LAW OFFICES OF
STROOCK & STROOCK & LAVAN LLP
180 MAIDEN LANE, NEW YORK, NEW YORK 10038-4982
212-806-5400

MEMORANDUM

DATE: February 21, 2001

RE: GISB Early Termination and Liquidation Provisions

TO: GISB Contract Subcommittee Participants

FROM: Mark N. Rae
Marvin J. Goldstein
Scott Le Bouef

This working paper (the "Working Paper") summarizes the results of the February 14, 2001 working session (the "Working Session") regarding the proposed addition of early termination and liquidation provisions to Section 10 of the Base Contract For Short-Term Sale and Purchase of Natural Gas (the "Short Term Gas Contract").

The starting point for this Working Paper was the Working Paper prepared by Exxon Mobil that proposed the text of a new Section 10 ("New Section 10") for the Short Term Gas Contract and that was the basis for the discussion at the Working Session (the "Exxon Mobil Working Paper"). However, because of the magnitude of the consensus changes that are being made in New Section 10 as proposed in the Exxon Mobil Working Paper, the text of New Section 10, as set forth below, does not show the changes from the Exxon Mobil Working Paper version of New Section 10. In those cases where no consensus was reached on an issue, the language in New Section 10 below that relates to the issue has been bracketed. The footnotes to this Working Paper highlight the main issues discussed at the Working Session and, where applicable, set forth proposed solutions to the open issues.

A. Proposed Change to the Base Contract

A check box will be added to the Base Contract to be located below the Section 7.2 Method Of Payment box and above the Section 13.5 Choice of Law box. This new check box will be titled "Forward Contract Damages." The choice under the box would be:

|__| If this Box is not checked, the provisions of Section 10.2.2 will be applicable in the event that an Early Termination Date is designated.

B. Proposed New Section 10

10.1. When reasonable grounds for insecurity of payment or title to the Gas arise, either party may demand adequate assurance of performance. Adequate assurance shall mean sufficient security in the form , amount and for the term reasonably specified by the party demanding assurance, including, but not limited to, a standby irrevocable letter of credit, a prepayment, a security interest in an asset acceptable to the demanding party or a performance bond or guarantee by a creditworthy entity. In the event (each an "Event of Default")[1] either party (the "Defaulting Party") (A) shall: (i) make an assignment or any general arrangement for the benefit of creditors; (ii) file a petition or otherwise commence, authorize, or acquiesce in the commencement of a proceeding or case under any bankruptcy or similar law for the protection of creditors or have such petition filed or proceeding commenced against it; (iii) otherwise become bankrupt or insolvent (however evidenced); (iv) be unable to pay its debts as they fall due; (v) have a receiver, provisional liquidator, conservator, custodian, trustee or other similar official appointed with respect to it or substantially all of its assets; (vi) fail to pay or perform any

[1] Exxon Mobil has suggested using the term "Section 10.1 Event of Default" in place of "Event of Default" to clarify that the liquidation provisions only apply to defaults as defined under Section 10.1 and not to any other defaults that may arise under the Contract.

obligation to the other party with respect to any credit support obligations[2] relating to the Contract,[3] (vii) fail to give adequate assurance of performance under this Section 10.1 within forty-eight (48) hours but at least one (1) Business Day of a reasonable written request by the other party; (viii) not have paid any amount due the other party hereunder on or before the second (2nd) Business Day[4] following written notice that such payment is due; (ix) have a Material Adverse Change, which shall mean with respect to a party or its guarantor, if any, a reduction in the rating of its long-term, senior, unsecured debt (not supported by a third party credit support obligation(s)) by Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc., to below "BBB-" or by Moody's Investor Services, Inc. to below "Baa3"[5]; [or (B) with respect to such party's guarantor, if any: (i) the occurrence of any of the events set forth in clauses (A)(i)-(v), (vii) or (ix) above with respect to such guarantor; or (ii) the failure of the guarantor's guaranty to be in full force and effect (other than in accordance with its terms) prior to the satisfaction of all of the obligations of such party under each transaction to which such guaranty

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[2] Exxon Mobil raised the issue as to whether or not "credit support obligations" should be a defined term.

[3] It was the consensus of the Working Session that a party's failure to meet its obligations under a credit support document relating to the Contract should be an Event of Default. It also was recommended that a section should be added to the Base Contract in which the parties would identify the related credit support documents (e.g., margin agreements, guarantees, etc.), if any, and the relevant credit support providers (e.g., guarantors, etc.), if any. Identification of related credit support documents and credit support providers in the Base Contract would reduce the potential for later disputes regarding whether a particular credit support document was or was not related to the Base Contract.

[4] Exxon Mobil has suggested reverting back to the original "two day" language. Exxon Mobil is concerned that the new extended time period may expose a party owed money to more risk during a holiday.

[5] The following language was deleted:

> provided, however, such Material Adverse Change shall not be considered if said party, within [forty-eight (48) hours but at least (1) Business Day] of such Material Adverse Change, establishes and maintains throughout the remaining term of this Agreement, a standby irrevocable letter of credit, in a form and amount acceptable to the other party and issued by an institution acceptable to the other party;

Exxon Mobil originally proposed this language as a revision of AEP's original language, but Exxon Mobil has advised that they believe this language is no longer needed.

relates without the written consent of the other party;][6], then the other party (the "Non-Defaulting Party") shall have the right, at its sole election, to immediately withhold and/or suspend deliveries or payments and/or to[7] terminate and liquidate the [Contract],[8] in the manner provided in Sections 10.2, without prior notice, in addition to any and all other remedies available hereunder.

10.2. In the event that the Non-Defaulting Party terminates the [Contract] as the result of an Event of Default, the Non-Defaulting Party shall have the right, at its sole election, to designate an early termination date (the "Early Termination Date") as any date [on or after the date the Event of Default occurs, but no later than twenty (20) days after the Event of Default][9] under Section 10.1 [so long as

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[6] This language was added to include certain events relating to a party's guarantor, if any, as Events of Default. As noted in footnote 1 above, it also was suggested that the Base Contract should be amended to require the parties to identify any related guaranties and guarantors.

[7] In this portion of the Exxon Mobil draft of New Section 10, there was language that might have been susceptible to the interpretation that the Non-Defaulting Party had to choose between either withholding and/or suspending deliveries and payments, on the one hand, and terminating the Contract, on the other. The new language set forth above is intended to make clear that the Non-Defaulting Party will have the flexibility to take either or both of these steps.

[8] Concern was expressed that the Short Term Gas Contract's current definition of "Contract" is inadequate for purposes of its use in New Section 10. The current definition has two potential shortcomings in this context. First, it does not appear to cover transactions entered into by means of binding oral agreements, which have not yet been reduced to Transaction Confirmations. As presently defined, a "Transaction Confirmation" must be a writing. The Non-Defaulting Party must have the right to terminate and liquidate binding oral transactions. Second, the "Contract" definition, by its terms, covers the Base Contract and "any" Transaction Confirmation. This provides the basis for an argument that each Transaction Confirmation and its Base Contract is separate from each other Transaction Confirmation and its Base Contract. From a bankruptcy perspective, this could be a problem. In a bankruptcy proceeding, it will be important for the non-bankrupt party to be able to argue that the Base Contract and all transactions entered into under it should be viewed as one integrated agreement, so as to reduce the potential for so-called "cherry-picking" in the proceeding by the bankrupt party or its trustee. It was suggested that the definition of Contract be amended to address these issues or, in the alternative, that a new term be created to cover the Base Contract and all transactions (whether or not reduced to a writing) entered into thereunder for purposes of New Section 10.

[9] Concern was expressed that the current requirement that the Early Termination Date must occur within 20 days after the occurrence of the Event of Default could cause problems in a case where the Non-Defaulting Party did not know that the Event of Default had occurred. Such a situation could arise, for example, under clause (iv) of New Section 10.1, which makes a party's inability to pay its debts as they come due an Event of Default. It may be very difficult for one party to learn that such an

the Event of Default is continuing].[10] [Upon] the Early Termination Date, the Non-Defaulting Party shall have the right, at its sole election, to terminate and liquidate [any and all transaction(s)] [11] under this [Contract] (including any portion of a transaction(s) not yet fully delivered) then outstanding, as follows:

Event of Default has occurred with respect to the other party or, alternatively, exactly when such an Event of Default has, in fact, occurred. It also was asserted that there should be no express time limit on the Non-Defaulting Party's designation of an Early Termination Date. The proponents of this view argued that the doctrines of good faith, fair dealing and laches, which are inherent in the laws of most states, should be sufficient to protect the Defaulting Party from any bad faith designation, or designation of a seriously delayed Early Termination Date by a Non-Defaulting Party. In the alternative, the proponents of this view argued that 20 days was too short a period in which to require the Non-Defaulting Party to determine whether to designate an Early Termination Date and that a more appropriate period would be 60 days.

[10] Some participants in the Working Session expressed the view that the requirement that the default be "continuing" should be removed. They argued that the real effect of this requirement is to extend the grace period available to the Defaulting Party for the cure of an Event of Default up to the moment before the Non-Defaulting Party designates an Early Termination Date and that such a time extension is unfair to the Non-Defaulting Party, who should be accorded a reasonable period of time after an Event of Default occurs in which to determine whether to designate an Early Termination Date.

[11] Concern was expressed regarding the requirement that "any and all" outstanding transactions be terminated. It was pointed out that there might be certain types of contracts that could not be terminated under applicable law (e.g., outstanding spot contracts after a bankruptcy filing) or a court or governmental order (e.g., the FERC orders recently issued in connection with problems in the California electricity markets). The proponents of this view also argued that there might be instances in which it might not be commercially practicable to terminate particular transactions on the Early Termination Date (e.g., where the market is not liquid enough to absorb the required terminations without seriously affecting the market price) or in which it might be in the interests of both parties to leave a particular contract in place (e.g., a prepaid forward contract to deliver gas to an electric utility serving a retail load). It was argued that New Section 10.2 should be amended to give the Non-Defaulting Party the discretion and flexibility to deal with such situations.

10.2.1. [Upon] the designation of an Early Termination Date, the Non-Defaulting Party shall determine, in good faith and in a commercially reasonable manner, the amount owed, if any, by each party with respect to all Gas delivered and received between the parties on and before the Early Termination Date, and all other applicable charges relating to such deliveries and receipts (including without limitation any amounts due under Section 3.2), for which payment has not yet been made by the party that owes such payment under this [Contract].

Section 10.2.2 below will be applicable unless the parties have indicated otherwise in the Base Contract.

10.2.2. [Upon] the designation of an Early Termination Date and in addition to Section 10.2.1 above, the Non-Defaulting Party shall determine, in good faith and in a commercially reasonable manner, the Market Value, as defined below, of each transaction closed out pursuant to Section 10.2. The Non-Defaulting Party shall (i) liquidate each closed-out transaction at its Market Value, as defined below, so that each such amount equal to the difference between such Market Value and the Contract Value, as defined below, of such transaction(s) shall be due to the Buyer under the transaction(s) if such Market Value exceeds the Contract Value and to the Seller if the opposite is the case; and (ii) discount each amount then due under clause (i) above to present value in a commercially reasonable manner as of the Early Termination Date (to take account of the period between the date of liquidation and the date on which such amount would have otherwise been due pursuant to the relevant transactions).

For purposes of this Section 10.2.2, "Contract Value" means the amount of Gas remaining to be delivered or purchased on a Firm basis under a transaction multiplied by the Contract Price, and "Market Value" means the amount of Gas remaining to be delivered or purchased on a Firm basis under a transaction multiplied by the market price determined by the Non-Defaulting Party in a commercially reasonable manner. To ascertain the Market Value, the Non-Defaulting Party may consider, among other valuations, any or all of the settlement prices of NYMEX Gas

futures contracts, quotations from leading dealers in energy swap contracts, similar sales or purchases and any other bona fide third-party offers, all adjusted for the length of the term and differences in transportation costs. A party shall not be required to enter into a replacement transaction(s) in order to determine the Market Value. Any extension(s) of the term of a transaction to which the parties are not bound as of the Early Termination Date (including but not limited to "Evergreen" provisions and options to extend) shall not be considered in determining Contract Values and Market Values. The rate of interest used in calculating net present value shall be determined by the Non-Defaulting Party in a commercially reasonable manner.

10.2.3. The Non-Defaulting Party shall setoff or aggregate, as appropriate, any or all amounts owing between the parties under Section 10.2.1, Section 10.2.2 (unless made inapplicable pursuant to the Base Contract) [and, at the option of the Non-Defaulting Party, any other agreement or arrangement between the parties to this Contract],[12] so that all such amounts are aggregated and/or netted to a single liquidated amount payable by one party to the other. [13] If any obligation is unascertained, the Non-Defaulting Party may in good faith estimate that obligation and set-off in respect of the estimate, subject to the Non-Defaulting Party accounting to the Defaulting Party when the obligation is ascertained. At its option, the Non-Defaulting

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[12] No consensus was reached as to the scope of the bracketed set-off provision. Two opposing views were presented. The first was that this set-off provision should be limited to only those amounts that are due and owing, as of the Early Termination Date, amongst the parties to the Contract. The second was that this set-off provision should be as broad as possible and should include, without limitation, amounts that may be due in the future under other agreements.

[13] Although not discussed in the Working Session, it may be worthwhile to consider adding a provision here that would permit the Non-Defaulting Party to withhold any net payment due to the Defaulting Party until the Non-Defaulting Party has received all payments and deliveries due and owing under the Contract or any other agreement between the parties. Such language would facilitate the orderly liquidation of the agreements between the parties. Of course, a withholding provision is less important to the extent the Contract incorporates a broad right of set-off.

Party may setoff any such net amount owed to it against any margin or other collateral held by it in connection with this [Contract].[14]

10.2.4. The Non-Defaulting Party shall give notice that a liquidation pursuant to Section 10.2 has occurred to the Defaulting Party no later than the Business Day following such liquidation, provided that failure to give such notice shall not affect the validity or enforceability of the liquidation or give rise to any claim by the Defaulting party against the Non-Defaulting Party. The net amount due pursuant to Section 10.2.3 shall be paid by the close of business on the fifth (5th) Business Day following notice of the Early Termination Date.[15]

10.2.5 The parties agree that each transaction terminated and liquidated under Section 10.2 shall constitute a "forward contract" within the meaning of the United States Bankruptcy Code and that Buyer and Seller are each "forward contract merchants" within the meaning of the United States Bankruptcy Code.

[10.3. The Non-Defaulting Party's remedies under this Section 10 are the exclusive and sole remedies of the Non-Defaulting Party with respect to the occurrence of any Event of Default.][16]

10.4. Each party reserves to itself all rights, set-offs, counterclaims, and other defenses which it is or may be entitled to arising from the [Contract].

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[14] A consensus was reached that Non-Defaulting Party should have the right, but not the obligation, to utilize collateral without having to give the Defaulting Party prior notice.

[15] See Footnote 11.

[16] Consideration should be given to deleting this Section 10.3, as it appears to be potentially inconsistent with Section 10.4.