UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION
Docket No. AD09-2-000

Credit and Capital Issues Affecting the Electric Power Industry
Tuesday, January 13, 2009

Written Statement of
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Good afternoon, Mr. Chairman and members of the Commission. My name is Philip Leiber and I am the Chief Financial Officer and Treasurer of the California Independent System Operator. The California ISO began operations in 1998, is headquartered in Folsom and manages most of California's high voltage electric grid of more than 25,000-circuit miles. The ISO facilitates wholesale energy transactions for over 100 market participants, and requires that buyers are either creditworthy or post collateral to cover their outstanding obligations. Creditworthy market participants may be granted an unsecured credit limit of up to $250 million, based on their credit ratings, size, and other factors.

Our peers and we faced a number of credit challenges during 2008, and the Commission's attention to credit matters at this time is appropriate. The December 2007 defaults in the PJM FTR market spurred us to tighten in 2008 our credit policy for these products that was established the year before. While smaller companies defaulted in the PJM FTR market, we were also affected by the problems of larger participants. A Bear Stearns subsidiary was a participant in the California ISO market. JPMorganChase assumed this entity's obligations, and there were no losses from that collapse. The Lehman Brothers bankruptcy in September also tested our credit practices. We were fortunate that Lehman Brothers had minimal obligations in the California market, and we required that they post collateral prior to their default, so no loss was incurred. However, losses were experienced at other RTOs. We were also confronted with the question of whether we should reject letters of credit from certain prominent banks that appeared troubled. We also had market participants that were severely strained due to bankruptcies of their major customers.

We face several challenges in credit management. We may underestimate what a debtor owes. We are improving our capabilities in this area and will shortly have settlement data available 7 business days after the trade date rather than the current 38 business days. With CRRs, we have the additional challenge of valuing an instrument that depends on future energy and congestion prices. We use an approach that relies on historical measures of volatility and auction prices, but the possibility of error remains. Another risk is that we permit an apparently creditworthy party to incur obligations that it is later unable to pay. We rely on credit ratings, financial statement data, and other information. Experience has shown that credit rating agencies often don't move ratings downward as quickly as is warranted. We use another 3rd party indicator to address this, but it isn't available for many market participants. We can also consider other qualitative factors, such as an entity's risk management practices, but those are supposed to be considered by the rating agencies in assigning credit ratings—and we have doubts that we are in a position to do a better job than they do. Other factors also complicate credit management. Presently in the California ISO Market, the long payment cycle amplifies the importance of credit decisions, as there are an average of 80 days of outstanding transactions. We also lack enforcement tools that are effective in some situations. We have the ability to curtail scheduling rights for defaulting entities, but that is problematic for load serving entities that are also providers of last resort.

The California ISO recently completed a stakeholder process to revise several aspects of its credit policy. These changes included reducing the maximum unsecured credit limit from $250 million to $150 million, and later in 2009, reducing the length of the cash clearing cycle from an average of 80 days to 25 days. When the payment cycle has been reduced, the maximum unsecured credit limit is to be further reduced to $50 million. Other changes include reducing the response time to post additional collateral from five to three days, and implementing penalties on late payments and collateral requests. Arriving at these proposals involved some balancing of the interests of debtors and creditors. Many creditors wanted further tightening of the credit standards. They have been particularly concerned about the current long settlement cycle, and uncertainty given changes in the ISO market arriving with the transition to MRTU. They would like to see significant immediate reductions in unsecured credit limits, and a change in the default allocation rule that has only net creditors bearing any risk of loss from a payment default.

ISO/RTO credit policies are very similar in many respects, and this is to be expected given the Commission's oversight and issued policy statements. We all set unsecured credit limits for most participants by using credit ratings to determine an allowable percentage of tangible net worth, and we have alternative approaches for special entity types such as governmentally owned utilities. We share some common challenges such as valuing congestion contracts, and what to do in the event of a default by a load serving entity that is a provider of last resort. Conversely, key differences in the policies remain, though some convergence is underway. There have been significant differences in the maximum unsecured credit limits (ranging from $25 million to $250 million), the length of cash clearing cycle (ranging from 20 days to 80 days), and the use of monthly or weekly invoicing. Credit requirements for FTRs have differed (particularly valuation approaches), and there is divergence on the issue of how losses are shared in the event of a payment default.

There are some key issues that the Commission will likely confront on credit in the near future. One is whether ISO/RTOs should continue to provide unsecured credit. This has been a keenly debated topic among stakeholders during 2008. Many are promoting the model of commodity exchanges which do not provide unsecured credit. More broadly, should the Commission promote further convergence on other credit matters, including issues such as default loss allocation rules? There may be benefits to a directive approach, and there are instances when such benefits are less likely to occur without central coordination. For example, through the North American Energy Standards Board process, a market participant has asked for alignment of CRR/FTR auction dates to reduce overlapping collateral requirements for those who participate in multiple markets. As noted previously, convergence happens naturally already to some extent. For RTOs that are the first to confront certain issues and develop policies, others learn from their experiences. This has been the case with CRR/FTR credit policies. But on other issues, it may be difficult to generate consensus through the governance processes of each entity, and a directive role may be appropriate.

That concludes my opening remarks.