

EPIC Merchant Energy Comments on CRR Credit Enhancements Discussed on the April 21, 2008 CRR Issues Conference Call

On the April 21, 2008 conference call, the CAISO and its stakeholders reviewed the Straw Proposal document for CRR Credit Policy Enhancements, dated April 14, 2008. The CAISO requested comments on these potential enhancements to its credit policies by April 28, 2008. EPIC appreciates the opportunity to provide comments on these important issues in the CAISO's CRR market.

Credit Policy Examples

Providing real life examples of how the CRR credit policy would work would be very beneficial. CAISO should present illustrations that would show how much credit would be required and when. Also, the timing of cash settlements (when does money exchange hands between the ISO and a CRR participant) should be clarified in these examples.

Retroactivity

Comments made during the last meeting suggested that changes to the CRR Credit Holding Requirement would apply to all existing CRR positions. EPIC is very concerned about the retroactive nature of this approach. Changes to the CRR Credit Holding Requirement should only apply to CRR positions acquired (i.e. bided on) after the changes are made effective.

CRR Credit Holding Requirement

CAISO is proposing to change the holding requirement by including the Historical Expected Value in the calculation once this value is available (1 year after the start of MRTU). EPIC is very pleased to see CAISO moving in the right direction by including Historical Expected Value in the formula. Like other stakeholders and the CAISO itself, EPIC agrees that the auction clearing price is not always the best indicator of the future value of a CRR.

At the same time, CAISO does use simulation prices to compute the credit margin and assess the volatility of a CRR. When we asked the question why isn't the same data used to compute an expected value, we were told that this is what was previously decided by stakeholders. This may be so, but we feel that it could be worth reconsidering that position. We have not heard a good argument as of why it is appropriate to use simulation data for the credit margin but not for the expected value. We do understand that simulation data can be expected to not perfectly match actual market prices, but we feel that it's still may be more accurate than auction clearing prices.

Finally, although the inclusion of the Historical Expected Value is a step in the right direction, EPIC is concerned that the proposed implementation would result in an overall increase of the holding credit requirement. This is because the proposed change is to look at the minimum of either the auction price or the expected value. In other words, this is a worse case scenario type of approach. The way the expected value is proposed to be included does address increasing the credit requirement where we are under collateralized but does nothing to reduce it where we are over collateralized. EPIC believes the following approach would increase the credit required to hold a short term CRR where under collateralized without resulting in an unnecessary overall increase:

$$\text{Holding Requirement} = \sum_{CRR_i} ((\text{Auction Price}_i - \text{Expected Value}_i) + \text{Credit Margin}_i \times MW_i)$$

Where the expected value is calculated based on simulation data until historical data is available.

CRR Credit Bidding Requirement

CAISO is proposing to calculate the bidding requirement by taking the maximum of \$500,000 or the absolute value of the bid price plus the credit margin. EPIC believes that this approach is flawed for two reasons:

- 1) Using a participant's bid price as a proxy for the future value of a CRR is inappropriate. CAISO and its stakeholders agree that the auction clearing price which is the result of all the participants bids put together is not always a good indicator of the future value of a CRR. So clearly, the bid price, which is the view of a single participant, should not be used as a proxy for the future value of the CRR.
- 2) Using the absolute value of the bid price introduces another flaw. It makes CAISO CRR credit policy require less credit for a CRR bid that is more risky. A sound CRR credit bidding requirement should increase as the risk presented by the bid increases, not the opposite.

For all CRR bids, the lower the bid price the less risky the bid is. This is for two reasons:

- 1) The lower the bid price the less likely it is that the bid will clear.
- 2) The lower the bid price, the less money the participant will have to pay for that CRR if it clears (or the more money the participant will receive). So, the lower the bid price, the lower the credit requirement should be.

Under the current proposal, as long as the bid price is positive, the credit requirement increases with the bid price. But because of the absolute value, when the bid price is negative, the lower the bid price the higher the credit requirement! For these two reasons, EPIC believes that the CRR credit bidding requirement should be changed to something along the lines of the following:

$$Bid\ Requirement = \max \left[\$500,000, \sum_{CRR_i} ((Bid\ Price_i - Expected\ Value_i) + Credit\ Margin_i \times MW_i) \right]$$

Where the expected value is calculated based on simulation data until historical data is available.

Bidding versus Holding Requirement

Unless we are considering portfolio diversification (which can only be assessed on the cleared side), a sound CRR Credit policy should have consistent bidding and holding requirement calculations where the holding requirement is not allowed to exceed the bidding requirement. Under the current proposal, the holding requirement could be higher than the bidding requirement.

EPIC's proposed changes address that issue by guaranteeing that under no circumstances the holding requirement could be higher than the bidding requirement. When looking at the above formulas, it can be seen that this is guaranteed for two reasons: cleared MWs can only be equal or less than bid MWs; Auction Price can only be equal or less than Bid Price.