

Comments of PacifiCorp Regarding Funds Transfer Agent Agreement

To: WEQ Executive Committee
NAESB Voting Members

Summary

Although it agrees that facilitating the entry of Women and Minority Business Enterprises (WMBE's) into the power markets is a desirable objective, PacifiCorp believes that the FTAA proposal is fatally flawed as it introduces significant risk into the market. As a result, PacifiCorp is submitting these comments in opposition to the FTAA proposal that is now before the Members for ratification, and is suggesting an alternative to that structure.

The integrity of individual power transactions is essential to regain financial standing and the industry's credibility with ratepayers, regulators, investors and other stakeholders. While its purpose is laudable, the FTAA introduces uncompensated business and legal risks that most power marketers would not undertake on a voluntary basis, as such risks are counterproductive for the well-being of the industry generally. We sincerely believe that the FTAA, as currently conceptualized in the form of agreement before you, introduces risk and uncertainty to power transactions and is therefore not in the interests of the electric industry, either individual market participants or the overall industry. Given these risks, it is unlikely that it will be used extensively, which defeats the intended purpose of involving WMBEs in the power markets.

Finally, the condition that NAESB support will be withdrawn if the FTAA is ever made mandatory evades the issue and does not address the real concerns. If this flawed, risky structure is approved by NAESB, it signifies to regulators that it is a workable solution to the issue. On that basis alone, the proposal can easily be made mandatory by regulators, who may easily ignore the condition attached to the approval. For these reasons, PacifiCorp requests that the Executive Committee reconsider its endorsement of the FTAA.

In the place of the FTAA, PacifiCorp believes the objective of WMBE participation in energy markets would be better promoted if the power transaction is structured as a brokered deal. The WMBE would arrange a transaction for a fee, but supplier and purchaser would contract directly with one another. No party would be bound to a transaction until the buyer and seller entered into a binding contract. Further, the buyer and seller would be able to utilize traditional risk management practices, including

guaranties, collateral and hedging, and each party would have recourse to the traditional legal rights and remedies. This structure entails fewer risks; therefore, more participants should be willing to enter into transactions with WMBEs, thus furthering the intended objective.

Specific Weakness and Objections

The FTAA does not remove the credit risk, and the transaction structure introduces unacceptable delay and performance risks to both supplier and the ultimate buyer of power. Further, the “withdraw support” condition offers no real protection against the FTAA being made mandatory and only exposes the very weakness of the idea.

- * Payment is not assured in bankruptcy. The WMBE remains a legal party to each side of the transaction as buyer and seller, so despite the escrow, the funds are still the WMBE’s in the event of a WMBE bankruptcy.
- * No direct rights between supplier and repurchaser. In the structure of the FTAA, it is unclear which events of default and remedies are available to signatories. The agreement seems to assume that no one would ever fail to perform. Specifically, the WMBE is the legal counterparty to both the Supplier and the Repurchaser and the transaction does not appear to be bankruptcy proof in the event the WMBE fails. That is, the Supplier and the Repurchaser have no rights against each other. Further, the Supplier has a delivery obligation to the WMBE and the WMBE has a separate delivery obligation to the Repurchaser. In the event of a WMBE bankruptcy during rising power prices, the WMBE could reject its delivery contracts and sell the power elsewhere, leaving the Repurchaser with only an unsecured liquidated damage claim against the WMBE.

The absence of direct rights also prevents the FTAA from providing all aspects of the intended conduit of creditworthiness from Repurchaser to Supplier. For example, there is no provision for dynamic creditworthiness monitoring, the provision of collateral or other safeguards in case of credit deterioration during the term of a contract.

- * Performance risk not addressed. As the FTAA keeps the transaction open for up to two days, until the WMBE has found a Repurchaser and received sign off from the escrow agent, the FTAA does not address performance risk with respect to the delivery of power. This risk can be greater than the simple credit risk in rising power markets. Such non-performance in a rising and volatile market proved to be far more costly to PacifiCorp and other market participants in 1998 with respect to the bankruptcy of The Power Corporation of America and other under-capitalized power marketers.
- * No-cost option creates open position risk. The delay built into the transaction process is contrary to common trading and risk management practices. A verbal

commitment becomes binding only upon the issuance by the FTA of its confirmations. This could take up to three days which could expose the Supplier to market price movements resulting in lost opportunity (rising prices) or rescission of the earlier agreement if the Repurchaser finds a better price. Failure of a transaction could also affect the Repurchaser side if the deal was relied upon to serve load and the Repurchaser had to replace the transaction with higher priced energy. A Supplier may, relying on the original agreement, enter into related transactions to firm up or hedge the transaction. Subsequently, if the FTA fails to confirm the deal, the Supplier could be exposed to risk. These risks would perhaps be greatest in periods of significant price volatility. In a time of falling prices a Supplier would be exposed, and in a time of rising prices, a Repurchaser would be exposed. If prices changed and the WMBE could not match the trade, the WMBE would have no obligation to complete the transaction, essentially giving the WMBE a zero-cost two-day option and exposing the original contracting party to extensive risk. This appears to be the most fundamental business flaw in the ongoing operation of the FTAA.

- * Use of the FTAA introduces of weak parties into energy markets. The industry has been financially weakened and should be working to increase overall creditworthiness levels, not to introduce, and empower with automatic two-day options, a whole new class of uncreditworthy parties. Over the last several years, the industry has made a great effort to insure that market participants have the financial capability to perform on their obligations. As a result, documentation has been adopted that requires counterparties to provide evidence of their ability to perform in the event that their financial position is called into question. While these criteria have placed stringent financial requirements on those who wish to participate in these markets, these criteria are similar to those that counterparties must meet were they to transact on the NYMEX, CAISO or NGX. Our view is that by opening the market to financially weak counterparties, we detract from much of the effort that the industry has taken to protect all of the industry participants from unnecessary financial risk.

Alternative Structure

Throughout the development of the FTAA there has been universal recognition that suppliers and buyers require assurances of creditworthiness and ability to deliver according to contracted specification and legal rights to prove such assurances. The FTAA transaction structure fails to provide these assurances because the ultimate buyer and seller do not have a direct contractual relationship, as the WMBE is the intermediary direct party to the buyer and the seller. As result, the ultimate buyer and the seller have no legal rights against each other and have no recourse to the normal credit protections that would exist between a buyer and a seller. Furthermore, since the FTAA structure relies on an indirect link between the supplier and buyer, it introduces additional financial risks due to the unacceptable delays between transaction initiation and completion.

Although the FTAA structure makes the WMBE a direct party to the buying and selling transactions with the attendant risks described in the previous comments, its economic interest and actual participation in the transaction is more in the nature of a broker. Essentially, the WMBE matches both the ultimate buyer and the seller, and then closes the transaction. All proceeds are paid to the escrow agent, the escrow agent transfers funds to the seller, and any remaining proceeds are paid to the WMBE. When viewed closely, the WMBE's roles looks much like a broker. Of course, unlike a broker transaction, the FTAA transaction is very complicated, and carries the additional cost of paying the escrow agent, which will be borne by the WMBE. In addition, due to the risks inherent in the FTAA transaction, it is unlikely that many market participants will choose to utilize the FTAA which means the WMBE's will not gain much access to the power markets through this structure.

In order to address the flaws in the FTAA structure, PacifiCorp proposes that the WMBE actually become a broker rather than a party to the transaction. This alternative structure allows the ultimate buyer and seller to contract directly with each other, and the WMBE would act as a broker, which reflects its actual economic interest in the transaction. In such a structure, payments would flow directly from buyer to seller, with the arranging broker collecting a fee. There would be no need for a neutral, third-party agent and the WMBE would not incur this added expense. Perhaps most importantly, the awkward and time-consuming chain of confirmations would be eliminated. Such a transaction structure would enable rapid transaction completion and provide necessary credit and delivery assurances to market participants. No party would be bound to a transaction until the buyer and seller entered into a binding contract, the buyer and seller would be able to utilize traditional risk management practices, including guaranties, collateral and hedging, and each party would have recourse to the traditional legal rights and remedies.

We believe that this less risky, less costly and less complex proposal should enjoy greater chances of acceptance and usage in energy markets, which is the ultimate goal of any WMBE proposal. A structure that is not used is of little benefit to WMBEs. The Executive Committee should provide such specific guidance to the FTAA Task Force and the Contracts Subcommittee to develop such a transaction structure.

Conclusion

In addition to the FTAA-specific issues, the Executive Committee's "withdraw support" condition hollows the endorsement. In the comments submitted prior to the EC vote, concern was raised that once "endorsed" in the consensus-based process of NAESB, the likelihood of the FTAA's adoption as a mandatory standard would be increased. PacifiCorp shares this concern and takes no comfort in the "withdraw support" amendment. Such a conditioning renders the WEQ's endorsement so tepid that it is clear that the underlying form enjoys little real support as a good idea for the industry. Nor is the condition that the WEQ's support be withdrawn a safeguard against the FTAA

being made mandatory. Once NAESB signifies its endorsement, there is nothing to prevent FERC or one or more states from making it mandatory. An argument that it was a good idea only as long as it was voluntary will certainly not be persuasive with regulators. Further such a back-door endorsement is an inauspicious beginning for the WEQ's standard development mission. The FTAA was available and voluntary before the Executive Committee voted on June 3; any parties that so choose may use it. However, reducing the WEQ's approval to the level to which no one can object, does not transform a bad idea into a good one. The WEQ should not provide its endorsement of an idea that is not good for the industry. There are better, less risky means to accomplish the goals of the FTAA, and NAESB should pursue those alternatives.

For these reasons, PacifiCorp urges the Executive Committee to reconsider its approval of the FTAA and consider the alternative suggested above.