

Operating Committee Meeting Fall 2009

WSPP TRAINING

Course (Hour) 2: Contract Formation and WSPP Agreement

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These training materials contain no legal opinions or formal interpretations of the WSPP Agreement.

CONTRACT LAW FRAMEWORK

- You've joined WSPP, or you've just become a trader. Now what?
 - WSPP Agreement enables you to trade, meaning, enter into contracts for transactions, WSPP terms and additional terms to which you and counterparty agree in a Confirmation.
- To understand the WSPP Agreement, you should understand the legal aspects of how a contract is formed, breaches, and remedies. Let's pack a one-year law contracts course into an hour or less. We will cover contract law framework and how the WSPP Agreement works in it.

CONTRACT FORMATION

- What is a contract? A binding agreement to do, or refrain from doing, a thing, such that one party is entitled, by law, to a remedy if the other party fails to perform.
- Who is bound? Only the counterparties, which have “privity” with each other. No other parties (e.g., in a daisy chain) have rights or obligations with respect to the counterparties’ contract.
 - What is an intended third party beneficiary?....
 - What is law; what is equity?
 - And, where is the law (common law; UCC- discussed later)

ELEMENTS OF CONTRACT FORMATION

- Offer and Acceptance
 - A deal is enforceable only if a K (lawyers use “K” for contract) between counterparties is formed.
 - K requires (a) agreement = offer and acceptance (meeting of the minds/mutuality) as to material terms and (b) consideration (an exchange of value)
 - If offer expires or is revoked before acceptance, no K can arise; an offer can be made open ended, or can expire on its own terms.
 - Rejection of an offer terminates the offer, even if ahead of the expiration point.
 - Solicitation of bids is not an offer, but bids usually are offers.

ELEMENTS OF CONTRACT FORMATION

- Uniform Commercial Code: What is it; how relate to power sales? (U.C.C. Article 2- sale of goods—is wholesale power “goods,” as required for UCC applicability?)
- UCC Variant: UCC provides that a definite and seasonable expression of acceptance constitutes legal acceptance, even if the acceptance states terms additional to or different from those offered or agreed upon, but if acceptance to the additional or different terms is made subject to assent, it is a counteroffer (U.C.C. 2-207(1)).

ELEMENTS OF CONTRACT FORMATION

- UCC effect of additional terms **consistent** with offered terms (Merchants): If the parties are both merchants, proposed additional terms become part of the contract unless (i) the offer expressly limits acceptance to the terms of the offer; (ii) the additional terms would materially alter the contract; or (iii) the offeror notifies the offeree within a reasonable time of objection to the additional terms (U.C.C. 2-207(2)). WSPP provisions pin this down.

ELEMENTS OF CONTRACT FORMATION

- But, terms that **contradict** offer provisions do not become part of the contract; contract is the offer, the terms agreed in the acceptance, plus terms implied by the UCC to replace conflicting terms (U.C.C. 2-207(2)).
- So, under UCC, a signed written offer by a merchant to buy or sell goods, which gives assurance that it will be held open, is not revocable for lack of consideration during the time stated (or if no time stated, for a reasonable time), provided that the period of irrevocability can in no event exceed three months (U.C.C. 2-205).

ELEMENTS OF CONTRACT FORMATION

- Material terms.
 - Agreements to agree are unenforceable – “General Motors” agrees to sell its Cadillac Division at a price to be negotiated. Not enforceable due to lack of material terms.
 - But, if a material term is to be set by an objective standard, e.g., a discernible market value such as an index, that term will be enforced. Similarly, quantity can float, e.g., all-requirements contracts or all-output contracts.

ELEMENTS OF CONTRACT FORMATION

- Consideration: Exchange of Money or other Value = Mutuality of Obligation
 - Agreement is enforceable only if supported by value: money or mutual performance obligations, which can include reliance. A 2-way street.
 - Consideration is a “bargain” (i.e., an exchange of promises or a promise for performance where each party gives something to receive something in return)—essence of mutuality.

ELEMENTS OF CONTRACT FORMATION

- Additional formation issue: Statute of Frauds.
 - The Statute of Frauds requires that certain types of contracts be in writing, or at least evidenced by a signed, written memorandum of essential terms. The basic purpose of the S/F is to prevent fraud and perjury.
 - UCC contracts for the sale of goods: Contracts for the sale of goods at \$500 or more must be in writing (U.C.C. 2-201). Under WSPP Agreement, electronically recorded telephone calls and emails satisfy the Statute of Frauds. Not instant messenger services, except by agreement.

ELEMENTS OF CONTRACT FORMATION

- Some exceptions: The buyer accepts and receives all or part of the goods (whereupon the contract becomes enforceable as to the goods accepted and received) (U.C.C. 2-201(3)(c)); the contract is between merchants and within a reasonable time a written confirmation (which satisfies the Statute as to the sender) is sent and the receiving party does not dispatch a written objection within 10 days (U.C.C. 2-201(2)).
- Where does WSPP Agreement address formation?
 - § 32 Transaction Specific Terms and Oral Agreements

PERFORMANCE AND BREACH

- What is performance; what is breach?
- Contract interpretation: judges and FERC interpret contracts. FERC has “concurrent” and sometimes primary jurisdiction (what is that?).
- Following are commonly applied legal doctrines of contract interpretation: Plain meaning of contract terms; each word given meaning; construe provisions harmoniously; parole evidence rule (no inconsistent extrinsic evidence- e.g., of negotiations).
- Obligations to perform in good faith.

PERFORMANCE AND BREACH

- Material Breach or Minor Breach: A breach of contract at the time performance is due gives rise to an immediate claim for damages. A breach will excuse the counterparty's duty to perform only if the breach is a material breach.
- Effect of Material Breach: A material breach allows the performing party to sue for breach of the entire contract. And, if the performance was also a condition precedent or concurrent to the other party's duty to perform, that duty is excused—meaning the contract is over and damages will be measured.

PERFORMANCE AND BREACH

- Effect of a Minor Breach: A minor breach gives rise to an immediate cause of action for damages caused by the breach, but not a cause of action on the entire contract. If the performance was also a condition precedent to a counterparty obligation (or concurrent obligation), the minor failure may suspend, but does not excuse, the counterparty's duty to perform.
- Distinguishing **Material** from Minor Breach: Very generally- a breach that destroys the value of the entire contract.

PERFORMANCE AND BREACH

- Form of Breach -- Prospective Inability to Perform: When circumstances make it appear that a party will be unable to perform.
- **Prospective inability to perform excuses the other party's duty to perform.** If prospective inability to perform arises from voluntary conduct, it may also constitute **anticipatory breach** (a breach in itself). Examples include where a vendor encumbers property after contracting to sell it to another, and where a party loses its **creditworthiness**.

PERFORMANCE AND BREACH

- Performance Assurance: Under the UCC, a party with reasonable grounds for insecurity can demand assurances of ability to perform, and may suspend performance until assurances are given. Unjustified failure to give assurances within 30 days constitutes K **repudiation** (U.C.C. 2-609).
- Excuse: Force Majeure (impossibility, impracticability). Excuse is implied as a matter of law, but is often included as a written contract term.

PERFORMANCE AND BREACH

- These aspects of contract law, and other terms, are found in the WSPP Agreement?
 - § 9 Payment (Consideration)
 - § 10 Uncontrollable Force (Force Majeure)
 - § 27 Creditworthiness (assurances)
 - § 32 Confirmation terms (product to be purchased/sold)
 - Schedules A, B, C (product to be purchased/sold)
 - § 30 Confidentiality
 - § 38 Floating Prices
 - § 33 and § 37 Representations and Warranties
 - § 34 Dispute Resolution

REMEDIES

- Remedies are to return the non-breaching party to the **position it would have been in “but for” the breach**, i.e., if performance had occurred.
- Expectation damages: Are based on the contract price, and are to put the non-breaching party in the position he would have been in if the promise had been performed. In other words, through a damages award the performing party obtains the **benefit of the bargain**.

REMEDIES

- Direct Damages versus Consequential (Special) Damages: Principle of Hadley v. Baxendale: A party injured by breach should recover only those damages that (i) should reasonably be considered as arising naturally or in the usual course of things or (ii) might reasonably have been contemplated by the parties at the time the contract was made. **Foreseeable.**
- What does this mean? If the dry cleaner destroyed your suit and consequently you missed a job interview, direct damages are the lost value of the suit, and consequential damages are the lost earnings from the job you didn't get.
- NERC penalties? **Consequential.**

REMEDIES

- Duty to Mitigate: An injured party cannot recover damages that it could have avoided by reasonable efforts. If a buyer fails to cover (buy substitute goods) when she could have, she will not be permitted to recover consequential damages that could have been avoided by covering (U.C.C. 2-715(2)). **Or direct damages.**
- Damages need to be proven with reasonable certainty. Factual question for judge/jury, proven with evidence.

REMEDIES

- Liquidated Damages. These are a **pre-agreed**, set number, e.g., \$1,000 for each day of delayed delivery after a contract delivery date. The law used to frown on LDs, as they removed authority from the court, but now LDs are widely accepted. LDs cannot be punitive, generally should apply only when an actual damages measure may be hard to assess, and can cover a component of damages while other components are not liquidated.
- WSPP approach is NOT liquidated; it is formulaic.

REMEDIES

- Other remedies? Injunctive relief, where money damages will not suffice (e.g., to prohibit disclosure of confidential information).
 - Rescission. Put the parties back where they were pre-contract. Infrequently sought and applied.
- **Netting** impact on ability to be paid. Purpose is not just to reduce cash movements. Setoff means that if your counterparty owes you \$100 and goes bankrupt, but you owe the counterparty \$125, you can keep the \$100 and pay the \$25. Otherwise, you would pay \$125 and have an unsecured (worthless claim) for \$100.

REMEDIES

- Where does the WSPP Agreement address remedies?
 - Articles 21, 22 Damages and Termination
 - Article 28 Netting
 - Article 35 Forward Contract merchant
 - Arbitration

WSPP AGREEMENT ORGANIZATION

- **Understanding the Agreement.** The following breaks down the articles into (a) administrative, (b) deal terms, (c) contract interpretation, and (d) regulatory matters.
- Administrative and Governance Provisions:
 - § 5 Joining WSPP and withdrawing
 - § 14 Transferring membership
 - § 7 Administration
 - § 8 EC (§ 8.1) and OC (§ 8.2); 90% (§ 8.3); notice of meetings; requirement of representative designation (§ 8.5); officers (§ 8.7)
 - § 16 Membership

WSPP AGREEMENT ORGANIZATION

- Transaction Terms:
 - § 4 Definitions
 - § 32 Transaction Specific Agreements (Confirmations)
 - § 38 Floating Prices
 - § 33 Title, Warranties
 - § 37 Additional Representations and Warranties
 - § 6 Service schedules, other products (§ 32.8), the OATT (also § 31)

WSPP AGREEMENT ORGANIZATION

- Transaction Terms (con'd):
 - § 9 Payment
 - § 29 Taxes
 - § 10 Uncontrollable Forces
 - § 21 Liability and Damages
 - § 22 Default; Liquidation
 - § 27 Creditworthiness
 - § 28 Netting
 - § 35 Forward Contracts
 - § 36 Trade Option Exception
 - § 30 Confidentiality
 - § 34 Dispute resolution

WSPP AGREEMENT ORGANIZATION

- Contract notices and contract construction:
 - § 11 Waiver (meaning, no waiver)
 - § 12 Notices
 - § 15 Severability
 - § 17 Parties' relationship (no jv, partnership, etc.)
 - § 20 No third-party beneficiaries
 - § 23 No restriction on members entering other agreements.
 - § 24 Governing law: Utah, or Canada if buyer/seller are there, or US law if buyer or seller is US government.

WSPP AGREEMENT ORGANIZATION

- § 25 Deferral to a party or the EC's determinations on certain members
- § 26 Complete agreement (no side deals outside the Confirmation). Also § 32.4 with respect to Confirmation.
- § 39 Amendment
- § 40 Execution by counterparts

WSPP AGREEMENT ORGANIZATION

- Regulatory Matters:
 - § 13 Regulatory approvals; FERC jurisdiction; BPA
 - § 18 No dedication of facilities
 - § 19 No retail services

A Note about § 4 Definitions –

Use of Capitalized Terms in the Agreement indicates that they are defined in the Agreement. The definitions are critical to the meaning of the language, and the language might not make sense unless you read the definition. When you see a Capitalized Term, refer to the definition.

AGREEING TO A WSPP TRANSACTION

- Agreement to and specification of material terms.
 - § 32.1.1 Confirmation process is to confirm (make binding) counterparties' agreement to price, quantity, delivery point, delivery period, and any other provisions.
 - Confirmation must be made by Documentary Writing or Electronic Writing (for statute of frauds). Details to follow.
- § 32.2.2 Confirmation can include modifications of any term of the WSPP Agreement (“Non-Standard Confirmation Provisions”).

AGREEING TO A WSPP TRANSACTION

- Confirmation procedure for Standard Provisions (not modifying WSPP Agreement terms).
- § 32.2.1 Transactions with duration under a week, by Documentary Writing or Electronic Writing, BUT, if transaction to commence within one week of agreement, a proposed Documentary Writing will not vary the terms of the Electronic Writing, unless both parties sign the Documentary Writing. In other words, the written confirmation will not vary the recorded telephone deal unless both parties sign the written.

AGREEING TO A WSPP TRANSACTION

- § 32.2.2 Transactions with duration of one week or more, only by Documentary Writing.
- § 32.2.3 **Seller shall propose** Documentary Writing within 5 Business Days of the agreement. Purchaser has 5 Business Days to respond; no response is acceptance.
- **If Seller fails to propose** the Documentary Writing within 5 Business Days, then **Purchaser has 5 Business Days to propose**, and Seller has 5 Business Days to respond; failure to respond is acceptance.

AGREEING TO A WSPP TRANSACTION

- Confirmation procedure for Non-Standard Provisions (modifying WSPP Agreement terms).
 - § 32.3.1 Transactions with duration under a week, by Electronic Writing or Documentary Writing executed by both Parties.
 - § 32.3.2 Transactions with duration of one week or more, only by Documentary Writing executed by both Parties.
 - § 32.3.3 Absent Confirmation under § 32.3.1 or § 32.3.2, the WSPP Agreement applies as filed (it is not varied for the transaction).

AGREEING TO A WSPP TRANSACTION

- § 32.4.2 Until Confirmation process is completed, oral agreement remains binding. § 32.5 waives the statute of frauds as necessary.
- § 32.10 Master Confirmations between Counterparties are permissible, which would apply to all further Confirmations between the applicable parties.
- § 38 Floating Prices can be incorporated into a transaction, and additional procedures, for Market Disruption, calculation, and index corrections are provided.

WSPP PRODUCTS

- Products.
 - § 6.1 Service Schedules A, B, C are **incorporated into** the Agreement as product definitions. Schedules may be added or removed.
 - § 32.8 Other products, including products defined under “any other document or form of agreement” (e.g. CAISO Tariff, ERCOT agreement or EEI, can be a product.) Unless otherwise agreed, the product definitions and force majeure shall have the meaning of the other agreement.

WSPP PRODUCTS- C

- Firm (Service Schedule C).
 - Capacity or capacity with energy
 - LD provision applies to this product for failure to deliver or purchase.
 - Interruptible in the following circumstances without paying damages:
 - Force Majeure
 - Within recall time, if agreed
 - Other agreed to circumstances

WSPP PRODUCTS- C

- Interruption is allowed for Seller to meet its public utility or statutory obligations to native load, but Seller would be responsible for payment of damages in those circumstances.
- Obligation on Seller to schedule the power as firm.
- Much discussion of “backed by Seller’s capacity reserves” in context of WECC contingency reserves interpretation.
- A seller with a single resource can sell C.

WSPP PRODUCTS- B

- Service Schedule B.
- Parties may negotiate the terms associated with scheduling, interruptions or rely on the terms in Service Schedule B.
- Interruptions allowed:
 - By Seller by giving proper recall notice.
 - By Seller when all or a portion of the output of the unit is unavailable.
 - By Seller to prevent system separation during an emergency if Seller has exercised all prudent operating alternatives prior to interruption.

WSPP PRODUCTS- B

- By the Seller to meet public utility or statutory obligations.
- By either party due to the unavailability of transmission.
- Transactions are to be prescheduled. Energy schedules may be modified with not less than 30 minutes notice.

WSPP PERFORMANCE AND BREACH

- The Confirmation sets out transaction-specific performance obligations, to which the following additional matters apply.
- § 33.1 Performance. Seller shall deliver, and Purchaser shall receive, per the Confirmation.

WSPP PERFORMANCE AND BREACH

➤ Warranties.

- § 33.2 Title and risk of losses passed from Seller to Purchaser at delivery point (or, if a Federal agency, per applicable law).
- § 33.3 Seller warrants good title and disclaims all other warranties.
- § 37 Additional warranties of legal capacity, no violation of law, solvency (customary contract provisions).

WSPP PERFORMANCE AND BREACH

- 10 Excuse.
 - Uncontrollable Force as defined, excuses performance. Is an event that (a) prevents performance; (b) which is “not within the reasonable control of, or the result of negligence of,” the party claiming the excuse, and (c) “which by the exercise of due diligence” could not have been avoided.
 - Non-exclusive examples are customary “force majeure,” that is, irresistible force.

WSPP PERFORMANCE AND BREACH

- Exclusions are Seller's cost of obtaining the energy or capacity; or Purchaser's inability due to price to use or resell.
- Party claiming excuse must give notice and exercise due diligence to remove. Impact of this phrase is the excuse = the extent of the Uncontrollable Force.
- Transmission cuts: not always an excuse....

WSPP PERFORMANCE AND BREACH

- Transmission cuts excuse performance only if (a) **parties agreed on a specific transmission path** at the time of the transaction (Confirmation), (b) **firm transmission was obtained**, and (c) that firm transmission was interrupted.
- **If no firm path** agreed in the Confirmation, then a cut excuses performance only if (a) the party obligated to provide for transmission arranged for firm service with Transmission Provider, (b) **the Transmission provider cut transmission due to an event of Uncontrollable Force**, and (c) the party which arranged cannot arrange substitute service by due diligence.

WSPP PERFORMANCE AND BREACH

- It follows that a cut of non-firm transmission is not a performance excuse (not Uncontrollable Force).

WSPP PAYMENT TERMS

- Payment Matters.
 - Billing/Payment/Disputes
 - Monthly billing; payable 20th day of month received or 10 days, whichever is later. Premiums on options payable in 3 days. Late payment earns interest 2% above WSJ prime.
 - Dispute of invoice must be written, stating basis, but entire bill must be paid when due. Disputes must be initiated within 2 years of invoice. A party may request the other party's records within that 2 years. (§ 9.6)
 - Bills failed to be issued must be issued within 2 years of the proper issue date.

WSPP PAYMENT TERMS

- § 28 Netting. If parties sign on to the netting agreement, then payments due shall be netted against amounts owed.
- § 29 Taxes. Price is deemed to include all Seller's tax obligations incurred up to the Delivery Point. If Purchaser required to pay, it may deduct from the price. Purchaser pays taxes assessed after the Delivery Point.

WSPP CONFIDENTIALITY

- § 30 Confidentiality. Transaction terms shall be confidential unless disclosure is (a) required in a regulatory proceeding or in any other litigation, or to NERC or a regional reliability council, (b) parties agree to disclosure, or (c) to developer of an index of power prices (see § 30.2, requiring further confidentiality protections).

WSPP CREDIT TERMS

- Credit.
 - WSPP Agreement itself does not include provisions for extension of credit or provision of collateral. A Collateral Annex (for margin posting) outside of the Agreement is available, useful, not widely used. Parties also use derivatives.
 - § 27 If a party's creditworthiness becomes **unsatisfactory** to the other party in that party's "reasonably exercised discretion," that party may require the other Party to provide **assurance** of payment: a letter of credit, cash prepayment, other acceptable collateral, a guarantee, or other acceptable resolution.

WSPP CREDIT TERMS

- Amount is limited to a reasonable estimate of damages for non-performance.
- § 27 provides 5 examples that support dissatisfaction.
- Other party has 3 Business Days to respond, or has committed an Event of Default under § 22 (allowing contract liquidation).

WSPP REMEDIES FOR NON-PERFORMANCE AND DEFAULT

- Two relevant Articles. Article 21 addresses remedies for **non-performance without the contract terminating and liquidating**. Article 22 addresses **Event of Default**, imposing **liquidation** remedy and procedures.
- § 21.1 Remedies specified in WSPP Agreement are exclusive:
 - No consequential or punitive damages.
 - Liability of Federal agency consistent with Federal law (potentially interesting point).

WSPP REMEDIES FOR NON-PERFORMANCE AND DEFAULT

- § 21.2 Where to press your claim under 21 or 22? Any forum having “competent jurisdiction,” which may be a court (state or Federal) or FERC, and without prior mediation.
- A party can seek specific performance (injunctive relief) of terms not pertaining to delivery (e.g., breach of confidentiality requirement).
- § 21.3 Schedule A is interruptible, and there is no remedy for interruption (delivery or receipt) unless parties agree to damages in the Confirmation.

WSPP “LDs”

- § 21.3 Formulaic damages, often referred to as liquidated damages.
 - For **seller's failure to deliver**, Seller will pay damages equal to (a) purchaser's replacement price, (b) less the contract price, (c) plus additional transmission costs incurred in replacing the power, (d) less transmission savings.
 - For a **purchaser's failure to receive**, Purchaser will pay damages equal to (a) seller's Resale Price, (b) less the contract price, (c) plus additional transmission costs incurred in reselling, (d) less transmission savings.

WSPP LDs

- § 21.3(d) allows **bookouts** between counterparties in lieu of damages. Distinguish, however, from chains where bookouts may be between entities lacking contractual privity.
- Each party has duty to minimize damages in a commercially reasonable manner.
- Disputes of the damages calculation (only) (not liability) go to informal mediation and then to **binding dispute resolution** under the WSPP dispute resolution procedures.

WSPP TERMINATION AND LIQUIDATION

- Article 22 Liquidation.
 - In times of substantial market swings, Article 22 liability can bet the company.
 - Arises upon “Event of Default,” which is **failure to** (a) **pay** an amount due if not remedied in 2 days, (b) provide **clean title**, (c) provide **assurances**, (d) **bankruptcy filing**. Analogous events for Guarantor.
 - Failure to deliver or purchase is not an Event of Default so long as the non-performing party makes the required payments under § 21. **Even if repetitive.**

WSPP TERMINATION AND LIQUIDATION

- No general provision that the failure to perform any term in the contract is an Event of Default due to severity of the remedy.
- § 22.2 If an Event of Default, **within 30 days**, the **non-defaulting party** may terminate all WSPP transactions between the parties.
- All transactions are liquidated (except Schedule A), and calculation formula is set forth to determine the liquidated amounts plus costs. Present value of contract revenue versus market value.

WSPP TERMINATION AND LIQUIDATION

- Performing party has unilateral right, but not obligation, to terminate and liquidate. This matters, because if performing party is out of the money (e.g., it is a buyer at a Contract Price above market value), it will not want to terminate and pay the defaulting party.
- Performing party out of money can terminate and make payments over duration of the contract being terminated.

WSPP TERMINATION AND LIQUIDATION

- Disputes on the calculation methodology (not liability) go to mediation and then to arbitration under the WSPP process.
- Detailed mediation/arbitration procedures in Exhibit D of Agreement.
- § 35 Forward Contracts. Allows liquidation in the event of bankruptcy of a party, under limited conditions as specified in the Bankruptcy Code.

QUESTIONS?

- Is there any time left for questions?