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MEMORANDUM

TO: California Independent System Operator Corporation ("CAISO")[1]

FROM: Keith J. Cunningham, Deborah L. Shaw and Ryan F. Kelley KJC

RE: Enforceability of the Net Billing and Setoff Provisions in the CAISO's Tariff in the Event of a CAISO Participant Bankruptcy

DATE: April 26, 2013

EXECUTIVE SUMMARY

In connection with your application for an exemption from the jurisdiction of the Commodity Futures Trading Commission ("CFTC") under the Commodity Exchange Act, you have asked us to advise you on the enforceability in a CAISO participant bankruptcy of the net billing and setoff provisions found in the CAISO tariff (the "Tariff").[2] More specifically, you have asked us whether the CAISO's relationship with its participants will satisfy the requirement found in Section 553 of the United States Bankruptcy Code[3] that there be "a mutual debt owing by such creditor to the debtor that arose before the commencement of the [bankruptcy] case . . . against a claim of such creditor against the debtor that arose before the commencement of the case. . . ."[4]

As is more fully discussed in this memorandum, we believe that there are two separate and independent bases upon which to conclude that the net billing and setoff provisions found in the Tariff will be enforceable in accordance with their terms in a CAISO participant bankruptcy."[5] First, when the CAISO participates in sales transactions as the contracting counterparty, it becomes the seller to each buyer and the buyer to each seller. That is, the CAISO undertakes obligations to its participants in its own right and capacity in exchange for reciprocal obligations from the participants to the CAISO. Accordingly, when the Tariff is

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[1] The memorandum is subject to the qualifications set forth in Exhibit A hereto.

[2] CAISO's net billing and setoff provisions are found in Sections 11.29.10.1 and 11.29.13.7 of the Tariff, which is the CAISO Fifth Replacement FERC Electric Tariff, a full copy of which is available at http://etariff.ferc.gov/TariffBrowser.aspx?tid=848.

[3] 11 U.S.C. §§ 101-1532 (the "Bankruptcy Code").

[4] *Id.* § 553(a). Setoff is the process by which parties who owe obligations to each other may apply their debts against each other, effectively net the difference, and thus avoid the "absurdity of making A pay B when B owes A." *See Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913).

[5] The Tariff refers to the CAISO as "contracting counterparty" specifically. Throughout this memorandum, the more general term "central counterparty" is used interchangeably therewith.

implemented in accordance with its terms, a federal court exercising bankruptcy jurisdiction and reasonable judgment after full consideration of all relevant factors should find that the mutual debt requirement set forth in Section 553 of the Bankruptcy Code is satisfied.

Second, because Section 201 of the Federal Power Act (the "FPA")[6] gives the Federal Energy Regulatory Commission ("FERC" or the "Commission") exclusive jurisdiction over the transmission of electric energy in interstate commerce and the sale of electricity at wholesale in interstate commerce,[7] the CAISO's net billing and setoff provisions should be enforceable against a bankrupt CAISO participant unless FERC takes action to relieve that participant from those terms. This conclusion principally relies on the United States Supreme Court's long line of cases holding that (i) FERC has exclusive jurisdiction over the reasonableness of filed rates, including the non-price terms and conditions in a FERC-approved tariff, such as the CAISO's net billing and setoff provisions,[8] and (ii) such filed rates may not be collaterally attacked in state or federal courts, or modified other than by FERC or an appellate court reviewing FERC's decision.[9] Although we are aware of no court decision that has considered the interplay between Section 553 of the Bankruptcy Code and the enforceability of a net billing or setoff provision in a FERC-approved tariff, we find it persuasive that in each instance in which a federal court has considered the interplay between the Bankruptcy Code and the FPA, it has respected FERC's exclusive jurisdiction and carefully refrained from taking action that would alter the rates, terms or conditions of the FERC-approved agreement before the court.

FACTUAL BACKGROUND

A. *Operation and Role of the CAISO*

The CAISO is a nonprofit public benefit corporation charged with operating the high-voltage electrical power lines of several utilities.[10] In addition to operating this electric transmission grid, the CAISO administers certain markets for electricity and capacity that are necessary for reliable operation of the grid, including the congestion revenue rights and convergence bidding markets that are the subject of the CAISO's CFTC exemption application.[11] The CAISO settles transactions by participant sellers and purchasers in these

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[6] 16 U.S.C. § 824.

[7] *Id.* § 824(b). *See also New York v. FERC*, 535 U.S. 1, 18-19 (2002).

[8] *See, e.g., Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354, 371 (1988) (filed rates also include non-price terms and conditions).

[9] *Id.* ("The only appropriate forum for such a challenge [of a filed rate] is before the Commission or a court reviewing the Commission's order."). FERC's exclusive jurisdiction has been preserved in recent federal legislation. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 expressly preserves FERC's exclusive jurisdiction over the reasonableness of filed rates, even while recognizing the CFTC's jurisdiction over certain futures and swaps transactions and the markets on which they are traded. *See* Pub. L. 111-203, H.R. 4173, at § 722(e), codified at 7 U.S.C. § 2(a)(1) (expressly preserving FERC's exclusive jurisdiction over filed rates).

[10] Officer's Certificate, Exhibit B, ¶ 1.

[11] *Id.*, ¶ 2.

markets pursuant to the rates, terms and conditions of a tariff approved by the FERC.[12] As a prerequisite to participation in the markets administered by the CAISO, each participant must execute a form agreement by and between itself and the CAISO (each a "Participant Agreement") which, among other things, incorporates by reference the terms of the Tariff and provides that each participant agrees to be bound by the terms of the Tariff.[13] The form of each Participant Agreement used by the CAISO is appended to and made a part of the Tariff.[14]

B. The CAISO as Central Counterparty

The Tariff provides that the CAISO is the contracting counterparty for purchase and sale transactions under the Tariff. Section 11.29 states, in relevant part, that

> [t]he CAISO shall be the contracting counterparty, in its own name and right, to each Scheduling Coordinator, CRR Holder, Black Start Generator, or Participating TO for any purchase or sale of any product or service, or for any other transaction, that is financially settled by the CAISO under the CAISO Tariff, except under the following circumstances;
>
> > (i) The CAISO shall not be the contracting counterparty for transactions that procure Station Power for a Generating Unit located in Mexico or for transactions that procure Energy or Ancillary Services within Mexico; for such transactions, the CAISO will not act as principal but instead as agent for and on behalf of the relevant Scheduling Coordinators.
> >
> > (ii) The Provisions of this Section 11.29 will not apply to the billing and payment of transactions associated with Trading Days that occurred prior to September 1, 2012. Billing and payment of such transactions shall be governed by the terms of the tariff effective on the Trading Days.
> >
> > (iii) The CAISO's status as contracting counterparty is not intended to affect the tax-exempt status of transmission facilities or entitlements subject to the CAISO's operational control.

Consistent with this role, the Tariff provides that the CAISO may, in its own right, establish and maintain bank accounts and obtain lines of credit.[15]

The Tariff also vests in the CAISO the exclusive rights to take action on default by a participant. Section 11.29.13.5 provides that

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[12] The Tariff was accepted by FERC most recently in Docket ER10-1563-001, as were the *pro forma* Participation Agreements appended thereto. *Id.*, ¶ 4; http://etariff.ferc.gov/TariffBrowser.aspx?tid=848.

[13] *See, e.g.*, Tariff, § 4.4.1(g) (Utility Distribution Companies); § 4.5.1 (Scheduling Coordinators); § 4.6.3 (Participating Generators); § 4.6.3.3 (Qualifying Facility Participating Generators); § 4.7 (Participating Loads); § 4.10.1.9.1 (Congestion Revenue Rights Entities); § 4.11.1.1 (Small Utility Distribution Companies); and § 4.14.1.8.1 (Convergence Bidding Entities).

[14] *See* Tariff, App. B.

[15] *See* Tariff, § 11.29.9.2.

> [t]he CAISO shall as soon as possible after taking action under 11.29.13.4 take any steps it deems appropriate against the defaulting Scheduling Coordinator to recover the default amount (and any Interest as set out in Section 11.29.13.3 including enforcing any Financial Security, exercising its rights of recoupment or set-off and/or bringing proceedings against the defaulting Scheduling Coordinator or CRR Holder pursuant to Section 11.29.21.1.

Section 11.29.20 further provides that

> [i]n the event of any default under the CAISO Tariff, the CAISO shall, in addition to any other remedies available at law in equity or under the CAISO Tariff, have the sole and exclusive right to take debt collection action against a Scheduling Coordinator or CRR Holder on account of a default under the terms of the CAISO Tariff. The CAISO shall make commercially reasonable endeavors to prevent any payment default or recover any default amount. The CAISO shall be entitled to recover from the defaulting Scheduling Coordinator or CRR Holder all costs and expenses associated with its collection efforts, including Interest, attorney's fees, and any related transaction costs as provided in Section 11.29.13.1.

C. Net Billing and Setoff Terms

The net billing and setoff terms in the Tariff that are central to the analysis in this memorandum are found in Section 11 of the Tariff. Section 11.29.10.1 of the Tariff, which governs the CAISO's monthly billing process, provides, in relevant part, that

> the net Invoice or Payment Advice for a Scheduling Coordinator, CRR Holder, Black Start Generator or Participating TO will reflect the entity's net financial obligations in all billing periods.

Thus, the CAISO must "net" each participant's purchases and sales for each billing period and then reflect the difference on the participant's invoice as one single amount that is owed by the invoiced participant, or owed to the participant if the participant's sales exceeded purchases for that billing period. Accordingly, if a participant has $1,000 in purchases and $900 in sales in a particular billing period, then the Tariff requires the CAISO to invoice the participant $100.

Section 11.29.13.7 of the Tariff addresses the rights of the CAISO if a participant defaults in the payment of an invoice. It provides, in relevant part, that

> [t]he CAISO is authorized to recoup, set off and apply any amount owed on any Payment Advice to which any defaulting CAISO Debtor[16] is or will be entitled, in or towards the satisfaction of any of that CAISO Debtor's debts arising under the CAISO Settlement and billing process.

[16] The term "CAISO Debtor" is defined in the Tariff as a "Business Associate that is required to make a payment to the CAISO under the CAISO Tariff and agreements with the CAISO." Tariff, App. A. The term "Business Associate" means "[a]ny entity with whom the CAISO interacts related to the CAISO Markets." *Id.*

This provision authorizes the CAISO to set off separate invoices as opposed to netting amounts reflected in a single invoice.

DISCUSSION

PART I: The CAISO's net billing and setoff rights should be enforceable under Section 553 of the Bankruptcy Code

A. Section 553 of the Bankruptcy Code

Section 553 of the Bankruptcy Code preserves the right of a "creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case . . ." as that right exists under applicable nonbankruptcy law.[17] Accordingly, the creditor must have a claim against the debtor and owe a debt to the debtor.[18] Both the debt and the claim must arise prior to the commencement of the bankruptcy case. The debt and the claim must be valid and enforceable under applicable state or federal substantive law.[19] Additionally, the debt and claim must be *mutual*.[20]

Even where these basic requirements are satisfied, Section 553 provides a number of exceptions to its protections.[21] As the facts and circumstances of any given bankruptcy case

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[17] 11 U.S.C. § 553(a).

[18] *See id.*; *Pub. Serv. Co. v. N.H. Elec. Coop., Inc. (In re Pub. Serv. Co.)*, 884 F.2d 11, 14 (1st Cir. 1989).

[19] *See* 11 U.S.C. § 553(a); *Pub. Serv. Co.*, 884 F.2d at 14.

[20] *See* 11 U.S.C. § 553(a); *Pub. Serv. Co.*, 884 F.2d at 14.

[21] In full, Section 553 provides:

> (a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that—
> (1) the claim of such creditor against the debtor is disallowed;
> (2) such claim was transferred, by an entity other than the debtor, to such creditor—
> (A) after the commencement of the case; or
> (B)(i) after 90 days before the date of the filing of the petition; and
> (ii) while the debtor was insolvent (except for a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, 560, or 561); or
> (3) the debt owed to the debtor by such creditor was incurred by such creditor—
> (A) after 90 days before the date of the filing of the petition;
> (B) while the debtor was insolvent; and
> (C) for the purpose of obtaining a right of setoff against the debtor (except for a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, 560, or 561).
> (b)(1) Except with respect to a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, 560, 561, 365(h), 546(h), or 365(i)(2) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim

will ultimately determine the extent to which, if at all, the CAISO may retain amounts based on the setoff rights established under the Tariff, we limit our discussion here to consideration of whether transactions under the terms of the Tariff effect mutual debts as between the CAISO and its participants so as to render the Tariff's setoff provisions enforceable under Section 553.

B. The CAISO Satisfies Section 553's Mutuality Requirement

As a preliminary matter, the Bankruptcy Code's setoff provisions do not apply to net billing. This is primarily because net billing is integral to and inseparable from the rate setting process established by the Tariff and, therefore, clearly protected by the filed rate doctrine discussed below. Additionally, net billing is not an offset of debts and claims because it is a prerequisite to the very determination of the debts and claims themselves; that is, net billing is a mere accounting method - arithmetic - for arriving at the actual amount of a party's obligation.[22] The entire liability owing from each participant in any given billing period, or, conversely, its entire right to payment, is derived from the netting process, which is the difference between the market participant's total purchases and its total sales for that period. Legally, no "gross" liability or right exists prior to the netting equation. This likely explains why a bankruptcy court that extensively examined Section 553 setoff issues in the context of "interline" shipments among multiple freight carriers referenced, but did not discuss, the netting that was performed by a central clearinghouse established by the parties for the purpose of arriving at each carrier's monthly liability or credit.[23] It does not appear that the net billing practice (in the form of net position reports provided monthly by the clearinghouse) was challenged in that case; rather, it was the setoff of amounts owed by a debtor to the other carriers during the preference period that was at issue. In any event, even if net billing is challenged as a setoff in a CAISO participant bankruptcy, net billing should withstand such challenge for the reasons that follow.

1. The CAISO has a right of setoff under non-bankruptcy law

To enforce a setoff right, a creditor must establish that (a) it has a right of setoff under non-bankruptcy law, and (b) that this right should be preserved in bankruptcy under

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> against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of—
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> (A) 90 days before the date of the filing of the petition; and
>
> (B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.
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> (2) In this subsection, "insufficiency" means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.
>
> (c) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

11 U.S.C. § 553.

[22] *See, e.g., Pettibone Corp. v. United States*, 34 F.3d 536, 539 (7th Cir. 1994).

[23] *Howard v. Burlington N. & Santa Fe Ry. Co. (In re Bangor & Aroostook R.R. Co.)*, 320 B.R. 226, 229, n. 6 (Bankr. D. Me. 2005).

Section 553 of the Bankruptcy Code.[24] The CAISO will meet each of these requirements if it enforces its setoff rights under, and in accordance with, the terms of the Tariff.

The CAISO's rights to setoff are expressly provided by the Tariff.[25] As discussed in more detail in Part II below, the setoff (and net billing) provisions in the Tariff and the *pro forma* Participation Agreements constitute filed rates subject to the filed rate doctrine, and because they constitute "filed rates," they carry the force of federal law.[26] Because the Tariff that expressly grants the CAISO setoff rights carries the force of law, we believe it is self-evident that the CAISO possesses an enforceable right of setoff under non-bankruptcy law.

2. *Enforcement of the setoff provisions in the Tariff will satisfy the mutuality requirement of Section 553 of the Bankruptcy Code*[27]

A creditor seeking to set off obligations pursuant to Section 553 of the Bankruptcy Code must establish that the obligations are "mutual."[28] Mutuality is strictly construed against the party seeking setoff.[29] Mutuality is not defined in the Bankruptcy Code, but courts generally recognize it to exist where the obligations are owed in the same right, between the

[24] *In re Garden Ridge Corp.*, 338 B.R. 627, 632 (Bankr. D. Del. 2006).

[25] *See* Tariff, §§ 11.29.10.1 (authorizing net billing) and 11.29.13.7 (authorizing setoff between invoices).

[26] *See infra* note 71.

[27] As a preliminary matter we note that the CAISO's defined setoff rights with respect to some transactions under the Tariff may be protected by Section 561(a) of the Bankruptcy Code, which creates a safe harbor for the protection of termination and offset rights under certain securities, commodities, and forward contracts. Although one bankruptcy judge has found that Section 561(a) does not override the mutuality requirement for setoff, a plausible argument can be made that the plain language of the statute belie this conclusion. *See In re Lehman Bros. Holdings Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010), *aff'd* 445, B.R. 130 (S.D.N.Y. 2011); *In re Lehman Bros. Inc.*, 458 B.R. 134 (Bankr. S.D.N.Y. 2011).

[28] *In re Braniff Airways, Inc.*, 814 F.2d 1030, 1035 (5th Cir. 1987) (Setoff requires (1) a pre-petition debt owed by the creditor to the debtor; (2) a pre-petition claim of the creditor against the debtor; and that (3) "the debt and claim are mutual obligations") (emphasis added); *BEA Systems, Inc. v. Shubert (In re Winstar Commc'ns.)*, 315 B.R. 660, 662-63 (D. Del. 2004) (to establish setoff right the creditor must show mutuality of obligation); 11 U.S.C. §553(a) ("[T]his title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor. . . .").

[29] *Cairns & Assocs., Inc. v. Conopco, Inc. (In re Cairns & Assocs., Inc.)*, 372 B.R. 637, 660 (Bankr. S.D.N.Y. 2007).

same parties standing in the same capacity.[30] Therefore, for "mutuality to exist, the debts must exist between the same parties in the same capacity."[31]

Recent amendments to the CAISO Tariff clearly establish the CAISO as a contracting counterparty in its own name and right, with only limited exception, to any transaction governed by the terms of the Tariff.[32] Central counterparties have long been utilized nationally and internationally in various financial and commodity exchange markets to manage risk of default among market participants.[33] Using central counterparties to clear marketplace transactions

> alters the allocation of performance risk that is inherent in [market] trades. In a traditional [market] transaction, the original counterparties remain at risk to the failure of each other to perform on their obligations for the life of the contract. In contrast to such "bilateral" trades, when trades are cleared the

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[30] *Meyer Med. Physicians Group, Ltd. v. Health Care Serv. Corp.* 385 F.3d 1039, 1041 (7th Cir. 2004); *In re U.S. Aeroteam, Inc.*, 327 B.R. 852, 864 (Bankr. S.D. Ohio 2005) ("[T]he essence of mutuality is that, at the time of setoff, each party owns its claim independently with the right to collect in its own name against the debtor in its own right and severally") (citing *Braniff Airways*, 814 F.2d at 1036) (internal punctuation omitted).

[31] *Dollar Bank, FSB v. Tarbuck (In re Tarbuck)*, 304 B.R. 718, 721 (Bankr. W.D. Pa. 2004); *see also W. Dealer Mgmt., Inc. v. England (In re Bob Richards Chrysler-Plymouth Corp., Inc.)*, 473 F.2d 262, 265 (9th Cir. 1973) (debts are not mutual where the liability of the party seeking setoff "arises from a fiduciary duty, or is in the nature of a trust.").

[32] There are three limited exceptions to this general rule. Tariff, § 11.29(a). First, the CAISO does not act as contracting counterparty for "transactions that procure Station Power for a Generating Unit located in Mexico or for transactions that procure Energy or Ancillary Services within Mexico." *Id.* § 11.29(a)(i). The CAISO adopted this exception to ensure that it and its participants could comply with the Tariff without violating Mexican law. Officer's Certificate, Exhibit B, ¶ 6. In 2012, transactions covered by this exception represented less than 0.01% (one one-hundredth of a percent) of the energy transmitted by CAISO to serve load and exports, and an even smaller, more insignificant percentage of overall financial settlements by the CAISO. Transactions covered by this exception are, as a result, immaterial to settlement of the CAISO market. *Id.*

Second, the CAISO does not act as contracting counterparty for transactions that occurred on Trading Days prior to September 1, 2012, which is the date on which the amendments making the CAISO a central counterparty became effective. Tariff, § 11.29(a)(ii); 142 FERC ¶ 61,111 ¶ 1 (2012); 140 FERC ¶ 61,169 ¶ 1 (2012).

Finally, the CAISO does not act as contracting counterparty when a municipal utility supplies its own load from a generating resource it owns if that resource was funded by tax-exempt debt. Officer's Certificate, Exhibit B, ¶ 7; Tariff, § 11.29(a). Such transactions do not have a counterparty for the sale of energy because the municipal utility is supplying itself. Officer's Certificate, Exhibit B, ¶ 7; 140 FERC ¶ 61,116 ¶¶ 11, 20 (2012) (where MISO stated in excepting analogous generator self-supply transactions from its central counterparty proposal that such transaction "do not have a counterparty for the sale of energy since the market participant is supplying itself," FERC found that "MISO's proposal to not be the counterparty to financial schedule and generator self-supply transactions is reasonable given that there is no ambiguity regarding the counterparty for those transactions.").

[33] See Randall S. Kroszner, *Can the Financial Markets Privately Regulate Risk? The Development of Derivatives Clearinghouses and Recent Over-the-Counter Innovations*, 31 J. MONEY, CREDIT & BANKING 596, 598-604 (1999).

> original counterparties' contracts with one another are replaced with a pair of contracts with a central counterparty . . . The [central counterparty] becomes the buyer to the original seller and the seller to the original buyer. If buyer or seller defaults, the [central counterparty] is contractually committed to pay all that is owed to the non-defaulting party.[34]

The rights and obligations of the CAISO, as contracting counterparty, demonstrate that the CAISO is not a contracting counterparty in form alone but also in substance. The CAISO Tariff, for example, provides for "Payments By and to the CAISO" rather than to the CAISO as fiduciary or by the CAISO as agent.[35] Further, the CAISO has the exclusive right to take debt collection action against a Scheduling Coordinator or CRR Holder in the event of a default.[36] Where the CAISO acts as a central counterparty to each transaction the CAISO maintains a credit relationship with each of its participants: it is the buyer to each seller and the seller to each buyer.[37] In sum, as "the buyer to every seller and seller to every buyer" in its market, the CAISO directly incurs obligations to its contracting participants in its own right and its own capacity.[38]

Although we are not aware of any United States case law specifically addressing the setoff rights of a central counterparty in bankruptcy, there is other relevant authority to support the conclusion that the CAISO, as central counterparty, will satisfy Section 553's mutuality requirement. First, in a functionally analogous bankruptcy court decision, *Allbrand Appliance & Television Co., Inc. v. Merdav Trucking Company*, the plaintiff/debtor, Allbrand Appliance, sold household appliances.[39] The defendant, Merdav Trucking Company, was an independent trucker that delivered merchandise to Allbrand's customers and collected amounts owed to Allbrand for merchandise purchased on "cash on delivery" terms.[40] Although, the debtor and Merdav had neither a written nor verbal agreement between them, the parties did not dispute that "in connection with Merdav's trucking services, Merdav assumed responsibility for the merchandise it undertook to deliver, collected the C.O.D.

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[34] PIRRONG, CRAIG, ISDA, THE ECONOMICS OF CENTRAL CLEARING: THEORY AND PRACTICE 5 (2011), *available at* http://www2.isda.org/search?keyword=pirrong.

[35] Tariff, § 11.29.9.1.

[36] *Id.*, § 11.29.20.

[37] Consequently, there exists mutuality with regard to payment obligation: net buyers must pay the CAISO and the CAISO must pay net sellers. That the CAISO's obligation to pay is tempered by the default allocation provisions of the Tariff is immaterial to its status as counterparty. *See, e.g.*, Tariff, § 11.29.9.6 ["Use of Accounts"], Tariff, § 11.29.12 ["CAISO's Responsibilities"], Tariff, § 11.29.13 ["Non-Payment By A Scheduling Coordinator Or CRR Holder"]. Indeed, central counterparties, such as clearinghouses, often charge losses against clearinghouse capital—including that owned by non-defaulting members. See Randall S. Kroszner, Member, Board of Governors of the U.S. Fed. Reserve Sys., Central counterparty clearing - history, innovation, and regulation (Apr. 3, 2006) *available at* http://www.bis.org/review/r060406e.pdf.

[38] Committee on Payment and Settlement Sys., Technical Comm. of the Int'l. Org. of Sec. Comm'ns, Bank for Int'l Settlements, *Recommendations for Central Counterparties* 1 (2004), available at http://www.bis.org/publ/cpss61.pdf.

[39] 16 B.R. 10, 11 (Bankr. S.D.N.Y. 1980).

[40] *Id.*

payments from Allbrand's customers, billed Allbrand weekly for such services, and within a week of delivery, remitted to Allbrand the C.O.D. moneys collected by Merdav."[41]

At the time of its bankruptcy filing, Allbrand owed approximately $100,000 to Merdav for trucking delivery and payment collection services.[42] At the same time, Merdav had approximately $25,000 in hand which were proceeds from outstanding C.O.D. collections it had made on behalf of Allbrand.[43] Merdav retained and set off the $25,000 against its prepetition claim.[44] Debtor Allbrand challenged this setoff as impermissible for lack of mutuality on the basis that the C.O.D. funds in Merdav's hands were actually property of the debtor held in trust for the debtor.[45]

Addressing whether Merdav satisfied the mutuality requirement found in Section 553 of the Bankruptcy Code, the United States Bankruptcy Court for the Southern District of New York found no basis for the existence of a trustee relationship such as would defeat mutuality.[46] Under the parties' arrangement, Merdav was responsible for the goods it delivered and free to deposit monies from C.O.D. collections in its own account, or wherever it chose, before remitting the proceeds to Allbrand.[47] Those facts precluded a finding of a trust or bailment relationship; rather, "the relationship between the . . . parties was simply one of debtor-creditor and the setoff here was based solely upon mutual debts or credits."[48] The court granted summary judgment in favor of Merdav, upholding its right to setoff.

A 2006 opinion from the Ninth Circuit Bankruptcy Appellate Panel provides a similarly strong functional analogy.[49] In *Coast Grain*, Bouma operated a dairy business and purchased grain from Coast Grain.[50] Bouma also participated in Coast Grain's "prepayment program" whereby Bouma deposited cash with Coast grain as advance payment for product.[51] The prepayment program featured "quality adjustments" made by Coast Grain, which were, in effect, interest on the prepayment account balance and also allowed participants to direct Coast Grain to direct prepayment monies to third parties on the participant's behalf.[52] During

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[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] *Id.* at 11-12.

[45] *Id.* at 12.

[46] *Id.* at 13.

[47] *Id.*

[48] *Id.* at 14.

[49] *See Bouma Dairy v. Braun (In re Coast Grain Co.)*, Nos. EC-051187-PaNMa, EC-05-1213-PaNMa, 2006 WL 6810917 (B.A.P. 9th Cir. 2006).

[50] *Id.* at *1.

[51] *Id.*

[52] *Id.*

the pendency of Coast Grain's case, the ability to offset third-party payments made on behalf of Bouma and Bouma's grain purchases against the balance of Bouma's prepayment account held by Coast Grain was scrutinized.[53]

In considering whether Section 553's mutuality requirement was satisfied, the bankruptcy court reasoned that all three conditions for mutuality were present because "Coast Grain's sales of dairy feed to Bouma, and the third-party payments made for Bouma's benefit, generated contract rights against Bouma of equal value. Bouma's liability for those contracts and Coast Grain's liability on the prepaid account were mutual obligations subject to potential setoff."[54] The appellate panel agreed with the bankruptcy court that Coast Grain became indebted to Bouma upon receipt of the prepayments and that each time Bouma directed payment to a third-party or purchased feed, a separate debt owed by Bouma to Coast Grain was created.[55] The panel found additional support for its conclusion on mutuality where Coast Grain created invoices for Bouma's feed purchases and "paid" the invoice by debiting Bouma's prepayment account and similarly debiting the prepayment account when Coast Grain issued a check to a third-party at Bouma's direction.[56] Significantly, the panel did not probe the relationship between Coast Grain and third-party payees to find mutuality, the contractual obligations held by Coast Grain and Bouma respectively were sufficient.[57]

A judicial decision involving a central counterparty's right to set off against a market participant should be an even more straightforward exercise than was undertaken in *Allbrand* and *Coast Grain*. Specifically, unlike in *Allbrand* where the course of dealing alone established the parties' agreement, the Participation Agreement and Tariff clearly and unambiguously evidence the debtor/creditor relationship of the CAISO and each of its participants and the right of the CAISO, in its own name and capacity, to issue invoices and payment advices, to establish and maintain bank accounts, to obtain a line of credit and to commence suit and obtain a judgment to recover amounts due to the CAISO under the Tariff. Thus, unless these revised Tariff terms are disregarded by a court, the central counterparty and each market participant will be bound to one another by clear and unambiguous written terms that will readily support a finding that their relationship is "simply one of debtor-creditor" and that any setoff right exercised by the counterparty is "based solely upon mutual debts or credits."

Second, although not a judicial decision, we find it noteworthy that FERC itself believes that a central counterparty ISO will satisfy concerns about market risk in the event it seeks to set off against a bankrupt participant. In its January 2010 Notice of Proposed Rulemaking, FERC proposed seven reforms addressing its concerns about creditworthiness and default risk in the nation's wholesale electric markets.[58] One of those proposals was to

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[53] *Id.* at *8-*10.

[54] *Braun v. Bouma Dairy (In re Coast Grain Co.)*, 317 B.R. 796, 805 (Bankr. E.D. Cal. 2004).

[55] *Bouma Dairy v. Braun (In re Coast Grain Co.)*, Nos. EC-051187-PaNMa, EC-05-1213-PaNMa, 2006 WL 6810917 at *9.

[56] *See id.*

[57] *See id.* at *9-*10.

[58] *See Credit Reforms in the Organized Wholesale Electric Markets*, Notice of Proposed Rulemaking, 75 Fed. Reg. 4310 (2010).

clarify "the ISOs/RTOs' status as a party to each transaction ***so as to eliminate any ambiguity or question as to their ability to net and manage defaults through the offset*** of market obligations[.]"[59] After soliciting public comment and holding a technical conference on the proposed reforms, FERC issued Order No. 741, which, among other things, expresses the view that the mutuality requirement for setoff potentially will be met if an ISO/RTO adopts central counterparty status.[60]

In addition, it is noteworthy that CFTC staff has expressed its support of FERC's views that a central counterparty ISO will have the effect of reducing or negating the risk of a mutuality challenge to setoff practices:

> [CFTC staff] fully supports FERC's proposals to require each RTO or ISO . . . to clarify its status as a party to each [financial transmission rights] transaction, thus enabling the RTO or ISO to offset, in the event of a bankruptcy of a participant, the obligations owed to such participant against the obligations owed by such participant. [61]

Finally, although we find the foregoing support persuasive if not compelling with respect to a conclusion that the contracting counterparty arrangement set forth in the Tariff establishes mutuality as between the CAISO and its participants, in Order No. 741 FERC noted:

> [m]any commenters argue that the central counterparty approach does not definitively eliminate the risk that a bankruptcy court would refuse an ISO/RTO's netting obligations between the ISO/RTO and the debtor market participant. For instance, Eastern Massachusetts, Dominion and NYISO believe that a bankruptcy court that is hostile to set-off would question whether the ISO/RTO is the central counterparty in form only and not substance. NYISO explains that taking title is just one factor that a bankruptcy court may consider in determining whether there is mutuality between the ISO/RTO and the market participant. NYISO points out that under PJM's proposal, PJM is only

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[59] *Id. (emphasis added).*

[60] 133 FERC ¶ 61,060 ¶ 94 (2010), *on reh'g* Order No. 741-A, 134 FERC ¶ 61,126, *reh'g denied*, Order No. 741-B, 135 FERC ¶ 61,242 (2011). It is also worth noting that when the setoff and net billing issue has arisen at FERC, it has been in the context of proceedings to address perceived market uncertainty on how a bankruptcy court *might* apply Section 553 of the Bankruptcy Code in a particular case, and consideration of proposals to alleviate any uncertainty that might exist in the least restrictive way. *See, e.g., Credit Reforms in Organized Wholesale Electric Markets,* 133 FERC ¶ 61,060 ¶¶ 80-122 (2010); *MidWest Independent Transmission System Operator, Inc.*, 128 FERC ¶ 61,093 ¶¶ 3, 18 (2009) (Midwest ISO filed proposed revisions to its credit policies to require that market participants grant it a security interest in the amounts due the participant if it wanted the Midwest ISO to continue certain netting practices to address the risk that a bankruptcy judge "could conclude" that net amounts are not in the "same capacity" and under the "same right"). The fact that FERC orders have recognized the potential credit risks associated with the interplay between an ISO's netting and credit practices and the setoff provisions in the Bankruptcy Code, especially in the absence of any court decision directly on point, does not diminish the strength of the jurisdictional argument set forth in Part II of this memorandum. To the contrary, looking at the rationale employed in all cases that have addressed the FPA and Bankruptcy Code conflict issue, it strengthens it.

[61] CFTC Staff Comments on FERC Notice of Public Rulemaking, Docket No. RM10-13-000, at 4 (Mar. 29, 2010).

> obligated to pay market sellers to the extent of its collections from market buyers. Thus, NYISO argues that PJM may not truly be taking on the debt obligation for market purchases, but rather be acting as an agent for many different buyers. Although NYISO acknowledges that this argument is unlikely to succeed, it demonstrates that the risk is not eliminated. In addition, Dominion points to Midwest ISO's argument that the central counterparty model does not defend against a challenge based on the absence of mutuality in netting across commodities and services. However, bankruptcy counsel noted that there would have to be a major change in case law for a challenge to an identified central counterparty to be successfully upheld regarding its ability to set-off in a bankruptcy.

133 FERC ¶ 61,060, ¶ 101 (2010). We are mindful that some of these same arguments could be asserted in a dispute involving the Tariff,[62] but are not, on balance, persuaded by these arguments for the reasons discussed herein.

C. Conclusion

The central counterparty arrangement implemented by the Tariff amendments provides for a direct credit relationship between the CAISO and its participants. For each transaction in which the CAISO is acting as a central counterparty in accordance with the terms of the Tariff, the CAISO will have an obligation to and claim against the participant-counterparty in its own capacity and its own right. Although we are not aware of any United States case law specifically addressing the setoff rights of a central counterparty in bankruptcy, other relevant authority discussed above offers support for the conclusion that the central counterparty structure implemented under the Tariff effects mutuality as between the CAISO and its participants. Thus, we are of the view that under present reported decisional authority and statutes applicable to bankruptcy cases, a federal court exercising bankruptcy jurisdiction and reasonable judgment after full consideration of all relevant factors should find that the mutual debt requirement set forth in Section 553 of the Bankruptcy Code is satisfied.

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[62] See *supra* note 37. In addition, where the Tariff provides that, "[f]or purposes of E-Tags, the CAISO is not, and shall not be listed as, the "Purchasing Selling Entity"; title to Energy shall pass directly from the entity that holds title when the Energy enters the CAISO Controlled Grid to the entity that removes the Energy from the CAISO Controlled Grid, in each case in accordance with the terms of this CAISO Tariff," a party could argue that this constitutes a limitation on the transfer of title and weighs against a finding of mutuality. This provision, however, is limited by its own terms to E-Tag procedures. Tariff § 4.5.3.2.2. Moreover, electric energy is a "good" within the meaning of the California Commercial Code. *Puget Sound Energy, Inc. v. Pac. Gas & Elec. Co. (In re Pac. Gas & Elec. Co.)*, 271 B.R. 626, 639-40 (N.D. Cal. 2002). As such, Section 2401 of the California Commercial Code allows the CAISO and its members to direct the manner and conditions upon which title passes. *See* Cal. Com. Code § 2401 ("[s]ubject to these provisions and to the provisions of the division on secured transactions (Division 9), title to goods passed from the seller to the buyer in any manner and on any conditions explicitly agreed on by the parties"). Finally, as the contracting counterparty to both the purchase and sale of Energy, the CAISO is owed (and owes) independent obligations from (and to) the buying and selling participants regardless of to whom the Energy is ultimately transferred. To dispel all doubts, one need only look to the facts: the CAISO issues invoices and payment advices, the CAISO receives payments and the CAISO is vested with the exclusive right to pursue a participant in the event it defaults on its obligations under the Tariff.

PART II: The CAISO's net billing and setoff provisions should be enforceable against a bankrupt CAISO participant unless FERC takes action to relieve that participant from those terms

A. FERC's Exclusive Jurisdiction and the Filed Rate Doctrine

Section 201 of the FPA gives FERC exclusive jurisdiction over "the transmission of electric energy in interstate commerce and . . . sale of electricity at wholesale in interstate commerce."[63] This is a "clear grant of power," making the Commission's jurisdiction over all such matters "plenary."[64] There is no dispute that the Tariff and the various Participation Agreements a CAISO participant must execute to participate in the markets administered by the CAISO govern the transmission of electric energy in interstate commerce and sale of electricity at wholesale in interstate commerce and, therefore, are subject to FERC's exclusive jurisdiction under the FPA.[65]

Because FERC has plenary authority over the transmission of electric energy in interstate commerce and the sale of electricity at wholesale in interstate commerce, the U.S. Supreme Court has recognized the "filed rate doctrine" in the interstate electric energy transmission and wholesale power context. As articulated by the Supreme Court in *Montana-Dakota Utilities v. Northwestern Public Serv. Co.*, the filed rate doctrine holds that "the right to a reasonable rate is the right to the rate which the Commission files or fixes, and . . . except for review of the Commission's orders, the courts can assume no right to a different one on the ground that, in its opinion, it is the only or the more reasonable one."[66]

Although the net billing and setoff provisions in the Tariff, and the *pro forma* Participation Agreements that are appended to and made a part of the Tariff, do not actually set the price for particular services, there is little doubt that they constitute filed rates subject to the filed rate doctrine.[67] In 2004, FERC specifically examined the effects on

[63] *New York v. FERC*, 535 U.S. at 6-7 (quoting 16 U.S.C. § 824(b)); *New England Power Co. v. New Hampshire*, 455 U.S. 331, 340 (1982).

[64] *FPC v. S. Cal. Edison Co.*, 376 U.S. 205, 215-16 (1964).

[65] *Rochester Gas and Elec. Corp. v. Pub. Serv. Comm'n*, 754 F.2d 99, 102 (2d Cir. 1985) (finding FERC had jurisdiction over incidental sales in part because "the FPA drew a bright jurisdictional line 'by making FPC jurisdiction plenary and extending it to all wholesale sales'") (quoting *FPC v. S. Cal. Edison Co.*, 376 U.S. at 215-16).

[66] *Montana-Dakota Util. v. Nw. Public Serv. Co.*, 341 U.S. 246, 251-52 (1951).

[67] *See Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 966 (1986) ("[T]he filed rate doctrine is not limited to 'rates' *per se*: our inquiry is not at an end because the orders do not deal in terms of prices or volumes of purchase.") (internal quotations omitted); *Cal. Dept. of Water Res. v. Calpine Corp. (In re Calpine Corp.)*, 337 B.R. 27, 32 (S.D.N.Y. 2006) ("FERC's jurisdiction and the filed rate doctrine stretches past regulation of rates . . . and extends to the terms and conditions of wholesale energy contracts"). Nor does anything in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") change the exclusive jurisdiction of FERC with respect to the rates, terms and conditions of a FERC-approved agreement. In enacting Dodd-Frank, Congress allocated to the CFTC jurisdiction over futures contracts, certain swap agreements, and the markets upon which they are traded. Congress expressly preserved, however, FERC's exclusive jurisdiction over any "agreement, contract, or transaction ... pursuant to a tariff or rate schedule approved" by the FERC where either no CFTC-regulated entity or market is involved with execution, trading, or clearing, or

market costs and competition in approving many of the independent system operator ("ISO")/regional transmission organization ("RTO") netting and setoff terms, demonstrating the integral connection between these provisions and market rates.[68] Moreover, FERC's recently adopted *Final Rule on Credit Reforms in Organized Wholesale Electric Markets* recognizes that FERC "has a statutory mandate to ensure that all rates charged for the transmission or sale of electric energy in interstate commerce are just, reasonable, and not unduly discriminatory or preferential; clear and consistent credit practices are an important element of those rates."[69] In the final credit reform rule, FERC directed all RTOs and ISOs to submit compliance tariffs that contain provisions addressing the potential bankruptcy setoff risk addressed in this memorandum by June 30, 2011 (with an effective date of October 1, 2011).[70] Rather than confirming that CAISO debtors might successfully avail themselves of Section 553's mutuality requirement, these efforts actually underscore the fact that the setoff and net billing provisions in a FERC-approved tariff or contract are fundamental components of the filed rate. And because they constitute "filed rates," they carry the force of federal law.[71]

B. Case Law Addressing the Interplay Between the Bankruptcy Code and the FPA

Given the vast and long-standing authority recognizing FERC's exclusive jurisdiction and the filed rate doctrine, it is not surprising that courts that have addressed the potential conflict between the FPA and the Bankruptcy Code have respected FERC's exclusive jurisdiction and carefully refrained from taking any action that would alter any rate, term or

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such registered entity or market is owned or operated by an RTO or ISO. See Pub. L. 111-203, H.R. 4173 at § 722(e), codified at 7 U.S.C. § 2(a)(1)(I)(i); FERC Comment Letter re RIN 3038-AD46, Further Definition of "Swap,"' "Security-Based Swap,"' and "Security-Based Swap Agreement"'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, July 22, 2011. All the transactions covered by the Tariff are thus within the exclusive jurisdiction of the FERC.

[68] *See Policy Statement On Credit-Related Issues For Electric OATT Transmission Providers, Independent System Operators And Regional Transmission Organizations*, 109 FERC ¶ 61,186 ¶ 20 (2004) ("shortened settlement periods and netting are cost-effective steps to reduce the exposure to risk among market participants"); *id.* ¶ 30 ("netting internal bilateral energy contracts, as opposed to ISO/RTO products, could also serve to reduce default costs and risk").

[69] 133 FERC ¶ 61,060 ¶ 2 (2010).

[70] *Id.* ¶ 32. The tariffs must include one of four approaches:

- Establishment of a central counterparty to take title to transactions;
- Requiring market participants to provide a security interest in their transactions in order to establish collateral requirements based on net exposure;
- Proposing another alternative, which provides the same degree of protection as the two above-mentioned methods; or
- Choosing none of the three above alternatives, and instead establishing credit requirements for market participants based on their gross obligations.

Id. ¶ 117.

[71] *California ex rel. Lockyer v. Dynegy, Inc.*, 375 F.3d 831, 839 (9th Cir. 2004) (once filed with FERC, the tariff in the contract constitutes "the equivalent of a federal regulation") (internal quotation omitted); *Fax Telecommunicaciones, Inc. v. AT&T*, 138 F.3d 479, 488 (2d Cir. 1998) ("tariffs are not simply contracts; they have the force of federal law").

condition governing the transmission or sale of electricity at wholesale in interstate commerce.[72] Illustrative of this restraint are two decisions, rendered in 2003 and 2006, by the United States District Court for the Southern District of New York.[73]

In the first decision, *NRG Power Marketing, Inc. v. Blumenthal (In re NRG Energy, Inc.)*,[74] the debtor, NRG Energy, Inc., simultaneously filed for Chapter 11 bankruptcy protection and filed a motion with the bankruptcy court to reject and cease performance under a financially burdensome power sales agreement between it and Connecticut Light & Power Co.[75] One day later, the Connecticut Attorney General successfully petitioned FERC to enjoin NRG from ceasing performance under its power sales agreement with Connecticut Light until such time as FERC could evaluate the effects of NRG's proposed cessation of service and whether NRG had public interest grounds for abrogating the power sales agreement.[76] Approximately one week after FERC enjoined NRG from ceasing performance under the Connecticut Light power sales agreement, the bankruptcy court approved NRG's motion to reject that agreement.[77] The bankruptcy court, however, declined to enjoin FERC or to vacate FERC's order requiring NRG to continue providing service pending FERC's evaluation of the effects of NRG's proposed cessation of service and whether NRG had public interest grounds for abrogating the power sales agreement.[78] In response, NRG sought declaratory and injunctive relief in the District Court for the Southern District of New York to allow it to cease

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[72] We could find no court or FERC cases addressing the jurisdictional conflict between Section 553 of the Bankruptcy Code and setoff provisions in filed rates subject to FERC's jurisdiction. The only court cases we found directly addressing the ability of a bankruptcy court to take action affecting a FERC-jurisdictional contract dealt with rejection of executory contracts under Section 365 of the Bankruptcy Code.

[73] Cases involving the interplay between the Bankruptcy Code and the FPA typically are heard by an Article III District Court judge, as opposed to an Article I Bankruptcy Judge, as a result of one party to the litigation invoking the mandatory "withdrawal of the reference" provisions found in 28 U.S.C. § 157(d). This section of Title 28 of the U.S. Code provides that "[t]he district court *shall*, on timely motion of a party, so withdraw a proceeding if the court determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce." 28 U.S.C. § 157(d) (emphasis added.)

[74] 2003 WL 21507685 (S.D.N.Y. June 30, 2003).

[75] *Id.* at *1.

[76] *Id.*

[77] *Id.* at *2.

[78] *Id.* The FERC public interest standard has been described as "very demanding," *Pac. Gas and Elec. Co. v. FERC*, 326 F.3d 243, 248 (D.C. Cir. 2003), and "a heavy burden." *Exxon Mobil Corp. v. FERC*, 430 F.3d 1166, 1177 (D.C. Cir. 2005). In contrast, rejection or assumption of an executory contract in bankruptcy is subject to the much more easily met "business judgment" standard. *See Orion Pictures Corp. v. Showtime Pictures, Inc. (In re Orion Pictures Corp.)*, 4 F.3d 1095, 1099 (2d Cir. 2003). The "business judgment" standard focuses merely on whether it would be "beneficial" to the debtor's estate to reject a contract. It is a standard that bankruptcy courts apply routinely in permitting debtors to reject ordinary, arms-length commercial contracts that have little to no impact on the public. *See, e.g., id.* (involving movie licensing deal); *Penn Traffic Co. v. COR Route 5 Co., LLC (In re Penn Traffic Co.)*, 2005 WL 2276879 (S.D.N.Y. Sept. 16, 2005) (involving contract for sale of land).

performance under the Connecticut Light agreement based upon the bankruptcy court's order authorizing rejection of that agreement.[79]

Noting that "FERC has exclusive jurisdiction over 'the sale of electric energy at wholesale in interstate commerce,'" and "[f]urther, the FPA vests in FERC the exclusive authority to pass upon the reasonableness of the structure, terms and conditions pertaining to the sale and distribution of wholesale electric rates," the District Court held that the Connecticut Light power sales agreement, as a wholesale power contract, fell "within the FPA's purview, and hence, FERC's exclusive jurisdiction. Accordingly, the FPA has vested FERC as the authority that may alter the terms of the Agreement."[80] The District Court then concluded that "given the unique regulatory framework for the business of selling electric energy and the pending FERC proceeding, the court lacks jurisdiction to grant Plaintiff's requested relief."[81] According to the court, "'[i]t is for [the federal regulatory agency] to state its conditions ... and for a court with power to review [its] decisions to say if they are arbitrary or valid.'"[82] That is precisely because FERC, as a federal regulatory agency, "need not defend its regulatory calculus in the bankruptcy court.... [I]f the decision is regulatory, it may not be altered or impeded by any court lacking jurisdiction to review it."[83]

Three years after rendering its decision in NRG, the same district court again addressed the interplay between the Bankruptcy Code and FERC's jurisdiction under the FPA. In *Cal. Dept. of Water Resources v. Calpine Corp.*, Chapter 11 debtor Calpine Corporation sought to reject financially burdensome long term power purchase agreements it had entered into with the California Department of Water Resources (the "Department") and others during the 2000-2001 California energy crisis.[84] Calpine argued that pursuant to Section 365 of the Bankruptcy Code, it could reject these long term power purchase agreements, without FERC's involvement or approval, because Section 365 of the Bankruptcy Code "allows the debtor or debtors in possession 'to assume or reject any executory contract of the debtor.'"[85] The Department and other parties whose contracts Calpine sought to reject successfully moved for withdrawal of the reference of the case to the bankruptcy court pursuant to 28 U.S.C. § 157(d)[86] and then argued in opposition before the District Court that the Court lacked subject matter jurisdiction to entertain Calpine's rejection motion because Congress granted exclusive jurisdiction over such contracts to the FERC.[87]

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[79] *Id.*

[80] *Id.* at *3 (internal citations omitted).

[81] *Id.*

[82] *Id.* (alterations are court's; quoting *In re FCC*, 217 F.3d 125, 135 (2d Cir. 2000)).

[83] *Id.*

[84] *Calpine Corp.*, 337 B.R. at 29-30.

[85] *Id.* at 34 (citing 11 U.S.C. § 365(a)).

[86] *See supra* note 73.

[87] *Id.* at 29.

The District Court began its analysis of the issues presented by the parties by summarizing the filed rate doctrine and recognizing that "FERC's jurisdiction and the filed rate doctrine stretches past regulation of rates, and extends to the terms and conditions of wholesale energy contracts."[88] The District Court then observed that

> [t]here are no provisions in the FPA that specifically limit FERC jurisdiction in the bankruptcy context. Quite the contrary, FERC, in its charge to maintain reasonable rates and uphold the public interest, must also consider the financial ability of a utility to continue service under a filed rate, a responsibility that would include similar considerations to those in the bankruptcy court. Conversely, FERC's lack of authority to modify a filed contract . . . suggests Congress thought no forum ought have such authority.[89]

Next, the District Court searched the Bankruptcy Code for evidence of congressional intent to limit FERC's regulatory authority. Finding "little evidence" of such intent, the court concluded that "absent overriding language, the Bankruptcy Code should not be read to interfere with FERC jurisdiction."[90] The court then framed the issue before it:

> Thus, in the situation presented here, the fundamental and dispositive issue for the Court to consider is whether rejection of the Power Agreements directly interferes with FERC's exclusive jurisdiction and regulatory authority over wholesale power contracts or otherwise constitutes a collateral attack of the filed rate.[91]

The District Court answered this question in the affirmative and held that it lacked "jurisdiction to authorize the rejection of the Power Agreements because doing so would directly interfere with FERC's jurisdiction over the rates, terms, conditions, and duration of wholesale energy contracts."[92] In support of its holding, the Court found that Calpine sought rejection based not only on its dissatisfaction with the rates under the various power agreements, but also because it sought a release from specific performance under the contracts, "thus altering the duration of the contract, which cannot be accomplished outside the exclusive jurisdiction of FERC."[93]

In contrast to the *NRG* and *Calpine* decisions, the Fifth Circuit Court of Appeals concluded in *Mirant Corp. v. Potomac Elec. Power Co.* that a bankruptcy court <u>can</u> reject a wholesale power contract pursuant to Section 365(a) without interfering with FERC's exclusive jurisdiction.[94] In so ruling, however, the Court underscored the fact that the grounds for the rejection cannot be based on the contract's filed rates - that is, a debtor can

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[88] *Id.* at 32.

[89] *Id.* at 33.

[90] *Id.*

[91] *Id.* at 35-36.

[92] *Id.* at 36.

[93] *Id.*

[94] *Mirant Corp. v. Potomac Elec. Power Co. (In re Mirant Corp.),* 378 F.3d 511, 521 (5th Cir. 2006).

reject a contract because it does not need the supply (the case with Mirant), but it cannot reject a contract because the price is too high.[95] The Court expressly acknowledged that rejection of a FERC-approved contract because of the rate terms would conflict with the filed rate doctrine.[96] The *Mirant* panel rationalized that rejection simply constitutes a breach of the contract, which neither invalidates the contract nor alters the contract's filed rate, because the creditor's claim will still be established by reference to the filed rate.[97] Even though ultimate recovery in the bankruptcy court might be altered, the Court deemed this an "indirect effect" on the FERC filed rate.[98] Even assuming the validity of the *Mirant* Court's rationale, which is questionable,[99] the careful distinction made in *Mirant* between an order *e*ffecting a breach and an order *a*ffecting a filed rate does not apply to the direct, rather than indirect, conflict between Section 553's mutual debt requirement and FERC's determination that the CAISO net billing and setoff provisions are just and reasonable components of the CAISO's filed rate.

C. Conclusion

Based upon our reading of the cases cited in Part II of this memorandum and other decisions cited by or relating to the subject matter of those cases, we are of the view that under present reported decisional authority, the FPA and statutes applicable to bankruptcy cases, a federal court exercising bankruptcy jurisdiction and reasonable judgment after full consideration of all relevant factors should find that the net billing and setoff provisions found in Section 11 of the Tariff are enforceable against a bankrupt CAISO participant unless FERC takes action to relieve that participant from those terms. Our principal reasons for reaching this conclusion are:

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[95] *Id.* at 520 (rejection decision not a collateral attack on filed rate "when the electricity purchased under the rejected contract is not necessary to fulfill a debtor's supply obligations"); *see also id.* at 519, citing with approval the decision in *Gulf States Utils. Co. v. Ala. Power Co.*, 824 F.2d 1465 (5th Cir. 1987), in which the Fifth Circuit Court of Appeals held that the FPA does not preempt a breach of contract damages claim if based on a rationale other than the contract rates, such as the contract quantity).

[96] *Id.* at 519 (court has authority to reject, "so long as that rejection does not constitute a challenge to that agreement's filed rate").

[97] *Id.*

[98] *Id.* at 519-20.

[99] At the same time the *Mirant* Court found that rejection of the power contract did not touch upon FERC's jurisdiction, it also recommended that, on remand, any consideration of rejection of a FERC-approved contract should apply a more rigorous standard of review than the business judgment standard; *i.e.*, the court should scrutinize "the public interest" - and "ensure that rejection does not cause any disruption in the supply of electricity to other public utilities or consumers." *Id.* at 525. This public interest review is the very public interest determination that FERC has been granted the exclusive authority to perform; under the relevant provisions of the FPA, FERC must examine the public interest before a change in rates, terms and conditions can occur. *See United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332, 344 (1956) (noting "the paramount power of the Commission to modify [contracts] when necessary in the public interest"); *see also Blumenthal v. NRG Power Mktg., Inc.*, 104 FERC ¶ 61,213 ¶ 34 ("The bankruptcy court lacks the jurisdiction, the mandate, the expertise, and the experience to address the public interest factors that must be evaluated when cessation of service through contract abrogation is involved.").

1. it is beyond dispute that FERC has exclusive jurisdiction over the reasonableness of filed rates;

2. ample authority, including FERC policy statements and rule making proceedings relating to credit reform and RTO/ISO net billing and setoff provisions, support the conclusion that the net billing and setoff provisions in the Tariff constitute "filed rates" subject to the filed rate doctrine;

3. it is well-established that filed rates may not be collaterally attacked in state or federal courts;

4. although we are not aware of any court decision considering the interplay between Section 553 of the Bankruptcy Code and the enforceability of a net billing or setoff provision in a FERC-approved tariff, we note that in each instance in which a federal court has considered the interplay between the Bankruptcy Code and the FPA, the court has respected FERC's exclusive jurisdiction and carefully refrained from taking action that would alter the rates, terms or conditions of the FERC-approved agreement before the court;

5. to the extent that the mutual debt requirement set forth in Section 553 of the Bankruptcy Code imposes any added requirement on the CAISO, it will directly interfere with FERC's exclusive jurisdiction and regulatory authority over the transmission and sale at wholesale of electricity in interstate commerce or otherwise constitute a collateral attack of the CAISO's filed rate;

6. the Fifth Circuit's cramped view of what constitutes an impact on the filed rate is not supported by Supreme Court precedent and has been rejected by other courts; and

7. even in the Fifth Circuit, it appears that the net billing and setoff provisions in the Tariff would be respected by the court since imposing an additional setoff requirement on the CAISO through application of Section 553 of the Bankruptcy Code will directly conflict with a filed rate, as opposed to incidentally result in a contract breach caused by rejection, as was the case in *Mirant*.

CONCLUSION

In the event of the bankruptcy of a market participant, a bankruptcy trustee or debtor could challenge the CAISO's right to exercise setoff for lack of mutuality. Assuming that transactions under the Tariff are implemented in accordance with its terms, the CAISO undertakes obligations as a formal contracting party in return for reciprocal obligations owed to the CAISO by each contracting market participant. Such transactions give rise to mutual debts between the CAISO and contracting market participants, each standing in the same right and same capacity. Therefore, the requisite mutuality for setoff rights to be enforceable under Section 553 exists for transactions in which the CAISO acts as contracting counterparty. Although we are not aware of any precedent squarely addressing the enforceability of a central counterparty's setoff rights, we are likewise not aware of any precedent that supports the notion that a central counterparty should not be entitled to set off. For these reasons and based upon the other conclusions reached in Part I, we are of the view that under present reported decisional authority and statutes applicable to bankruptcy cases, a federal court exercising bankruptcy jurisdiction and reasonable judgment after full

consideration of all relevant factors should find that the mutual debt requirement set forth in Section 553 of the Bankruptcy Code is satisfied with respect to transactions under the Tariff in which the CAISO is acting as a central counterparty.

Moreover, as discussed in Part II, under present reported decisional authority, the FPA and statutes applicable to bankruptcy cases, a federal court exercising bankruptcy jurisdiction and reasonable judgment after full consideration of all relevant factors should find that the net billing and setoff provisions found in Section 11 of the Tariff are enforceable against a bankrupt CAISO participant unless FERC takes action to relieve that participant from those terms.

EXHIBIT A

(Qualifications)

In preparing this memorandum, we have, with your permission, assumed that the constitutionality or validity of a relevant statute, rule, regulation or agency action cited in this memorandum is not at issue, and that whenever the CAISO seeks to enforce its setoff rights under the Tariff, amounts will be validly due and owing from the bankrupt CAISO participant to the CAISO, and by the CAISO to the bankrupt CAISO participant, in accordance with the terms and conditions of the Tariff. With respect to factual matters, we have relied upon, without any independent verification, the factual information provided to us in the Officer's Certificate attached hereto as Exhibit B signed by Nancy Saracino, Vice President, General Counsel and Chief Administrative Officer of the CAISO. We have assumed without investigation that there has been no relevant change or development between the dates as of which the information cited in the preceding sentence was given and the date of this memorandum and that the information upon which we have relied is accurate and does not omit disclosures necessary to prevent such information from being misleading.

While we have not conducted any independent investigation to determine facts upon which our opinions are based or to obtain information about which this memorandum advises you, we confirm that we do not have any actual knowledge which has caused us to conclude that our reliance and assumptions cited in the preceding paragraph are unwarranted or that any information supplied in this memorandum is wrong. The term "actual knowledge" whenever it is used in this memorandum with respect to Pierce Atwood LLP means awareness at the time this memorandum is delivered on the date it bears by the following Pierce Atwood LLP lawyers who have had significant involvement with preparation of this memorandum (the "Designated Lawyers"): Keith J. Cunningham, Deborah L. Shaw and Ryan F. Kelley.

Our advice on the legal issues addressed in this memorandum is based exclusively on the laws of the United States of America and is limited to transactions in which the CAISO acts as a contract counterparty. We note that provisions in the Bankruptcy Code other than Section 553, including the preferential, fraudulent and unauthorized transfer provisions found in Chapter 5 of the Bankruptcy Code, could, depending on the facts and circumstances of any particular case, determine the extent to which, if at all, the CAISO may retain amounts based on the setoff rights established by the Tariff. Moreover, because the facts and circumstances of the particular bankruptcy case will determine the extent to which, if at all, the CAISO's setoff rights may be avoided as preferential under Sections 553(a)(2), (a)(3) or (b) of the Bankruptcy Code, we express no opinion on the extent to which the CAISO's setoff rights may be affected in any particular bankruptcy case by those provisions.[100]

This memorandum speaks as of the time of its delivery on the date it bears. We do not assume any obligation to provide you with any subsequent opinion or advice by reason of any fact about which our Designated Lawyers did not have actual knowledge at that time, by reason of any change subsequent to that time in any law covered by any of our opinions, or for any other reason. The attached Exhibits are an integral part of this memorandum.

This memorandum is solely for your benefit and may not be relied upon by any other person. A copy of this memorandum, however, may be provided to the Commodity Futures

[100] See *infra* note 21 for the full text of these sections.

Trading Commission for information purposes. In addition, a copy of this memorandum may be posted on the Commission's website in connection with the CAISO's application for an exemption pursuant to Section 4(c) of the Commodity Exchange Act, as amended. Without our written consent: (i) this memorandum may not be cited or quoted in any financial statement, prospectus, private placement memorandum or other similar document; (ii) this memorandum may not be cited or quoted in any other document or communication which might encourage reliance upon this memorandum by any person or for any purpose excluded by the restrictions in this paragraph; and (iii) copies of this memorandum may not be furnished to anyone for purposes of encouraging such reliance.

EXHIBIT B

(Officer's Certificate)

To: Pierce Atwood LLP

Re: Memorandum by Pierce Atwood LLP Regarding Enforceability of the Net Billing and Setoff Provisions in the CAISO's Tariff in the Event of Bankruptcy

I, Nancy Saracino, Vice President, General Counsel and Chief Administrative Officer of the California Independent System Operator Corporation ("CAISO"), hereby certify for and on behalf of the CAISO as follows:

1. The CAISO is a nonprofit public benefit corporation charged with the reliable and efficient operation of the high-voltage electric transmission lines owned by several utilities.

2. In addition to operating this electric transmission grid, the CAISO administers certain markets for electricity, capacity and other services that are necessary for the reliable and efficient operation of the grid. The products and services in these markets are the subject of the CAISO's application to the CFTC for an exemption from its regulatory oversight.

3. The CAISO operates in accordance with a tariff issued by the Federal Energy Regulatory Commission. The CAISO's Fifth Replacement FERC Electric Tariff, which is available on the Federal Energy Regulatory Commission's website at http://etariff.ferc.gov/TariffBrowser.aspx?tid=848, has been accepted by FERC and is in full force and effect as of the date hereof (the "Tariff").

4. Section 11.29 of the Tariff and its subsections, including section 11.29.10.1, 11.29.13.5, and 11.29.13.7 (collectively, the "Billing and Netting Provisions"), are the sections of the Tariff (and other governing documents) that govern the financial netting associated with invoices to market participants.

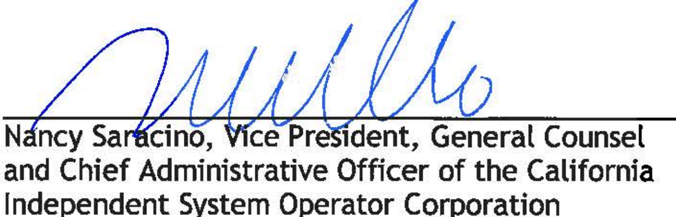
5. The CAISO operates in compliance with the Billing and Netting Provisions.

6. Under Section 11.29(a)(i) of the Tariff, the CAISO does not act as contracting counterparty for "transactions that procure Station Power for a Generating Unit located in Mexico or for transactions that procure Energy or Ancillary Services within Mexico." The CAISO adopted this exception to ensure that it and its participants could comply with the Tariff without violating Mexican law. In 2012, transactions covered by this exception represented less than 0.01% (one one-hundredth of a percent) of the energy transmitted by CAISO to serve load and exports, and an even smaller, more insignificant percentage of overall financial settlements by the CAISO. Transactions covered by this exception are, as a result, immaterial to settlement of the CAISO market.

7. Under Section 11.29(a) of the Tariff, the CAISO does not act as contracting counterparty when a municipal utility supplies its own load from a generating resource it

owns if that resource was funded by tax-exempt debt. Such transactions do not have a central counterparty for the sale of energy because the municipal utility is supplying itself.

Dated: April 26, 2013



Nancy Saracino, Vice President, General Counsel
and Chief Administrative Officer of the California
Independent System Operator Corporation