied warranties,⁸ but the New York courts have gone for the worst

of both worlds by concluding that while electricity isn't a good,⁹ "as a matter of policy" provisions of the UCC can be implied into contracts for its sale.¹⁰ Courts sometimes determine whether electricity is a good in the context of a tort claim, with answers varying based on whether it is encountered within, or escaping from, wires.¹¹ Ironically, the New York bankruptcy court determining that electricity was a good under Utah law noted that "Utah courts have not ruled on whether electricity should be considered a good covered by Article 2[, but] have held that other states' interpretations of identical UCC provisions are relevant", and then went on to use California's interpretation, rather than New York's.¹²

Implied Warranties

ISDAs with Power Annexes are typically governed by New York law, and although electricity, at the moment, isn't a "good" in New York, a future court might take judicial notice of physics and overrule precedent, or apply provisions of the UCC "as a matter of policy," for example to a delivery in a jurisdiction that treats electricity as a good. Parties commonly "reach-through" the ISDA with Power Annex to trade wholesale energy products defined by other tariffs, contracts or power pool agreements,¹³ and a court in a jurisdiction that does not consider electricity a good could find that the law governing that underlying defining document controls.

Whether UCC Article 2 applies to a transaction could depend on whether or not it is a good, but even if not, since its provisions might be implied into it "as a matter of policy," the UCC and the potential effects of its terms on wholesale energy transactions should be considered by contracting parties. The most obviously dangerous would be the UCC's implied warranties. Here is an example clause to disclaim those:

UCC/Disclaimer of Warranties. Whether or not the provisions of the applicable Uniform Commercial Code (UCC) are found to apply to Transactions hereunder, and a Product or energy is found to be a "good" for the purposes of the UCC or otherwise, PARTY A AND PARTY B EACH ACKNOWLEDGES THAT IT HAS ENTERED INTO THIS AGREEMENT AND IS CONTRACTING FOR THE PRODUCTS AND ENERGY TO BE SUPPLIED HEREUNDER BASED SOLELY UPON THE EXPRESS REPRESENTATIONS AND WARRANTIES SET FORTH HEREIN AND, SUBJECT THERETO, ACCEPTS SUCH PRODUCTS AND ENERGY "AS-IS" AND "WITH ALL FAULTS". PARTY A AND PARTY B EACH EXPRESSLY DISCLAIMS ANY OTHER REPRESENTATION OR WARRANTY, WRITTEN OR ORAL, EXPRESS OR IMPLIED, RELATING TO SUCH PRODUCTS AND ENERGY, INCLUDING, WITHOUT LIMITATION, ANY REPRESENTATION OR WARRANTY WITH RESPECT TO CONFORMITY TO MODELS OR SAMPLES, MERCHANTABILITY, OR FITNESS FOR ANY PARTICULAR PURPOSE.

Adequate Assurances

Some parties considering the application of the UCC to wholesale energy transactions have sought to provide that specific collateral thresholds, for example in the ISDA Credit Support Annex, or other provisions, such as a clause sought by one sub-investment grade utility that no collateral other than a limited number of advance payments may be sought absent the utility's further downgrade, wholly supplant the adequate assurances clause of UCC § 2609¹⁴ that is implied by the UCC into all contracts for the sale of goods, and by New York courts into contracts for the sale of electricity as a non-good.¹⁵ However, § 2609 covers matters beyond financial assurances. For example, a wholesale energy buyer might read in the newspaper that the employees of a merchant power plant operator are to go on strike, or that the plant or its operator has lost regulatory authority to sell wholesale energy, and should be able to ask for assurances that the plant will remain operational and delivering energy so that, if such assurances are not forthcoming, it can determine and exercise its remedies. Therefore, if contracting to limit financial assurances to explicit contract terms only, which itself is not necessarily recommended, care should be taken to avoid causing collateral damage to the ordinarily anticipated commercial functioning of a contract via an overbroad waiver of § 2609; for example rather than broadly "waiving all adequate assurances," one could instead state that no financial assurances or collateral posting will be required except as specifically set forth in the contract.

MARKET REDESIGN

Wholesale energy transactions almost always specify a delivery point, either for actual delivery of the energy, or for purposes of pricing. These delivery points are typically major interconnections on the nation's energy grid, or other pricing points.¹⁶ The change to a delivery point could meaningfully affect the economics of the transaction. Delivery points could become unavailable or changed for a number of reasons other than force majeure, and delivery point relocations or revisions could introduce intervening wires on which new transmission or congestion charges might be incurred when bringing energy to or taking it away from the changed point. In light of announced changes and market redesign initiatives, wholesale energy market participants have been grappling with what happens if a change to a delivery point occurs after entering into a forward transaction for delivery to that point, and how parties might enter into a forward transaction now, actually knowing that the delivery point is to change during the term, in a manner not yet known, that could substantially change the transaction's economics.

In 2005, a subcommittee of the EEI Contracts Committee chaired by Elizabeth Sager drafted language to address the latter issue with respect to proposed changes in California.¹⁷ The language seeks to define two specific delivery points in a manner that includes what each are expected to be redesigned into, setting forth the specifics of the currently anticipated redesign process in detail, along with an agreement to "work

together in good faith to designate an alternate” if the redesign does not occur in the manner contemplated.¹⁸ The subcommittee interacted well with the California Independent System Operator¹⁹ and the language it developed as the full story was still unfolding and hence not yet fully known²⁰ has received solid marketplace acceptance.

An understanding of the applicable contract law doctrines as they pertain to changes in a delivery point would be appropriate when drafting. Parties should consider whether to state definitively if the vanishing of a delivery point means the vanishing of their transaction.²¹ In addition to providing that the parties will continue the transaction with an attempt to address changes equitably (if that is a desired outcome), parties might consider stating that a redesign would be a Market Disruption Event, putting them on the path of the Disruption Fallback mechanisms provided in the ISDA Definitions, which is typically incorporated by the parties by reference, sometimes with customization,²² into the ISDA Schedule. This waterfall typically ends with No-Fault Termination, or a walk-away, but travel down its path could lead to the development of an undesirable pricing as a stopping point along the way.²³ This might be substantially the same as what would happen under the common law or judicial resolution if not contractually addressed, but perhaps not, and the issue is worth considering when drafting.

FERC ORDER 888

A bank’s energy trading subsidiary might interact with a typical utility in one or more of four distinct ways:

- (1) as a wholesale energy trading counterparty under the ISDA with Power Annex (or other trading contract),
- (2) as the buyer of transmission to move energy, either within or across the utility’s system,
- (3) as the owner (perhaps by foreclosure) of a physical generating plant interconnected to the utility’s system, and
- (4) as a retail customer.

Each such interaction may be between the same corporate legal persons, but they are all regulatorily separated. However, language in the ISDA with Power Annex could put both parties at risk of overstepping this regulatory separation, and so parties should consider adding language to the Power Annex to protect against this risk.

Transmission Function

Under FERC Order No. 888²⁴ and FERC rules, a FERC-jurisdictional utility’s transmission function must provide unbundled transmission pursuant to a FERC-approved Open Access Transmission Tariff (OATT), and must post all available transmission capacity on its publicly available Open Access Same-Time Information System (OASIS),²⁵ through which all entities in the market, including the merchant function of the same utility, must interact with the

transmission function. Even to interconnect its own power plants to its own transmission system, the merchant function must go through OASIS.

To ensure these rules are respected, utilities under FERC’s jurisdiction, which is most of those that own transmission, are required to erect a solid wall between their merchant and transmission functions. FERC’s Standards of Conduct²⁶ require that except in emergency circumstances affecting system reliability, employees engaged in the transmission function must operate completely separately from employees of the merchant function.²⁷ Pursuant to FERC’s Standards of Conduct,²⁸ the merchant function is only allowed to receive information from the transmission function on the same basis as it is received by unrelated, third-party transmission customers.

With respect to interconnections, FERC requires all FERC-jurisdictional transmission providers to adopt and attach to their OATTs standard forms of interconnection agreements,²⁹ and allocates in detail the distribution of risks between the transmission provider and generator. Vertically integrated utilities can rarely deviate from the standard forms. The OATTs contain limitations of liability, typically to a standard of gross negligence or intentional wrongdoing,³⁰ the tinkering with which FERC does not take lightly.³¹

Retail Services

The utility is potentially transacting with the ISDA counterparty as a retail service customer. Under retail electric service tariffs, the utility’s liability for failure to deliver electricity is strictly limited,³² for example to a standard of gross negligence.³³

Broad Netting and Setoff

The transmission function, distribution function, and merchant function can all be within the same corporate entity, and the ISDA Master Agreement, especially when used with the Power Annex, has broad netting and setoff language that covers amounts that may be owed by either party to the other on account of the ISDA or potentially broadly defined Specified Transactions or other sources of obligations. Further, general practice is to add language to the ISDA Master Agreement Schedule even further enhancing netting and setoff.³⁴ Broad netting and setoff is good for market liquidity and financial stability, but in agreeing to such language, the merchant function must avoid entering into a contract that potentially waives liability that the transmission or power delivery functions of the same legal person had capped.

For example, assume an ISDA with Power Annex between Utility, acting in its merchant function capacity, and Bank. Utility’s merchant, transmission and power delivery functions are within the same corporate entity. Bank opens an office, and installs an expensive trading room, in Utility’s service territory, becoming a retail customer of Utility’s power delivery function pursuant to Utility’s retail service tariff. Bank enters into transactions for wholesale

energy with Utility's merchant function pursuant to the ISDA with Power Annex, and separately into transactions for transmission of that wholesale energy with Utility's transmission function pursuant to its OATT. Utility's local substation fails, blacking out Bank's trading room, rendering Bank unable to perform its trade with the merchant function, and causing damage to Bank's equipment. In this example, Bank should pursue its remedies against the power delivery function under the tariff for retail service, like all other retail customers. Bank should not have setoff remedies against the merchant function that are unavailable to the other ratepayers by asserting that the liquidated damages it owes the merchant function for failure to deliver energy are offset by damages or a performance failure caused by the blackout. Likewise, limitations of liability set forth in Utility's transmission function OATT should not be nullified, if the energy was not delivered because Utility's transmission function failed to transmit it, by a claim of damages as a set-off or failure of a performance condition precedent. Bank agreed to these limitations of liability when it signed up for retail service or bought transmission on OASIS, and so should be held to them, in the same manner as all other customers of these functions.

Here is an example clause that utilities with segregated merchant and transmission functions could use to cover these regulatory considerations:

FERC Orders/Functional Separation. Notwithstanding anything to the contrary herein, in no way shall Utility have any liability to Bank under this Agreement, and Bank may not use any provision of this Agreement, by set-off or otherwise, to hold Utility liable for any amounts (i) in excess of limitations of its transmission or distribution function's liability pursuant to the tariffs and other agreements of those functions with or applicable to Bank or (ii) respecting any act or omission by its transmission or power delivery function.

ELECTRICAL SYSTEM FUNCTIONING

In futures markets, parties almost always enter into contracts for delivery of a commodity not anticipating actual physical delivery, but rather the entering into of an offsetting trade prior to when delivery is due. Likewise, over-the-counter derivatives transactions never anticipate a physical delivery of a commodity. However, about one-tenth of transactions in wholesale energy markets are entered into in anticipation of an ultimate physical delivery. Investor-owned utilities, public utility districts, municipal utilities, and other load-serving entities are participating in wholesale markets to acquire physical energy to serve their retail customers. If this energy does not show up, real people in real places really could be blacked out. There would be no market if the entities that delivered electricity to homes and businesses could not use them to get what they need in order to provide this reliable electric service. Wholesale power markets must meet their needs.

The Power Annex is basically the EEI's Master Power Purchase & Sale Agreement, with the addition of what is commonly called a Mobile-Sierra waiver.³⁵ The EEI Master Agreement, and other forms of trading agreements commonly used in the wholesale energy marketplace, such as the Western Systems Power Pool Agreement (WSPP), are products of committees of market participants.³⁶ These committees can become divided, often to the point of paralysis, when it comes to significant divergences between the interests of load serving entities and marketers or other financial participants. The contracts that are published represent the extent of the consensus that these diverging interests can reach, and not the full panoply of issues presented, some of which might be commercially quite significant. It is this breach into which are advancing regulators and electric system reliability authorities, concerned to varying degrees with reliability of energy delivery, market functioning, and price efficiencies.

For example, in currently pending regulatory proceedings, FERC staff is disinclined to count the consensus EEI firm energy product, known as Firm (LD)³⁷ as a network resource for purposes of obtaining network transmission service under an OATT.³⁸ FERC staff's objection to the product seems to be its lack of designated operating reserves and the seller's ability under the agreement to simply deliver cover damages cash instead of power.³⁹ A potentially remedial approach could be to transact in a product with a physically firmer definition. In the West, a standard product known as WSPP Schedule C energy is treated by market participants as firm and is not interrupted for economic reasons;⁴⁰ parties could potentially further brace WSPP Schedule C to meet potential FERC requirements, should it become necessary, by specifically providing in the transaction confirmation that the seller is responsible to carry and designate operating reserves in support of the product,⁴¹ or that despite exculpatory language in the applicable trading enabling agreement, failure to deliver the product is indeed an event of default with remedies beyond liquidated damages for the undelivered trades.⁴²

Determining which contract terms enable products to meet which regulatory requirements is especially complicated in resource-constrained jurisdictions, such as California, which (in a defective fashion with disastrous consequences) required formerly vertically integrated utilities to divest themselves of generating assets and acquire energy through regulated markets and contracts.⁴³ Also having the potential to fundamentally change the market once set, would be the rules of the regional system reliability authorities, which have not yet set the requirements of who must provide the operating reserves.⁴⁴ At the moment, and for the foreseeable future, the relative distinctions made by regulatory, system reliability, or other governing authorities present exceptionally large penumbras and opportunities for confusion. As these developments continue, at FERC and at local or regional levels,⁴⁵ eventually there will be a split in the value of physically firm energy and financially settled "firm" energy. Despite the liquidity financial products offer to the marketplace by enabling participation of speculative

market players, an inability to designate a product as a network resource or counting in full towards reserve requirements for the control area simply makes it less valuable. Stay tuned.

CONCLUSION

The ISDA with Power Annex is a powerful risk-mitigating, liquidity-enhancing tool for energy trading, but it should not be used without customization for a dynamic legal landscape and constantly changing marketplace realities. The examples above of core legal uncertainties in energy markets, including known immediate potentials for major changes, are among the reasons parties should be sure to put the terms in the ISDA with Power Annex or EEI Master Agreement, or any other energy trading contract, and transactions under it, that are right for their own requirements. Wholesale energy markets are among the most rapidly evolving markets for any traded commodity, anywhere. One of the great rewards of working in these markets is the constant opportunities to develop contracting techniques to keep pace.

Notes

* Jeremy Weinstein is an attorney in Walnut Creek, California. email: jweinstein@prodigy.net. The author gratefully acknowledges the review and comments of Stacey Kusters of PacifiCorp, Dede Russo of Saracen Energy, Eric Freedman of Preston Gates, Arnie Podgorsky of Wright & Talisman, Noel Trask of Exelon Power Team, J. Marcus Nettelton of J.P. Morgan, and Thomas King of the Turlock Irrigation District. I dedicate this article to the memory of my friend, John Fryer.

- 1 Joint press release is available at <http://www.isda.org/press/press080703.html>; Power Annex is available at <http://www.isda.org/publications/pdf/PowerAnnex-NA.pdf>.
- 2 See Weinstein, Master Netting Agreement Developments in the Energy Industry, 23 Futures & Derivatives L. Rep., No. 3, at 5 (May 2003) and, for legal background (somewhat dated in light of the so-called Bankruptcy Abuse Prevention and Consumer Protection Act of 2005), Cadwalader, Wickersham & Taft, Survey of the Legal Landscape Applicable to Master Netting Agreements (2002), available at http://www.eei.org/industry_issues/legal_and_business_practices/master_netting_agreement/survey.pdf. The 2005 Act confirms bilateral cross-product netting and setoff across the “safe harbor” categories of protected contracts (forward contracts, swap agreements, repurchase agreements, commodity contracts and securities contracts), and for the ability of “master netting agreement participants” to enter into “master netting agreements.” 11 U.S.C.A. §§ 101(38A), 101(38B), 561.
- 3 Sub-Annex G to the 2005 ISDA Commodity Definitions, Article 15, Physically-Settled North American Power Transactions.
- 4 UCC § 2-105.
- 5 See the thorough and conscientious discussion by Collanton & Hales, Electricity: A “Good” under the UCC. Should be a Simple Question - Right? (May 26, 2005), available at <http://www.mofo.com/news/updates/bulletins/bulletin02011.html>. Note that if it is clear that the contract is one for sale of “goods,” the parties cannot “opt out” of the UCC in any

manner other than as provided in UCC §§ 1-102(3) & 2-102: by addressing the filled gaps in their own contract. If it is not clear that the contract is about “goods,” the parties should be even more sensitive to the differences between how the common law and the UCC would apply to the contract.

- 6 *Enron Power Marketing, Inc. v. Nevada Power Co.*, 55 U.C.C. Rep. Serv. 2d 31 (S.D. N.Y. 2004), opinion supplemented, 2004 WL 3015256 (S.D. N.Y. 2004).
- 7 See, e.g., *In re Pacific Gas and Electric Co.*, 2004 U.S. Dist. LEXIS 22023 (N.D. Cal., Sept. 30, 2004) (Article III Judge Susan Illston implying UCC § 2-609 into Qualifying Facility power sale agreements because the electricity sold thereunder is a good, even if QFs weren’t entitled to apply it on account of the automatic stay); *In re Pacific Gas and Electric Co.*, 271 B.R. 626, 638-640, 47 U.C.C. Rep. Serv. 2d 598 (N.D. Cal. 2002).
- 8 See *New Balance Athletic Shoe, Inc. v. Boston Edison Co.*, 29 U.C.C. Rep. Serv. 2d 397 (Mass. Super. Ct. 1996).
- 9 Perhaps because no Reddy Kilowatt comic books were handy. The court stated: “The consumer pays for electricity by kilowatt hour, that is, the length of time electricity flows through the system. There is no individual product. Instead, the consumer pays for use of the electricity.” *Bowen v. Niagara Mohawk Power Corp.*, 183 A.D.2d 293, 590 N.Y.S.2d 628, 631, Prod. Liab. Rep. (CCH) P 13389, 140 Pub. Util. Rep. 4th (PUR) 24, 19 U.C.C. Rep. Serv. 2d 716 (4th Dep’t 1992). This is not an accurate description of electric retail service, see discussion by Collanton & Hales, *op. cit.*, nor is it sufficiently meaningful in the context of, for example, a sale by Arizona Public Service to the Los Angeles Department of Water and Power delivered at Palo Verde that could be 100 megawatts of firm energy or 50 megawatts of unit contingent energy from a distant plant. One imagines that if nuclear energy had in fact turned out to be “too cheap to meter” (Lewis L. Strauss, Chairman of the Atomic Energy Commission, Speech to the National Association of Science Writers, N.Y., N.Y., Sept. 16th, 1954), utility billings would have looked like service billings, but only because energy would have been bought and sold irrespective of the quantity consumed. A further indicator of electricity being “moveable” and hence a “good” is that, in some circumstances, people will pay others to have it taken away. See, e.g., California Independent System Operator Corp., FERC Electric Tariff, Third Replacement Vol. No. 1, § 39.2 (adding requirements for Negative incremental Energy bids that are less than -\$30 per megawatt-hour). Note that the drafters of the UCC believed that even money would be a good were it not culled out of its definition. UCC § 2-105.
- 10 *Norcon Power Partners, L.P. v. Niagara Mohawk Power Corp.*, 92 N.Y.2d 458, 682 N.Y.S.2d 664, 705 N.E.2d 656, 37 U.C.C. Rep. Serv. 2d 323 (1998).
- 11 E.g., *Hedges v. Public Service Co. of Indiana, Inc.*, 396 N.E.2d 933, 27 U.C.C. Rep. Serv. 945 (Ind. Ct. App. 1st Dist. 1979) (a transaction in goods when metered in the home, but not when escaping from high-voltage lines). Courts conceivably could likewise distinguish on the basis of whether the transaction is for retail electric service or wholesale energy. One commentator has offered that courts are struggling with an “ambiguity” in the UCC created by its omission to define “thing” or “movable.” Maggs, Patterns of Drafting Errors in the Uniform Commercial Code and How Courts Should Respond to Them, 2002 Univ. of Ill. L. Rev. 81, 101 (2002). However, in a world of common sense (admittedly not to be taken for granted), a need to define “thing” or “move” should be considered stepping beyond legislation and into metaphysics.

- See instead Nimmer, Images and Contract Law- What Law Applies to Transactions in Information, 36 Houston L. Rev. 1, 32 (1999) (discussing issues presented by “predominant purpose test” used by majority of courts), available at http://www.houstonlawreview.org/archive/downloads/36-1_pdf/HLR36P1.pdf; and Karlin & Karlin, *The California Parol Evidence Rule*, 21 Southwestern U. L. Rev. 1361, 1377-82 (1992) (written words really can have meanings).
- 12 *Enron Power Marketing, Inc. v. Nevada Power Co.*, 55 U.C.C. Rep. Serv. 2d 31 (S.D. N.Y. 2004), opinion supplemented, 2004 WL 3015256 (S.D. N.Y. 2004). Yet another irony of not knowing from Utah whether electricity is a good in Utah is that parties trading under the WSPP do not know which Statute of Frauds applies—that of Utah Code § 25-5-4(1)(a), “every agreement that by its terms is not to be performed within one year” is “void unless ... in writing, signed by the party to be charged”, Utah Code § 70A-2-201 (UCC § 2201), “a contract for the sale of goods for the price of \$500 or more is not enforceable ... unless there is some writing ... signed by the party against whom enforcement is sought”, or Utah Code § 70A-1-206 (UCC § 1206), “[except for contracts for the sale of goods], a contract for the sale of personal property is not enforceable ... beyond \$5,000 in amount or value of remedy unless there is some writing ... signed by the party against whom enforcement is sought” Note Utah does not have an exemption from the Statute of Frauds equivalent to California’s UCC § 1206(3) and Civil Code § 1624(b) or New York’s UCC § 1206(3) and General Obligations Law § 5-701 for “qualified financial” (i.e., trading) contracts.
- 13 A popular reach-through clause:
- Other Products and Service Levels.* If the parties agree to a service level defined by a different agreement (e.g., the WSPP Agreement, the ERCOT Wholesale Electricity Enabling Agreement, etc.) for a particular Transaction, then, unless the Parties expressly state and agree that all the terms and conditions of such other agreement will apply, such reference to a service level/product shall be defined by such other agreement, including, if applicable, the regional reliability requirements and guidelines as well as the excuses for performance, Force Majeure, Uncontrollable Forces, or other such excuses applicable to such other agreement, to the extent inconsistent with the terms of this Agreement, but all other terms and conditions of this Agreement shall remain applicable.
- 14 § 2-609. *Right to Adequate Assurance of Performance.* (1) A contract for sale imposes an obligation on each party that the other’s expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either party the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return. (2) Between merchants the reasonableness of grounds for insecurity and the adequacy of any assurance offered shall be determined according to commercial standards. (3) Acceptance of any improper delivery or payment does not prejudice the aggrieved party’s right to demand adequate assurance of future performance. (4) After receipt of a justified demand failure to provide within a reasonable time not exceeding thirty days such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract.
- 15 *Norcon Power Partners, L.P. v. Niagara Mohawk Power Corp.*, 92 N.Y.2d 458, 682 N.Y.S.2d 664, 705 N.E.2d 656, 37 U.C.C. Rep. Serv. 2d 323 (1998).
- 16 See Platts, Methodology and Specification Guide: North American Electricity map at 10 and passim (Dec. 2005), available at http://www.platts.com/Electric%20Power/Resources/Methodology%20&%20Specifications/na_power_method.pdf?S=n; list of Dow Jones Index pricing points available at <http://www.djindexes.com/mdsidx/?event=energyUSDaily>.
- 17 The CAISO stated that under a locational marginal pricing (LMP) based market design it would provide pricing at individual generation nodes and aggregated pricing points (trading hubs and load aggregation points), including Existing Zone Generation Trading Hubs (EZ Gen Hubs) as successor delivery points for existing internal congestion zones (NP15, SP15 and ZP26), to represent the average price paid to generation within the zone. The definitions and discussion are available at http://www.eei.org/industry_issues/legal_and_business_practices/master_contract/product.htm.
- 18 The definition for SP15 Zone, available at http://www.eei.org/industry_issues/legal_and_business_practices/master_contract/SP_15_Definition_9705.pdf, reads:
- SP15 Zone; provided, however, if the California Independent System Operator or its successor (CAISO) implements trading hubs under a locational marginal pricing design during the Delivery Period, the Delivery Point shall be the Existing Zone Generation SP15 Trading Hub (SP15 EZ Gen Hub), as such trading hub is contemplated by the CAISO in its filing made to ... and approved in principle by FERC pursuant to an Order issued June 10, 2005; provided further, if the SP15 EZ Gen Hub (under any name) is not established as part of a market redesign that is implemented during the Delivery Period, the parties agree to promptly work together in good faith to designate an alternate Delivery Point to reasonably approximate the characteristics of the SP15 Zone.
- 19 A small favor never to be taken for granted. The subcommittee membership included Dede Russo, David Perlman, Randy Osteen, Lisa Mellencamp, Melissa Lauderdale, and the author.
- 20 Explained in an excellent write-up by its chairwoman, available at http://www.eei.org/industry_issues/legal_and_business_practices/master_contract/Sp15NP15DeliveryPointDefinition1.pdf.
- 21 An example of such a clause when continued delivery of physical energy is a paramount consideration:
- Market Redesign.* If the current definition of the Delivery Point set forth in a Transaction is modified, redefined, replaced or eliminated in the transmission provider, control area operator, regional transmission operator or other applicable tariff, deliveries of Product by Seller shall continue but will be instead delivered to or divided among the modified, redefined, replacement or substitute Delivery Points, zones or nodes in a manner that reasonably approximates the characteristics of the originally designated Delivery Point and puts the parties in the same economic position as they were prior thereto, as mutually agreed by the parties negotiating in good faith.
- 22 For example, Postponement is not necessarily an appropriate Disruption Fallback for transactions in wholesale energy (or other commodity transactions, such as wholesale gas under the ISDA North American Gas Annex), because the commodity may in fact change hands on dates during which the commodity pricing mechanism is subject to a disruption, and the selling party should not be deprived of the full value of the commodity on the day on which the transaction takes place.
- 23 See, e.g., 1993 ISDA Commodity Definitions § 7.5; 2005 ISDA Commodity Definitions § 8.5. The market currently

is split on whether to provide for a separately tailored waterfall for Market Disruption Events for physical energy transactions. See previous footnote.

- 24 Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities: Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Order No. 888, 61 Fed. Reg. 21540 (May 10, 1996).
- 25 E.g., the Entergy OASIS, available at <http://oasis.entrerasolutions.com/OASIS/EES>; Southern Company OASIS, available at <http://www.weboasis.com>; and the Tennessee Valley Authority OASIS, available at <http://www.oatioasis.com/tva>. In regions where the FERC has approved an Independent System Operator (ISO) or a Regional Transmission Organization (RTO), the ISO or RTO administers the OATT, is itself the transmission provider, manages transmission reservations and scheduling, and generally, but not always, manages generator interconnections. The original utility transmission owner continues to own the transmission facilities, but delegates these functions and other aspects of control of the transmission system to the ISO or RTO. FERC's theory is that the existence of the ISO or RTO and its expected independence will convey a stronger expectation of open access to the market and thereby enhance competition. ISO/RTOs exist in the mid-Atlantic States (PJM Interconnection), New York (New York Independent System Operator), New England (ISO New England), the Midwest (Midwest Independent System Operator), Southwest (Southwest Power Pool), and California (CAISO). In these regions, parties should be sure to consult the tariffs and market rules of the applicable organization, and not just the utility's tariff.
- 26 Standards of Conduct for Transmission Providers, Order No. 2004, 68 Fed. Reg. 69134 (Dec. 11, 2003); Order No. 2004-A, 69 Fed. Reg. 23562 (Apr. 29, 2004); Order No. 2004-B, 69 Fed. Reg. 48371 (Aug. 10, 2004); Order No. 2004-C, 70 Fed. Reg. 284 (Jan. 5, 2005); all replacing prior rules, Open Access Same-Time Information System and Standards of Conduct, Order No. 889, 61 Fed. Reg. 21737 (May 10, 1996).
- 27 See, e.g., the East Kentucky Power Cooperative, Inc. Standards of Conduct for Transmission Providers, available at http://www.oatioasis.com/EKPC/EKPCdocs/EKPC_SOC.doc.
- 28 There is a good discussion of the distinction between "Codes of Conduct" and "Standards of Conduct" in M. Naeve, J. Richman, D. Hill, et al., *Energy Regulatory Compliance: The Skadden Handbook* at 196-200 (2005). Codes of Conduct are intended to protect captive ratepayers of utilities from preferential dealings between a regulated company and its unregulated affiliates. Standards of Conduct apply to the relationship between the transmission function and its energy affiliates, and are meant to prohibit anti-competitive behavior. Under a Code of Conduct, the regulated merchant function and regulated transmission function are on the same side of the wall separating them from their unregulated affiliates; under Standards of Conduct, the regulated merchant function joins the unregulated affiliates on the other side of the wall.
- 29 Standardization of Generator Interconnection Agreements and Procedures, Order No. 2003, 68 Fed. Reg. 49846 (Aug. 19, 2003); Standardization of Small Generator Interconnection Agreements and Procedures, Order No. 2006, 70 Fed. Reg. 34100 (Jun. 15, 2005); see also Interconnection for Wind Energy, Order No. 661, 70 Fed. Reg. 34993 (Jun. 16, 2005).
- 30 See, e.g., *Southwest Power Pool, Inc.*, Order (Docket No. ER05-666-003), 112 FERC ¶ 61,100 (issued Jul. 21, 2005) ("[W]e find the gross negligence and intentional wrongdoing standard to be just and reasonable for several reasons. ... [P]rior to unbundling, many state commissions had approved retail tariff provisions permitting utilities to limit their liability for service interruptions to instances of gross negligence or willful misconduct. ... [S]uch provisions balance lower rates for all customers against the burden of limited recovery for some ... We agree.").
- 31 See, e.g., *Southern Company Services, Inc.*, Order (Docket No. ER06-100-100), 113 FERC ¶ 61,239 (issued Dec. 2, 2005); *Midwest Independent Transmission System Operator, Inc.*, Order (Docket Nos. ER04-1160-000 ER04-1160-001), 110 FERC ¶ 61,164 (issued Feb. 16, 2005).
- 32 E.g., Consolidated Edison Co. of N.Y., Inc. P.S.C. No. 9 - Electricity First Revised Leaf No. 62-A Superseding Original Leaf No. 62-A, Date of Issue: Aug. 16, 2004; Date Effective: Nov. 15, 2004 (available at <http://www.coned.com/documents/elec/062A-064.pdf>): III.14. Liability:
- (A) Continuity of Supply: ... in case the supply of service shall be interrupted or irregular or defective or fail from causes beyond its control or through ordinary negligence of employees, servants or agents the Company will not be liable therefor. The Company may, without liability therefor, interrupt service to any Customer or Customers in the event of emergency threatening the integrity of its system, if, in its sole judgment, such action will prevent or alleviate the emergency condition. ... [T]he Company will compensate Customers for losses ... which result from power failures attributable to malfunctions in the Company's local distribution system as set forth below. The Company will reimburse residential Customers ... for actual losses of food spoiled due to lack of refrigeration ... upon submission of an itemized list and proof of loss, up to a maximum of \$350 for any one Customer for any one incident. The Company will reimburse [business] Customers ... for actual losses of perishable merchandise spoiled due to lack of refrigeration, upon submission of an itemized list and proof of loss, up to a maximum of \$7,000 for any one Customer for any one incident. The Company's total liability ... is limited to \$10,000,000 per incident. ... The Company shall not be responsible ... for losses of power attributable to deficiencies in generation or transmission facilities, nor for losses of power arising from malfunctions in the local distribution system attributable to directives from the New York Independent System Operator or to conditions beyond the Company's control, such as storms, floods, vandalism, strikes, or fires or accidents external to the Company's operations, as long as reasonable efforts are made to restore service as soon as practicable. ... This provision shall not affect the Company's liability for damages resulting from its gross negligence or willful misconduct.
- 33 See, e.g., *Food Pageant, Inc. v. Consolidated Edison Co., Inc.*, 54 N.Y.2d 167, 445 N.Y.S.2d 60, 429 N.E.2d 738 (1981); see also *Milliken & Co. v. Consolidated Edison Co. of New York, Inc.*, 84 N.Y.2d 469, 619 N.Y.S.2d 686, 644 N.E.2d 268 (1994) (utility does not have a duty of care to non-customers hurt by failure to provide electricity to the buildings they are in).
- 34 Here is a clause that a major New York investment bank typically adds to its ISDA Master Agreements:
- Upon the occurrence of an Event of Default or Termination Event under Section 5(b)(iv) with respect to a party (X), the other party (Y) will have the right (but not be obliged) without prior notice to X or any other person

to set-off or apply any obligation of X owed to Y (or any Affiliate of Y) (whether or not matured or contingent and whether or not arising under this Agreement, and regardless of the currency, place of payment or booking office of the obligation) against any obligation of Y (or any Affiliate of Y) owed to X (whether or not matured or contingent and whether or not arising under this Agreement, and regardless of the currency, place of payment or booking office of the obligation). Y will give notice to the other party of any set-off effected under this Section 6(f).

Utilities might be restricted by regulators from using ratepayer assets to contract for the benefit of non-ratepayer assets, and need to strike the references to affiliates. Additionally, the last sentence of the example is probably best changed to provide instead that no notice will be given, so that there will be mutuality and no violation of the automatic stay (11 U.S.C.A. § 553), and that if what is sought as a setoff is potentially a preference, the argument that the 90-day clock of 11 U.S.C.A. § 547 did not need to wait for a notice before starting to tick is preserved.

35 The waiver builds in a reference to FERC 2002 policy statement proceedings that may or may not still be pending. ISDA/EEI North American Power Annex, Part [6](h)(iii)(ccc). And not that a specific waiver is necessarily required, anyway. See, e.g., *PacifiCorp v. Reliant Energy Services, Inc., et al.*, Order, 105 FERC ¶ 61,184 at P 48 (Docket Nos. EL02-80-001 et al.), (issued Nov. 10, 2003) (parties might be waiving Mobile-Sierra without explicitly so stating).

36 The EEI Master Agreement and continually developed optional provisions are available at http://www.eei.org/industry_issues/legal_and_business_practices/master_contract/index.htm. For the story of the development of the EEI Master Agreement, and the drafters' intent for many of its clauses, see Katz, *Using the EEI-NEM Master Contract to Manage Power Marketing Risks*, 21 Energy L.J. 269 (2000). The WSPP Agreement is a FERC-filed and approved multilateral umbrella contract, allowing organizations to transact under its terms by joining the WSPP itself as members. Information concerning the WSPP and membership is available at <http://www.wspp.org>.

37 The EEI Master Agreement provides in § 5.1(c), as does Part [6](i)lii(B) of the Power Annex, that "failure to perform ... obligations to deliver or receive the Product," is not an Event of Default and that "the exclusive remedy" for such an event "is provided in Article Four" (or, in the case of the Power Annex, Section 5(a)(ii) of the ISDA Master Agreement). Its firm energy product is:

"Firm (LD)" means, with respect to a Transaction, that either Party shall be relieved of its obligations to sell and deliver or purchase and receive without liability only to the extent that, and for the period during which, such performance is prevented by Force Majeure. In the absence of Force Majeure, the Party to which performance is owed shall be entitled to receive from the Party which failed to deliver/receive an amount determined pursuant to Article Four.

38 FERC Notice of Proposed Rulemaking (NOPR) on Preventing Undue Discrimination and Preference in Transmission Service, 71 Fed. Reg. 32685 (Docket Nos. RM05-25-000 and RM05-17-000), pp. 283-297 (June 6, 2006). Note FERC determined that a firm purchase need not be backed by a capacity purchase to qualify as a network resource in *Illinois Power Co.* 102 FERC ¶ 21,257 at P 14 (2003), *reh'g denied* 108 FERC ¶ 61,175 (2004), and that a network customer can designate as a network resource a system purchase that is

not backed by a specific generator, *Wisconsin Public Power, Inc. v. Wisconsin Public Service Corp.*, 84 FERC ¶ 61,120 at 61,650-61,651 (1998).

39 407. We propose to maintain our current policy regarding the power purchase agreements that network customers may designate as network resources. In particular, a network customer will continue to be able to designate resources from system purchases not linked to a specific generating unit, provided the [PPA] is not interruptible for economic reasons, [and] does not allow the seller to fail to perform under the contract for economic reasons

408. A [PPA] that is structured so that a network customer cannot specify all of the information required in section 29.2 [of the pro form OATT, including source of supply, control area location, transmission arrangements and delivery point(s) to the transmission provider's system] cannot be designated as a network resource. 409. In response to suggestions that liquidated damages products should not be designated as network resources because they are interruptible for economic reasons, we clarify that network customers may not designate as network resources those [PPAs] that give the seller a contractual right to compensate the buyer instead of delivering power even if the seller is able to deliver power. For instance, a network customer may not designate as a network resource a purchase agreement that allows the seller to interrupt service for reasons other than reliability, but allows the buyer to force delivery at a higher price. In addition, a network customer may not designate as a network resource a [PPA] that requires a seller to pay the buyer's cost of replacement power when the seller chooses not to deliver energy for economic reasons.

FERC Notice of Proposed Rulemaking (NOPR) on Preventing Undue Discrimination and Preference in Transmission Service, 71 Fed. Reg. 32685 (Docket Nos. RM05-25-000 and RM05-17-000), pp. 287-290.

40 In western North America, the debate regarding the extent of a seller's obligation to provide operating reserves in support of firm energy products has been ongoing for some time now, and particularly intense in the context of WSPP Schedule C energy, which is defined in Schedule C of the Western Systems Power Pool Agreement, available at http://intranet.wspp.org/WSPP_Agreements/Forms/AllItems.aspx. In contrast to the EEI Master Agreement or the Power Annex, the WSPP in §§ 21.3(b) and 22.1 does not affirmatively state that failure to deliver a product is not an Event of Default, but it does not state that it is, either, and provides liquidated damages as the "sole and exclusive remedy". Whether this is a limitation on liability for a default, or an economic choice, is a question of the Utah law that governs the WSPP. WSPP Schedule C energy is defined in § C-3.8 as "interruptible only if the interruption is: (a) within the recall time or allowed by other applicable provisions governing interruptions of service ... mutually agreed to by the [parties], (b) due to an Uncontrollable Force , or (c) where applicable, to meet Seller's public utility or statutory obligation to its customers. If service ... is interrupted under Section C-3.8(a) or (b), neither [party] shall be obligated to pay damages[; otherwise], the Non-Performing Party shall [pay] damages"

The circumstances set forth in § C-3.8(a), (b) and (c) all seem related to "reliability." See FERC NOPR on Preventing Undue Discrimination, *supra*, P 409. The popularity of this standardized energy trading product in the West, along with

ongoing disputes as to the nature of the reserves obligations inherent in the product, have led market participants to emphasize the NERC FS (Firm Service) tags assigned to it. Long-term trades in WSPP Schedule C energy face the issue of what they trade if the WSPP changes the definition mid-way through the term. Here is an example provision sometimes added to the EEI Master Agreement (and Power Annex) that summarizes the key features of the product:

“West Firm”, or “WSPP Schedule C” or “Schedule C” or “WSPPC-Firm” or any similar description means with respect to a Transaction, a Product that is or will be scheduled as firm energy consistent with the most recent rules adopted by the WECC for which the only excuses for failure to deliver or receive are if an interruption is (i) due to an Uncontrollable Force as provided in Section 10 of the WSPP Agreement; or (ii) where applicable, to meet Seller’s public utility or statutory obligations to its customers. Notwithstanding any other provision in this Agreement, if Seller exercises its right to interrupt to meet its public utility or statutory obligations, Seller shall be responsible for payment of damages for failure to deliver firm energy as provided in Article 4 of this Agreement.

Note that whether the product allows seller the choice of delivering energy or cash for cover damages is also controlled by the general terms of the enabling agreement itself (and confirmations, as applicable). See *supra*. One view is that WSPP Schedule C includes both capacity and energy components, and so includes the requirement of steel in ground, somewhere, but others might argue that the liquidated damages measure under the WSPP does not include damages for failure to provide the agreed capacity.

- 41 Or other FERC-deemed essential elements required to meet § 29.2 of the pro forma OATT as applicable. Additionally, the WSPP through its committees can amend the WSPP and Schedule C definition to address the specific infirmities once known and articulated, should the requisite 90% supermajority be reached.
- 42 For example, in the case of WSPP Schedule C (or “West Firm”) traded under an EEI Master Agreement or the Power Annex by virtue of the aforementioned reach-through clause. With respect to the WSPP itself, failure to deliver (except when due to force majeure) is already an event of default, but as the remedy is liquidated damages for the energy, from a practical standpoint some might treat WSPP Schedule C as tantamount to EEI Firm (LD), with the only difference being that designation of default with no difference as to damages. In some circumstances that designation could matter, e.g.,

which party has clean hands, or the matter under discussion here. Another approach is to provide in the EEI Master Agreement or Power Annex itself that, although individual failures to deliver or receive energy might not be events of default, enough such failures will be, so that the “economic choice” is removed and, more importantly for the utility, reliability of supply is assured. Here is an example clause for the Power Annex:

Additional Events of Default. The following are additional Events of Default: (i) If, during any consecutive 90 day period under any Transaction, there occur five or more “Seller Failures” as that term is used in Part [6](c)(i), where Seller is the Defaulting Party and Buyer is entitled to its remedies under Part [6](c)(ii). (ii) If, during any consecutive 90 day period under any Transaction, there occur five or more “Buyer Failures” as that term is used in Part [6](c)(ii), where Buyer is the Defaulting Party and Seller is entitled to its remedies under Part [6](c).

- 43 See, e.g., *Southern California Edison Co.*, Order (Docket Nos. ER02-2263-003, ER02-2263-004, ER02-2263-005), 114 FERC ¶ 61,268 (issued Mar. 16, 2006) (day-ahead capacity call option that can be satisfied with liquidated damages sufficient control over generating capacity to require change in status filing). See also Weinstein, *Inside California’s Power Crisis*, 5 *Energy & Power Risk Management*, Electricity Special Report at p. 17 (Mar. 2001).
- 44 See, e.g., Freedman, *Asking Tough Questions of Generators and Control Areas: Who Will Be Responsible for Providing Operating Reserves?*, presentation to Northwest Independent Power Producers Coalition, Dec. 7, 2004.
- 45 E.g., California’s Resource Adequacy Requirements (RAR) program establishes system procurement obligations requiring load-serving entities to procure the capacity resources, including reserves, needed to serve aggregate system load; the issue of being resource-adequate on an aggregate system basis with transmission-constrained local load pockets is being addressed through what are known as the two-phase Local RAR proceedings. California Public Utilities Commission, draft decision of ALJ Wetzell, *Opinion on Local Resource Adequacy Requirements* at p.5, Rulemaking 05-12-013 (mailed May 30, 2006), available at http://www.cpuc.ca.gov/PUBLISHED/COMMENT_DECISION/56784.htm.