



Memorandum

To: ISO Finance Committee
From: Phil Leiber, Treasurer & Director of Financial Planning; Byron Woertz, MRTU
cc: ISO Board of Governors, ISO Officers
Date: June 8, 2005
Re: ISO Credit Policy for Scheduling Coordinators – Proposed Changes

This memorandum requires Board action.

Executive Summary

On May 6, 2005 Management informed you of a “final draft” set of recommended changes to its policies and procedures to enhance the financial security in the ISO’s markets. The ISO discussed these proposed changes with stakeholders at an April 26th, 2005 web conference, and has received written comments from several Scheduling Coordinators (SCs) regarding the proposed changes.

We classified the changes in three categories:

- Changes that the ISO already has implemented;
- “Phase 1” changes that the ISO proposes to implement in 2005. These are the changes addressed in this Board memorandum; and
- “Phase 2” changes that Management proposes to pursue in 2006.

With this memo, Management requests authorization to proceed with preparing and filing the Tariff language for the recommended Phase 1 changes and to develop detailed procedures for implementing each of the changes.

Motion

MOVED:

That the ISO Governing Board approves the “Phase 1” changes to the ISO Credit Policy for Scheduling Coordinators, as set forth in Attachment A to the memorandum to the ISO Finance Committee dated June 8, 2005, and directs ISO Management to proceed with developing Tariff language (as necessary) and operating procedures to implement the policy changes.

Proposed Changes

Over the past three and a half years, the ISO has considered several changes to its policies for ensuring adequate financial security for all market participants. The ISO has communicated regularly with stakeholders as it has considered each of these options, most recently through stakeholder meetings on November 30, 2004 and on April 26, 2005. The table included in Attachment A, "SC Credit Policy: Changes Under Consideration," describes the credit review team's proposed changes to the ISO's credit policies. Section numbers refer to the sections of the document posted on the ISO web site for stakeholder review¹.

Matters Considered and Changes Already Implemented

The ISO has already implemented several improvements and changes which did not require Tariff revisions, including:

- Requiring SCs that use more than one Scheduling Coordinator Identification (SCID) number to schedule their market transactions to provide sufficient security for all SCIDs' obligations in aggregate;
- Requiring new SCs to post security for at least 14 days of expected market transactions, with the SC's posting requirement to be reviewed weekly and adjusted as necessary;
- Implementing the Scheduling Coordinator Aggregate Liability Estimator ("SCALE") as the tool for estimating SCs' financial liabilities;
- Continuing to allow "net creditor" months to offset "net debtor" months within an SC's security posting requirements; and
- To reduce volatility in security posting requirements, basing security posting requests on the lesser of (1) the most recent SCALE figure or (2) a moving average of the most recent SCALE estimates over the past month. No further changes are expected to the SCALE tool until 2006, at which point the new Settlements and Market Clearing system will generate liability estimates. .

Proposed Phase 1 Changes

Management is requesting the Board's approval to move forward with the Phase 1 changes identified in Attachment A. These include the following:

Credit Limits for SCs - At present, SCs with an Approved Credit Rating² receive unlimited unsecured credit in the ISO's markets. Management proposes to set credit limits for each SC, based on credit ratings, other third party credit assessments and entity-specific financial data. The ISO proposes specific approaches for:

- Rated Public / Private Corporations,

¹ At <http://www.caiso.com/docs/2003/04/21/2003042117001924814.html>.

² Defined in the Tariff. In short, entities that have an A-/A3 Moody's/S&P long-term credit rating, A2/P2 short-term rating, or whose obligations are backed by the State or Federal Government

- Unrated Public / Private Corporations,
- Rated Governmentally Owned Utilities, and
- Unrated Governmentally Owned Utilities³.

Other changes include providing additional granularity in calculating credit limits by using long-term rather than short-term ratings, creating a \$250 million unsecured credit cap for any single entity, and eliminating separate credit standards for market and GMC obligations.

Setting credit limits for entities is the most substantive of the changes proposed, and will require additional ongoing effort by the ISO. Rather than hire additional analysts to perform complex credit assessments, the ISO intends to maintain a generally objective "rules-based" approach and to obtain assistance from third party credit organizations to evaluate and administer the credit limits. Management intends to post on the ISO website the specific information to be used to set such limits, and how the assessments for each entity type will be performed. The documents distributed for stakeholder review illustrate the proposed approach for each entity type. The annual cost for the third party assistance anticipated to be necessary is likely to be in the very low six-figure range, less than the cost of expanding the ISO's credit staff to perform similar services.

ISO-Approved Security Documents - In general, SCs use pro-forma security documents for letters of credit, guarantees and other security documents, although there have been a few exceptions. Management proposes to require SCs to use standardized documents to the greatest extent possible. In special circumstances, the ISO will consider exceptions, but SCs must allow the ISO 10 business days to consider the exception. Until and unless the ISO approves an exception, SCs must use standardized documents.

Security Agreement Expiration - Currently, all security documents remain in effect through their stated expiration date. All security documents will expire and be considered void 30 days prior to their stated expiration dates. SCs can avoid a lapse in security coverage by ensuring that documents are renewed at least 30 days prior to expiration or by providing for perpetual effectiveness.

Credit Insurance - The ISO does not currently have a credit insurance program in place. Over the past several months, the ISO has discussed with several insurance companies the possibility of offering credit insurance to provide additional assurance of payment to suppliers for unsecured market and GMC liabilities.. This insurance would cover the portion of outstanding market and GMC liabilities that is not secured by collateral, which would include the liabilities of entities granted some unsecured credit under the proposed change noted above. There would likely be an overall limit for the entire market and limits per Scheduling Coordinator. The insurance would be part of an overall credit management approach and would not replace collateral requirements or credit monitoring by the ISO. In fact, the ISO would have to maintain or enhance its oversight of credit requirements as a condition of insurability and in order to maintain an overall lower premium. If such a program is determined to be

³ After the publication for stakeholder review of our proposed approach for setting limits for various entity types, we determined that additional opportunities for unsecured credit should be provided for unrated Governmental Owned Utilities. Accordingly, we will grant unsecured credit to these entities based on the formulas published to date (which provide unsecured credit of up to 5% of net assets if certain financial ratios are met), and may provide unsecured credit based on an assessment of other quantitative and qualitative factors as set forth in FERC's November 2004 credit policy statement.

cost effective and of value in encouraging additional entities to supply power during this summer's expected tight conditions, Management may proceed to purchase the credit insurance. Quotes received in early June indicate coverage costs are higher than anticipated, but Management will continue to negotiate cost and terms with carriers in an attempt to structure an attractive program.

Number of Days Included in Liability Calculation - Although the ISO generally requires SCs to post security from the previously- paid invoice to the next scheduled invoice (approximately 102 days), there have been exceptions. Management proposes to eliminate the "Weekly Period" posting option and will require a security posting based on a level number of days outstanding from invoice-to-invoice. As the ISO moves to accelerated payments (planned for Q1 2006), it is projected that security posting requirements for all SCs will decrease by approximately 50 percent.

Risk of Loss for Funds Held By the ISO - The ISO Tariff does not currently address how to remedy the situation where funds held by the ISO as security for SCs are invested (consistent with the ISO investment policy) for their account, suffer a loss of principal. Management proposes to add a section to the ISO Tariff that addresses the risk of loss of funds held and invested by the ISO on behalf of Market Participants. Market Participants will bear any risk of loss of principal and/or interest of such funds. The updated ISO Investment Policy (also scheduled for approval at this Board meeting) will specify that it will only invest such funds in a bank account, high-quality money market fund, or US Government security unless a specific agreement between the ISO and SC specifies another type of investment (also limited to investments permissible in the ISO investment policy).

Proposed Phase 2 Changes

Management proposes to take no action currently on Phase 2 changes listed in Attachment A until 2006. Should Management desire to proceed with these changes, we will return to the Board for approval.

Stakeholder Comments

The ISO received written comments from approximately 10 entities following the two stakeholder meetings on credit matters. **Appendix 1** contains a record of stakeholder comments and questions about the proposed changes, and ISO responses to this feedback. Such comments were also posted to the ISO web site as received⁴. The feedback covers a range of issues on various elements of the ISO's proposal. Several stakeholders have requested additional details about the changes, and some have noted ongoing discussions with the ISO regarding special circumstances. However, since the April 26 stakeholder meeting, the ISO has not received comments opposed to any of the ISO's proposed changes. Importantly, many entities have expressed support for, and none have opposed the proposal to set specific credit limits for individual SCs.

Timeline for Moving Forward

If the Board approves the proposed changes, Management will continue working to prepare necessary Tariff changes. Our intent is to coordinate the Tariff filing for credit policy changes with other needed Tariff filings in the near future. Our best estimate is that such a filing could take place in September, 2005. In that case, the proposed changes could take effect as soon as November, 2005. Management will work

⁴ At <http://www.caiso.com/docs/2003/04/21/2003042117001924814.html>.

with internal business units, stakeholders, and outside vendors who are to support the ISO in the administration of the credit limit setting process to ensure that operating procedures are in place prior to FERC approval of the Tariff changes so that the revised policies may be implemented as early as possible.

The ISO will plan to address "Phase 2" changes during 2006.