

Interoffice Memo

To: Contract Subcommittee
WSPP Inc.

From: Arnie Podgorsky

Cc: Michael Small

Date: August 7, 2006

Re: July 11-12, 2007 WSPP Contract Subcommittee Meeting (Seattle) and Draft Language

I. Introduction

The Contract Subcommittee met on the above dates. The agenda, and working materials prepared by the Damages Working Group (DWG), are appended to these notes.

The DWG developed a damages survey, the generic results (no attribution to specific members) of which were previously provided to WSPP members. The DWG assessed the responses and identified the following issues raised in the survey responses or otherwise arising frequently in transactions:

1. Assertions by some members that transmission cuts are Uncontrollable Forces (UF) that excuse performance, without regard to the specific limitations on the excuse stated in sections §§ 10(1) and 10(2).
2. Measuring § 21.3 damages when:
 - (a) a cut occurs shortly before or during the hour and where redirect/resupply is infeasible (i.e., no replacement transaction is feasible) and that infeasibility also means that there is no market from which to determine a “market price” (see definitions of Replacement Price and Resale Price in §§ 4.16a and 4.16b. The problem applies on Seller and Purchaser sides. For example, where Seller cannot redirect (for lack of a market) is the market price zero, or how otherwise should it be determined?
 - (b) no reliable index is available, Seller’s other transactions indicate a considerable delta between its buy price and its higher sale price, and in calculating damages a non-performing Purchaser seeks to calculate against that lower buy price and performing Seller believes its higher sell price is the correct market indicator.

3. Is the measure of damages under § 21.3 adequate, bearing in mind that it excludes recovery, for example, of :
 - (a) generator startup costs where Purchaser covers Seller's cut shortly before or during the hour and external replacement (e.g. balancing) is unavailable.
 - (b) other consequential damages (an example discussed at the Subcommittee meeting was transmission rate ratchet costs).
4. Where counter-parties have multiple transactions for the same hour and a cut occurs, how to identify the cut transaction for purposes of calculating damages.
5. Bookouts. With regard to a transaction not to be performed or that was not performed, a bookout is a second transaction for the identical block that offsets the non-performed transaction so that performance (a) occurs (when the bookout was entered into ahead of the initial transaction) or (b) appears to have occurred (in the view of some members, when entered into after the transaction was scheduled to be performed).

On July 11 the DWG, through working materials, presented examples of how the issues arise in transactional settings. The working materials are provided with this memorandum. Meeting participants discussed the issues at length and in detail. On July 12 the Subcommittee discussed the following matters.

II. Means of Achieving More Consistent Application of the WSPP Agreement, Including Business Practices and Training

WSPP legal counsel had presented straw-man business practices (see the meeting materials posted on the WSPP homepage) to facilitate discussion whether explanations of the Agreement in this form would assist WSPP membership. Counsel explained that business practices would need to be consistent with, and not vary, the terms of the WSPP Agreement. For example, business practices could explain contract provisions seeming to be clear but which some parties, nevertheless, may not correctly apply (for example, the limited circumstances in which transmission cuts are UFs). Another category business practices could cover is how the Agreement applies to specific examples, where the terms of the Agreement are not explicit.

Some Subcommittee participants expressed concern that organizations which have business practices treat the practices as binding, and that this would be inappropriate for WSPP. Some urged that in light of industry usage, the term "business practices" itself connotes this binding quality. Others expressed concern that a party should have a right to disagree with a practice and in a litigated dispute should not be compromised the possibility that evidentiary weight is given to the practice.

A straw vote was taken among members participating in the Subcommittee meeting. The vast weight of the vote was against forming WSPP business practices. Subsequent discussion of alternatives included:

(1) business practices parties could voluntarily adopt, and those adopting the practices would be listed (as is done with the netting agreement).

(2) a blog or a comments posting on the WSPP internet site where members could address problems or post explanations of how they view particular provisions. Some members noted that monitoring would be needed to prevent accusations directed to named members and that posting of irresponsible positions could create more problems and ambiguity.

(3) need for more training to achieve more consistent understanding of how the Agreement is applied in detailed settings, such as the DWG examples presented the day before in the working materials.

No determinations were made with regard to items (1) and (2). As to item (3) legal counsel undertook to pursue additional training, subject to the approval and direction of the WSPP Officers.

III. **Discussion of Issues**

Issue 1: Transmission Cuts

The issue is assertions in some transactions that transmission cuts are Uncontrollable Forces (thereby excusing non-performance) without regard to the specific prerequisites that must exist for a cut to be a UF under sections § 10(1) and 10(2).

This problem was seen primarily as a training issue (see business practices discussion above). That is, the Agreement is clear on its face, but representatives of some members are unaware of the restrictions or do not adequately understand them.

Even so, it was considered advisable to update the language to reflect the fact that WECC now directs balancing authorities (BA) to require cuts as needed to address unscheduled loop flow. Those changes are set out below in redline (additional notations are highlighted to distinguish them from contract text).

The Subcommittee also discussed that when the BA directs a load serving entity (LSE) to make cuts (versus the Reliability Authority directing the BA to make the cut), and the LSE is in a position to determine which transactions to cut based on its own economics. There was not significant support for adding a provision that an LSE's cut at the direction of a BA is necessarily a UF. [Verify that the BA can cause cuts without directing the LSE.]

There was considerable discussion of what is a “path” within the meaning of § 10(1), that is, whether a “path” should be limited to a specific, designated, facilities path or should include a network-style or non-specific point to point arrangement such as “COB North to South.” By vote, the Subcommittee determined not to address this issue at this time.

The following changes to the Agreement were discussed and approved for reporting out to the OC for consideration (some language reflects editing or enhancement by counsel after the meeting, as was discussed at the meeting):

4.16a Reliability Authority: a NERC Regional Reliability Council or an independent system operator or regional transmission organization that performs the functions of a NERC Regional Reliability Council. *[Reletter current 4.16a – d]*

10. UNCONTROLLABLE FORCES:

No Party shall be considered to be in breach of this Agreement or any applicable Confirmation to the extent that a failure to perform its obligations under this Agreement or any such Confirmation is due to an Uncontrollable Force. The term "Uncontrollable Force" means an event or circumstance which prevents one Party from performing its obligations under one or more transactions, which event or circumstance is not within the reasonable control of, or the result of the negligence of, the claiming Party, and which by the exercise of due diligence the claiming Party is unable to avoid, cause to be avoided, or overcome. So long as the requirements of the preceding sentence are met, an “Uncontrollable Force” may include and is not restricted to flood, drought, earthquake, storm, fire, lightning, epidemic, war, riot, act of terrorism, civil disturbance or disobedience, labor dispute, labor or material shortage, sabotage, restraint by court order or public authority or directive of a Reliability Authority, *[Note, this change is to add clarity to the application of Uncontrollable Force under 10(2)]* and action or nonaction by, or failure to obtain the necessary authorizations or approvals from, any governmental agency or authority. *[Note: while no change to this last phrase is proposed at this time, it is noted that the phrase may be a reg-out clause that may belong elsewhere or may be inconsistent with representations that all members have necessary regulatory approvals.]*

The following shall not be considered “Uncontrollable Forces”: (i) Seller’s cost of obtaining capacity and/or energy; or (ii) Purchaser’s inability due to the price of the capacity and/or energy, to use or resell such capacity and/or energy. No Party shall,

however, be relieved of liability for failure of performance to the extent that such failure is due to causes arising out of its own negligence or due to removable or remediable causes which it fails to remove or remedy within a reasonable time period. Nothing contained herein shall be construed to require a Party to settle any strike or labor dispute in which it may be involved. Any Party rendered unable to fulfill any of its obligations by reason of an Uncontrollable Force shall give prompt notice of such fact and shall exercise due diligence, as provided above, to remove such inability within a reasonable time period. If oral notice is provided, it shall be promptly followed by written notice.

Notwithstanding the "due diligence" obligations or obligations to remove or remedy the causes set forth in the foregoing paragraph (which do not apply to this paragraph except as specified below), where the entity providing transmission services for transactions under this Agreement and Confirmation interrupts such transmission service, the interruption in transmission service shall be considered an Uncontrollable Force under this Section 10 only in the following two sets of circumstances:

- (1) An interruption in transmission service shall be considered an Uncontrollable Force if (a) the Parties agreed on a transmission path for that transaction at the time the transaction under this Agreement was entered into by the Parties' thereto, [Following language and concept requested, but not voted upon by Subcommittee] and where the path either specified the facilities for the transmission, a point-to-point path, or a network transmission arrangement, (b) firm transmission involving that transmission path was obtained pursuant to a transmission tariff or contract to effectuate the transaction under this Agreement and Confirmation, and (c)

Option 1: the entity providing transmission service curtailed or interrupted such firm transmission pursuant to provisions of the applicable transmission tariff or contract that requires adherence to directives of a Reliability Authority;

Option 2: No change.

- (2) If the Parties did not agree on the transmission path within the meaning of (1) for a transaction at the time the transaction was entered into, an interruption in transmission service shall be considered an Uncontrollable Force only if (a) the

Party contracting for transmission services shall have made arrangements with the entity providing transmission service for firm transmission to effectuate the transaction under the Agreement and Confirmation, (b) the entity providing transmission service curtailed or interrupted such transmission service due to an event of Uncontrollable Forces or provision of like effect, and (c) the Party which contracted for such firm transmission services could not obtain alternate energy at the delivery point, alternate transmission services, or alternate means of delivering energy after exercising due diligence.

No Party shall be relieved by operation of this Section 10 of any liability to pay for power delivered to the Purchaser or to make payments then due or which the Party is obligated to make with respect to performance which occurred prior to the Uncontrollable Force.

Issue 2: Measuring § 21.3 Damages

(a) Cuts shortly before or during the hour:

The problem: a cut occurs shortly before or during the hour where (i) redirect/resupply is infeasible (there is no available replacement transaction) and (ii) there is no market at the applicable point from which to determine a “market price” within the meaning of the definitions of Replacement Price and Resale Price in §§ 4.16a and 4.16b. In these circumstances, how is the “market price” determined? If a Seller cannot redirect, is the power worthless and the Resale Price zero (e.g., spilled hydro). The problem arises on Seller and Purchaser sides. For example, on the Purchaser side, if no power is available for purchase (including balancing service), then is the market price the marginal cost of generation?

Counsel noted that the structure and intent of the Agreement is to facilitate prompt calculation of damages without necessitating factual inquiry other than price. That is, the Agreement does not anticipate that the damages determination would require a determination of what the performing party actually experienced as a result of the non-performance. The Agreement’s easy to apply formulaic approach implements that intent, even if sometimes it achieves only rough justice and not full compensation. Indeed, the essence of liquidated damages is that because actual losses will be difficult to calculate, the parties stipulate to a damages amount in advance, which, when measured to the actual loss, may be too much or too little. The Agreement drafters clearly did not intend there to be full compensation in all circumstances: the preclusion of consequential damages and some direct damages often means that the performing party will receive less than full recompense.

The Subcommittee suggested that counsel provide options to define “market price” (see §§ 4.16a and b). Options could include qualifying in the definitions that the market price must be determined at the contractual delivery time, or that the market price for the applicable hour at an earlier time (when transactions were available) would be used, but with a premium to account for the insufficient response time.

4.16a Replacement Price: The price at which the Purchaser, acting in a commercially reasonable manner, effects a purchase of substitute capacity and/or energy in place of the capacity and/or energy not delivered (for energy) or made available (for capacity only) by the Seller or, absent such a purchase, the market price for such quantity of capacity and/or energy, as determined by the Purchaser in a commercially reasonable manner, at the delivery point, and for the hour(s), specified for the transaction in the Confirmation-, provided, that if the Seller did not inform the Purchaser [] minutes or earlier before the scheduled hour of performance that the Seller would not perform, then the market price for such hour shall be determined in accordance with the first part of this sentence plus [] thereof to cover administrative costs.

4.16b Resale Price: The price at which the Seller, acting in a commercially reasonable manner, effects a resale of the capacity and/or energy not received by the Purchaser or, absent such a resale, the market price for such quantity of capacity and/or energy, as determined by the Seller in a commercially reasonable manner at the delivery point, and for the hour(s), specified for the transaction in the Confirmation-, provided, that if the Purchaser did not inform the Seller [] minutes or earlier before the scheduled hour of performance that the Purchaser would not perform, then the market price for such hour shall be determined in accordance with the first part of this sentence less [] thereof to cover administrative costs.

(b) When there is no reliable index available, Seller’s other transactions indicate significant delta between its buy price and its higher sale price, in calculating damages a non-performing Purchaser seeks the benefit of that lower buy price and the performing Seller seeks the benefit of its higher sale price, which is the correct market indicator?

The Subcommittee suggested no action with respect to this part (b). Additionally, Counsel notes that the issue is relevant to the performing party’s obligation to determine the

market price in a “commercially reasonable manner.” The Agreement provides no guidance about commercial reasonability in this situation.

Issue 3: Is the Measure of Damages under § 21.3 Adequate?

The Subcommittee determined not to recommend revision of damages language to include additional costs borne, for example, by a performing Purchaser that must start a generator to cover a non-performing Seller; conversely, in light of the specific waiver in the contract of other damages, there is no need to state that specific consequential damages are included. Counsel notes that this result and the associated discussion included recognition that the Agreement accords a priority to expedient resolution above remedies that would do a better job of making whole but would require intensive evidence and proof.

Issue 4: Cuts among Multiple Transactions

Where counter-parties have multiple transactions for the same hour and a cut occurs, how is the cut transaction to be identified in order to determine the damages calculation?

The Subcommittee asked counsel to draft options covering (a) weighted average, (b) last transaction deemed the first transaction cut, and (c) performing party selects (the least popular option with the Subcommittee). The Subcommittee did not anticipate determining which option is preferable, but intended that all options be presented to the OC.

Options for a new 21.3(a)(3) (with subsequent subparts to be renumbered) follow:

- (3) In the event the Parties entered into two or more transactions for the same hour and in two or more of such transactions the same Party is the Purchaser and the same Party is the Seller, non-performance occurs in fewer than all of such transactions, and the non-performed transactions cannot reasonably be identified on the basis of delivery points, quantities, or other indicia, then

Option 1 (Weighted Average):

the Contract Price shall be determined by calculating the average price of the non-performed transactions on a weighted basis where the weighted variable is the quantity of capacity or energy specified in the Confirmation for the applicable transaction.

Option 2(Cuts Assumed in Reverse Chronological Order):

the date and time of each applicable Confirmation shall be identified. The most recent Confirmation shall be deemed non-performed and if other transactions were not performed they shall be identified to remaining Confirmations in reverse chronological order.

Option 3 (Performing Party Selects Non-Performed Transaction)

the Performing Party shall have the right to identify which transactions were non-performed transactions.

Issue 5: Bookouts

As discussed at the meeting, bookouts (some call them buy-backs) raise several issues:

- (a) **Pre- and Post-Transaction Bookouts.** Bookouts (or buy-backs) are transactions that, on an offset basis, are intended to fulfill other transactions that otherwise would be non-performed. Bookouts can be differentiated between those entered into prior to the scheduled transaction time, and those entered into after that time. (Some parties do one but not the other.) A bookout entered into prior to the transaction time has the effect, by offset, of fulfilling the scheduled transaction (that otherwise would be non-performed). By contrast, a bookout entered into after non-performance cannot cause a non-performed transaction to be performed (in fact, performance did not occur). Rather, that post-transaction bookout is an informal settlement of a damages claim that otherwise could be resolved formally under § 21.3. Parties are at liberty to settle claims informally in whatever manner they select, consistent with regulatory requirements.

Some members raised concern that in particular circumstances, either pre- or post-transaction bookouts could appear as wash sales, potentially raising market manipulation concerns notwithstanding the lack of any such intent. Caution in this respect is advised. Note that this concern generally would be inapplicable to scheduling bookouts, that is, bookouts that occur when reconciling of ordinarily scheduled transactions identifies potential offsets that are booked out rather than physically delivered.

- (b) **Daisy Chains.** Transactions commonly occur within daisy chains of multiple transactions where, e.g., A sells to B, who sells to C, who sells to D. In daisy chains, the source (A) only has a contractual relationship (“privity”) with the party to which it sells (B), and the sink (D) has privity only with the party from which it buys (C). Each other party has privity with the party from which it buys and the party to which it sells, but not with other parties in the chain (e.g., B and C have privity, but C has no privity with A). By definition then, the source and sink (A and D) have no privity.

Stated differently, in chains, each party has contract rights and obligations only as to the party to which it is linked by a Confirmation (or other contractual arrangement, e.g., under an agreement other than the WSPP Agreement).

The Subcommittee discussed that bookouts between source and sink are common. These bookouts occur informally, despite the lack of privity. Many members believe that these source/sink bookouts resolve all claims in the chain, despite the lack of privity. Many members may support contract provision to allow such bookouts in order to resolve non-performance in lieu of § 23.1 damages. Some members may prefer to avoid the damages remedy because some stigma is associated with it. Offset by bookout is considered less odious.

An after-transaction source/sink bookout theoretically could resolve all damages rights and obligations within the chain if all participants were WSPP members, if the Agreement so provided. Agreement language would need to bind all WSPP members in the chain to the result, and would need to include procedures to inform them that the bookout had created performance (or resolved non-performance) such that notices of curtailment they may have received were rendered ineffective from a cash-flow standpoint.

- (c) **Accounting Issues.** Bookouts that occur in the normal course of scheduling have a different accounting result than bookouts created to resolve non-performance. The former are customary scheduling transactions and would be treated, from an accounting standpoint, as ordinary course transactions. The latter should be designated differently (e.g., with a buy-back nomenclature) to avoid confusion; accounting principles may preclude entry of these bookouts into financial books as actual performed transactions, which they are not.
- (d) **Contract Language.** The prevailing view within the Subcommittee was to begin to address bookouts/buybacks with contract language applicable to counter-party transactions, but not chains. Chains are particularly difficult because not all transactions in a chain are likely to be WSPP transactions. This problem may receive additional attention at the Subcommittee at the direction of the OC. There was minimal support for removing damages provisions in favor of a bookout approach.

The following language is proposed for consideration:

New definition:

“Buy-Back” is a transaction where:

- (a) (i) in circumstances where non-performance under a Confirmation is expected, and prior to the time performance under that Confirmation was required to commence the Parties entered into a second transaction for the purpose of fulfilling their

respective obligations under the first transaction by offset rather than physical delivery,
or

(ii) after non-performance under a Confirmation, the Parties entered into a second transaction for the purpose of finally settling losses incurred by the Performing Party due to the non-performance; and

(b) the second transaction, under either (i) or (ii), was performed.

New Agreement section:

New 21.3(e):

In the event a Buy-Back occurs, then no damages shall be calculated or due under § 21.3(a)(1) or (2), as applicable, with respect to the non-performed transaction.