California ISO
Your Link to Power

California Independent
System Operator Corporation

March 29, 2010

The Honorable Kimberly D. Bose
Secretary
Federal Energy Regulatory Commission
888 First Street, NE
Washington, DC 20426

Re: California Independent System Operator Corporation
Docket No. RM10-13-000

Dear Secretary Bose:

Pursuant to the Commission's Notice of Proposed Rulemaking issued on January 21, 2010, in the above referenced docket, the California Independent System Operator Corporation (ISO) submits the attached comments detailing its response to the Commission's request for comment on various credit reform proposals.

Respectfully submitted,

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UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Credit Reforms in Organized Wholesale	**)**	
Electric Markets.	**)**	**Docket No. RM10-13-000**
	)	

COMMENTS OF THE
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION
ON NOTICE OF PROPOSED RULEMAKING

The California Independent System Operator Corporation (California ISO) hereby submits its comments in response to the Notice of Proposed Rulemaking (NOPR) issued by the Federal Energy Regulatory Commission (Commission) on January 21, 2010 to amend its regulations for the purpose of reforming credit practices in organized wholesale electric markets to ensure that the credit practices result in jurisdictional rates that are just and reasonable.[1]

I. INTRODUCTION

Through the NOPR, the Commission proposes to adopt regulations that will establish credit practices for organized wholesale electric markets run by independent system operators (ISOs) and regional transmission organizations (RTOs). The Commission developed the proposed regulations in response to recent events in the financial markets and a growing concern by some in the industry that historic credit practices may no longer be adequate to protect the integrity of the wholesale electric markets and safeguard consumers from the potentially high costs of excessive risks and defaults.[2]

[1] The NOPR (also referred to herein as the Credit NOPR) was noticed in the Federal Register at 75 Fed. Reg. 4310 (January 27, 2010).

[2] Credit NOPR at P 1.

The California ISO commends the Commission for undertaking this review of ISO/RTO credit practices and seeking ways to minimize the risks in organized wholesale electric markets subject to the Commission's jurisdiction under the Federal Power Act. As the NOPR notes, Commission policies on credit are integral to ensuring that jurisdictional rates are just and reasonable.[3] For this reason, the Commission included credit practices in the scope of its oversight beginning with its initial crafting of the *pro forma* Open Access Transmission Tariff. The current review demonstrates the Commission's continued commitment to examine and review credit policies in organized wholesale electric markets. Periodic Commission assessment plus continuous ISO/RTO review help to ensure that credit policies evolve to keep pace with changes in the wholesale power markets, helping to minimize the risk of unsecured defaults while avoiding undue credit requirements. The California ISO believes that the combination of ongoing ISO/RTO review and Commission oversight has resulted in important credit policy enhancements, and that the smooth operation of the wholesale electric markets is dependent upon credit policies that are appropriately tailored to the unique character of the wholesale electric markets, as supervised by the Commission. With this in mind, the California ISO offers suggestions in these comments for credit practice enhancements that other ISOs/RTOs may want to consider.

The California ISO notes that although the current proposals are an important step in updating credit practices in organized wholesale electric markets, they are likely to need periodic enhancements and refinements as the wholesale electric markets in electricity continue to evolve. For this reason, the California ISO believes that to the extent that any of the proposed rules are adopted as final rules, they should be reflective of general performance standards that each ISO/RTO must fulfill in its credit policies, but that some variation should be permitted in how each individual ISO/RTO fulfills the final rule's requirements. This approach

[3] Credit NOPR at P 2.

would permit enhancements to be implemented as the wholesale markets in electricity evolve and would recognize the regional variation that is a fundamental characteristic of these markets. Generally, the Commission could accomplish this goal by recognizing a degree of flexibility in how each ISO/RTO can meet the overall requirements of the rules, subject to particular oversight and review of the Commission in each ISO/RTO tariff.

Wholesale electric markets themselves have evolved significantly since ISOs and RTOs were first formed over a decade ago, and those markets will continue to change as the Commission refines its policies and regulations to serve the changing needs of the nation's consumers. The rules governing organized wholesale electric markets must respond to the physical realities of the electric grid. Wholesale market rules will need to change as new facilities are added to the electric grid, driven by numerous factors, including an increased role for wind, solar, and other renewable resources in the power mix and the need for transmission infrastructure upgrades to accommodate these new resources. In addition, the use of the electric grid can be expected to change in the future as there is an increased emphasis on electric efficiency efforts and the role of demand response in organized wholesale electric markets.

The California ISO urges all interested parties to recognize that these drivers of wholesale electric market rules – as well as more general changes in financial market conditions – must be considered as enhancements and refinements to credit practices in wholesale electric markets are considered. The California ISO commits to work with the Commission and interested parties to consider all the factors that affect wholesale electric markets as enhancements to ISO/RTO credit practices are considered.

II. COMMENTS

A. General Discussion

1. *The Commission requests comment on whether the proposed credit practices should be applied in the same way to all market participants or whether they should be applied differently to certain market participants depending on their characteristics*.[4]

As discussed in the California ISO's joint filing with the ISO/RTO Council (IRC) submitted in this proceeding, ISOs/RTOs should have authority to apply different credit practices to certain types of market participants, because each market participant has a different business model. These different business models may result in different impacts on wholesale electric markets and different risks of default. Currently, the Commission's credit policies recognize these differences and allow ISOs/RTOs the flexibility to evaluate the creditworthiness of these entities and to determine their eligibility for, and amount of, unsecured credit. This current flexibility helps balance the need for a liquid market with appropriate risk management. The Commission's rules should continue to provide for this flexibility.

2. *The Commission proposes that any changes resulting from this rulemaking be submitted no later than June 30, 2011, to go into effect no later than 60 days after filing. The Commission also requests comment on whether the changes proposed should be put in place earlier.*[5]

As a general matter, implementation of the necessary systems and tariff changes by June 30, 2011 to implement the type of credit practice enhancements proposed in the NOPR is not unreasonable, although changes requiring software enhancements could require a much

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[4] Credit NOPR at P 11.

[5] Credit NOPR at P 12.

longer lead-time than is proposed. However, given that some proposals require clarification or more discussion, and in light of its general posture that ISOs and RTOs should have the ability to develop and improve their own credit policies, the California ISO reserves comment on whether any adopted changes should have an earlier or later effective date.

B. <u>Shortening the Settlement Cycle</u>

1. *The Commission proposes to revise its regulations to require that each RTO and California ISO include credit provisions in its tariff revisions to implement a settlement cycle of no more than seven calendar days with no more than an additional seven calendar days for final payment (i.e., weekly settlement periods)*.[6]

2. *The Commission further requests comment on the practicality of organized wholesale electric markets implementing daily settlement periods within one year of implementation of weekly settlement periods.*[7]

The Commission's proposed regulations would require that each ISO/RTO implement a settlement cycle no longer than seven calendar days, followed by a period for final payment no longer than an additional seven calendar days. Although not expressly stated in the NOPR, the Commission apparently intends the proposed move to weekly settlements to be transitional. As a possible next step, the NOPR poses a daily settlement period and requests comments on the practicality of the organized wholesale electric markets implementing that substantially shorter settlement cycle within one year of putting weekly settlements in place.[8] In support of these measures, the Commission states that shortening the settlement cycle will reduce the total amount of market payments outstanding, reduce the exposure to credit risk, allow updated

[6] Credit NOPR at P 15.

[7] Credit NOPR at P 15.

[8] Credit NOPR at P 15.

transaction prices and charges to be timely used in determining credit risk exposure, lower the level of collateral each market participant must provide, and allow earlier detection of default situations.[9]

The California ISO agrees in principle with the concept articulated in the NOPR. However, based upon its experience in developing and implementing its own payment acceleration program, the California ISO has found that compressing the payment calendar to a minimal daily period would likely produce diminishing returns in terms of the reduction in credit risk while producing profoundly negative impacts on market participants.

As noted in the NOPR,[10] the California ISO on June 4, 2009 filed proposed tariff amendments to implement a payment acceleration program that would speed up the process by which the California ISO invoices and settles market transactions. At that time, the California ISO's average cash clearing schedule exceeded 80 calendar days. This lengthy time period caused an increased amount of market charges and payments to be outstanding, and exposed market participants to increased credit risk and increased creditworthiness requirements to secure their financial transactions with the California ISO.

The payment acceleration program, as proposed by the California ISO and approved by the Commission, became effective on November 1, 2009. Under payment acceleration, the timeline for the California ISO's release of the initial settlement statement was reduced from 38 business days to 7 business days after each trading day.[11] The program also replaced monthly invoicing (with a payment due date 43 business days after the last day of the month) with semi-monthly invoicing where the invoice for the first billing period of the month (first through fifteenth

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[9] Credit NOPR at PP13-15.

[10] Credit NOPR at P 8.

[11] *Cal. Indep. Sys. Operator Corp.*, 128 FERC ¶ 61,265 (2009).

day of the month) is issued seven business days after the end of the period and the invoice for the second billing period (fifteenth through the last day of the month) is issued seven business days after the end of the month. Payment is due five business days after the date on which each invoice is issued. These changes shortened the California ISO's cash clearing schedule from 80-plus calendar days to approximately 22-25 calendar days (depending on the length of the month). The significant reduction in the payment schedule timeline under the payment acceleration program was designed to reduce the aggregate dollar amount of outstanding market payments and thereby reduce overall credit risk to the market. In order to capture these benefits from payment acceleration, the California ISO submitted a filing on September 4, 2009 to amend the creditworthiness provisions in the tariff that require market participants to post financial security to provide assurance that they can meet their present and future financial obligations. The filing proposed to reduce the maximum unsecured credit limit for market participants from $150 to $50 million. On November 19, 2009, the Commission issued an order accepting this change effective January 5, 2010.[12]

Since deployment, the payment acceleration program and the reduced credit requirement have operated successfully to reduce financial risk in the market. A recent analysis performed by the California ISO shows that, in comparison to the prior settlements timeline, aggregated outstanding liabilities under payment acceleration declined by 68 percent for a sample month. The California ISO believes, however, that further shortening the timeline to weekly settlements, as proposed by in the NOPR, may not result in incremental benefits significantly beyond those already achieved through the payment acceleration program and reduction of the maximum unsecured credit limit. For example, the California ISO's analysis shows that the Commission's proposed move to weekly settlement periods would reduce aggregated outstanding liabilities by only an additional 10 percent for the same sample month.

[12] *Cal. Indep. Sys. Operator Corp.,* 129 FERC ¶ 61,142 (2009).

The California ISO also notes that its current settlement timeline consists of a normal 15-day settlement period (which can vary by one or two days depending on the length of the month) with five additional business days for payment. Assuming that the seven days to receive payment contemplated in the Commission's weekly settlements proposal is equivalent to five business days, then the California ISO already has that feature in place and no further reduction in credit risk can be achieved through that particular aspect of the proposal.

More importantly, the California ISO is concerned that shifting to weekly settlements could significantly impact market participants. During the extended stakeholder initiative for payment acceleration, the California ISO considered a weekly settlement process. In response to stakeholder feedback, the California ISO opted not to implement weekly invoicing at that time. Stakeholders were primarily concerned that a shift from an 83-day settlement cycle to weekly settlements would be too dramatic and would create validation and other software and resource issues. The California ISO explained to stakeholders that its future plans are ultimately to invoice on a weekly basis, but agreed that the initial deployment of payment acceleration would use semimonthly invoicing as a means of shortening the initial implementation of payment acceleration and serving as a reasonable transition to a weekly cycle.[13]

With respect to this proceeding, the California ISO also solicited stakeholder input on the California ISO's preliminary positions on the issues raised in the NOPR, including the weekly settlements proposal. While some stakeholders supported a shorter settlement cycle, others took issue with the practicality of implementing the proposal and with the potential for market participants to bear additional administration burdens and incur increased costs.

As previously stated, the California ISO's future plans are ultimately to invoice on a weekly basis. Our existing systems and software will accommodate weekly settlements. We

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[13] See transmittal letter for California ISO payment acceleration filing, Docket Nos. ER09-1247-000, *et al.*, (June 4, 2009) at 4.

are concerned, however, that a move to weekly settlements at this time could significantly impact market participants, and we urge the Commission to carefully consider their comments in reaching its decision whether to adopt the proposal in the NOPR on the issue.

The California ISO does not support the possibility raised in the NOPR of requiring a daily settlements period. We believe that the benefits such a requirement would achieve would not be commensurate with the implementation challenges and increased costs that would be imposed on the California ISO and stakeholders. According to the California ISO's analysis, for the sample month, daily settlements would reduce aggregate outstanding liabilities by only an additional 8 percent. The analysis also calculated that approximately 85 percent of California ISO market participants had daily obligations of *less than* $12,000 during the sample month. Based on these findings, the California ISO believes that the cash management costs to process daily invoices for 85 percent of market participants would exceed the differential in the collateral that the California ISO tariff requires each market participant to post in order to assure its creditworthiness. The California ISO also submits that implementation of daily settlements would necessitate major modifications to its systems and software, which would require significant expense and commitment of time and resources. Market participants would likewise find it necessary to modify their settlements software and procedures to handle daily settlements, at their considerable expense.

In the California ISO's opinion, the benefits of moving to daily settlements do not justify the incurrence of the substantial cost that would be required by the California ISO and its market participants to implement that timeline. We accordingly urge the Commission not to include this requirement in the final regulations that result from this proceeding.

3. To reconcile the discrepancy in cash flow, a market participant may need to arrange cash management facilities to manage more frequent payments under a weekly settlement period. The Commission invites comments on this proposal, and whether it would involve a one-time cost to establish such a facility or ongoing costs that could significantly affect liquidity and rates.[14]

As expressed in the joint IRC filing, the Commission correctly identifies that a move to weekly settlement periods may require market participants to arrange cash management facilities to satisfy more frequent payment obligations. Market participants are in the best position to identify and determine what, if any, cash management facilities may be necessary to move from the currently applicable settlement period to a weekly settlement period. The California ISO does not believe that any rule is needed or should be adopted.

C. <u>Use of Unsecured Credit</u>

1. *The Commission proposes to revise its regulations to require that each RTO and ISO include in the credit provisions of its tariff revisions to reduce the extension of unsecured credit to no more than $50 million per market participant.*[15]

The California ISO supports this rule in principle, but recognizes that the Commission should incorporate some degree of flexibility in how individual ISOs/RTOs would comply with the proposed rule's requirements, especially with respect to how the individual ISO/RTO treats the unsecured credit obligations of affiliates. As stated in the joint IRC filing, the California ISO supports this proposed rule in part because the California ISO recently amended its tariff to limit the extension of unsecured credit to no more than $50 million per market participant for all

[14] Credit NOPR at P16.

[15] Credit NOPR at P 19.

market activities, including congestion revenue right auctions, to reflect the California ISO's payment acceleration tariff amendment.[16] However, as noted in the joint IRC filing, it is important that the $50 million amount remain a cap, rather than a specifically-mandated amount, such that individual RTOs and ISOs may file with the Commission to establish lower limits on unsecured credit as appropriate. It is important to permit each individual ISO/RTO to be able to adjust this requirement in light of its unique characteristics and market composition.

2. The Commission seeks comment on whether there should be a further aggregate cap to cover an entire corporate family (e.g., holding company, subsidiaries, associates, and affiliates) and also whether the cap should be different for markets of different sizes.[17]

The Commission correctly identifies that the relationship of one market participant to another, particularly if it is a parent, subsidiary or affiliate, is an important factor in determining credit exposure. Currently, the California ISO reviews the corporate family relationship between entities, and does not permit a parent company to back one or more of its subsidiaries if such backing would exceed the $50 million maximum unsecured credit limit. In short, a parent backing its affiliate is subject to the $50 million maximum unsecured credit limit and must also satisfy eligibility requirements to receive unsecured credit in accordance with the California ISO tariff.[18] Under the California ISO tariff, market participants with affiliates have the right to apply for unsecured credit based on their own merits, but the California ISO may consider the creditworthiness of the market participants' affiliates as part of its consideration whether to extend unsecured credit.[19] This structure of allowing affiliates – which are separate corporate

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[16] *Cal. Indep. Sys. Operator Corp.*, 129 FERC ¶ 61,142 (2009).

[17] Credit NOPR at P 19.

[18] *See* Section 12.1.1.1.2 of the ISO tariff.

[19] *See* Section 12.1.4 of the ISO tariff.

entities – to stand on their own financial merits, permits corporate families of different sizes and financial strength to have access to unsecured credit in varying amounts commensurate with their financial strength, subject to the California ISO's consideration of the affiliates' overall financial condition. The California ISO believes that its current credit policy provides appropriate flexibility without sacrificing risk mitigation.

3. *The Commission further requests comment on the practicality of eliminating unsecured credit in connection with adopting daily settlement within one year of implementation of weekly settlement periods*.[20]

The Commission correctly recognizes that if it adopts a daily settlement rule unsecured credit may no longer be a necessary tool for market participants. However, given that the Commission has not yet mandated a daily settlement cycle, the California ISO reserves comment on whether to limit the use of unsecured credit altogether under a daily settlement cycle.

D. <u>Financial Transmission Rights Markets</u>

1. Given the unique characteristics of and risks inherent in financial transmission rights markets, the Commission proposes to revise its regulations to require that each RTO and ISO include in the credit provisions of its tariff provisions that eliminate unsecured credit in financial transmission rights markets.[21]

Although the California ISO supports this requirement in principle, the Commission should recognize that there may be a variety of specific practices that would meet this requirement.

[20] Credit NOPR at P 20.

[21] Credit NOPR at P 23.

Presently, the California ISO does not have separate credit requirements for financial transmission right markets (known in the California ISO market as congestion revenue rights (CRRs)). Each Market participant is required to have a combination of unsecured credit and posted financial security that is sufficient to cover its estimated aggregate liability, which includes both market obligations and CRR obligations. CRR holders may use all or a portion of their unsecured credit limit or financial security in excess of the market obligations to back their CRR obligations. The California ISO generally agrees with the Commission that elimination of the use of unsecured credit to secure CRR obligations or participate in CRR auctions, coupled with a requirement that market participants post a secured form of financial security for CRRs, would potentially reduce market participants' exposure to CRR credit risk. The California ISO already has, however, taken other measures that reduce risk in connection with CRRs. For instance, the California ISO requires candidate CRR holders to have sufficient collateral not only to cover their bids but also to cover a credit margin in the CRR auctions.[22] The CRR holding credit requirements for both allocated and auctioned CRRs also include this credit margin.[23] In addition, if a market participant holds negatively valued CRRs for which it expects to be paid by the California ISO in exchange for paying the California ISO a monthly income stream, the market participant must have sufficient credit to cover the prospective obligation of the CRRs. Lastly, in the event that a market participants' CRR portfolio is positively valued, the California ISO tariff does not allow the market participant to offset this value against other market obligations.[24] The California ISO does not necessarily oppose the elimination of unsecured credit in the CRR market, but believes the current credit policy set forth in its tariff provides sufficient mitigation of risk. This credit policy ties unsecured credit limits for a market participant

[22] *See* Section 12.6.2 of the ISO tariff.

[23] *See* Section 12.6.3.4 of the ISO tariff.

[24] *See* Section 12.6.3.1 of the ISO tariff.

that is a CRR holder to the market participant's overall $50 million unsecured credit cap, requires collateral for negatively valued CRRs, and prohibits offsets of positively valued CRRs against other market obligations.

E. Ability to Offset Market Obligations

1. The Commission proposes to revise its regulations to require that each RTO and ISO revise its tariff to clarify that it will be a party to each financial transaction, so as to eliminate any ambiguity or question as to their ability to manage defaults and to set off market obligations.[25] The Commission seeks comment on whether this clarification of status would have ramifications beyond addressing the risk highlighted here.[26]

The California ISO filed preliminary comments on this issue jointly with the Midwest ISO in this proceeding on March 15, 2010. The California ISO and Midwest ISO asked parties to weigh the costs of the proposed solution against the scope of the risk – namely, the likelihood of a successful challenge to an ISOs/RTO's right to net the debts of a bankrupt market participant against credits due. These comments will reference that initial filing, but avoid repeating it.

The California ISO submits that the proposed rule will impose significant costs that ultimately will be borne by ratepayers. These costs outweigh any benefits that may result, given that no actual losses have resulted from this particular risk, and that the risk can be mitigated through less costly means.

The costs of the proposed rule begin with financial reporting. If ISOs/RTOs were required to become principals to the market settlement transactions, Generally Accepted Accounting Principles would require that the transactions be reflected on corporate financial

[25] Credit NOPR at P 25.

[26] Credit NOPR at P 25.

statements. Even though the market transactions would ultimately net to zero, the California ISO would need significant additional resources to ensure that the transactions are recorded properly on the books. Simply posting the market transactions to financial statements is not an option; the presentation must comply with accounting standards, conventions, and rules. To give just one example of the many accounting decisions that would need to be made, an ISO/RTO would have to determine whether each charge type should be netted or grossed for presentation on the financials, and on what interval any netting should occur. After the work required for initial setup, the ISO/RTO would need to validate market transactions on a continuing basis. Currently, the California ISO does not validate market transactions, only market participants do that. If the transactions were recorded on the California ISO's own books, it would need a validation group, along with business processes and software such as those used by major market participants. While the California ISO has a strong control environment for the benefit of its customers, it does not currently have sufficient resources to achieve the level of validation that would be required if it were to report financial transactions in the same way that market participants do.

These changes in financial reporting would magnify the complexity, and therefore the costs of, audits, on the order of hundreds of thousands of dollars in additional fees. Like the ISO/RTO, auditors would need to validate the underlying transactions, with some sampling for every charge type – e.g., energy, bid cost recovery, CRR balancing accounts, transmission access charges, convergence bids, must-offer charges, and exceptional dispatch charges. Moreover, to support the audit, counsel would have to examine and opine upon the ISO/RTO's potential liability in every dispute relating to market transactions, which would then need to booked or disclosed depending upon the determination. Currently, the California ISO only needs to address such issues if there is a risk of corporate exposure, which generally does not exist because the California ISO is not a principal in the transactions. This additional work could not necessarily be avoided by establishing a rate mechanism to protect the California ISO against liability for market defaults, because the mechanism and its implementation would always be subject to challenge before the Commission.

These additional complexities would also affect the California ISO's access to capital markets. For the same reasons that audit expenses would increase, bond offerings would become more time consuming, complex, and expensive. The need to evaluate $7 billion of additional financial transactions both revenue and expense would multiply the demands placed on underwriters and corporate personnel. Rating agencies and potential purchasers of bonds would have to dig through layers of complexity to determine the underlying financial substance of the California ISO as an issuer, which would be obscured by the market activity. The California ISO would face the additional challenge of explaining the degree of protection afforded against absorbing losses from market participant bankruptcies, an issue that is straightforward now. While these challenges would not preclude future bond offerings, they would represent unnecessary new impediments and expenses.

Wholly apart from reporting and auditing, the proposed rule could also lead to new legal expenses by requiring an ISO/RTO to become a party in every dispute among market participants. This is not currently necessary; in the ongoing litigation of issues arising from the 2000-2001 California energy crisis, the California ISO has participated mainly as a facilitator – providing data and implementing settlements and refunds. Had the California ISO been a principal in the transactions, however, it would have needed to expend significantly greater legal resources throughout the extensive litigation, a level of involvement necessary for legal reasons but not one that would have brought any added value to resolution of these longstanding disputes. Similarly, if the California ISO became a principal in all transactions, it would be necessary to participate in all proceedings that involve its markets or settlement processes, such as transmission revenue requirement filings, which are now left generally to the parties in interest. All of this would add to ratepayer costs without bringing any added value to the process, the Commission or the parties to the disputes.

These potential costs must be weighed against the risk that the Commission is seeking to avoid. As noted in the March 15 filing with the Midwest ISO, the risk of loss from a bankrupt market participant challenging the right to net market transactions is theoretical only – there are no adverse decisions on this issue involving ISOs/RTOs.[27] Despite numerous opportunities, to date only one market participant has challenged netting by an ISO or RTO for alleged lack of mutuality, and that argument was ultimately abandoned.[28] Several practical considerations may discourage other market participants from raising such a challenge again, including a desire to continue their market relationships post-bankruptcy and reluctance to incur litigation expenses over relatively small sums.[29]

Even if a bankrupt market participant were to challenge ISO/RTO netting, it is far from certain that the challenge would be successful. To avoid payment obligations based on a purported lack of mutuality, the bankrupt market participant would have to overcome several different and independent counterarguments.

First, mutuality arguably is not required for ISO/RTO netting because the settlement of a payment period is a single integrated transaction under which no right of payment arises until all netting is complete. When debits and credits are incurred as part of single transaction, rather than as multiple transactions, the equitable doctrine of recoupment authorizes netting without

[27] *See* Joint Comments of the California Independent System Operator Corp. and the Midwest Independent Transmission System Operator Inc. (March 15, 2010) (March 15 filing) at 2-3.

[28] *Id.* at 2.

[29] *See* March 15 filing at 2 (citing Memorandum by Watchell, Lipton, Rosen & Katz to PJM regarding Setoff and Credit Risk of PJM in Member Bankruptcies (March 17, 2008) (Wachtell Memo) at 9-10, 11 n. 44). The Wachtell Memo is cited in the NOPR at page 15, n. 28.

the need to demonstrate mutuality.[30] The strength of this argument may depend in part on the language of particular ISOs/RTOs' tariffs, but the tariff language can be modified as needed without adopting the proposed rule.

Second, assuming mutuality is required for ISO/RTO netting, arguably the debts that ISOs/RTOs offset when they act as a market administrator *are* mutual, because, among other things, the ISO/RTO "is acting in the same role as both debtor and creditor."[31] Notably, the Wachtell Memo cited in the NOPR does not conclude there is a lack of mutuality in power transactions; only that the degree of mutuality is "uncertain."[32]

Third, several bankruptcy courts have recognized an exception to the mutuality requirement when contracting parties, particularly sophisticated parties as is the case here, provide for non-mutual setoff in their agreements.[33] Bankruptcy courts could find that ISO/RTO tariffs and Operating Agreements that expressly provide for setoff of market obligations fit within this exception.

Fourth, the filed rate doctrine arguably prohibits a bankruptcy court from preventing ISO/RTO netting because doing so would alter the rates, terms and conditions of the ISO/RTO's services and, thus, conflict with the Commission's exclusive ratemaking authority. For example, availability charges, which are assessed at the end of a month based on performance over the entire month, are part of the total rates, terms and conditions approved by the Commission. If a market participant filed for bankruptcy, and the ISO/RTO was not allowed to net availability

[30] *See* Wachtell Memo at 11-12; *see generally* 5 *Collier on Bankruptcy* ¶ 553.10 (15th ed. 2009) (describing doctrine of recoupment).

[31] Charles Jordan Tabb*, The Law of Bankruptcy*, Foundation Press Inc., Westbury, New York (1997), § 6.26, p. 409.

[32] *See* Wachtell Memo at 8.

[33] *See* Wachtell Memo at 4, n. 18; *see also* 5 *Collier on Bankruptcy* ¶ 553.03[3][b][ii] (15th ed. 2009) (collecting cases).

charges as part of the overall invoice, because the date of assessment was post-petition, the Commission approved rates, terms and conditions would be changed. To the extent that the Commission has exercised its authority to approve an ISO/RTO tariff, therefore, challenges to ISO/RTO netting could be barred.

In sum, the Commission should not mandate that ISOs/RTOs restructure their markets to become counterparties based only on an unquantified and purely theoretical risk. As explained above, even if there is some risk that a bankrupt market participant could challenge netting, this risk has yet to materialize through numerous bankruptcies by market participants, it may never materialize, and the potential risk is outweighed by substantial costs to ISOs/RTOs and electricity ratepayers. Accordingly, rather than adopt the proposed rule, the California ISO recommends that the Commission require ISOs/RTOs to explore less costly alternatives to mitigating whatever risk there may be. In particular, the Commission should direct ISOs/RTOs to revise their tariffs to emphasize that ordinary course settlement payments made in the ordinary course of business–*i.e.*, net payments – represents a single transaction, thereby providing further support for the "recoupment" counterargument described above and in the March 15 filing.

F. <u>Minimum Criteria for Market Participation</u>

1. *The Commission proposes to revise its regulations to require that each RTO and ISO include in the credit provisions of its tariff language to specify minimum participation criteria for all market participants. The Commission requests comment on what the minimum criteria should be, as well as the process by which the organized wholesale electric markets adopt such criteria.*[34]

[34] Credit NOPR at P 27.

Consistent with the joint IRC filing, the California ISO believes that imposing minimum criteria for market participation could be beneficial so long as the criteria do not present an undue barrier to entry. The California ISO notes, however, that the Commission does not actually propose any minimum criteria. Determining which minimum participation criteria should be established for all market participants is a multifaceted issue which must take into account the unique features of each ISO and RTO market structure. The California ISO believes that each ISO and RTO must maintain some flexibility as to whether a new market participant is credit worthy enough to participate in the market administered by that ISO or RTO.

Minimum criteria for market participation in the California ISO's markets already exist. For example, in order for a market participant to participate in the California ISO markets, it must, among other requirements, pay an application fee, agree to enter into certain pro forma contracts, maintain minimum technology standards and satisfy initial collateral requirements to participate in the energy market and satisfy minimum available collateral requirements for CRR auction participation. The California ISO believes there should be further discussion and consideration conducted in concert with the Commission and interested stakeholders to determine what type of minimum participation criteria could exist to ensure appropriate risk management without creating undue market entry barriers before any specific nation-wide standards are proposed.

G. <u>Material Adverse Change</u>

1. The Commission proposes to revise its regulations to require that each RTO and ISO include in the credit provisions of its tariff language to specify under what circumstances a *market administrator may invoke a “material adverse change” as a justification for requiring additional collateral.*[35]

The Commission correctly identifies the need for ISO/RTOs to be able to require additional collateral to safeguard organized electricity markets from unexpected changes in the financial market as well as material changes in the financial condition of market participants. The California ISO tariff already includes language specifying instances that would be a considered a “material adverse change” and thus already satisfies the Commission’s proposed directive requiring each ISO/RTO to include credit provisions in its tariff to specify what circumstances constitute a material adverse change. While an illustrative list of certain circumstances that may be considered a “material adverse change” is helpful, the Commission should preserve the authority for each ISO/RTO to maintain the flexibility to request a collateral call for unforeseen events. The California ISO tariff allows the California ISO to reduce market participant’s unsecured credit limit and to request additional financial security whenever it concludes that additional financial security based on unforeseen circumstances is necessary provided that the California ISO provides a written explanation.

2. The Commission requests comment as to specific language regarding the circumstances under which a market administrator may invoke the “material adverse change” provision and the process by which the organized wholesale electric markets would adopt such language.[36]

The California ISO agrees that requiring the tariffs of ISOs/RTOs to provide specific language regarding circumstances under which an ISO or RTO can request additional collateral in the event of a “material adverse change” is beneficial in providing market participants with

[35] Credit NOPR at P 29.

[36] Credit NOPR at P 29.

guidance and confidence as to what could be considered a material adverse change. Equally important is the ability of ISOs/RTOs to remain flexible in requesting additional collateral due to an unforeseen material adverse change as noted above. The joint IRC filing provides a list of circumstances under which a material adverse change would occur: (1) in the event of a bankruptcy; (2) insolvency of a market participant; or (3) a change in a market participant's credit rating, and so forth. The list of circumstances constituting a material adverse change identified in the IRC filing is an illustrative but not exclusive list. Any list of material adverse changes submitted by ISOs and RTOs in response to a final rule in this proceeding similarly should be an "including, but not limited to" provision so as to provide for the flexibility that the ISOs/RTOs will need to address unanticipated circumstances which justify an additional collateral call. Please see the discussion contained in the IRC filing for the specific proposed language.

H. Grace Period to "Cure" Collateral Posting

1. *The Commission proposes to revise its regulations to require that each RTO and ISO include in the credit provisions of its tariff language to limit the time period allowed to post additional collateral when additional collateral is requested by the organized wholesale electric market.*[37]

The Commission is correct to recognize the importance of a limited time period to post additional collateral as a key to promoting confidence in the ISO/RTO markets. By establishing a defined period in which to satisfy a collateral call, the exposure period is quantifiable and the default period becomes certain.

[37] Credit NOPR at P 31.

2. *The Commission requests comment on the appropriate time period to post additional collateral, e.g., two business days, as PJM has adopted, and whether the time period should be standardized among organized wholesale electric markets.*[38]

Recently, the California ISO amended its tariff to shorten the additional collateral call period from five business days to three business days and to include a progressive discipline process for those market participants who are habitually late in posting financial security.[39] This tariff change was the result of a stakeholder process in which collateral call periods of one-day, two-day and three-day periods were considered. After reviewing the stakeholder comments, the California ISO concluded that a three-day collateral call period was appropriate. In making this determination, the California ISO evaluated the value and purpose of the collateral call. The purpose of an additional collateral call is to enhance a market participant's position against a default. The California ISO did not adopt a shorter collateral call period in order to avoid creating undue burdens on some market participants who may be unable to satisfy a collateral call due to the administrative challenges of posting a collateral call in anything less than three business days. Some market participants, namely municipalities and state and federal agencies, noted that it was not feasible given their business structure to satisfy collateral call periods in fewer than three days. Therefore to promote continued business and to avoid unnecessary defaults based on an administrative burden rather than a financial inability, the California ISO adopted a three-day period. The California ISO continues to supports this time frame.

[38] Credit NOPR at P 31.

[39] *California Indep. Sys. Op. Corp.,* 126 FERC P 61,285 (2009).

III. CONCLUSION

The California ISO recognizes the importance of a sound credit policy in wholesale electric markets and commends the Commission for continuing to review, monitor, and improve the credit practices to enhance market efficiency and consumer protection. It is this type of review and collaboration between the Commission and the ISOs/RTOs that allows organized wholesale electric markets to continue to maintain the confidence of their participants, balance credit exposure, and continue to efficiently deliver energy to consumers.

March 29, 2010

Respectfully submitted,

/s/ Grace Arupo

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CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing document upon all of the parties listed on the official service list for the captioned proceeding, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated at Folsom this 29th day of March, 2010.

Anna Pascuzzo

Anna Pascuzzo

CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing document upon the parties listed on the official service list in the captioned proceedings, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated at Folsom, California this 29th day of March, 2010.

/s/ Anna Pascuzzo

Anna Pascuzzo