Memorandum

To: ISO Board of Governors

From: Keith Casey, Vice President, Market and Infrastructure Development

Date: March 17, 2010

Re: **Decision on Credit Policies Affecting Congestion Revenue Rights**

This memorandum requires Board action.

EXECUTIVE SUMMARY

The California Independent System Operator Corporation has implemented short-term and long-term congestion revenue rights (CRRs) as a feature of its new market design in effect since April 1, 2009. CRRs provide payments (or charges) based on price differences between two locations. CRRs are released through annual and monthly allocation and auction processes. Management's experience in conducting these processes provides an opportunity to consider refinements. This proposal would reduce unnecessary pre-auction credit thereby improving the efficiency of collateral usage and reducing barriers to participation in the auctions and reduce the costs of participating in a CRR auction.[1]

Management is proposing three modifications to the calculation of pre-auction credit requirements and two enhancements to reduce the cost of participating in a CRR auction. The three modifications of the pre-auction credit requirement consist of:

1. Reducing the credit margin portion of the pre auction credit requirement,

2. Limiting the pre-auction credit requirement for a negative valued CRR to just the credit margin, and

3. Reducing the minimum credit requirement for participating in a monthly CRR auction from $500,000 to $100,000.

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[1] The ISO has identified several issues as candidates for further refinements, some of which are improvements to business practices to implement policies that the ISO's Board of Governors has previously approved. The CRR stakeholder process is continuing on issues other than CRR-related credit policy, and non-credit policy changes will be presented to the Board in early 2010. The ISO is proceeding with the credit policy enhancement as expeditiously as possible, since it is independent from the non-credit issues for which the stakeholder process is in progress.

These modifications will reduce the amount of financial security required for participating in the auction while ensuring sufficient collateral is available to cover both the payments due to the ISO for CRRs awarded through the auction and the credit requirement for holding the awarded CRRs.

Next, management proposes two additional credit policy enhancements to reduce the cost of participating in a CRR auction.

1. Enabling more effective use an auction participant's collateral by using the new credit tracking system to determine if sufficient collateral is available at the time of a bid, and

2. Removing rules limiting the amount of collateral that is available for an auction.

Management proposes that the Board approve the following motion adopting these changes to the CRR-related credit policy:

> ***Moved, that the ISO Board of Governors approves the proposal regarding the revision of congestion revenue rights-related credit policies, as detailed in the memorandum dated March 17, 2010; and***
>
> ***Moved, that the ISO Board of Governors authorizes Management to make all necessary and appropriate filings with the Federal Energy Regulatory Commission to implement the proposed tariff change.***

DISCUSSION AND ANALYSIS

The ISO's credit policy for CRRs is designed to protect the financial interests of market participants against risks associated with CRRs by ensuring collateral is sufficient to cover the positions of market participants. At the same time, the ISO is mindful that excessive collateral requirements would create unnecessary barriers to enter in the CRR market. To balance these factors, based on the outcomes of market operation and feedback from stakeholders, Management proposes three enhancements to revise the calculation of pre-auction credit requirements to reduce the pre-auction credit requirements for market participants in certain circumstances. This reduction in pre-auction credit requirements simply eliminates elements that have been determined to be unnecessary. The ISO's credit policy will still ensure that the CRR auction participants are fully collateralized.

First, the pre-auction collateral requirement should be designed so that it is sufficient to cover the maximum exposure of a CRR bid. The credit risk of a CRR bid consists of two components, the bid value and the credit margin. Currently the maximum credit exposure of the two components is evaluated separately and can result in a pre-auction financially secure amount of credit requirement under some circumstances that exceeds the amount of collateral required to pay for and hold the CRRs awarded in the CRR auctions. Management proposes to modify the credit requirement so that the maximum collateral requirements for a CRR bid will be based on the sum of the two components, which can result in reduced collateral requirements. Currently, the pre-auction credit requirement is set by the sum of the bid cost (bid segment price multiplied by the bid segment quantity) plus a credit margin (credit margin multiplied the total MWs bid for a CRR). The new proposed method would potentially reduce the pre-auction credit requirement by reducing the credit margin portion of the requirement to the credit margin multiplied by the bid segment quantity that would result in the greatest credit exposure rather than the total quantity bid.

Second, the existing ISO tariff requires market participants bidding for negative-valued CRRs to post collateral as a pre-auction credit requirement sufficient to meet the holding credit requirements of the CRRs before they are paid for the CRRs awarded in the auction. In effect, the bidder for a negative valued CRR must post collateral to cover both the bid credit exposure and the credit margin exposure. Based on the current rule, the ISO could receive more collateral than is necessary for negatively valued CRRs resulting in a money swap that is not necessary. For example, the auction winner of a -$100,000 CRR needs to post a financial security of $100,000 plus the credit margin (for example, $50,000) before he is paid the $100,000 winning bid. Under the proposed method, an unnecessary money exchange is eliminated by the ISO simply retaining the auction proceeds for the negatively valued CRRs (market clearing price times the cleared MW value), which will be used, along with the credit margin, to meet the credit requirements for holding CRRs The ISO will hold the proceeds until the CRR holder posts an alternative form of collateral, such as a letter of credit. Excluding negative bids from the pre-auction credit requirement calculation will avoid a portion of the pre-auction credit requirement for bidding for negative-valued CRRs without compromising on the ISO's policy of requiring all CRRs to be fully secured.

Third, Management is proposing to reduce the minimum collateral requirement for participating in the monthly auction from $500,000 to $100,000. This minimum collateral requirement was put in place to prevent the possible misuse of auction opportunities. For example, a market participant could submit negative priced bids to create profitable opportunities for other associated parties and then default at the end of the auction. Similar situations have occurred in other ISOs. The minimum security requirement discourages such behavior, without unnecessarily burdening other participants. Some stakeholders suggested that a lower minimum pre-auction financial security requirement for monthly auctions is more appropriate since the volumes are smaller than in the annual auctions. In monthly auctions from April to September of 2009, about 60% of the auction participants had either payments due to the ISO or holding credit requirements less than $100,000 at the end of the auctions. Therefore, we recommend reducing the minimum financial security requirement for participating in a monthly CRR auction from the current $500,000 (which applies to both annual and monthly auctions) to $100,000. Management is not proposing any change to the collateral requirements of the annual CRR auction.

Management also proposes two additional credit policy enhancements that will reduce the cost of participating in a CRR auction. First, under the current rules an auction participant must dedicate enough of their available credit to the auction to cover their aggregate bids in the auction. This collateral is unavailable for other market activity until winning bids are published which takes approximately two weeks. With a planned new credit tracking system, Management proposes to remove this requirement and allow the new system to determine if sufficient collateral is available at the time of a bid. Dedicating credit at the time of bid is a more effective use of an auction participant's collateral. Second, the ISO currently limits an auction participant to 90% of their available credit in an auction. Under this rule the ISO will make a collateral call when a market participant's obligations to the ISO exceed 90% of their collateral amount. The 90% policy was put in place to avoid an immediate collateral call from being issued if an auction participant chose to use 100% of their collateral in an auction. With the removal of the requirement to dedicate a portion of collateral to an auction, it is no longer necessary to limit the amount of collateral that is available for an auction.

The enhancements described herein ensure that the collateral required for participating in the CRR auction will be sufficient to cover both the payments due to the ISO for winning the auction and the credit requirement for holding the winning CRRs. Auction winners will not need to post additional financial security in order to hold the winning CRRs. In addition, this proposal will allow market participants to more fully utilize their collateral and minimize the opportunity cost of participating in a CRR auction thus allow them to participate in other segments of the market.

POSITIONS OF THE PARTIES

The stakeholder process included the publication of an issue paper in August 2009, a straw proposal and an update to the straw proposal in September 2009, and the draft final proposal in November 2009. Stakeholder comments identified issues in addition to those initially identified by the ISO and assisted in the formulation of this proposal. The resulting proposal has received essentially unanimous support as reflected in stakeholders' submitted comments. The reduction in minimum credit requirement in the monthly auction is the direct result of a stakeholder comment.

Inasmuch as the other credit policy enhancements were not part of the original stakeholder process and evolved out of the recent design of the new credit tracking system, two separate stakeholder calls were held where these enhancements were described - the first as part of a weekly CRR conference call with CRR participants, and the second, a recent call with the broader set of market participants. There were no objections raised on either call.

MANAGEMENT RECOMMENDATION

Management recommends the adoption of the changes described herein to the CRR-related credit policy. These revisions to the current credit requirements for participation in CRR auctions will reduce the pre-auction credit requirement for some bids while maintaining adequate credit coverage and allow auction participant to more efficiently manage all of their available credit, thereby improving the efficiency of collateral usage and facilitating participation in the auctions.