



Market Participant Guarantee Agreement

Credit Work Group Meeting

April 25, 2008

- **Finance & Audit (F&A) Committee Request**
- **Credit Work Group (CWG) – Market Participant (MP) Guarantee Agreement Subgroup**
- **Risk Factors in the ERCOT market**
- **Walk through of default scenarios w/ a guarantor**
- **Business Points in the MP Guarantee Agreement**
- **Summary**
- **Conclusion**

- **At its special meeting on February 6, 2008, the F&A Committee asked:**
 - ERCOT Staff to
 - have outside counsel review the MP Guarantee Agreement and propose changes that would strengthen the document
 - report back to F&A on the proposed changes, including how the changes will strengthen the document
 - CWG to review and comment on proposed changes to the MP Guarantee Agreement

- **The CWG Subgroup has reviewed the initial draft proposed by outside counsel and some participants have been reluctant to accept changes that strengthen the MP Guarantee Agreement.**
- **It would be helpful to discuss the most significant open business points with the entire CWG before finalizing CWG comments on the changes proposed by outside counsel.**

- **ERCOT has unique risk characteristics, which include:**
 - ISO cannot (in the short term) limit MWh use of BES
 - Determined by QSE
 - By default, if a QSE does not have a bilateral contract, Load is met through BES
 - It can go from 0 to 20% or 40% or 100% of Load before ERCOT Credit Staff is aware of the change

 - BES prices can fluctuate dramatically and unexpectedly due to
 - the amount of MWhs taken from BES
 - any shortage of generation during a timeframe
 - scarcity pricing incentive practices
 - the nature of an energy-only market
 - \$3,000 price cap

 - Collateral calculation is based on historical MWh usage, which, in stress cases, does not provide sufficient collateral to cover forward exposure

- **As a result of the above, significant exposure can occur before it is identified by ERCOT and collateralized**
 - From unexpected market shocks (curtailments, weather events, etc.)
 - From individual Market Participant behavior

- **ERCOT Staff assumption (to be confirmed by CWG): ERCOT, as the ISO, acts as supplier of last resort and, in extreme situations, is more likely than any one Counter-Party to incur loss given its high level of price and volume volatility and inability to hedge exposure**

- **Since ERCOT has not had to enforce the MP Guarantee Agreement, want to confirm how the process will go in a liquidation scenario.**

- **Example 1: Counter-Party represents Load**
 - EAL is \$15,000,000, ERCOT holds the following collateral:
 - Guarantee for \$10,000,000 and LC for \$5,000,000
 - Market event or CP activity generates an exposure through NLRI of \$40,000,000
 - ERCOT makes a collateral call for an additional \$25,000,000
 - Counter-Party fails to make the collateral call and therefore commits a material breach under the Standard Form Agreement (SFA).
 - Pursuant to SFA, ERCOT issues a breach notice giving Counter-Party two (2) Business Days to cure.
 - Counter-Party fails to cure the breach which constitutes an event of default under the SFA.
 - Then, either
 - Counter-Party files for bankruptcy protection; or
 - ERCOT begins Mass Transition process pursuant to Protocol Section 15.1.3
 - ERCOT makes demand on the guarantee and the LC for the full amount
 - LC funds by close of business on next banking day
 - Guarantee – ?

➤ **Example 2: Counter-Party holds CRRs**

- EAL is \$10,000,000, ERCOT holds the following collateral:
 - Guarantee for \$7,000,000 and LC for \$3,000,000
- System constraints change and exposure is \$40,000,000
- ERCOT makes a collateral call for an additional \$30,000,000
- Counter-Party fails to make the collateral call and therefore commits a material breach under the SFA.
- Pursuant to SFA, ERCOT issues a breach notice giving Counter-Party two (2) Business Days to cure.
- Counter-Party fails to cure the breach which constitutes an event of default under the SFA.
- Counter-Party files for bankruptcy protection
- ERCOT makes demand on the guarantee and the LC for the full amount
 - LC funds by close of business on next banking day
 - Guarantee - ?

- **What scenarios have Market Participants encountered where they have needed to draw on a guarantee?**
- **Known scenarios where subsidiaries have been placed in bankruptcy or allowed to default (but not the parent)**
 - ERCOT Staff assumption (to confirm with CWG): When a subsidiary is allowed to default or be placed into bankruptcy, it is a conscious decision made on the part of the parent entity (often the guarantor)
- **Known scenarios where both the subsidiary and the parent has defaulted or filed bankruptcy**

Business Points in the MP Guarantee Agreement

Current document:

1. Guarantor shall “immediately on demand and without presentment . . . , pay the amount due”
2. Silent as to defenses that may be raised
3. Revocation on 30 days notice
4. Liabilities – under Protocols and per SFA
5. Maximum amount Guarantor liable

Proposed changes:

1. Specifically define payment time frame consistent with LC requirements
2. Clarify that guarantor waives right to all Counter-Party defenses. Defenses remain with the Counter-Party and are not diminished
3. Irrevocable throughout the agreed term of the guarantee
4. Liabilities – all liabilities that may be owed and clarifies that status in bankruptcy
5. “Credit Support Amount” – option to be unlimited?

- **Business points in the current document are, in many cases, common practice by Counter-Parties**
 - Current MP Guarantee Agreement is generally considered “adequate” by ERCOT Legal and outside counsel, however
 - In places, MP Guarantee Agreement is not as clear as it could be and
 - It does not fully incorporate the concept of the guarantor “standing in the shoes” of the Counter-Party.

- **Credit risk at ERCOT can be more extreme than at individual Counter-Parties**

- **At the point in time that the document must be enforced, either the parent**
 - Is defaulting as well, or
 - The parent has allowed the subsidiary to default and be liquidated

Given the circumstances under which ERCOT will likely be enforcing a guarantee, it seems reasonable to ensure that the MP Guarantee Agreement is very clear and relatively easy to enforce

- It seems particularly important then that ERCOT's position using the MP Guarantee Agreement should be no less than for other collateral required under the ERCOT Protocols
 - Timing of receipt of funds
 - Defenses available
 - Treatment in bankruptcy

- If the guarantor is considered to be “standing in the shoes” of the Counter-Party, the MP Guarantee Agreement should be stronger than other forms of collateral (e.g. more like doing business with the guarantor directly)
 - Irrevocable throughout the agreed term of the guarantee
 - For an unlimited amount