Memorandum

To: ISO Board of Governors

From: Ryan Seghesio, Chief Financial Officer & Treasurer

Date: October 25, 2012

Re: **Decision on Credit and Financial Tariff Enhancements**

This memorandum requires Board action.

EXECUTIVE SUMMARY

Management proposes implementing the following credit and financial related tariff enhancements:

- Implementing less stringent provisions for late invoice payments, including increasing from two to four the number of times within a rolling 12-month period that a market participant can be late without incurring a financial penalty. Consistent with this proposed modification, the other provisions in the tariff section will be modified so that each market participant is subject to financial penalties upon the fifth (and each subsequent) late payment in the rolling 12-month period and to possible enforcement actions upon the seventh (and each subsequent) late payment in the rolling 12-month period. This change is warranted to reflect the ISO's move from semi-monthly invoicing to weekly invoicing.
- Eliminating surety bonds, escrow accounts, certificates of deposit, and payment bond certificates as acceptable forms of financial security, to enhance the ISO's ability to call on credit support expeditiously in the event of non-payment.
- Modifying the ISO's unsecured credit calculation to eliminate the ability of a market participant with a speculative-grade Moody's KMV Equivalent Rating or credit agency issuer rating to receive unsecured credit. This change will enhance protection for the ISO market from the greater risk of default that may result from market participants with speculative-grade credit ratings transacting in the market.
- Adding the automated clearing house service as an alternative option to the current Fedwire option for making payments. The automated clearing house service provides a less expensive alternative to the Fedwire service.

Management recommends that the Board approve the following motion:

> ***Moved, that the ISO Board of Governors approves the credit and financial tariff enhancements described in the memorandum dated October 25, 2012; and***
>
> ***Moved, that the ISO Board of Governors authorizes Management to make all the necessary and appropriate filings with the Federal Energy Regulatory Commission to implement the proposed tariff change.***

DISCUSSION

The ISO continually monitors the best practices of other ISOs and RTOs as well as the electric industry to consider enhancements to the ISO's own credit and financial policies to protect the market against the risk of default. To that end, in 2011, the ISO formed a working group to provide stakeholders a forum to discuss credit best practices and a means to propose tariff enhancements before taking them to the larger stakeholder community through the ISO's stakeholder initiative process. The proposed enhancements discussed in this memorandum were first raised and vetted in the credit working group and then presented to, and ultimately supported by stakeholders representing a broad range of interests in the stakeholder initiative process. Management also proposes to provide market participants with the automated clearing house payment option as an alternative to the Fedwire payment service. Management plans to propose a February 1, 2013 effective date for these enhancements.

<u>Less stringent progressive discipline for late invoice payments</u>

On April 7, 2010, the ISO implemented the progressive disciplinary program for late invoice payments set forth in tariff section 11.29.14. Pursuant to that program, the ISO permits each market participant to make up to two "no-fault" late invoice payments in a rolling 12-month period without any penalties or enforcement action. Pursuant to section 11.29.14, the market participant is subject to financial penalties upon the third (and each subsequent) late payment in the rolling 12-month period and to possible enforcement actions upon the fifth (and each subsequent) late payment in the rolling 12-month period. These measures have been highly successful in reducing instances of late payments.

On October 1, 2011, to comply with FERC Order No. 741, the ISO moved from semi-monthly invoicing to weekly invoicing, effectively doubling the potential for market participants to make late payments. Subsequently, several market participants proposed that the ISO consider increasing the number of allowed "no-fault" late payments from two to four in order to match the doubled number of invoicing periods. Based on the positive changes in payment behavior the ISO has observed since section 11.29.14 went into effect and the reasons given by market participants for making late payments from time to time, Management determined that increasing the number of allowed “no-fault” late payments from two to four would not reduce the effectiveness of the late payment progressive discipline program in encouraging timely payments.

For these reasons, Management proposes to modify section 11.29.14 to increase from two to four the number of late payments allowed in a rolling 12-month period before financial penalties are assessed. Consistent with this proposed modification, Management also proposes to adjust the other provisions in the tariff section so that each market participant is subject to financial penalties upon the fifth (and each subsequent) late payment in the rolling 12-month period and to possible enforcement actions upon the seventh (and each subsequent) late payment in the rolling 12-month period.

Eliminating certain forms of financial security

Management proposes to modify tariff sections 12.1.2 and 12.2 and make any other necessary tariff changes to eliminate escrow accounts, surety bonds, certificates of deposit, and payment bond certificates as acceptable forms of financial security. The purpose of these modifications is to eliminate forms of security that do not provide the ISO with prompt access to funds in the event of a payment default. Any delay in drawing on funds backed by these types of financial security instruments may affect the ISO’s ability to timely clear the market, which could result in a socialized default.

For example, an escrow account is a three-party agreement between the market participant, the market participant’s bank, and the ISO. The market participant deposits cash with the bank that the ISO can draw on in the event of non-payment. However, these cash deposits are considered assets of the bank and, therefore, could be put at risk in the event the bank becomes insolvent, potentially “locking up” these funds when the ISO must draw on them.

Drawing on a surety bond or a payment bond certificate, which is usually underwritten by an insurance company, could lead to a long investigation before a determination is made whether to honor the draw request. Similarly, the funds may not be readily available to the ISO under the terms and conditions of certificates of deposit compared to cash or a letter of credit.

Likewise, certificates of deposit have strict terms and conditions, dictated by the issuing bank that may not favor the ISO and, ultimately, may delay payment to the ISO in the event of a default.

When Management surveyed other ISOs and RTOs, it found that only the New York ISO and the Electric Reliability Council of Texas accept surety bonds and that no ISO or RTO (including NYISO and ERCOT) accepts the other forms of financial security that Management proposes to eliminate. Moreover, only seven of the ISOs market participants use these forms of financial security. The ISO has contacted these market participants and they are already considering alternative forms of financial security.

Eliminating eligibility for unsecured credit for market participants with speculative-grade credit ratings

Management proposes to modify the unsecured credit limit calculation set forth in the tariff to eliminate the ability of market participants with credit ratings below investment grade (*i.e.*, speculative-grade credit ratings) to receive unsecured credit. Requiring these market participants to back their financial obligations with a secured form of financial security instead of unsecured credit will enhance protection for the ISO market from the greater risk of default that may result from market participants with speculative-grade credit ratings transacting in the market. Management proposes to implement this modification in a way that is transparent and objectively determined.

The tariff and the Business Practice Manual for Credit Management set forth rules for calculating unsecured credit limits based on a percentage of a market participant's tangible net worth. The rules for determining the percentage are based on a market participant's Moody's KMV Equivalent Rating or lowest credit agency issuer rating, or, for a market participant that has both of those types of ratings, the average of the two ratings. A market participant with the highest credit rating can receive a credit limit of up to seven percent of their tangible net worth – capped at the maximum unsecured credit limit of $50 million. Percentages under the rules are stepped down from that highest credit limit to as low as one percent of tangible net worth for the lowest-rated investment-grade entity. Under current rules, a market participant with an investment grade rating and a speculative grade rating would have those ratings averaged and could conceivably receive a significant amount of unsecured credit.

Pursuant to Management's proposal, a market participant that has either a Moody's KMV Equivalent Rating or a credit agency issuer rating that is currently below or that falls below investment grade will be deemed to have an allowable percentage of tangible net worth of zero for purposes of calculating its credit limit under the rules, and thus will receive no unsecured credit (either through adjustment of its previously positive unsecured credit limit for an existing market participant or through notification of a zero unsecured credit limit if it is a new market participant). The market participant will receive an unsecured credit limit of zero even if it has an investment-grade Moody's KMV Equivalent Rating but a credit agency issuer rating below investment grade, or vice versa (*i.e.*, the market participant will not receive an unsecured credit limit greater than zero based on the average of the two ratings). The market participant will remain ineligible for unsecured credit until the ISO's next quarterly review of the market participant's financial condition or thirty calendar days, whichever is later.

Optional Automated Clearing House Payment Services

The tariff currently requires use of the Fedwire payment service. Management proposes to provide market participants with the alternative option to elect automated clearing house payment services to pay the ISO, receive payments from the ISO, or both.

Automated clearing house payment services are less expensive but do not provide "same-day" settlement. The Fedwire payment service is more expensive but allows fund transfers to be processed within the same day if initiated early enough. The ISO presented this option to stakeholders during the credit policy stakeholder meeting held on July 31, 2012. No participant indicated any objection. The ISO has published additional information outlining the benefits of the automated clearing house payment services option and how it compares with the Fedwire payment service. If a market participant does not elect to use the automated clearing house payment services then, consistent with existing tariff requirements, the Fedwire payment service will be utilized.

POSITIONS OF PARTIES

With the exception of the automated clearing house payment option, each of the proposed enhancements discussed in this memorandum was first raised and vetted in the credit working group and then presented to, and ultimately supported by stakeholders representing a broad range of interests in the stakeholder initiative process. During the stakeholder process, stakeholders generally supported each proposal or chose not to comment. A stakeholder matrix summarizing stakeholder positions on each of the enhancements is attached for your reference.

MANAGEMENT RECOMMENDATION

The credit and financial tariff enhancements discussed in this memorandum are designed to mitigate credit risk of participation in the ISO market and to provide additional flexibility concerning payment options and late payment penalties. Because of this and the general stakeholder support, Management recommends that the Board approve the proposed tariff enhancements.