

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Policy Statement on Electric Creditworthiness) Docket No. PL05-3-000

**REPORT OF THE
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION**

Introduction

In response to Paragraph 33 of the November 19, 2004 “Policy Statement on Credit-Related Issues for Electric OATT Transmission Providers, Independent System Operators and Regional Transmission Organizations,” 109 FERC ¶ 61,186 (2004) (“Policy Statement”), the California Independent System Operator Corporation (“CAISO”) hereby submits this Report. Paragraph 33 specifically requests Independent System Operators (ISOs) and Regional Transmission Organizations (RTOs) to submit a report within 90-days of the issuance of the Policy Statement addressing “progress toward implementing shortened settlement periods, netting or any other measure that they determine might serve to reduce the mutualized default risk in their markets or their reasons for not yet adopting such measures.” The report should also “detail any future plans that that ISO/RTO has, at that time, for reducing the mutualized default risk in its market.” The CAISO’s Report addresses these issues and others discussed in the Policy Statement including the Commission’s suggestions to OATT Transmission Providers and ISOs/RTOs to make credit-related procedures and

standards more transparent and to incorporate quantitative and qualitative factors in assessing creditworthiness.

1. Transparency

Although primarily directed to OATT Transmission Providers, which may not have made their credit policies public, the Policy Statement provides that all transmission providers must post their credit policies on their websites, to the extent they have not already done so or incorporated such requirements in their tariffs. Credit Policy at P. 12. The Commission has expressed its expectation that all transmission providers: (1) make their credit-related practices more transparent and comprehensive; (2) post on their websites, the procedures that they use to do their credit analysis; and (3) provide a customer with a written analysis setting forth how that entity applied its credit standard to that customer, if that customer is required to provide security. The stated goal is to enable customers to understand the information requested by the transmission provider for the creditworthiness assessment and to determine for themselves the general amount and type of security they may need to provide. *Id.*

In addition to recognizing that OATT Transmission Providers have had less transparent credit policies than ISOs/RTOs, the Commission should also recognize that there is a fundamental difference between these two types of transmission providers. OATT Transmission Providers provide access to the grid. ISOs/RTOs provide access to the grid *and* operate energy and ancillary services markets. This distinction should justify different creditworthiness standards for OATT Transmission Providers and ISOs/RTOs.

The CAISO supports the goal of transparency and has endeavored to involve stakeholders in the development and implementation of improvements to the CAISO's credit policies and their implementation. The CAISO's credit policies are set forth in the Tariff, primarily at Sections 2.23 *et seq.*, and in a Credit Policy & Procedure document posted on the CAISO's website.¹ In addition, the CAISO has been engaged in a stakeholder process since April 2003, which has resulted in improvements in the CAISO's credit policies. All of the proposed policies and stakeholder comments are also available on the CAISO's website.² This is an ongoing process, with additional changes under consideration, including potential changes resulting from consideration of the Commission's Policy Statement. The CAISO is targeting mid-to-late-2005 for implementation of many of the proposed changes, after final stakeholder review, CAISO Governing Board review, and Commission approval for any changes to the CAISO Tariff that may be required (and any software development necessary for implementation).

The CAISO's standards for determining creditworthiness are clear and transparent. Only entities with an Approved Credit Rating are deemed creditworthy.³ All other entities must post security in one of the enumerated forms of security, including cash, letter of credit or corporate guaranty from an entity with an Approved Credit Rating, to cover the entity's "outstanding and estimated liabilities." CAISO Tariff Section 2.2.3.2.

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

² These documents can also be found at the same location as the CAISO's credit policies at the link provided in footnote 1.

³ Approved Credit Rating is defined in the CAISO's Master Definitions Supplement of Appendix A to the CAISO Tariff.

The CAISO estimates and communicates each market participant's ongoing financial obligation, and, hence, security posting obligation, on a weekly basis. The method used by the CAISO to determine the amount of security that is required—Scheduling Coordinator Aggregate Liability Estimate (SCALE)—is posted on the CAISO's website. This method uses actual settlements data in the CAISO's settlement system for charges incurred but not billed and estimates for charges for market activities that have not yet been reflected in the CAISO's settlement system.⁴ Whenever the CAISO determines that additional security is needed, it presents the market participant with the supporting calculations thereby allowing each market participant to understand its SCALE calculation.

In addition to providing each market participant with its SCALE calculation, the CAISO's credit policies also provide a market participant the opportunity to respond and provide documentation demonstrating that its outstanding liability is less than that calculated by SCALE. The CAISO's policies, thus, afford market participants a form of due process prior to the CAISO taking any enforcement action and reflect the fact that when it comes to an estimate of market activities that are not fully reflected in the CAISO's settlement system, market participants themselves may be in a better position to make this calculation than the CAISO. The result is a process for determining market participants' outstanding liabilities

⁴ Specifically, SCALE incorporates outstanding obligations and actual settlement charges reflected in the CAISO's settlements system, but must rely on predictive settlement data and historical settlement data to calculate obligations from the trade date until actual settlement data is available, approximately 50 days from the trade date. Predictive data comes from the CAISO settlement system, but uses estimates for generation, load and intertie MWhs, rather than meter data, which is not yet available. The CAISO has refined these estimates, which has improved the accuracy of its calculations. However, there is still a period of time between the trade day and the time when predictive data is available (approximately 10-17 days) during which the CAISO relies primarily on historical settlement data which may not always correlate with a market participant's current activity.

that is as transparent as possible, given that the CAISO must use estimates for the most recent period of market activity and given that market participants may have more accurate information than the CAISO for this same period.

2. Creditworthiness Determination

The Policy Statement also urges all transmission providers to develop “qualitative” and “quantitative” measures in determining a market participant’s creditworthiness. Policy Statement at P. 13. As noted above, the CAISO’s Tariff requires all market participants to post security to cover 100% of their outstanding liabilities unless they have an Approved Credit Rating. Thus, although perfectly transparent, this aspect of the CAISO’s credit policy appears to be inconsistent with the Commission’s directive to develop qualitative as well as quantitative measures for entities that are unrated and for entities that have a credit rating that is less than an investment grade rating. One of the Commission’s primary concerns behind the emphasis on such criteria appears to be to ensure that transmission providers’ credit policies not be “turned into barriers to legitimate market activity.” *Id.* at P. 12.

The CAISO does not believe that high credit standards should be considered an unfair or inappropriate barrier to entry into or continued participation in the market, particularly concerning markets operated by ISOs/RTOs. First, the services have been provided and the obligation to pay has accrued—the bill just has not been delivered yet. If the settlement period were ideally shortened to daily settlement, then credit requirements would be eliminated, but buyers would have to pay cash (rather than post cash or the

equivalent). Second, it may be appropriate to have higher credit standards for ISOs/RTOs than for OATT Transmission Providers. Entities that only provide transmission services are dealing with sunk costs and incur very little incremental costs in providing service. ISOs/RTOs operate energy markets in which the net sellers who participate incur substantial costs in providing their service. Further, OATT Transmission Providers extend credit at their own risk. ISOs/RTOs, on the other hand, do not extend their own credit. Rather, market participants themselves are extending credit through their participation in the CAISO's markets.

In addition, the CAISO also believes that qualitative as well as quantitative factors are already taken into consideration by the expert credit rating agencies, such as Standard and Poor's and Moody's Investors Service. They determine their ratings based on numerous qualitative and quantitative factors and the CAISO believes that it would be a wasteful duplication of resources for ISOs/RTOs to attempt to develop such expertise internally, particularly when there is no reason to believe that ISOs/RTOs could do a better job than the rating agencies. Notwithstanding the foregoing comments, the CAISO recognizes that non-credit rated entities may be creditworthy⁵ and believes that no market participant, even with an investment grade rating, should receive unlimited credit.⁶ In addition, the CAISO agrees that consideration of qualitative information might serve a useful role in setting credit limits for participants.

However, the CAISO is much more comfortable relying on quantitative, rather

⁵ Non-rated entities can always obtain a rating from one of the rating agencies.

⁶ In this regard, the CAISO has proposed a tiered system that would establish varying amounts of credit based on credit ratings and/or other quantitative factors.

than qualitative measures and believes that transparency is necessarily compromised with an approach that incorporates qualitative measures. Accordingly, the CAISO does not intend to adopt a mixed quantitative and qualitative approach in the near term but will consider how such a program might be developed for the intermediate term. If such a program is to be ultimately adopted, it must be approached carefully, with thoughtful design in consultation with stakeholders, and administered with adequate staff or outside resources. Time and resources are not available at the CAISO for such an endeavor during 2005 given other pressing priorities. A deliberate and measured approach would be necessary to ensure the continued presence of other elements the Commission has indicated are necessary, such as transparency and non-discrimination and shortening the settlement period.

With respect to rated entities that do not have an Approved Credit Rating, although the CAISO's Tariff currently requires these market participants to post security to cover 100% of their outstanding liabilities, there can be a degree of non-compliance with this requirement, and thus, some amount of unsecured credit is extended to such entities in the CAISO's markets, for reasons discussed shortly. In other words, at times not every market participant has posted sufficient security to cover outstanding liabilities as calculated by the CAISO using SCALE (which sometimes can only be determined accurately on a retroactive basis). The CAISO estimates that the maximum unsecured charges owed by market participants without an Approved Credit Rating from January 1, 2004 to July 31, 2004 averaged approximately \$2.4 million, which was 1.5

percent of the \$164 million average owed by market participants for this same period. The peak unsecured charges (\$11 million) for this period occurred between April and June 2004 and constituted 5.1 percent of charges owed.

The CAISO has worked continuously to improve the accuracy of SCALE by incorporating more actual market data for each market participant and reducing the use of factors that are less exact, such as assumptions based on historical data rather than real-time information. Although the CAISO has endeavored to introduce more science than art into its SCALE calculations, there continues to be an element of judgment. Even with continuous improvement, the SCALE calculations can be inaccurate to a degree. Most recently, the CAISO's implementation of Phase 1B element of its Market Redesign and Technology Upgrade (MRTU) project caused some SCALE calculations to be inaccurate. The CAISO is already well on the way to resolving the Phase 1B issues. The CAISO believes that the SCALE calculation represents a very effective means by which to limit security posting to the amount necessary to secure the obligations of entities to the CAISO market, thereby appropriately balancing the need to avoid excess costly collateral requirements for participants, and limiting credit risk to CAISO market creditors.

Moreover, even when accurate, SCALE calculations can be volatile. Since the CAISO cannot require market participants to post security in excess of 100% of their outstanding market liability,⁷ there is necessarily a lag between

⁷ Moreover, given the concerns expressed by the Commission in its Policy Statement, it appears unlikely that the Commission would approve a Tariff amendment that would require market participants to post security in excess of their estimated liabilities. *See also PJM Interconnection, L.L.C.*, 104 FERC ¶ 61,309 at P 30 (2003) (market participant challenged PJM's requirement that

request and receipt of additional security. In addition, some market participants have not responded promptly, by either posting additional security or providing documentation to support an estimate of outstanding liability different from the CAISO's SCALE calculation.

In the circumstances referred to above, the CAISO has not taken enforcement action (currently limited to either suspending scheduling privileges, suspending a Scheduling Coordinator's certification or disconnection)⁸ against these entities for a number of reasons. First, in many cases, there may be a legitimate disagreement regarding the actual amount of outstanding liabilities. Second, there has been no reason to believe that the market participants in question are at risk of defaulting on their payment obligations. Third, if the market participant is a provider of last resort (POLR), there is no back up provider to which the CAISO could shift load-serving responsibility. In this situation, termination of a market participant's scheduling privileges may not protect creditors—the load still exists and will be served by resources in the

net obligations not exceed 85% of posted security and the Commission required PJM to explain in a compliance filing "why financial assurance in the form of depository accounts or letters of credit, which meet PJM's requirements, should not be honored in the full amount." *Id.* In a subsequent filing, submitted in Docket No. ER05-12-000, PJM proposed (and the Commission has accepted) tariff revisions eliminating PJM's 85 percent credit requirement and revising its credit retention policy, effective December 1, 2004. See *PJM Interconnection, L.L.C.*, 109 FERC ¶ 61,241 (2004).

⁸ Section 2.7.2.3 of the CAISO Tariff provides that the CAISO "may reject a schedule" if a market participant has not posted adequate security. "Order Addressing Creditworthiness Tariff Provisions Proposed by the California Independent System Operator Corporation and California Power Exchange," *California Independent System Operator Corporation*, 94 FERC ¶ 61,132 (Feb. 14, 2001); "Order Granting Motion," *California Independent System Operator Corporation*, 95 FERC ¶ 61,026, at 61,080 (Apr. 6, 2001); "Order Denying Rehearing of California ISO Creditworthiness Order," *California Independent System Operator Corporation*, 95 FERC ¶ 61,391 (June 13, 2001); "Order Granting Motion Concerning Creditworthiness Requirement and Rejecting Amendment No. 40," *California Independent System Operator Corporation*, 97 FERC ¶ 61,151 (Nov. 7, 2001); "Order Clarifying the Creditworthiness Requirement, Denying Rehearing and Rejecting in Part Compliance Filings," *California Independent System Operator Corporation*, 98 FERC ¶ 61,335, at 62,425 (Mar. 27, 2002).

CAISO's market. In addition, unscheduled load appearing in Real Time would present significant operational issues that could threaten reliable grid operations. Finally, the CAISO believes that the margin that may exist from time to time between the CAISO's SCALE calculations and the amount of security actually posted (as discussed herein concerning the January through July time period) is practically unavoidable and is likely to be within the risk tolerance of the CAISO's market participants.⁹

To address these concerns, the CAISO is engaged in a continuous effort to improve the accuracy of its estimates of outstanding liabilities and to develop other improvements to the CAISO 's credit policies. The CAISO would also like to improve compliance with security posting requirements and has developed (at least conceptually) penalties for noncompliance. For those market participants that are slow to respond to a request for additional security (by posting the additional security as requested, or providing documentation to support estimates of liabilities), penalties may well be a more effective tool for achieving compliance than the existing means for addressing such problems. The CAISO would also like to explore with stakeholders the issue of risk tolerance associated with temporal volatility and the business process of asking for and obtaining additional security. The CAISO also plans to develop clear criteria for terminating the scheduling rights of market participants that are not POLRs and transferring their load to the relevant POLR when appropriate (e.g. the market participant has

⁹ The CAISO believes that unless it can require market participants to post an amount in excess of their estimated liabilities, it is practically impossible to ensure that the market is 100% secure at all times. Nevertheless, the CAISO believes that market participants should be apprised of this risk and weigh it against the benefits of participation in the CAISO's markets and plans to seek stakeholder comment on risk tolerance.

failed to post adequate security or failed to provide documentation after a reasonable time). Finally, the Commission should recognize the POLR problem as one that applies to all ISOs/RTOs and can only be addressed by state and local regulatory authorities. State and local regulatory authorities must take responsibility for ensuring that POLRs are creditworthy.

3. Shortened Settlement Period

The CAISO believes that shortening the settlement period, or “Payment Acceleration” in CAISO parlance, is the single most important element of reducing credit risk in the CAISO’s market. Payment Acceleration is the CAISO’s top priority in this regard. Currently, CAISO financial clearing occurs approximately 55-60 days after the end of a trade month, resulting in an average of 70-75 days between trade date and payment. The CAISO Payment Acceleration initiative will reduce the 70-75 day turnaround to 30-35 days.

The CAISO has already initiated stakeholder review of its Payment Acceleration initiative with market participants. The Payment Acceleration will become possible after the implementation of the CAISO’s new Settlement and Market Clearing System (SaMC), the first phase of which will be tested and implemented between September 1, 2005 and December 31, 2005. Assuming successful implementation of SaMC, Payment Acceleration will be implemented in spring 2006. Thereafter, the CAISO will evaluate shortening the settlement period further including, possibly, going to weekly invoicing, subject to the outcome of additional stakeholder processes. The CAISO has also designed

SaMC to facilitate and be compatible with possible further independent financial clearing of CAISO market obligations.

4. Netting

The Commission's Credit Policy also recommends, "minimizing the size of the credit risk exposure" by netting obligations owed by and to individual market participants. Credit Policy at P. 25. The CAISO agrees that netting can reduce the amount of security that a market participant may be required to post without increasing the credit risk exposure. The Commission believes that three types of netting should be adopted: (1) netting accounts payable and accounts receivable within one product class (e.g. energy); (2) netting accounts payable and receivable across products (e.g. energy and ICAP); and (3) netting internal bilateral energy contracts. *Id.* at P. 26. The CAISO already nets accounts receivable and accounts payable within and across products (*i.e.* 1 and 2 above) for energy and ancillary services and other CAISO market charges. Currently the CAISO invoices market charges separately from the CAISO's Grid Management Charge (GMC) and imposes a higher standard of creditworthiness for the GMC than for market charges. Among the changes proposed by the CAISO as part of the current stakeholder process, is to bill both market charges and GMC on the same invoice and to employ the same standard of creditworthiness for both types of charges.

As to the third type of netting, under the current market design, the CAISO does not have a day-ahead energy market and does not settle bilateral energy

contracts—parties settle these contracts outside of the CAISO’s settlement system

5. Other Measures and Future Plans for Reducing Risk

The CAISO began to explore the possibility of credit insurance in late 2003 and continues to work with insurance brokers to develop products that might be cost-effective alternatives for market participants. Two such products are under consideration. One product would be a replacement for a market participant’s security posting requirements, and might be a more cost-effective collateral option for participants, in lieu of current security options such as letters of credit or escrow accounts. Another product would be an insurance policy that the CAISO would purchase to mitigate the risk of overall losses to the market. Such a policy would provide specific limits of coverage by named participant in exchange for an annual premium. We continue to study issues such as cost recovery and cost effectiveness of such a policy.

In addition to exploring the risk tolerance of market participants, as discussed above, to address the nature of volatility of outstanding liabilities and the accuracy of SCALE calculations, the CAISO would like to reconsider how defaults are allocated. Currently, the CAISO Tariff, Section 11.13 allocates any shortfall in accounts receivable to creditors. Thus, net sellers bear the risk of a net buyer’s default. The CAISO believes that a more equitable allocation may be to allocate any shortfall to all market participants, which is an approach used by other ISOs/RTOs. This issue has not yet been discussed with stakeholders. The

CAISO intends to study this issue further and develop a recommendation for consideration by stakeholders.

The CAISO continues to be interested in the concept of a centralized clearinghouse for financial obligations, which would allow netting of financial obligations associated with multiple products across broader geographical regions. The CAISO is exploring these ideas as part of its ongoing stakeholder process.

Conclusion

The CAISO believes that the Policy Statement raises important issues that the CAISO either has incorporated or intends to incorporate into its stakeholder process. As noted above, this process began in April 2003 and has resulted in improvements, including the development of SCALE, a much more accurate tool for measuring outstanding liabilities than previously employed by the CAISO. More recently, the CAISO posted proposed changes—many of which are discussed in this report—on November 10, 2004, just prior to the Commission's issuance of its Policy Statement. The CAISO held a stakeholder meeting on November 30, 2004 and received additional stakeholder comment on December 17, 2004. Since then, the CAISO has been reviewing stakeholder comments and the Policy Statement and plans to publish revised proposed credit policies and conduct additional stakeholder meetings to discuss new issues. The CAISO anticipates implementing certain changes that may require amendments of the CAISO Tariff. Some of these changes are targeted for implementation of SaMC. Others may be more appropriate to include as part of the CAISO's MRTU Tariff filing. The CAISO still plans to engage in an effort of continuous improvement to

those policies that do not require Tariff changes and to continue the dialogue with market participants to ensure that the CAISO's credit policies are commercially reasonable, transparent, fair and equitable.

February 17, 2005

Respectfully submitted,

/s/ Sidney L. Mannheim

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February 17, 2005

The Honorable Magalie Roman Salas
Secretary
Federal Energy Regulatory Commission
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**Re: Policy Statement on Electric Creditworthiness
Docket No. PL05-3-000**

Dear Secretary Salas:

Enclosed for electronic filing please find Report of the California Independent System Operator Corporation.

Thank you for your assistance in this matter.

Respectfully submitted,

/s/ Sidney L. Mannheim

Sidney L. Mannheim
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