Loss Socialization and Unsecured Credit

EPIC Proposal: If an unsecured credit entity defaults, the cost of that default should be socialized only to those participants that utilize unsecured credit. Entities that post cash should not be responsible for an unsecured credit member's default.

CAISO's current loss socialization policy harms smaller member companies such as EPIC. EPIC's proposal provides a fair and reasonable approach to addressing the risk that unsecured credit presents to the CAISO market and the industry as a whole.

CAISO Should Require Unsecured Credit Defaults be Allocated to Entities Receiving Unsecured Credit

CAISO should reconsider and modify its rules concerning the socialization of costs caused by member company financial defaults. Smaller member companies such as EPIC are required to back all of their trades in CAISO with cash or cash equivalent collateral equal to 100 percent or more of total exposure. Select companies within CAISO, typically larger in size, are allowed to trade utilizing millions in unsecured credit. The differences in treatment between these two participant groups are stark. These differences create inequalities among market participants.

Not surprisingly, market participants that receive the unsecured credit benefit have recently voted to continue this policy. Retaining the unsecured credit benefit is a separate question from requiring those receiving unsecured credit to pay for unsecured credit participants' defaults. The question is not whether market participants should have unsecured credit but who holds responsibility for an unsecured credit default.

When one of the beneficiaries of the current unsecured credit system defaults, the financial losses are spread to EPIC and other smaller companies on an equal basis with the larger companies that originally helped to create this exposure. This has occurred several times within the industry already this year. CAISO's policy of socializing unsecured credit default losses across all members is discriminatory, unreasonable and anticompetitive.

Only CAISO Members Using Unsecured Credit Should Be Charged For Unsecured Defaults

CAISO members receiving the valuable financial and competitive benefits associated with unsecured credit should also be required to pay all losses that occur when there is a default due to unsecured trading. In this way the preferred class of members that enjoys the benefit of trading on unsecured credit also pays the costs that are created when there is a default within the class. Those that do not want to assume the risk of paying for the unsecured defaults of others could merely opt to forego using unsecured credit. This approach is also fully consistent with FERC policy because it matches cost allocation with cost incurrence.

Not only is allowing unsecured credit blatantly unfair and anti-competitive but it acts to insulate this preferred class of participants from the full consequences of their actions. Because losses are currently socialized across all members this policy acts to reduce the total cost to each member and thus masks the true harm and full risk associated with the unsecured credit policy.

Action Is Needed To Protect Smaller Companies

Every day that CAISO's unsecured credit and loss socialization policies remain in effect is another day when EPIC and other small companies are forced to face the risk of large losses due to the actions of others. Across the industry, these losses have already totaled in the tens of millions. Given the current economic environment, it is not difficult to imagine these losses totaling in the hundred of millions of dollars. This could lead to cascading defaults across the industry.

Although a major utility could probably withstand even a several hundred million dollar loss, and potentially avoid any corporate harm by recovering this loss from its ratepayers, the threat to smaller companies from the current CAISO policies is significant. Even the losses from a mid-sized failure could financially compromise a smaller company. This is not a risk created by EPIC's trading, or by the trading of others that post cash collateral, and therefore cash collateral companies should not be subject to this type of threat.

Potential Losses From Participants Posting Cash Collateral Are Not Comparable With The Threat Caused By Unsecured Credit

EPIC would like to respond in advance to one argument that may be raised. If CAISO exempts participants that post cash collateral from the requirement to pay losses when a participant using unsecured credit defaults; then, CAISO also must exempt unsecured credit users from losses caused when a trader posting cash collateral has a deficiency default. Although this argument seemingly offers some symmetry, upon examination it does not logically or reasonably follow. In the case where a participant posting cash defaults, and there is inadequate collateral posted, this is a system failure type loss and should therefore be socialized across all participants. A participant that posts cash has covered its total exposure; therefore, a loss in this instance only occurs when:

1. The proper amount of cash collateral was not in fact collected by CAISO from the participant.
2. There was inadequate monitoring of the participant's collateral accounts by CAISO.
3. CAISO failed to establish an adequate cash collateral amount.

In all of these situations the cash collateral default occurred either due to an CAISO administrative error or due to an inadequate CAISO collateral posting policy.

None of these deficiencies are linked to the actions of participants that posted cash collateral and in no way could one reasonably argue that the trading of the cash collateral group was the proximate cause of the loss (although the opposite is true). In all of these instances the other participants posting cash collateral had no way to avoid the harm, because they do not control CAISO administration or CAISO's policies.

Further, participants who use unsecured credit could avoid liability for unsecured credit losses by posting cash collateral, thereby removing themselves from this more risky group. Cash participants, who are not permitted to trade based on unsecured credit, do not enjoy this choice.

EPIC Merchant Energy

<u>CAISO Response</u>:

EPIC raises several interesting and valid points worthy of further consideration.

CAISO is committed to exploring loss sharing and other credit policy enhancements such as unsecured credit that might represent a fairer method of sharing the risk of payment default among all Market Participants participating in the CAISO market. Due to widely disparate views on this issue as well as CAISO resource and system constraints as previously described during the course of this stakeholder process, the CAISO will continue discussion of this topic outside of the current credit policy enhancement stakeholder process. This proposal and others will be further explored and debated in arriving at a solution that, as much as possible, aligns the diverse interests of all Market Participants around supporting strong and effective credit risk mitigation measures.

EPIC also appropriately recognizes that while the primary source of most of the risk of payment default is from the extension of unsecured credit, there are other potential contributors as well. Losses are possible from entities that are not granted unsecured credit, and in fact have posted all the collateral requested by the ISO/RTO, when the actual payment obligations exceed the estimated used as the basis for collateral requests (this was a contributor to the PJM FTR defaults). On this front, CAISO's implementation of an enhanced credit management system with daily liability calculations using estimated settlement statements will reduce risk in this area.

CAISO looks forward to EPIC's continued views as we continue the dialogue on this issue.