December 16, 2004

California Department of Water Resources ("the Department") Comments on CAISO SC Credit Policy: Changes Under Consideration

Prepared by Jerry Green

In summary, the Department favors the majority of changes under consideration while offering a few suggestions. Comments offered reflect our reading and understanding of two documents: the document on changes under consideration dated November 10, 2004 and the presentation used at the November 30, 2004 meeting.

<u>Creditworthiness</u>

1. We agree that no entity should be granted unlimited credit. As a governmental agency we will pay our bills and I would expect the same from other municipal and governmental agencies. However, if CAISO markets exhibit high volatility and prices, cash flow can be an issue. Providing some level of unsecured credit but not unlimited credit should help dampen any cash flow problems that may arise.
2. We think it is reasonable to allow some credit to entities with a lower than investment grade rating under the tired approach especially when combined with the use of an alternative scoring model such as the Moody's KMV product.
3. With respect to Tangible Net Worth and its use, we agree that some measure of an entity's liquidity should be used to determine their amount of unsecured credit. While we don't have a specific alternative in mind, some other measure of liquidity (such as a working capital ratio or a quick ratio) might provide a better measure though you can run into comparison problems between the financial reporting requirements of public entities and municipalities and governmental agencies.
4. We agree that a tiered approach should also be used to determine the amount of unsecured credit for municipalities and governmental agencies. Unfortunately, the use of a Moody's KMV score is unavailable for this class of market participant so the supposed benefit of "quickness" of recognition to changes in financial health isn't realized. The CAISO could attempt to compensate for this by having two different scales of % of net worth in initial unsecured credit. For example, for the class of market participants that a Moody's KMV score is available a combined numeric rating score of < 1.5 yields 7.5%. For a municipal or governmental agency where only a long-term bond rating is available, that same numeric rating score of < 1.5 could yield a 7.0% or 6.5%. Maybe this isn't necessary since municipal and governmental agencies have the ability to collect revenues to cover costs but again, the name of the game here is free cash flow and the ability to make payments in a timely manner.
5. We think the use of the Moody's KMV model is worthwhile.
6. We think the use of a concentration limit is also worthwhile, but feel that 35% may be too high of a limit. 25% or maybe even 20% may be more appropriate.

7. We support the implementation of a single credit standard.

BAID / SCID specific security postings

The recommendation is to maintain the current policy of requiring each SC to provide appropriate financial security for all SC ID's for which it is responsible. While it is true that the Department has one SC agreement, the two entities that transact in the CAISO markets are separate legal entities (have two distinct funding sources). The Department would prefer to not aggregate these two entities (the State Water Project and California Energy Resource Scheduling) but keep them separate as to their respective potential credit collateral obligations.

Approved Security Forms

We agree with the CAISO recommendations outlined in the November 30 presentations. With also agree with the wisdom of having an alternative or replacement form of security in place 30 days prior to the expiration of the existing form as a way to protect market participants. I believe what we are thinking here is a type of "evergreen" agreement – with the goal of not having a lapse in the form of security as long as some form of security is required.

Liability Obligation

With respect to new SC's we agree with the CAISO recommendations to require the SC to post security to cover 14 days of estimated charges, increasing postings as needed as well as with the use of the simplified spreadsheet to estimate obligations.

SCALE

Though I have no experience with SCALE, I have faith in the CAISO that it is a reasonable tool for estimating a SCs financial obligation.

We support the use of more conservative assumptions to provide greater assurance that SCs with a financial security posting obligation are adequately secured.

Number of Days Included in Liability Calculation

We agree with the recommendation to permit SCs with the discretion to post security for a either a fixed period or a variable period. Providing the flexibility as to how to manage its own security posting should be left up to the individual SC.

Price Volatility and Forecasted Liabilities

We agree that the CAISO should revisit this issue and implement a volatility adjustment if a significant increase in price volatility is seen.

Liability Obligation Calculations and Security Posting Requirements for Special Circumstances

What constitutes "substantially reduced participation" in the CAISO markets? This needs to be quantified prior to adoption of the recommendation to hold a 5% residual security posting for a period of one year. The other comment is that if this recommendation is adopted but as a result of the implementation of a new settlement system in 2005, we hope the CAISO will revisit the one year residual security posting holding period if a shorter holding period is warranted.

Security Posting Requirements by Individual Trade Months

Though the majority of the time the Department is a net-debtor, some months it is a net-creditor. As such we prefer the continuance of the policy that allows net creditor months to offset net debtor months. Should this policy be applied across the board equally? This seems like a perfect place to follow the November 19 FERC Order and "consider qualitative and quantitative factors" and possible exercise the discretion to not make this policy the same for all market participants.

Unsecured Obligation Penalties

We think it is reasonable to asses a penalty for an unsecured obligation and we also favor a "safe-harbor" or avoidance of penalties if a SCE complies with a CAISO security posting request. After all, the goal of the revised SC credit policy is to offer a greater level of protection to market participants and this combination offers a reasonable balance. We also request for consideration a different standard between a municipal or governmental agency and a private entity when it comes to the number of days allowed between a CAISO posting request and receipt of such request. As a state agency, we must follow the rules and regulations of other agencies that control over us, thus making our ability to process payment requests (or in this case, the posting of collateral) in the same timeliness fashion as non-governmental entities difficult if the time frame between receiving the CAISO request to post collateral and when that collateral is required is short. We believe unequal treatment can be rationalized by following FERCs words in its November Order where it said to consider the "nature of the organization and operating environment".