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April 12, 2006

## VIA ELECTRONIC FILING

The Honorable Magalie R. Salas  
Secretary  
Federal Energy Regulatory Commission  
888 First Street, N.E.  
Washington, D.C. 20426

Re: California Independent System Operator Corporation  
Docket Nos. ER06-700-\_\_\_\_

Dear Secretary Salas:

Attached please find the Motion for Leave to File Answer and Answer to Protests, Answer to Motions to Intervene and Comments, and Answer to Request for Order Requiring Supplemental Filing, of the California Independent System Operator Corporation, submitted in the captioned docket.

Please contact the undersigned in this matter.

Respectfully submitted,

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Counsel for the California Independent  
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**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

California Independent System            )  
Operator Corporation                        )                   Docket No. ER06-700-\_\_\_\_

**MOTION FOR LEAVE TO FILE ANSWER AND ANSWER TO PROTESTS,  
ANSWER TO MOTIONS TO INTERVENE AND COMMENTS, AND ANSWER  
TO REQUEST FOR ORDER REQUIRING SUPPLEMENTAL FILING, OF THE  
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION**

On March 7, 2006, as clarified and corrected on March 14, 2006, the California Independent System Operator Corporation (“CAISO”)<sup>1</sup> submitted amendments (“the March 2006 Credit Policy Amendments”) to the ISO Tariff in the captioned proceeding to modify the credit requirements and procedures in the ISO Tariff. The CAISO requested that the March 2006 Credit Policy Amendments, as revised by the March 14 filing, be made effective on May 14, 2006.

The Commission established a March 28, 2006, comment date for the March 7 filing of the March 2006 Credit Policy Amendments, and in response a number of parties filed motions to intervene. In addition, Constellation submitted comments, and NCPA and TANC submitted protests. Cities/M-S-R submitted a protest and a request for an order requiring a supplemental filing. The Commission also established an April 4, 2006, comment date for the March 14 corrected supplemental filing of the March 2006 Credit Policy Amendments. A

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<sup>1</sup> Capitalized terms not otherwise defined herein have the meanings set forth in the Master Definitions Supplement, Appendix A to the ISO Tariff.

number of additional parties submitted motions to intervene by April 4, and SCE filed comments on the revised March 2006 Credit Policy Amendments.

The CAISO does not oppose any of the motions to intervene submitted in this proceeding.<sup>2</sup> However, pursuant to Rules 212 and 213 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §§ 385.212, 385.213, the CAISO respectfully requests leave to file an answer, and files its answer to the protests of the March 2006 Credit Policy Amendments.<sup>3</sup> The CAISO also files its answer in response to the comments of SCE and the request of Cities/M-S-R for an order requiring a supplemental filing. As explained herein, the Commission should accept the March 2006 Credit Policy Amendments as filed and should not require the CAISO to submit a supplemental filing and should not direct the CAISO to place its Credit Policy & Procedures Guide on file.

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<sup>2</sup> Motions to intervene were submitted by: the California Electricity Oversight Board; the Cities of Anaheim, Azusa, Banning, Colton, Pasadena, and Riverside, California; the Cities of Redding and Santa Clara, California, and the M-S-R Public Power Agency ("Cities/M-S-R"); Constellation Energy Commodities Group, Inc., and Constellation NewEnergy, Inc.; the Modesto Irrigation District; the Northern California Power Agency ("NCPA"); Pacific Gas and Electric Company; Portland General Electric Company; the Sacramento Municipal Utility District; Southern California Edison Company ("SCE"); Strategic Energy L.L.C.; the Transmission Agency of Northern California ("TANC"); and Williams Power Company, Inc.

<sup>3</sup> The CAISO requests waiver of Rule 213(a)(2) (18 C.F.R. § 385.213(a)(2)) to permit it to make this answer to the protests. Good cause for this waiver exists here because the answer will aid the Commission in understanding the issues in the proceeding, provide additional information to assist the Commission in the decision-making process, and help to ensure a complete and accurate record in the case. See, e.g., *Entergy Services, Inc.*, 101 FERC ¶ 61,289, at 62,163 (2002); *Duke Energy Corp.*, 100 FERC ¶ 61,251, at 61,886 (2002); *Delmarva Power & Light Co.*, 93 FERC ¶ 61,098, at 61,259 (2000).

**I. ANSWER**

**A. The CAISO's Credit Policy & Procedures Guide Should Continue to Be Posted on the ISO Home Page But Should Not Be Filed as Part of the CAISO Tariff.**

The CAISO's Credit Policy & Procedures Guide "provides Market Participants and FTR Bidders further detailed information regarding credit-related provisions described in Section 12 of the ISO Tariff."<sup>4</sup> Cities/M-S-R, NCPA, and TANC each assert that the CAISO should be required to file the Guide for Commission approval under Section 205 of the Federal Power Act ("FPA"), as opposed to posting the Guide on the ISO Home Page, which has been the CAISO's practice since 2003.<sup>5</sup> For the reasons explained below, requiring the CAISO to file the Guide for approval under the FPA would be contrary to the Commission's credit transparency policy statement, established precedent concerning the level of detail in the ISO Tariff, and the Commission's application

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<sup>4</sup> Guide at 5. The Guide includes information on the processes used to administer the CAISO's credit policy, the methodology used to calculate Unsecured Credit Limits and Estimated Aggregate Liabilities, acceptable forms of Financial Security and the associated processes for requesting, posting, and administering Financial Security, security requirements for FTR Bidders, consequences for Market Participants' failure to meet their credit related obligations, and other credit-related information. *Id.* The Guide is posted on the ISO Home Page at <<http://www.aiso.com/17b3/17b3715165ef0.pdf>>.

The CAISO's credit requirements apply to both Market Participants and FTR Bidders. Throughout this answer, references to "Market Participants" are references to both Market Participants and FTR Bidders, unless otherwise specifically stated or the context indicates otherwise.

<sup>5</sup> Cities/M-S-R at 8-13; NCPA at 3; TANC at 6-7. Cities/M-S-R and TANC argue that the CAISO should file the Guide under Section 205 of the FPA, and NCPA asserts that the CAISO should include the Guide in the ISO Tariff, but these entities are essentially arguing for the same thing.

SCE makes the argument that the CAISO should file the Guide under FPA Section 205 in the context of the implementation of the CAISO's Market Redesign & Technology Upgrade ("MRTU") Tariff. SCE at 4. As explained in Section I.J, below, any MRTU-related concerns are premature and beyond the scope of the instant proceeding.

of the rule of reason. Requiring the CAISO to file the Guide for approval under the FPA would also inappropriately limit the flexibility of the CAISO to apply both qualitative and quantitative factors in assessing the credit limits of CAISO Market Participants.

**1. The Commission’s Policy Statement on Electric Creditworthiness Endorses the Posting of Credit Procedures on ISO and RTO Websites.**

The Commission’s policy statement on creditworthiness procedures endorses the posting of credit analysis procedures used by ISOs and RTOs on their websites as consistent with the interests of transparency and the Commission’s objectives concerning the application of such procedures. In its *Policy Statement on Electric Creditworthiness*, the Commission noted that “the majority of ISOs and RTOs . . . post their credit requirements on their websites or Open Access Same-Time Information System (OASIS) sites or incorporate them into their tariffs.”<sup>6</sup> However, the Commission stated that many “OATT Transmission Providers” (*i.e.*, public utilities other than ISOs and RTOs)<sup>7</sup> were not making their credit requirements as readily available and transparent to their customers as were ISOs and RTOs. In order to redress this problem, the Commission stated that it “expects OATT Transmission Providers, ISOs, and RTOs to: (1) make their credit-related practices more transparent and comprehensive; (2) post on their websites the procedures that they use to do

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<sup>6</sup> *Policy Statement on Electric Creditworthiness*, 109 FERC ¶ 61,186, at P 9 (2004) (“*Policy Statement*”).

<sup>7</sup> For purposes of the Policy Statement, the Commission defined an OATT Transmission Provider as “an entity that provides electric transmission service that is neither an ISO nor an RTO (*i.e.*, a traditional utility).” *Id.* at P 1 n.1.

their credit analyses; and (3) provide a customer with a written analysis setting forth how that entity applied its credit standards to that customer, if that customer is required to provide security.”<sup>8</sup> The *Policy Statement* also stated that “OATT Transmission Providers, ISOs, and RTOs must consider both qualitative and quantitative measures in their assessment of the credit risk of a party and *post* the criteria they use to determine these factors.”<sup>9</sup> Thus, the *Policy Statement* envisions the posting of credit procedures on ISOs’ and RTOs’ websites.

The CAISO has satisfied the Commission’s expectations as described in the *Policy Statement*. The CAISO has made its credit-related practices completely transparent by providing the credit requirements in Section 12 of the ISO Tariff and providing the implementation detail in the Guide, which is posted on the ISO Home Page. The combination of tariff language and related implementation detail that is posted on the CAISO’s website satisfies the Commission’s requirements as provided in its *Policy Statement*. Indeed, implementation details related to the CAISO’s credit requirements were included in the original version of the Guide that has been posted on the ISO Home Page since 2003. Since then, the CAISO has posted revised versions of the Guide as the Guide has been updated.<sup>10</sup> Furthermore, by including the criteria for assessing both qualitative and quantitative measures used in the CAISO’s assessment of the credit risk of a party in the Guide, rather than in a filed tariff,

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<sup>8</sup> *Id.* at P 12.

<sup>9</sup> *Id.* at P 13 (emphasis added).

<sup>10</sup> There have been four versions of the Guide, including the one discussed in this answer. See Guide at 2.

the CAISO has preserved the flexibility to consider both qualitative and quantitative factors that may be applicable to a specific entity in applying the CAISO's credit procedures, and to improve this process on a routine basis as the CAISO obtains experience and feedback from Market Participants in the process. This flexibility is discussed at greater length in Section I.A.4 of this answer. Also, as the *Policy Statement* requires, the Guide provides for the CAISO to make available in writing the results of its credit analyses to Market Participants that are required to provide security.<sup>11</sup>

**2. The March 2006 Credit Policy Amendments Maintain or Increase the Level of Detail Currently Found in the Credit Provisions of the ISO Tariff.**

Section 12 of the ISO Tariff describes the CAISO's creditworthiness requirements, the requirements for posting security, the circumstances in which a Market Participant fails to satisfy those requirements, and steps the CAISO can take if a Market Participant fails to satisfy the requirements. The March 2006 Credit Policy Amendments revised Section 12 to change certain of these requirements, steps, and circumstances, but did not eliminate any subject addressed in the currently effective version of the ISO Tariff or otherwise decrease the level of detail in the ISO Tariff. If anything, the level of detail in revised Section 12 is greater than it was prior to the filing of the March 2006 Credit Policy Amendments – for example, that filing more than doubled the length of Section 12.

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<sup>11</sup> See *id.* at 8-17. Among other things, the Guide states that the CAISO will, upon request, provide a Market Participant or FTR Bidder with a written analysis as to how its Unsecured Credit Limit was determined pursuant to the eight-step process for calculating Unsecured Credit Limits set forth in the Guide. *Id.* at 11.

The commenters that argue that the Guide should be filed for approval under FPA Section 205 are essentially arguing that the level of detail in Section 12 of the ISO Tariff is not just and reasonable even with the addition of the further detail contained in the March 2006 Credit Policy Amendments. In essence, these arguments are a collateral attack on the current level of detail in the ISO Tariff. These commenters have failed to carry their burden of showing that the level of detail in the current, Commission-approved Section 12 is unjust and unreasonable.<sup>12</sup> Absent that required showing, their arguments must be rejected.

The Guide has never been part of the ISO Tariff and should not be added to the Tariff now. As the CAISO noted in the proceeding in which it filed its Simplified and Reorganized Tariff, the Commission has long recognized that it would be appropriate to *reduce* the amount of detail in the ISO Tariff. The CAISO explained that, pursuant to direction provided by the Commission, in the future the CAISO intends to propose the removal from the Tariff of certain Protocols, sections of Protocols, or appendices of Protocols from the ISO Tariff that contain “operational guidelines” or “details or procedures necessary to implement tariff provisions” that need not be included in the Tariff.<sup>13</sup> The CAISO also intends to accomplish this objective in the context of the development of

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<sup>12</sup> Cf. *Outback Power Marketing, Inc., et al. v. PJM Interconnection, L.L.C.*, 104 FERC ¶ 61,079, at P 13 (2003) (finding that complainants under FPA Section 206 had shown that lack of detail in PJM’s tariff regarding credit requirements was unjust and unreasonable, and that PJM must therefore provide further detail in its tariff).

<sup>13</sup> Transmittal Letter for Simplified and Reorganized ISO Tariff, Docket No. ER05-1501-000 (Sept. 22, 2005), at 3 (quoting *Pacific Gas and Electric Co., et al.*, 81 FERC ¶ 61,320, at 62,471 (1997)).



subject area-specific Business Practice Manuals (“BPMs”) that support the MRTU Tariff and which are to be developed with stakeholder participation over the next few months.<sup>14</sup> In its order accepting the CAISO’s Simplified and Reorganized Tariff, the Commission noted and did not disagree with the CAISO’s goal of reducing the amount of detail in the Tariff.<sup>15</sup>

### **3. The Level of Detail in the Credit Provisions of the ISO Tariff Satisfies the Commission’s “Rule of Reason”.**

Pursuant to the Commission’s “rule of reason,” a filed tariff or rate schedule is required to include only “those practices that affect rates and services significantly.”<sup>16</sup> The level of detail found in Section 12 of the ISO Tariff – both before and after the filing of the March 2006 Credit Policy Amendments – satisfies the rule of reason and thus does not need to be augmented by the further detail found in the Guide. In earlier proceedings involving ISOs, the Commission has found that its rule of reason does not require the filing of implementation details or formulae for approval under Section 205 of the FPA.<sup>17</sup> Because the Guide consists solely of further details regarding the

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<sup>14</sup> See <<http://www.caiso.com/17ba/17baa8bc1ce20.html>> (section of the ISO Home Page that concerns the development of BPMs).

<sup>15</sup> See *California Independent System Operator Corp.*, 113 FERC ¶ 61,186, at PP 4 n.6, 32-34 (2005).

<sup>16</sup> *Midwest Independent Transmission System Operator, Inc.*, 113 FERC ¶ 61,081, at P 118 n.77 (2005) (quoting *City of Cleveland v. FERC*, 773 F.2d 1368, 1376 (D.C. Cir. 1985)).

<sup>17</sup> See, e.g., *Pennsylvania-New Jersey-Maryland Interconnection, et al.*, 81 FERC ¶ 61,257, at 62,267 (1997) (rejecting argument that PJM should be required to file manuals containing operating procedures); *Northeast Utilities Service Co. and Select Energy, Inc. v. ISO New England Inc. and New England Power Pool*, 105 FERC ¶ 61,122, at P 21 (2003), *reh’g denied*, 109 FERC ¶ 61,204, at P 20 (2004) (rejecting argument that ISO New England and NEPOOL should be required to include methodology for calculating marginal losses in its tariff where tariff already provided “sufficient specificity” on the subject).

provisions in Section 12, the Guide does not need to be filed as part of the ISO Tariff under the rule of reason.

**4. Requiring the Guide to Be Filed Would Limit the CAISO's Flexibility to Consider Qualitative and Quantitative Factors in Applying Its Credit Requirements and to Respond to Market Participant Concerns.**

As noted above, in the *Policy Statement*, the Commission directed OATT Transmission Providers, ISOs, and RTOs to “consider both qualitative and quantitative measures in their assessment of the credit risk of a party and post the criteria they use to determine these factors.”<sup>18</sup> The Commission listed a large number of qualitative and quantitative factors to be considered.<sup>19</sup> By including the Guide on the ISO Home Page, the CAISO is able to efficiently update the criteria it uses for making assessments of credit risk based on qualitative and quantitative factors, and to address any other concerns that Market Participants may have regarding the Guide. In this way, the CAISO can improve the provisions in the Guide in a timely and efficient manner as needed, rather than having to submit a tariff amendment whenever these criteria need to be updated or modified to address Market Participant concerns.

An example of how the CAISO has fine-tuned the provisions in the Guide is the CAISO's development of the means for determining Market Participants'

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<sup>18</sup> *Policy Statement* at P 13.

<sup>19</sup> The qualitative factors “include, among others: applicant's history; nature of organization and operating environment; management; contractual obligations; governance policies; financial and accounting policies; risk management and credit policies; market risk including price exposures; credit exposures; and operational exposures; event risk; and the state or local regulatory environment.” *Id.* at P 13 n.13. The quantitative factors “include, among others: financial statements, in general, and profitability, capital structure, and cashflow, in particular.” *Id.* at P 13 n.14.

estimated financial liabilities. Originally, the Guide reflected the CAISO's use of an "Estimated Aggregate Liability" or "EAL" tool to estimate such liabilities. From March 2004 to the present, however, the CAISO has used the "Scheduling Coordinator Aggregate Liability Estimate" or "SCALE" tool for that purpose.<sup>20</sup> The CAISO determined that the SCALE approach is the more accurate tool for estimating liabilities, because EAL was based on historic usage data whereas SCALE is based on current market data and better estimates concerning recent transactions for which data may not yet be available.<sup>21</sup> The CAISO developed and enhanced the specific components of the SCALE tool over many months and did so through an open and transparent process with stakeholder advice and comment. The CAISO does not believe that SCALE could have been developed and implemented as efficiently as it was if the CAISO had been required to file SCALE, and any modifications that needed to be made to SCALE, for Commission approval.

Further, the need under the March 2006 Credit Policy Amendments to determine Unsecured Credit Limits based on qualitative and quantitative factors suggests that a balancing approach should be used, rather than a rigid, fixed, formulaic approach. As with the evolution from EAL to SCALE, the CAISO and its Market Participants will benefit from the CAISO's flexibility to improve the way in which the qualitative and quantitative factors are balanced. The new approach

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<sup>20</sup> See "Scheduling Coordinator Aggregate Liability Estimate (SCALE) Implementation Questions and Answers," available on the ISO Home Page at <<http://www.caiso.com/docs/2004/02/25/2004022511011914971.pdf>>.

<sup>21</sup> *Id.*

is significantly more complex compared to the current approach under which entities with Approved Credit Ratings have unlimited credit, while entities without Approved Credit Ratings have zero credit. Although the CAISO has considered the new approach for nearly two years and requested and received significant stakeholder feedback on it, the CAISO nevertheless expects that experience with the new approach will yield information that the CAISO can use to make improvements. In addition to benefiting the CAISO and Market Participants, allowing the CAISO the flexibility to improve its methodology eases the burden on the Commission, as it reduces the potential for multiple future tariff amendments that the Commission would have to address.

#### **5. Market Participants Have the Ability to Raise Concerns Regarding the Guide.**

Cities/M-S-R and NCPA express concerns that the CAISO may unilaterally make changes to the Guide without stakeholder input.<sup>22</sup>

Cities/M-S-R and NCPA ignore the fact that the CAISO has included stakeholders in its development of new and updated credit policies and procedures, including those to be included in the Guide.<sup>23</sup> The CAISO will continue to include stakeholders in the process of developing revisions to the Guide in the future as appropriate. The CAISO will commit to provide a notice

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<sup>22</sup> Cities/M-S-R at 11; NCPA at 3-4.

<sup>23</sup> See "ISO Credit Policy Stakeholder Process," available on the ISO Home Page at <<http://www.caiso.com/docs/2003/04/21/2003042117001924814.html>>. The Commission has stated that it prefers revisions to credit practices to be vetted through a stakeholder process, though the Commission does not require such a vetting process in every case (e.g., where there is an urgent need to minimize the credit risk that is shared by market participants). See *Midwest Independent Transmission System Operator, Inc.*, 114 FERC ¶ 61,278, at P 49 (2005) (citing Policy Statement at P 32).

and comment opportunity for any substantive changes to the formulas or approach used to provide Unsecured Credit Limits, apart from correction of errors, clarifications, or routine updates, which would be noted in the Guide revision history only. Also, the CAISO will consider and respond to any stakeholder feedback it receives regarding a suggested change. The CAISO will clearly indicate in the revision history section of the Guide the places where any changes have been made. In addition, all changes must be fully consistent with authority specified in Section 12 of the ISO Tariff.

Many, if not most, of the changes the CAISO expects it may make to the Guide will be the result of stakeholder feedback. The CAISO strongly encourages continuing dialogue on how its credit policies might be improved and looks forward to receiving such feedback. For example, as explained in Section I.B, below, the CAISO is open to the consideration and development of alternative measures for determining the creditworthiness of municipal utilities that consider cash flow rather than net assets, as NCPA has suggested.

Market Participants also have protections to ensure that the CAISO will not be able to discriminate against them through the application of the provisions in the Guide. The CAISO is committed to the principles of transparency and non-discrimination contained in the *Policy Statement*. As the Commission noted in the *Policy Statement*, if a customer believes it has been discriminated against in the application of creditworthiness standards, the customer can contact the

Commission's enforcement hotline or file a complaint pursuant to Section 206 of the FPA.<sup>24</sup>

Finally, regardless of any changes to the methodology in the Guide that the CAISO may make in the future, no Market Participant may receive more than \$250 million in unsecured credit.<sup>25</sup> As this limit is specified in the Tariff, the CAISO will be unable to modify the credit limit-setting approach to permit an Unsecured Credit Limit in excess of \$250 million unless that Tariff provision is modified through a Section 205 filing.

**B. The CAISO's Flexibility in Revising the Guide Would Make It Easier for the CAISO to Develop an Alternate Means of Calculating Unsecured Credit Limits for Non-Profit Entities Such as NCPA.**

In Section I.A.4, above, the CAISO explained the usefulness of having the flexibility to modify the Guide as needed to address new issues. As noted earlier, the need for that flexibility is demonstrated by some of the comments filed in this proceeding. NCPA argues that the CAISO's method of calculating Unsecured Credit Limits is not well suited to the measurement of the financial strength of a non-profit entity such as NCPA, and states that an alternate measure of financial strength should be developed for those kinds of entities.<sup>26</sup> The CAISO is willing to work with NCPA to develop such an alternative measure and to implement such a measure through changes to the Guide through a stakeholder process that includes notice to and an opportunity for comment by all interested

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<sup>24</sup> *Policy Statement* at P 15.

<sup>25</sup> See proposed Section 12.1.1 of the ISO Tariff.

<sup>26</sup> NCPA at 4-5.

stakeholders. For the reasons explained in Section I.A.4, the CAISO will be able to accommodate NCPA's and other stakeholders' entity-specific concerns much more efficiently if it can make any needed changes to the Guide, provided the changes are consistent with and authorized by Section 12 of the ISO Tariff, without having to submit them for Commission approval.

**C. The Commission Should Not Require that the CAISO Modify Its Tariff or Guide to Provide All Market Participants With the Ability to Challenge the CAISO's Unsecured Credit Limit Determinations as to Each Market Participant.**

Cities/M-S-R argue that the Commission should require that the credit provisions of the ISO Tariff and the Guide be modified to provide all Market Participants (and not just the Market Participant or FTR Bidder seeking an Unsecured Credit Limit) with the ability to challenge the CAISO's determinations of Unsecured Credit Limits, in order to prevent the CAISO from "establishing improper Unsecured Credit Limits for other entities."<sup>27</sup> Cities/M-S-R are concerned that the CAISO will grant inappropriately high Unsecured Credit Limits to some Market Participants, thereby increasing the likelihood of "charge backs" to other Market Participants, such as those which occurred in the 2000-2001 California energy crisis. The Commission should not require such modifications to the Tariff provisions or the Guide because the revised credit provisions of the ISO Tariff were designed in large part to prevent a recurrence of certain credit-related issues that arose during the California energy crisis.<sup>28</sup> Moreover, any Market Participant that believes the CAISO has granted an inappropriately high

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<sup>27</sup> Cities/M-S-R at 13.

<sup>28</sup> Transmittal Letter for March 2006 Credit Policy Amendments at 2-3.

Unsecured Credit Limits already has the ability to challenge the CAISO's determination through an FPA Section 206 complaint.

The CAISO submitted the March 2006 Credit Policy Amendments to better ensure that Market Participants satisfy creditworthiness standards and to discourage defaults in the CAISO's markets.<sup>29</sup> Thus, the CAISO has a strong interest in establishing an appropriate Unsecured Credit Limit for each Market Participant. The fact that the CAISO has included in these amendments a cap on the Unsecured Credit Limit of \$250 million, which can be reduced by the CAISO Board of Governors but cannot be increased without a further Tariff amendment, demonstrates that the CAISO recognizes that there must be a limit on the unsecured credit extended to any entity.<sup>30</sup>

In addition, the approach used by the CAISO to set credit limits is laid out in detail in the Guide and is therefore transparent to all Market Participants. To the extent that an entity's financial information is available, any Market Participant can derive the maximum Unsecured Credit Limit that the CAISO would grant that entity by applying the formulae in the Guide. The CAISO does not currently post the Unsecured Credit Limits of individual Market Participants. The CAISO would be prepared to explore the publication of such information, but would want to seek stakeholder input on such publication, including input concerning any issues associated with confidential or proprietary information that may serve as the basis for such credit limits. Under the approach set forth in the Guide, the

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<sup>29</sup> *Id.* at 2, 4.

<sup>30</sup> *See id.* at 6-7.



CAISO can only reduce the maximum Unsecured Credit Limit of a Market Participant by considering additional factors.<sup>31</sup> If any Market Participant believes the CAISO's approach for determining Unsecured Credit Limits results in inappropriately high limits for particular Market Participants, that Market Participant is free to raise that concern to the CAISO. If their concerns are not met through that process, the Market Participant has the right to file a complaint under Section 206 of the FPA challenging either the CAISO's process for determining Unsecured Credit Limits or the resulting limits awarded to those particular Market Participants. Because there are existing mechanisms for Market Participants to raise these issues with either the CAISO or the Commission, there is no basis for the request of Cities/M-S-R for modifications to the ISO Tariff or the Guide to provide an additional process for Market Participants to challenge Unsecured Credit Limits.

**D. The CAISO's Use of the Moody's KMV Measure in its Credit Analyses is Appropriate.**

SCE argues that the CAISO should use public agency information rather than a non-public default probability measure, Moody's KMV, to calculate a Market Participant's Unsecured Credit Limit.<sup>32</sup> However, the CAISO has incorporated the Moody's KMV measure into its credit analyses for sound reasons. In the *Policy Statement*, the Commission stated that, pursuant to the requirement to apply qualitative factors in determining whether security should be provided for transmission service, ISOs and RTOs "should not automatically

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<sup>31</sup> See Guide at 11.

<sup>32</sup> SCE at 2. See Guide at 11-13 (incorporating the Moody's KMV measure).

determine that an applicant is not creditworthy if it does not have a credit rating or that credit rating is below investment grade.”<sup>33</sup> The Moody’s KMV measure provides the CAISO with a basis on which to extend unsecured credit to entities without a credit rating that is unbiased, is applied the same manner each time, is as transparent as possible, and is subject to validation. The CAISO has chosen to consider Moody’s KMV ratings in addition to standard credit ratings because the Moody’s KMV default probability measures have been shown, at least for public companies, to be more responsive than traditional credit ratings to changes in underlying credit quality ahead of a bankruptcy event. Thus, the use of the Moody’s KMV ratings furthers the CAISO’s goal of ensuring that Market Participants satisfy creditworthiness standards based on an analysis that considers both quantitative and qualitative factors.

**E. The CAISO Will Communicate With Market Participants Regarding Adjustments to Their Credit Limits.**

SCE claims that the CAISO will not notify a Market Participant if the CAISO adjusts the Market Participant’s credit limit.<sup>34</sup> SCE ignores the CAISO’s proposed revisions to Section 12.4 of the ISO Tariff. Those provisions state that if a Market Participant’s Estimated Aggregate Liability, as calculated by the CAISO, at any time exceeds its Aggregate Credit Limit, the CAISO will direct the Market Participant to post an additional Financial Security Amount within five Business Days that is sufficient to ensure that the Market Participant’s Aggregate

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<sup>33</sup> *Policy Statement* at P 14.

<sup>34</sup> SCE at 2.

Credit limit is at least equal to its Estimated Aggregate Liability.<sup>35</sup> Any change the CAISO would make to a Market Participant's Unsecured Credit Limit that would result in the entity being required to post an additional Financial Security Amount would be subject to that same process. Further, the CAISO will provide written documentation of any changes to a Market Participant's credit limit, upon request, as required by the *Policy Statement* and the Guide.<sup>36</sup>

The CAISO expects to receive feedback from Market Participants about how the CAISO uses financial and other information for Market Participants to set their Unsecured Credit Limits. The CAISO notes that it has not yet contracted with third-party vendors who will be assisting the CAISO in the process of setting such limits. As a result, the CAISO has not yet determined the frequency with which changes in Unsecured Credit Limits will be communicated to Market Participants who are not required to post an additional Financial Security Amount. However, the CAISO anticipates that it will communicate more frequently with Market Participants whose changes in Unsecured Credit Limits are of concern to the CAISO and less frequently with Market Participants whose changes are not of concern. Finally, the CAISO believes that these decisions are

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<sup>35</sup> See March 2006 Credit Policy Amendments at Attachment B (Section 12.4 of the ISO Tariff). See *also* Guide at 22 (describing the process for reviewing, complying with, and disputing request for an additional Financial Security Amount).

<sup>36</sup> As noted in Section I.A,1, above, the *Policy Statement* requires an ISO or RTO to provide a customer with a written analysis setting forth how that entity applied its credit standards to the customer, if the customer is required to provide security. *Policy Statement* at P 12. Further, the Guide states that the CAISO will, upon request, provide a Market Participant or FTR Bidder with a written analysis as to how its Unsecured Credit Limit was determined. Guide at 11.

business decisions to be worked out with Market Participants, the details of which need not and should not be included in the Tariff.

**F. The CAISO's Provisions Regarding Calculation Methods Do Not Need to Be Modified as SCE Suggests.**

SCE argues that “[w]hen calculating exposure, [the] CAISO should apply netting across all charges and/or payments,” rather than calculating exposure based on gross activity.<sup>37</sup> The CAISO already does so. Under the CAISO’s current methodology, financial settlement of energy market transactions is performed monthly, and all transactions for a Market Participant are netted and billed on a single invoice.<sup>38</sup> The CAISO’s credit procedures require non-creditworthy entities to post financial security sufficient to cover their net monthly obligations. Therefore, the CAISO calculates liabilities on a net basis, and its credit requirements are based on net transactions. The CAISO has not proposed to modify that netting approach in this filing and does not envision modifying that netting approach in the future.

SCE also states that it is unable to determine whether the different calculation methods the CAISO will use to determine Unsecured Credit Limits for different types of Market Participants are reasonable and equitable and argues that the CAISO should provide sample calculations for all types of entities.<sup>39</sup> SCE’s suggested approach would require the CAISO to include in the Guide an example of the calculation for any Market Participant with entity-specific

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<sup>37</sup> SCE at 2.

<sup>38</sup> See ISO Tariff, §§ 11.3, 11.6.2.

<sup>39</sup> SCE at 2-3.

concerns. The CAISO believes that the sample calculations already contained in the Guide are sufficient to provide a general understanding of how Unsecured Credit Limits will be calculated.<sup>40</sup> To the extent SCE or any other party has concerns about how credit limits for any class of entities are calculated, they will have available the avenues described in Section I.C of this answer to pursue those concerns.

**G. The CAISO Clarifies that Credit Applications Only Need to Be Provided Once and that the CAISO Will Use Quarterly Financial Information to Determine Tangible Net Worth.**

SCE states that the CAISO has not indicated how often a credit application must be submitted, and that it should only be submitted one time.<sup>41</sup> The CAISO confirms that it plans to request a credit application from a Market Participant just once.

SCE also states that the CAISO does not explain whether, if a Market Participant's Unsecured Credit Limit is reviewed on a quarterly basis, year-end or quarterly financial information will be used to determine the Market Participant's tangible net worth. SCE believes that only year-end information should be used because it has been verified and audited.<sup>42</sup> The CAISO clarifies that it intends to use quarterly financial information because such information is available on a more timely basis, and the benefits of utilizing more timely information to assess

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<sup>40</sup> See Guide at 15.

<sup>41</sup> SCE at 3.

<sup>42</sup> *Id.*

the creditworthiness of Market Participants outweigh the concerns with using quarterly information that may not be verified and audited.

**H. The CAISO Will Not Restrict All Affiliated Entities to a Single Unsecured Credit Limit.**

SCE states that the CAISO has proposed to treat all Affiliates under one Unsecured Credit Limit, and that each Affiliate that is public and rated by a public agency should have its own Unsecured Credit Limit.<sup>43</sup> The CAISO clarifies that it does not intend generally to group all affiliated entities and restrict them to a single Unsecured Credit Limit. However, the CAISO believes that, in limited circumstances, it would be imprudent to ignore relationships between financially troubled affiliated entities, and in some cases the CAISO may restrict the amount of credit that it would otherwise grant to a particular affiliated entity.<sup>44</sup> It is for this reason that Section 12.1.1.1 of the ISO Tariff, as proposed in the March 2006 Credit Amendments, states that the ISO “*may determine that the maximum Unsecured Credit Limit specified in Section 12.1.1 applies to the combined activity of such Affiliates.*” (Emphasis added.)

**I. Filing a Document with the Securities and Exchange Commission Is Sufficient Notification to the CAISO of a Material Change in Financial Condition.**

SCE contends that the filing of any document such as a Form 8-K report with the U.S. Securities and Exchange Commission (“SEC”) should be considered sufficient notification to the CAISO regarding any Material Change in

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<sup>43</sup> *Id.*

<sup>44</sup> As a separate matter, the CAISO does consolidate multiple business associate identification numbers (“BAIDSs”) of a single Scheduling Coordinator for credit purposes. Accordingly, each Scheduling Coordinator will have a single Aggregate Credit Limit against which its liabilities will be compared.

Financial Condition.<sup>45</sup> It is important that the CAISO have information regarding a Market Participant's Material Change in Financial Condition on a timely basis, *i.e.*, within five Business Days.<sup>46</sup> Thus, if such information is contained in an SEC document, a Market Participant should either provide the document to the CAISO directly or inform the CAISO where the information can be found on the SEC's website, within the five Business Day period.<sup>47</sup> The CAISO will attempt to determine a means by which it could monitor SEC filings of Market Participants, but prefers that they also have the obligation to inform the CAISO directly of significant events.

**J. SCE's MRTU-Related Issues Are Premature and Beyond the Scope of the Instant Proceeding.**

SCE raises several issues regarding how the revised credit provisions of the ISO Tariff will work after the MRTU Tariff becomes effective.<sup>48</sup> Docket No. ER06-615, not the instant proceeding, concerns the MRTU Tariff, and that Tariff is not even expected to go into effect until late in 2007. Thus, SCE's issues are premature and beyond the scope of the instant proceeding. Nevertheless, the CAISO provides responses to certain questions raised by SCE for the information of the Commission and interested parties.

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<sup>45</sup> SCE at 3.

<sup>46</sup> See proposed Section 12.1.1.2 of the CAISO Tariff.

<sup>47</sup> See Guide at 9 (stating that if a Market Participant's financial information such as a Form 8-K report is to be provided for a CAISO credit review, the Market Participant may simply indicate to the CAISO where the information is located on the Internet).

<sup>48</sup> SCE at 4-5.

SCE states that it is unclear which credit provisions will apply under MRTU, the ones currently in the MRTU Tariff or the ones contained in the March 2006 Credit Policy Amendments. Prior to the MRTU implementation date, the CAISO intends to conform the MRTU Tariff to reflect the latest effective tariff language, including the March 2006 Credit Policy Amendments as accepted by the Commission.

SCE also argues that the Guide should be filed under Section 205 of the FPA because of concerns related to how this Guide will be applied under MRTU. As explained in Section I.A, above, there are compelling reasons why the Guide should not be filed for approval. The CAISO envisions that the Guide will be converted to a subject-specific BPM under MRTU and revised to support the MRTU Tariff. The first draft BPM on credit policies will be published in draft form later this year for stakeholder review and comment. The broader issue of whether MRTU BPMs (either all of them or specific BPMs or parts of BPMs) should be on file as part of the Tariff will be addressed in the MRTU Tariff docket.

In addition, SCE states that it is unclear whether the CAISO will net market purchases with market sales when the MRTU Tariff goes into effect. As explained in Section I.F, above, the CAISO currently calculates liabilities and credit requirements on a net basis and does not envision changing that netting approach in the future.



## II. CONCLUSION

For the reasons explained above, the Commission should accept the March 2006 Credit Policy Amendments as filed and without modification, and should not require the CAISO to file its Credit Policy & Procedures Guide for Commission approval.

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Dated: April 12, 2006

## CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing document upon all parties on the official service list compiled by the Secretary in the above-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, California this 12<sup>th</sup> day of April, 2006.

/s/ Sidney M. Davies  
Sidney M. Davies