# Stakeholder Comments Template

# Subject: Credit Policy Enhancements

| **Submitted by** | **Company** | **Date Submitted** |
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This template has been created for submission of stakeholder comments on the topics covered in the September 22, 2008 Credit Policy Enhancements stakeholder meeting. Upon completion n of this template, please email your comments (as an attachment in MS Word format) to CreditPolicyComments@caiso.com. All comments will be posted to CAISO's Credit Policy Stakeholder Process webpage at http://www.caiso.com/docs/2003/04/21/2003042117001924814.html.

Submissions are requested by close of business on October 7, 2008 or sooner.

Please submit your comments to the following questions for each topic in the spaces indicated.

**EPIC can support many of these proposals. However, these proposals would not be necessary if CAISO would adopt EPIC's suggestions on unsecured credit and tangible net worth. Those suggestions are attached to these comments as Attachment A.**

1. Do you support CAISO's proposal (Alternative 3) to replace the use of Credit Rating Default Probabilities and Moody's KMV Default Probabilities with the use of agency issuer ratings and Moody's KMV Spot Credit Rating in its eight-step process credit assessment process? Do you agree that these ratings should be blended according to the same percentages already established in the eight-step process? Do you agree that Moody's KMV Spot Credit Rating should be used, according to the same blending percentages, to assess whether a financial institution meets CAISO's "reasonably acceptable" test for accepting a Letter of Credit or an Escrow Account (i.e., the blending must yield a result greater than or equal to four (4.00) to be "reasonably acceptable"?)

   EPIC Response

   EPIC supports measures to ensure that the finances of entities posting unsecured credit are reviewed in the shortest timeframe possible.

2. Do you support CAISO's proposal to expand the definition of Tangible Net Worth to exclude assets that are earmarked for a specific purpose such as restricted assets and assets related to affiliated entities? Do you also agree that CAISO should also exclude highly volatile assets such as derivative assets?

   <u>EPIC Response</u>

   EPIC will support this proposal as an interim measure and any other that help shape a more conservative approach to CAISO's practice of extending unsecured credit.

3. Do you support CAISO's proposal (Alternative 2) to reduce the maximum amount of unsecured credit that it will assign to the most creditworthy party to $100 million?

   <u>EPIC Response</u>

   EPIC supports this proposal as an interim measure, as it may lower the exposure of market participants at CAISO. A default on exposure over $100M will be an undue burden on market participants who have the obligation to absorb this, and every, default. EPIC would support any further lowering of this amount as well.

4. Do you support CAISO's proposal (Alternative 2) to allow Guarantees and other forms of Financial Security to be issued from Canadian entities? Do you support expanding this policy to accept Financial Security from non-US / non-Canadian based entities using rules similar to those adopted by ISO New England if CAISO can clear the legal hurdles and complexities of developing the necessary processes and agreement language for accepting Financial Security from foreign entities? Are ISO-NE's restrictions sufficient and necessary? Should other safeguards be put in place? Should CAISO consider extending this policy to other types of Financial Security such as Letters of Credit?

   <u>EPIC Response</u>

   CAISO should be careful not to expose market participants to another form of risk (currency risk), while forming this policy. Canadian entities should be required to post US dollars. No foreign entity should be extended unsecured credit because of the difficulties in recovering any money from these entities in the event of a default.

5. Do you agree that an Affiliate Guaranty, where a Guarantor backing the obligations of one Affiliate must provide the same Guaranty for all of its Affiliates in the CAISO market, is essential to help mitigate the risk of a payment default by an under-secured and thinly capitalized Affiliate? Does the concept presented present regulatory issues for non-regulated parents backing regulated and non-regulated affiliates?

   <u>EPIC Response</u>

EPIC supports this proposal as it is appropriate and fiscally responsible.

The practice of extending unsecured credit creates the need to consider funding a reserve account, the need to guarantee affiliates, and procuring credit insurance in order to mitigate the risk of an unsecured default. These measures, even when properly utilized, simply act as a displacement of risk.

If the parent companies and affiliate/subsidiary companies were properly collateralized (cash) the risk associated with affiliates is greatly reduced and the tools put in place to attempt to mitigate this risk become superfluous.

6. Do you support CAISO's proposal (Alternative 1) to reduce the time to post additional Financial Security from five (5) Business Days to three (3) Business Days?

<u>EPIC Response</u>

EPIC supports this measure, as it is in line with other ISO's and lowers the overall risk in the market. EPIC supports this measure because it may help provide earlier notice that an entity is unexpectedly in financial distress. Note that many of the large financial institutions that recently found themselves in trouble had recent high credit ratings and were not generally know to be suffering.

7. Should CAISO change its policy allowing 100% of Market Participant's available credit (i.e., Aggregate Credit Limit minus Estimated Aggregate Liability) to be available for a Congestion Revenue Rights ("CRR") auction? Is setting the amount of available credit at 90% of available credit a reasonable approach to ensure some buffer remains in place for a Market Participant's other market activities? Should a lower threshold be considered?

<u>EPIC Response</u>

It is EPIC's position that credit requirements should be appropriate to the level of risk inherent in the product. CRR's are a unique and distinct product and the credit requirement associated with this product should reflect this risk. The credit requirements for "other" market activities, such as convergence bidding, should be structured appropriately to the credit risks associated with those activities. Utilizing this methodology, the 90% threshold would result in the overly-conservative credit policy.

8. Are you in favor of the CAISO funding a reserve account as a means of providing a source of funds in the case of a payment default? How would you propose that such an account be funded?

<u>EPIC Response</u>

EPIC does not support the creation of a reserve account if such an account is funded by payments from market participants. A reserve account would simply act as a displacement of risk. Moreover, a reserve account would negatively impact liquidity. A reserve provides a very poor return for the money invested. Therefore, it is EPIC's position that a reserve account should only be created if it is funded through penalties associated with late payments or other market activities.

9. Are there other payment default risk mitigation strategies, of those that were presented, that you support and would want CAISO to investigate further such as a Line of Credit, credit insurance, establishing a captive insurance company, developing a blended finite risk program or a capital market transfer to provide potential funding sources in the case of payment default? Are there other strategies that were not covered that CAISO should investigate and/or pursue?

EPIC Response

EPIC suggests a policy of no unsecured credit coupled with appropriate collateralization. The opportunity and administrative costs associated with the options described above typically make them very unattractive to market participants. EPIC does not support moving forward with any of the above options.

10. Do you support CAISO changing its loss sharing/chargeback mechanism to include the allocation of a payment default to all Market Participants – not just net creditors during the default month? What measure should be used to apportion exposure to the chargeback?

EPIC Response

EPIC supports this policy revision.

11. Do you agree with CAISO's proposal to assess financial penalties on Market Participants who are late in paying their invoices two or more times in a rolling 12 month period? Are the financial penalties sufficient to ensure compliance with the payment provisions of the CAISO Tariff? Do you agree that Market Participants who are late a third time in a rolling 12 month period should also have to post cash in lieu of any unsecured credit for a period of 12 months of on-time payments? Do you agree that any penalties collected should fund a reserve account that can be used as a source of funds in the case of a payment default?

EPIC Response

EPIC would like to see a more stringent policy in place. Beginning with the first late payment in a rolling 12 month period, market participants will receive a notice of late payment. Upon the second occurrence in a rolling 12 month period, unsecured credit is reduced to zero and must be replaced with cash.

Beginning with the third late payment in a rolling 12 month period (and all subsequent late payments), a monetary penalty will be assessed. This penalty will be the greater of 2% of the invoiced amt. or $1,000 (but not over $25K). EPIC believes the upper bound of this penalty should be increased from $10K in order to provide an incentive for prompt payment on large transactions. Upon the fourth late payment, the participant's market activity is suspended.

Penalties should fund an interest bearing reserve account to fund any future default.

12. Do you agree with CAISO's proposal to assess a financial penalty on a Market Participant who is late in posting additional collateral on the third and each subsequent time in a rolling 12 month period? Are the financial penalties sufficient to ensure compliance with the collateral posting provisions of the CAISO Tariff? Do you agree that any penalties collected should fund a reserve account that can be used as a source of funds in the case of a payment default?

<u>EPIC Response</u>

It is EPIC's view that postings on collateral calls be made in the shortest time frame reasonable. These collateral calls are made because CAISO has determined that a participant's position in under-collateralized. The situation puts the other market participants at risk until it is resolved. If the participant is unable to meet the collateral call, this information needs to be known as quickly as possible. The procedure for the posting of additional collateral should make it clear to market participants that posting in a timely manner is critical to market stability.

Beginning with the FIRST late payment/posting in a rolling 12 month period, assess a monetary penalty of the greater of 2% of the invoiced amt. or $1,000 (but not over $10K). On the SECOND occurrence in a rolling 12 month period, unsecured credit is reduced to zero and must be replaced with cash. On the THIRD occurrence in a rolling 12 month period, all market activity is suspended.

Penalties should fund an interest bearing reserve account to fund any future default.

13. Do you support the creation of a Credit Working Group ("CWG") as a means to formalize the CAISO's approach to managing credit policy change? How do you envision the CWG adding value to CAISO's existing stakeholder process (e.g., regularity of meetings, membership, etc.)?

<u>EPIC Response</u>

EPIC has supported changes to the CAISO's 'stakeholder' process for some time. EPIC believes the current process is flawed and does not meet any measure of a true stakeholder process as found in other ISOs. In the CAISO process few votes are taken, few motions are presented and staff makes final decisions on practices and filings from stakeholders' submitted comments. Stakeholders who do not agree with business practice changes or draft tariff changes, are left to argue their case at FERC. Consensus and compromise solutions are not found in the current CAISO process.

Therefore, EPIC supports the creation of a Credit Working Group, if this group has the independence, authority and control found in all other ISO stakeholder processes. The group's chair should be a member of the stakeholder community and not CAISO staff. A member of the CAISO staff should be assigned to support each group. EPIC believes that CAISO should form such stakeholders groups for all the issues facing CAISO.

## ATTACHMENT A

### Comments on CAISO's Proposed Credit Policy Enhancements

EPIC Merchant Energy appreciates the opportunity to provide comments on the topics covered in the September 22, 2008 Credit Policy Enhancements stakeholder meeting. In this paper, EPIC presents a general overview of our position on unsecured credit and tangible net worth. EPIC also provides comments regarding the individual proposals in the Stakeholder Comments Template.

Currently, CAISO extends unsecured credit to many market participants. This unsecured credit may be equal to part or all of the participant's exposure. It is EPIC's belief that extending unsecured credit to market participants is an extremely dangerous practice that is out-of-step with the rest of the world markets. This practice leaves market participants, not the ISO, at risk for the difference between potential exposure and posted collateral. Unsecured credit is an undesirable legacy from the old world of bilateral trading.[1] Market based trading, with its long-term products and volatile LMP pricing, requires modern ISO credit policies. The current futures and commodities markets do not allow unsecured credit but require cash or cash equivalents in order to secure transactions.

The practice of extending unsecured credit to market participants is fundamentally flawed. The exposures created in deregulated electricity markets are unpredictable and unhedgeable. In an attempt to reduce the occurrence and severity of defaults, CAISO has suggested certain credit policy enhancements (lowering the maximum unsecured credit limit, refining the definition of tangible net worth, redefining guarantees on behalf of affilliates, etc…) to manage credit risk more effectively. However, these processes are not sufficient to manage the risks inherent in the trading of highly volatile commodities such as electricity.

Another major shortcoming of the CASIO practice of extending unsecured credit is the method and frequency of unsecured credit limit determination. Unsecured credit is currently established based solely upon an assessment of a participant's financial standing, without consideration of the collective loss tolerance of the entire market in the event of default. As the recent subprime mortgage crisis and large energy company difficulties clearly demonstrates, the various credit ratings used by the industry to determine eligibility for unsecured credit are poor bellwethers of financial stability. Moreover, the timeliness of the credit reviews performed by the CAISO is inadequate. These reviews take place on a monthly, quarterly or annual basis-yet a participant's financial standing can disintegrate in a matter of DAYS.

Yet another shortcoming is the fragmentation of risk across markets. The United States and Europe have multiple spot markets. It is common practice for large companies to participate in a number of these spot markets at the same time. These are the very same companies that are the most likely to receive unsecured credit from CAISO. Credit information about a participant in one spot market is often unknown to the operators of other spot markets. As a result, unsecured credit may be assigned without

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[1] Market Reform, PJM Credit and Clearing Analysis Project, dated June 2008. "When compared to other organized (i.e. centrally-operated) commodity markets, the credit practices utilized in most electricity cash markets – and it should be stressed that PJM is by no means unusual here – are deficient. In most cases the policies and processes currently in place – with long settlement timeframes and liberal unsecured credit – are an artifact of historical practice, having evolved in a piecemeal and often perfunctory manner from the days of wholesale settlement between regulated monopoly utilities. In a competitive wholesale market, with a diverse set of participants and where price is free to float, the risk profile is decidedly different, and must be managed accordingly."

consideration of potential obligations in other markets. Even if each spot market performs its own credit analysis correctly, the aggregate exposure of a market participant may exceed its credit capacity.

Still another problem with this practice is that the extension of unsecured credit creates an uneven playing field in the CAISO markets. Currently, those participants who are allowed unsecured credit have a clear advantage on every transaction they submit because they do not have to pay a cash premium associated with their transaction. Allowing unsecured credit is a discriminatory practice that hurts smaller companies and financial marketers. Marketers with unsecured credit have a financial advantage for each and every transaction they submit.[2] EPIC requests that CAISO provide figures on the total potential unsecured credit, total actual unsecured credit being used today and the anticipated unsecured credit that will be used under MRTU.

**Tangible New Worth**

CAISO should not use the concept of Tangible Net Worth (TNW) or Minimum Capitalization (MC) as it continues to structure MRTU. Recently, a number of large companies with high TNW have been in financial distress. Enron, Lehman Brothers, Bear Stearns and AIG each had quite a bit of TNW! If the the CAISO market were fully collateralized, TNW and MC become irrelevant concepts in the market. It does not logically follow that a lack of TNW would make a market participant a greater risk. EPIC believes that the adoption of a TNW requirement is:

- Discriminatory to small companies, especially financial marketers who are members of CAISO and full market participants. Those able to qualify for and meet the TNW requirement are those same companies that already benefit by posting unsecured credit. Post cash or cash equivalents and the TNW concept is unnecessary
- Historically FERC has been concerned with barriers to entry and discriminatory policies against small entities. Establishing TNW requirements are a barrier to entry and to participation.
- TNW or quantitative financial ability and trading sophistication are not synonymous. One does not flow from the other. In fact, one could argue that those companies who qualify under TNW, and therefore are not required to post cash or cash equivalents, are a greater risk than smaller companies, as these companies may hold positions that are many times that of smaller companies.

**EPIC Proposal**

If the CAISO does not eliminate the extension of unsecured credit entirely, EPIC proposes a compromise solution. Market participants should be required to post 30% of their current unsecured credit limit in cash or cash equivalents. Market participant will still be able to enjoy the full extent of their unsecured credit line. However, in order to receive the full allotment of this credit, the participant must post 30% in cash or cash equivalents. Note that this proposal has no effect on the collateral currently being posted above the unsecured credit limit. (See Exhibit 1)

This solution represents a balance between CAISO's desire to operate secure markets and their interest in avoiding any practice that would constrain large market participants. This policy will benefit ALL market participants. In this new world, no market participants will be able to participate in the spot market without posting cash or cash equivalents. This cash or cash equivalents will act as the first level of defense in the case of a default. All market participants who are currently exposed to default risk will gain from this policy.

[2] According to PJM's calculations, their markets potentially allow 5.7 billion dollars of unsecured credit, which 2.2 billion is currently used. Surely it is fiscally irresponsible for PJM to allow this much unsecured credit.

Exhibit 1: EPIC Unsecured Credit Proposal

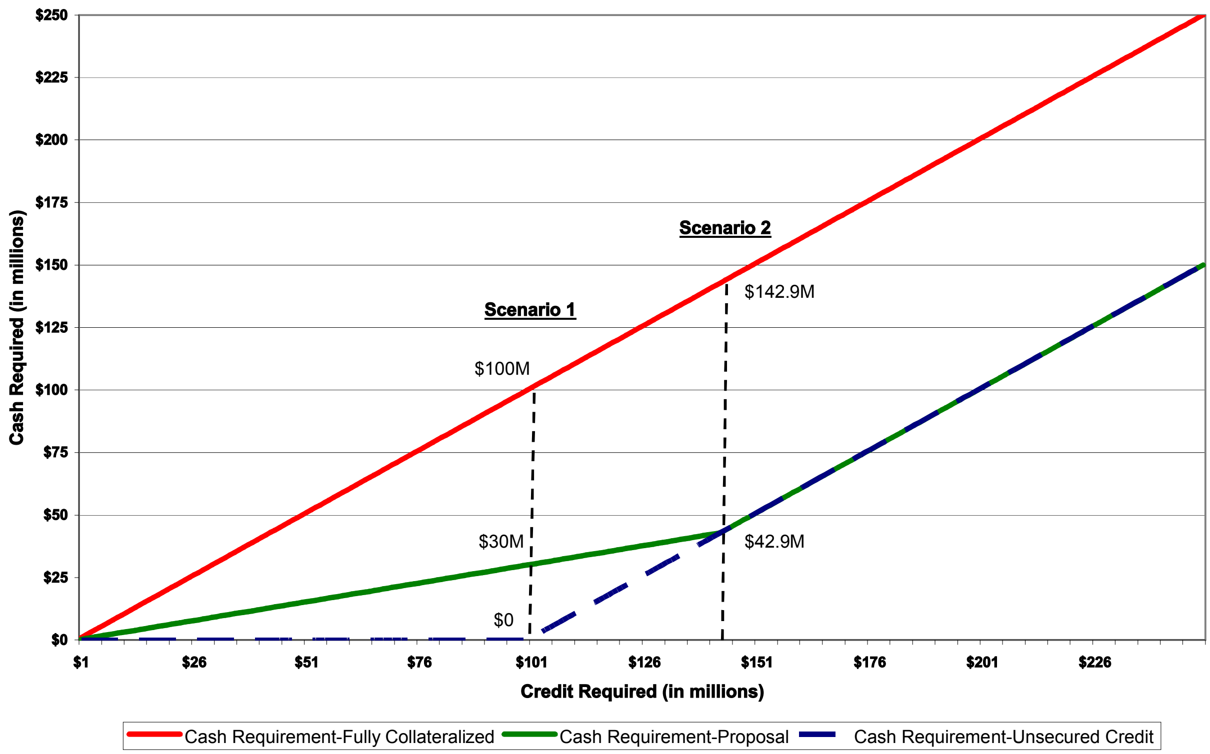


Exhibit 1 assumes that $100M in unsecured credit is extended and then displays the difference between a fully collateralized entity (red line), and entity with $100M in unsecured credit (blue dotted line) and EPIC's proposal of 30% collateralization (green line).

The red line represents the amount of cash or cash equivalents a market participant has to post in order to receive credit from CAISO if they are not extended any unsecured credit. Every dollar posted in cash or cash equivalents results in one dollar's worth of credit. The blue dotted line represents a company that is extended $100M in unsecured credit. The green line represents the amount of cash or cash equivalents required to receive credit under EPIC's proposal.

Scenario 1

In order to utilize $100M of credit, the participant above would need to post $30M (Green Line) in cash or cash equivalents. Under the currently proposed CAISO market rules of extending unsecured credit, participants can have up to $100M of unsecured credit (Blue Dotted Line).

Scenario 2

Participants receive $142.9M worth of credit after posting $42.9 (Green Line). Under the current CAISO market rules governing unsecured credit, participants would have to post the same amount of cash ($42.9M-Blue Dotted Line) in cash or cash equivalents in order to receive $142.9M in credit. This solution satisfies the two competing interests of CAISO: Additional security is provided because 100% unsecured credit is eliminated, but certain market participants still have the financial flexibility to leverage their posted cash or cash equivalents.