

Memorandum

To: ISO Board of Governors
From: Ryan Seghesio, Chief Financial Officer and Treasurer
Date: July 8, 2011
Re: **Decision on Modifications to Credit Reform Policy**

This memorandum requires Board action.

EXECUTIVE SUMMARY

The Federal Energy Regulatory Commission's Order 741 – Credit Reforms in Organized Wholesale Electric Markets - requires all Independent System Operators and Regional Transmission Operators to adopt certain market clearing and credit reforms that are designed to protect organized wholesale electric markets from default by a market participant. At its May 18 board meeting, the ISO Board of Governors approved all provisions of the ISO's credit reforms developed in compliance with FERC's order and authorized Management to make all necessary and appropriate filings with the Commission to implement the proposed tariff change. The ISO filed its proposed changes with FERC on June 30.

The ISO now seeks to enhance the aspect of the credit requirements dealing with the standards for minimum participation in ISO markets. Since late last year, the California ISO, along with other ISOs and RTOs, has been engaging in discussions with the Commodity Futures Trading Commission in anticipation of filing a request for an exemption from CFTC jurisdiction for all markets, products and transactions that exist pursuant to our FERC- approved tariff. There has been significant debate over whether certain ISO and RTO markets – the markets for financial transmission rights (in California these are known as congestion revenue rights) and convergence bidding – are subject to CFTC jurisdiction and thus require significant compliance steps by ISOs and RTOs to conform to the requirements of the Commodity Exchange Act. When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") in 2010, it provided that the CFTC shall exempt agreements, contracts or transactions entered into pursuant to a FERC-approved tariff if the CFTC concludes that doing so is in the public interest and consistent with the purposes of the Commodity Exchange Act.

To avoid the regulatory uncertainty and legal compliance risk associated with ambiguity over the application of the Commodity Exchange Act to our markets, the ISO joined with other ISOs and RTOs to engage in informal discussions with the CFTC with the intent of filing an exemption request.

To support an exemption application, the ISO must demonstrate to the CFTC that granting it is in the public interest and consistent with the Commodity Exchange Act. The FERC Order 741 process has been important for strengthening the credit rules for ISO and RTO markets.

However, the CFTC staff has recently made clear that one element of the ISO's compliance with Order 741 – that related to minimum participation – will require more than just self-certification by market participants to ensure that entities doing business in our markets and potentially exposing other participants to risk have sufficient controls and risk management practices in place. We also believe that FERC will concur that requiring verification as part of the ISO's minimum participation requirements will prevent thinly capitalized entities lacking basic risk management experience from creating a credit risk which may lead to a potential disruption in the market.

In its June 30 compliance filing, the ISO proposed minimum participation requirements as described to stakeholders and approved by the Board. In the filing, the ISO indicated that it had initiated a supplemental stakeholder process to develop a more robust verification component beyond what was previously approved. Further, the filing stated that the ISO planned to seek Board approval in July and shortly thereafter submit a supplemental compliance filing that provides an alternative to its minimum participation requirements that includes verification to FERC.

Because of the need to get this item to the Board in an expeditious manner, the ISO conducted a limited and expeditious stakeholder process of the verification element. Accordingly, stakeholders may voice a concern that they have not had an opportunity to conduct a comprehensive review of the ISO's proposal. Nevertheless, Management proposes the Board approve its minimum participation verification process.

This new verification process requires all market participants to have an officer annually attest that they have a comprehensive set of risk management policies, procedures and controls commensurate with the way they participate in the ISO market. Further, certain congestion revenue rights market participants must not only attest, but also must provide documented evidence of these risk management policies, procedures and controls for ISO verification and review. Management believes this minimum participation verification process achieves the objective to provide an alternative to self-certification by including a verification component to the ISO's minimum participation requirements.

While we are requesting approval of the framework for the verification proposal, we intend to continue working with market participants as we develop the actual tariff language to ensure that we have captured the feedback regarding the details of the proposal that accomplishes the goals outlined in this memo while ensuring it is done in a fashion that is sensitive to the business models and risk profiles of our market participants.

Moved, that the ISO Board of Governors approves the proposed credit policy modification establishing minimum criteria for participation in the ISO to include verification by the ISO, as described in the memorandum dated July 8, 2011; and

Moved, that the ISO Board of Governors authorizes Management to make all necessary and appropriate filings with the Federal Energy Regulatory Commission to implement the proposed tariff change.

BACKGROUND

On October 21, 2010, FERC issued Order 741 – *Final Rule Regarding Credit Reforms in Organized Wholesale Electric Markets* (<http://www.ferc.gov/whats-new/comm-meet/2010/102110/E-3.pdf>), requiring each ISO and RTO to adopt certain market clearing and credit reforms that are designed to protect organized wholesale electric markets from default by a market participant.

The CFTC has taken an active interest in reforms the ISOs and RTOs are implementing under FERC's guidance in the Order 741 proceeding. One area of particular interest to the CFTC is minimum participation requirements for entities entering and participating in the ISO market. The ISO, together with the other ISOs and RTOs, is preparing a request that asks the CFTC to exempt our markets from its jurisdiction on the grounds that FERC already exercises jurisdiction over them. In developing this waiver request, the ISOs and RTOs have needed to demonstrate that certain core principles under the Commodity Exchange Act are met by FERC's regulatory framework for these markets.

An element of FERC's regulatory framework, under development through the Order 741 process, is the minimum participation requirement, and in particular the element requiring that market participants self-certify that they meet certain risk management, business process and training standards. In the ISO's work with the CFTC to develop our exemption request, the CFTC has made clear that self-certification without verification will not satisfy Commodity Exchange Act core principles, and we believe that FERC will concur that the opportunity and right to verify should be an element of minimum participation criteria.

With the inclusion of a verification process, all prospective and existing market participants will be required to have select risk management and business practice documentation, processes and controls related to their area of participation in the ISO market. Certain market participants who hold risky congestion revenue rights portfolios will be required to submit the actual documentation to the ISO, and the ISO must then evaluate the material provided against industry best practices for compliance with the minimum participation requirements. This evaluation will determine if an entity will be allowed to participate in the ISO market.

MINIMUM PARTICIPATION VERIFICATION PROCESS

Under our current proposal, prospective and existing market participants will have to file an annual officer certification form that is largely consistent with the form in Attachment 1. The general intent of the form is to have market participants self-certify that they have general risk management policies in place, properly trained employees, and the ability to interact efficiently with ISO policies and procedures (all of which was approved by the Board at the May 18 meeting and filed with FERC in our June 30 compliance filing). In order to meet the verification process that FERC and the CFTC desire, we propose to expand the annual certification process in the following ways:

- The ISO will have the authority to request from a market participant a copy of its written risk management policies, procedures and controls.

- Congestion revenue rights entities (market participants who transact in the ISO's congestion revenue rights market) will provide a narrative response to key elements of their risk management policies and trading practices.
- Certain congestion revenue rights entities, based upon a risk based metric described in the certificate, will be required to submit their written risk management policies, procedures and controls.

POSITIONS OF THE PARTIES

The ISO held an initial stakeholder call on June 24 to inform stakeholders of developments related to minimum participation requirements and the need for a supplemental filing to the ISO's June 30 Order 741 compliance filing, to allow the ISO time to develop, stakeholder, and obtain Board approval of, an alternative minimum participation requirements proposal which includes verification. On that call, the ISO provided stakeholders a high-level view of PJM's proposal, which already included verification, and encouraged stakeholders to view PJM's entire proposal on their website.

On June 28, the ISO issued a market notice to:

(1) notify market participants of the posting of the ISO's draft verification proposal, including an officer certification form; (2) request comments on the draft verification proposal and officer certification form by July 1; and (3) schedule a conference call for July 5 to discuss the ISO's proposal. The ISO received thirteen sets of comments from stakeholders which are summarized on the accompanying stakeholder matrix (Attachment 2).

On July 5, the ISO conducted a stakeholder call addressing all questions and issues raised by stakeholders in their written comments. Stakeholders neither clearly opposed nor supported the ISO's verification proposal. Many stakeholders expressed a concern that the proposal was onerous and would result in additional administrative burdens and costs without a clear benefit. Certain market participants expressed concern that the ISO did not allow sufficient time for them to complete a comprehensive analysis of the proposal. Others felt there was insufficient context and lack of stakeholder visibility related to the CFTC. Additional stakeholder comments recommended changes to specific elements of the straw proposal. The ISO incorporated many stakeholder recommendations and others will be left to a stakeholder process that will continue based on the Board's approval of the verification process framework.

The ISO incorporated changes suggested during the stakeholder process into the form of the verification in Attachment 1. We believe that the framework for verification that we are asking the Board to approve today is sound, allowing us to ensure that the risk management controls are in place while placing the least possible burden on market participants and the ISO. We will continue to work with market participants to refine the requirements consistent with the general policy suggested for Board approval today, before we file the amended language with FERC.

MANAGEMENT RECOMMENDATION

Management recommends approving the general framework of the enhancements described in this memo to the minimum the minimum participation requirements that were approved as part of FERC Order 741. These enhancements will add a verification process to self-certification method being implements.

Management will continue to work with stakeholders in the coming weeks to finalize the details of the annual certification form and tariff language.