



California ISO
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Straw Proposal

California ISO Credit Policy Enhancements

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Please direct comments to CreditPolicyComments@caiso.com

ISO Credit Policy Enhancements Straw Proposal

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ISO Credit Policy Enhancements Straw Proposal

1 Executive Summary

In the September 8, 2008 whitepaper titled *Proposed Enhancements to California ISO Credit Policy* (located at <http://www.caiso.com/203c/203cd7594fbb0.pdf>) and at a September 22, 2008 stakeholder meeting, the ISO summarized several proposed credit policy enhancements with stakeholders. Based on these discussions and stakeholder written comments received October 7, 2008 (located at <http://www.caiso.com/docs/2003/04/21/2003042117001924814.html>), the ISO offers straw proposals on ten of twelve of the proposed credit policy enhancements as well as a straw proposal for a new Credit Working Group to enhance the existing stakeholder process for future credit policy matters.

The following recommended enhancements to the ISO credit policy generally represent changes to the ISO business practices and can be implemented with little to no impact to existing ISO systems.

1. Replacing the use of Moody's KMV and Credit Rating Default Probabilities in the ISO's existing eight-step process with a method of assigning a fixed percentage of Tangible Net Worth or Net Assets based on Moody's KMV equivalent rating and Credit Agency Issuer Ratings;
2. Refining the definition of Tangible Net Worth to clarify the assets that are considered intangible assets and describing the treatment of certain assets such as restricted assets, affiliate assets and derivative assets in setting a Market Participant's Unsecured Credit Limit;
3. Reducing the maximum amount of unsecured credit offered by the ISO to \$150 million;
4. Allowing entities outside of the United States and Canada to provide guarantees under certain conditions;
5. Requiring parental guarantors backing the obligations of an affiliated entity participating in the ISO market to extend the guaranty to include all of the guarantor's affiliates in the ISO Market;
6. Reducing the time allowed to post additional Financial Security to three (3) Business Days;
7. Limiting the amount of Financial Security a Candidate Congestion Revenue Right (CRR) Holder can allocate to a CRR auction to 90% of available credit;
8. Establishing financial penalties for Market Participants who are late in paying invoices that will fund a reserve account up to a predetermined limit and then offset the Grid Management Charge (GMC) once that limit is achieved (this proposal, if approved by the ISO Board of Governors cannot be implemented prior to the rollout of MRTU. The business practices for a progressive discipline program (described in the body of this document) will still be put in place until such time that the financial penalties can be implemented);
9. Establishing financial penalties for Market Participants who fail to post additional Financial Security within the three Business Day posting period that will fund a reserve account up to a predetermined limit and then offset GMC once that limit is achieved (this proposal, if approved by the ISO Board of Governors cannot be implemented prior to the rollout of MRTU); and
10. Creating a Credit Working Group (CWG) to enhance the existing stakeholder process.

The stakeholder proposal to change the loss sharing methodology to include all Market Participants during the period of a payment default will have significant settlements impact and, regardless if stakeholder consensus can be achieved, cannot be implemented prior to the rollout of MRTU. As a result, the proposal is presented in this paper for continued discussion only.

Because of widespread stakeholder opposition, two of the originally proposed credit policy enhancements – a market funded reserve account and procuring credit insurance and/or some other credit instrument to reduce Market Participants' exposure to a payment default – will not be explored further at this time. Commenters were primarily concerned about the upfront costs to implement these proposals and uncertainty as to whether the benefits would outweigh the costs. During the course of the ISO's ongoing review of credit best practices, the ISO may revisit these proposals at a later date.

2 Milestones and Estimated Timeline for Implementing Credit Policy Enhancements

The following table provides key activities and an estimated timeline for the remaining activities associated with the implementation of these credit policy enhancements. Items in **bold** in the following table are critical activities and target dates for stakeholder events and/or deliverables. The red arrow indicates where we are in the process.

Activity	Estimated Target Date
Publish Market Notice for on-site stakeholder meeting	8/29/2008
Post whitepaper of proposed credit policy enhancements	9/8/2008
Post on-site stakeholder meeting agenda and presentation	9/18/2008
Conduct on-site stakeholder meeting (stakeholder meeting 1 of 3)	9/22/2008
Obtain stakeholder written comments resulting from on-site stakeholder meeting	10/7/2008
Post response to stakeholder written comments in the form of a straw proposal and publish Market Notice for stakeholder conference call	10/20/2008
Post stakeholder conference call agenda and presentation	10/23/2008
Conduct stakeholder conference call (stakeholder meeting 2 of 3)	10/27/2008
Receive stakeholder written comments resulting from stakeholder conference call	11/4/2008
Post draft final credit policy enhancement whitepaper and publish Market Notice for final stakeholder conference call	11/11/2008
Post stakeholder conference call agenda and presentation	11/14/2008
Conduct final stakeholder conference call (stakeholder call 3 of 3)	11/18/2008
Receive stakeholder written comments resulting from stakeholder conference call	11/25/2008
Post final credit policy enhancements whitepaper	12/2/2008
Present credit policy enhancements to ISO Board of Governors	12/16/2008
File Tariff language for FERC approval	1/6/2009
Obtain FERC order	3/3/2009
Post BPM changes; credit policy enhancements effective date	3/3/2009

3 Recommended ISO Credit Policy Enhancements

Based on stakeholder response during the credit policy enhancement stakeholder meeting on September 22, 2008 and their written comments received after the meeting, the ISO is recommending a number of credit policy enhancements that will affect the amount of unsecured credit that the ISO assigns to a Market Participant or a Guarantor, the types of security the ISO will accept and other changes that are aimed as reducing Market Participants' exposure to credit risk in the ISO market. In addition, the ISO is recommending the formation of a Credit Working Group due to overwhelming support from stakeholders.

3.1 Changing the Methodology for Determining the Percent of Tangible Net Worth or Net Assets to Assign

In order to simplify the existing eight-step process and to eliminate the issues of having critical components used in the calculation of the Percent of Tangible Net Worth (TNW) or Net Assets (NA) embedded in the ISO Tariff, the **ISO recommends that it replace the use of Estimated Default Probabilities in assigning unsecured credit limits with a model of assigning unsecured credit limits based on Credit Agency Issuer Ratings and Moody's KMV equivalent rating (if available).** The following table would replace the Credit Rating Default Probabilities table in Section 4.3.1.3 of the Business Practice Manual (BPM) for Credit Management and would also be included in the ISO Tariff:

Grade	Moody's KMV Equivalent Rating*	Credit Agency Issuer Rating			Percent of TNW or Net Assets
		Moody's	S&P	Fitch	
Investment Grade	Aaa	Aaa	AAA	AAA	7.50
	Aa1	Aa1	AA+	AA+	7.50
	Aa2	Aa2	AA	AA	7.00
	Aa3	Aa3	AA-	AA-	7.00
	A1	A1	A+	A+	6.00
	A2	A2	A	A	5.00
	A3	A3	A-	A-	4.00
	Baa1	Baa1	BBB+	BBB+	3.00
	Baa2	Baa2	BBB	BBB	2.00
	Baa3	Baa3	BBB-	BBB-	1.00
Speculative Grade	Ba1	Ba1	BB+	BB+	0.00
	Ba2	Ba2	BB	BB	0.00
	Ba3	Ba3	BB-	BB-	0.00
	B1	B1	B+	B+	0.00
	B2	B2	B	B	0.00
	B3	B3	B-	B-	0.00
	Caa1	Caa1	CCC+	CCC+	0.00
	Caa2	Caa2	CCC	CCC	0.00
	Caa3	Caa3	CCC-	CCC-	0.00
	Ca	Ca	CC	CC	0.00
	D	D	C	C	0.00
			D	D	0.00

* Moody's KMV equivalent rating is the equivalent credit category based on Moody's KMV Estimated Default Frequency (EDF). The credit category is based on Moody's KMV Spot Credit Category (CreditEdge Plus™) or Bond Default Rate Mapping (RiskCalc®).

All available Credit Agency Issuer Ratings and/or the Moody's KMV equivalent rating will be considered in determining the Percent of TNW or NA to be assigned. The ISO will retain the blending percentages used in the current eight-step process. That is, for a Rated Public/Private Corporation the TNW Percentage equals 50% of Moody's KMV plus 50% of the lowest of the available Credit Agency Issuer Ratings. Using the lowest of all available Credit Agency Issuer Ratings is a change from the use of a simple average as used in the current eight-step process and the original proposal. This change was recommended by two stakeholders and is consistent with Market Participants' desire to be generally

more conservative in assigning unsecured credit limits. Taking the lowest rating is also similar to the practices used by some of the other ISOs/RTOs.

The blending percentages and method of calculating the amount of unsecured credit will remain unchanged (except for the maximum amount of unsecured credit allowed) for Unrated Public/Private Corporations, Rated Governmental Entities, Unrated Governmental Entities other than those receiving appropriations from the federal government or a state government, Unrated Governmental entities that receive appropriations from the federal government or a state government and Local Publicly Owned Electric Utilities.

Example 1:

A Rated Public/Private Corporation has a Moody's issuer rating of "A2", an S&P issuer rating of "BBB+", a Fitch issuer rating of "A" and a Moody's KMV equivalent rating of "Baa2". The ISO would calculate the allowable Percentage of TNW or NA as follows:

Lowest issuer rating: S&P issuer rating of "BBB+" 3.00% of TNW or NA

Moody's KMV equivalent rating of "Baa2" 2.00% of TNW or NA

TNW Percentage = 50% of issuer rating + 50% of Moody's KMV

TNW Percentage = (50% * 3.00%)+(50% * 2.00%) = 1.50% + 1.00% = 2.50% of TNW or NA

Example 2:

Same as Example 1 except a Moody's KMV equivalent rating does not exist or is not judged by the ISO to be reasonably applicable:

Lowest issuer rating: S&P issuer rating of "BBB+" 3.00% of TNW or NA

TNW Percentage = 100% * issuer rating = 100% * 3.00% = 3.00% of TNW or NA

In keeping with the TNW percentage based on the lowest available Agency Issuer Rating, it seems prudent to extend that policy to those Market Participants who only have a "short-term rating" instead of an issuer rating. The ISO's current practice has been to use the middle equivalent long-term rating when only a short-term rating is available in order to determine the Percentage of TNW or NA to use in the eight-step process. To be consistent with the above recommendation, the **ISO recommends changing this practice to use the lowest equivalent long-term equivalent rating when a Market Participant only has a short-term rating.** The following table from Section 3.3 of the ISO's BPM for Credit Management shows the effect of this change where the current equivalent rating is underscored while the recommended policy is shown bolded and in a larger font:

S&P		Moody's	
Short Term Rating	Equivalent Long Term Ratings	Short Term Rating	Equivalent Long Term Ratings
A-1+	AAA/AA+/AA/AA-/A+	P1	Aaa/Aa1/Aa2/AA3/A1/A2/A3
A-1	A+/A/A-	P2	A3/Baa1/Baa2/Baa3
A-2	A-/BBB+/BBB	P3	Baa3/Ba1/Ba2/Ba3
A-3	BBB/BBB-	NP	B1/B2/B3/Caa1/Caa2/Caa3/Ca/C
B	BB+/BB/BB-		
C	B+ / B / B- / CCC+ / CCC / CCC- / CC / C		
D	D		

3.2 Refining the Definition of Tangible Net Worth

It is recommended that the definition of Tangible Net Worth (TNW) be refined to provide additional examples of intangible assets as follows:

Tangible Net Worth equals total assets minus intangible assets minus total liabilities where intangible assets are those assets not having a physical existence such as patents, trademarks, franchises, intellectual property and goodwill.

The ISO also recognizes that certain highly volatile assets such as derivative assets (e.g., assets so designated as derivative assets, net value of long-term trading book, etc.) that can fluctuate substantially between financial reporting periods and assets that are reserved for a specific purpose such as restricted assets (e.g., assets so designated as restricted, affiliate assets, nuclear decommissioning fund, etc.) may not be available to settle a claim in the event of a default and, therefore, should not be used as the basis for setting or increasing a Market Participant's Unsecured Credit Limit (UCL). Because the ISO must rely on quarterly and/or annual financial reports and Market Participant's self reporting of material changes in their financial condition (as required by the ISO Tariff) to monitor how these assets fluctuate between financial reporting periods, the ISO recommends that the above assets be considered when determining the amount of unsecured credit granted to a Market Participant.

Stakeholders recognized that certain assets, such as those described above, should be excluded when considering the amount of unsecured credit to be granted. Stakeholders who commented supported different aspects of the original proposal but, overall, showed strong support for a change that would limit a Market Participant's ability to have a high UCL when certain risky assets were not considered in setting the UCL.

The original proposal of expanding the definition to include all the types of assets that might be excluded was problematic in that the definition may not have been broad enough to ensure that other, risky assets, not specifically described in the definition, would be evaluated in setting the UCL. In addition, stakeholders also cautioned that assets with an offsetting liability must be considered together in the calculation to ensure such exclusions did not result in an inappropriate over-reduction of the TNW result. Rather than proceed with the original recommendation to include exclude certain risky assets from the calculation of TNW, the ISO will exercise its good, prudent business judgment when evaluating the types of risky assets described above when determining whether a Market Participant's UCL should be reduced in the eight-step process. Other than the refinement of the definition of TNW above, this will not require a Tariff or BPM change.

3.3 Setting the Maximum Unsecured Credit Limit

Lowering the maximum amount of unsecured credit offered by the ISO is largely viewed by stakeholders as an appropriate response in the current economic environment and a way of lowering the credit risk of participating in the ISO market. Although there was significant support among those stakeholders who commented to set a limit between zero and \$100 million, the ISO, at this time, revises its original proposal and **recommends that the maximum amount of unsecured credit to be granted by the ISO to be \$150 million** with the proviso that this limit be reevaluated 1) with the release of Payment Acceleration and 2) after MRTU has been successfully running through the summer months next year. Much of stakeholder's support for the ISO's original proposal of \$100 million may have been influenced by the comment that an analysis of Estimated Aggregate Liability (EAL) levels since 2006 did not approach the proposed limit. Unfortunately, this assertion did not take into consideration the impact of CRRs or other MRTU market charges may have on EAL. As a result, the ISO recommends taking a more incremental approach to the downward adjustment of the maximum level of unsecured credit at this time and fine tuning it later when more data about actual credit consumption is available.

3.4 Accepting Financial Security from Non-U.S. Based Entities

ISO credit policy is to accept certain approved forms of Financial Security that is "reasonably acceptable" to the ISO as provided in tariff section 12.2. In determining whether an instrument is "reasonably acceptable", the ISO considers commercial reasonableness and the exercise of good, prudent business judgment when evaluating whether to accept any form of Financial Security. In practice, the ISO has accepted guarantees from Canadian entities that meet the ISO's creditworthiness standards. In addition, the ISO has accepted guarantees from other non-U.S. entities that have an affiliated entity having a U.S. base of operations, has a standalone credit rating that meets the ISO's creditworthiness standards and independently reports its financials. For other types of Financial Security such as Letters of Credit, Escrow Accounts, etc. from foreign financial institutions, the ISO has required the financial institution backing the Financial Security to have a retail branch in the U.S. In recent months, three peer ISOs have been (or have proposed) accepting guarantees from foreign entities based on a strict set of criteria as presented in the Foreign Guaranty Benchmark table below:

FOREIGN GUARANTY BENCHMARK

	PJM (approved by FERC)			MISO (pending FERC approval)	ISO-NE (approved by FERC)
A foreign guaranty					
Must contain provisions equivalent to those contained in the ISOs standard form of Foreign Guaranty with any modifications subject to review and approval by counsel	x			x	
Must be denominated in U.S. currency	x			x	
Must be written and executed solely in English, including any duplicate originals	x			x	
May not exceed 50% of participant's total credit if the guarantor is rated less than BBB+	x				
Will not be accepted for more than the following limits	Rating of foreign guarantor A- and above	Max. if country rating is AAA	Max. if country rating is AA+	Max. if country rating is AA+ or above	Max. if country rating AA- or above
	A- and above	US\$50MM	US\$30MM	US\$25MM	US\$10MM
	BBB+	US\$30MM	US\$20MM	US\$15MM	
	BBB	US\$10MM	US\$5MM	US\$5MM	
	BBB- or below	None	None	None	

	PJM (approved by FERC)			MISO (pending FERC approval)	ISO-NE (approved by FERC)
A foreign guarantor					
Must satisfy all provisions of domestic guarantor	x				x
Must be an affiliate of the participant	x			x	
Must maintain an agent for acceptance of service process in the U.S.; such agent shall be situated in the ISO's state, absent legal constraint	x			x	
Must be rated by at least one rating agency acceptable to the ISO; the credit strength of guarantor may not be determined based on financials without an actual rating	x				
Must have a rating of BBB or above	x				
Must provide financials in GAAP format	x			x	Or international accounting standards
Must provide a Secretary's Certificate certifying the adoption of Corporate Resolutions: 1) authorizing and approving the guaranty and 2) authorizing the officers to execute and deliver the guaranty on behalf of the guarantor	x			x	x
Must be domiciled in a country with a minimum long-term rating of AA+ or above 1) from at least two rating agencies; 2) each agency's sovereign rating for the domicile will be considered to be the lowest of : country ceiling, senior unsecured government debt, ...; 3) the lowest of two or more ratings will be used.	x			x	AA-minimum
Must be domiciled in a country that recognizes and enforces judgments of US courts	x			x	
Must have a principal place of business in a country with a reciprocity agreement with the U.S.					x
Must demonstrate financial commitment to activity in the US by 1) trading American Depositary Receipts on the NYSE, ASE or NASDAQ or 2) have equity ownership in excess of \$100MM in the wholly-owned or majority owned subsidiaries in the US	x			x	ADR requirement only
Must satisfy all applicable Tariff and Operating Agreements including this credit policy	x			x	
Must pay all expenses to review and accept the guaranty beyond nominal in-house legal and credit review	x			x	
Must, at its own expense, provide the ISO a legal opinion...confirming the enforceability of the guaranty, etc.	x			x	x

Both PJM and MISO (which is largely modeled on the PJM approach) has stricter criteria but higher guaranty limits than ISO-NE. The ISO's proposal to accept guarantees from Canadian entities was largely supported by stakeholders. Some stakeholders had mixed views regarding extending the policy to other foreign (i.e., non-Canadian) entities. With the increasing number of ISO Market Participants having foreign ties and acceptance of foreign guarantees by other ISOs, it seems commercially reasonable for the ISO to reconsider its position on foreign guarantees as well. Further, it seems as though the PJM/MISO model (more so than the ISO-NE model as originally proposed) offers additional safeguards that may make stakeholders more comfortable about foreign guarantees.

The ISO continues to recommend that non-U.S. and non-Canadian guarantees be accepted subject to the establishment of sufficient safeguards and the suitable resolution of certain legal concerns (i.e., issues related to the complexity and enforcement of international laws and the challenges and costs of getting a judgment outside of the U.S.). It would appear that the PJM/MISO model would provide those additional safeguards and would eliminate many of ISO's legal concerns. Therefore, the **ISO recommends accepting foreign guarantees using the PJM/MISO model but with the single-tier, lower guarantee limits proposed by MISO**. Because of differences in banking regulations, the ISO is not recommending extending this policy to include Letters of Credit or other forms of Financial Security at this time. This is consistent with the practices of the other ISOs/RTOs including those who are now (or will be) accepting foreign guarantees.

3.5 Accepting Guarantees on Behalf of Affiliated Entities

The proposal to require a corporate parent guarantor to guarantee the obligations of all affiliated entities in the ISO market met with widespread acceptance among stakeholders. Some commenters have suggested that there are legal and regulatory hurdles that are insurmountable when regulated entities are involved. The ISO has requested that commenters identify specific concerns as the ISO does not understand why a corporate parent's guaranty of both regulated and non regulated Market Participant affiliates should pose any problem as no funds of the regulated entity would be used for any obligation of a non regulated entity.

It is worth noting that the ISO is not requiring the posting of guarantees, or that other forms of Financial Security would be precluded. Affiliates may still choose to post another form of Financial Security to secure their obligations to the ISO. However, if an Affiliate's obligations are backed by a parental guaranty, then that guaranty must also extend to other Affiliates participating in the ISO market. Appendix A provides a draft form Guaranty for discussion purposes.

3.6 Reducing the Time Allowed to Post Additional Financial Security

Stakeholders strongly supported the ISO's original proposal to reduce the time to post additional Financial Security to three (3) Business Days. There is some stakeholder support to reduce the number of days even further to two (2) Business Days to align with the majority of other ISOs/RTOs or even one (1) Business Day. Stakeholders argue that shorter posting periods should not be a major impediment in processing an amendment to a Letter of Credit (L/C) since cash can be used temporarily to satisfy the call while the L/C is being processed.

The ISO remains committed to shortening the time to post additional Financial Security as a means of reducing Market Participant exposure to an entity continuing to accrue large liabilities during a long posting period. At this time, the **ISO continues to recommend that the posting requirement be reduced to three (3) Business Days**. Further reductions may be appropriate in the future after Market Participants have adapted to this new requirement. This measured reduction is consistent with the approach used in reducing the maximum amount of unsecured credit in Section 3.3 of this straw proposal. The ISO credit policies were designed so that adequate security should be available during the posting period by adding an additional seven days of security requirements to the ISO's 95-day settlement cycle. The use of an additional period of days to cover the posting period would continue with the current proposal.

3.7 Calculating Available Credit for CRR Auctions

Stakeholders were largely supportive of the ISO's original proposal to limit the amount of collateral available for a CRR auction to 90% of available credit in order to leave some credit capacity for continued market activity during the period of the start of the CRR auction until the auction is settled. In addition, this recommended policy enhancement is intended to ensure that a collateral request is not issued because the 90% threshold for such a request is exceeded when 100% of available credit is assigned to the CRR auction. One stakeholder commented that the limit should be set as low as 80% while another suggested lower thresholds for lower rated entities. Opposing comments suggested that the limit was unnecessary and/or overly conservative.

Because the proposed solution may initially require a manual workaround and the long-term solution requires incorporating this logic into the CRR bidding software or another software solution that might feed the CRR bidding software, a straightforward solution with simple rules is desired. We can build on this solution in the future if stakeholders see the added benefit of a more conservative application of this policy.

As currently defined, Available Credit is calculated as Aggregate Credit Limit (ACL; which is comprised of a Market Participant's UCL plus any posted Financial Security) minus their EAL. **The ISO recommends that the amount of credit available for a CRR auction be calculated as follows:**

$$\text{Available Credit} = (\text{ACL} - \text{EAL}) * 0.90$$

3.8 Establishing Financial Penalties for Late Payments

Stakeholders overwhelmingly supported the ISO's recommendation to assess financial penalties on Market Participants that are late in paying their invoices. Some stakeholders favored more stringent rules with a higher cap than the ISO proposed (one stakeholder suggested eliminating the cap altogether). Whereas most stakeholders supported the proposal that financial penalties fund a market reserve account that could be used as a funding source to mitigate the financial burden of a payment default, other stakeholders suggested that the financial penalties be used to reduce the GMC. The ISO sees the merits of both suggestions; that is, using financial penalties to fund a market reserve account and to reduce the GMC. Therefore, **the ISO recommends that, in addition to interest on delinquent amounts as provided for in Section 11.12.1 of the ISO Tariff, a Market Participant who pays late two or more times in a rolling 12 month period will be assessed a monetary penalty of the greater of 2% of the invoiced amount or not less than \$1,000 but not to exceed \$20,000 in any given month (an increase of \$10,000 from the original proposal). Market Participants who are late in paying a third time in a rolling 12 month period will, in addition to the financial penalty, have their Unsecured Credit Limit reduced to zero and must post cash in lieu of unsecured credit or any other form of Financial Security to secure their obligations for a period of 12 months of timely payments. Any penalties assessed as part of this credit policy enhancement would fund the Market Reserve Account up to a limit of \$5,000,000. Any financial penalties in excess of \$5,000,000 (and with a Market Reserve Balance of that amount or more) would be used as a credit toward the GMC revenue requirement in the subsequent year. Should the ISO have to draw on the Market Reserve Account in the case of a payment default, the Market Reserve Account would be replenished to the established limit of \$5,000,000 before excess funds would be used to reduce the GMC revenue requirement.**

Because this proposal requires a new charge code and may have other settlements and market clearing design implications, it cannot be implemented prior to the rollout of MRTU. However, **the ISO recommends that a progressive discipline program be implemented at this time as a way to induce timely payments until such time that financial penalties can be added to the program sometime after the rollout of MRTU. The basic elements of the progressive discipline program include:**

- Monitoring SCs missing the payment deadline, regardless of amount owed, during a rolling 12-month period based on the ISO's published late payment report;
- Assessing interest based on the number of days the invoice is past due and distributing the interest to net creditors in the case of an actual payment default;
- Sending a delinquent SC two warning letters for the first two instances of missing the payment deadline;
- Requiring a delinquent SC to post cash in the form of a prepayment in lieu of other forms of Financial Security upon the third instance of a late payment for a period no less than 12 months following the late payment. Subsequent late payments would result in extending the number of months that a delinquent SC would have to post cash and could result in other enforcement actions as described in the ISO Tariff;
- Revoking (in full or in part) a delinquent SCs Unsecured Credit Limit, if any, during the period that cash postings are required; and
- Accepting other forms of Financial Security and evaluating reinstating a UCL only upon completing 12 months of on-time payments.

3.9 Establishing Financial Penalties for Failure to Respond to Calls for Additional Financial Security within the Specified Timeframe

Stakeholders overwhelmingly supported the ISO's recommendation to assess financial penalties on Market Participants that fail to post additional Financial Security within the required posting period. As with the financial penalties for late payers, some stakeholders favored more stringent rules including a suggestion that the ISO suspend any Market Participant who is late from entering into any transaction until financial security is posted. In addition, most stakeholders supported the proposal that financial penalties fund a Market Reserve Account that could be used as a funding source to mitigate the financial burden of a payment default while other stakeholders suggested that the financial penalties be used to reduce the GMC.

The ISO recommends that Market Participants who fail to post additional Financial Security within the prescribed posting period be assessed the greater of 2% of the collateral amount or \$1,000 but not to exceed \$20,000 (an increase of \$10,000 from the original proposal) on the third, and each subsequent occurrence in a rolling 12 month period. Any penalties assessed as part of this credit policy enhancement would fund the Market Reserve Account up to a limit of \$5,000,000. Any financial penalties in excess of \$5,000,000 (and with a Market Reserve Account balance of \$5,000,000 or more) would be applied as a credit toward the following year's GMC revenue requirement. Should the ISO have to draw on the Market Reserve Account in the case of a payment default, the Market Reserve Account would be replenished to the established limit of \$5,000,000 before excess funds would be used to reduce the GMC.

A Market Participant may still dispute the amount of Financial Security being requested by following the steps in Section 10.1 of the BPM for Credit Management. Within the prescribed posting period, the Market Participant must either demonstrate to the ISO's satisfaction that the Financial Security request is all or partially unnecessary, or post the required Financial Security Amount calculated by the ISO. If the ISO and the Market Participant are unable to agree on the appropriate level of Financial Security during the prescribed posting period, the Market Participant must still post the additional Financial Security amount and continue the dispute procedure as described in Section 10.1 of the BPM for Credit Management or be considered late according to this recommended credit policy enhancement. Any excess Financial Security amounts will be returned to the Market Participant if the dispute process finds in favor of the Market Participant. However, financial penalties that may have been assessed as part of this credit policy enhancement would not be returned. To be clear, no penalties would be assessed if the collateral requirement was posted within the required posting period.

Because this proposal requires a new charge code and may have other settlements and market clearing design implications, it cannot be implemented prior to the rollout of MRTU. However, **the ISO**

recommends that a progressive discipline program, similar to the one described above for late payers, be implemented at this time as a way to induce timely posting of financial security until such time that financial penalties can be added to the program.

3.10 Creating a Credit Working Group

There was unanimous support among stakeholders to form a Credit Working Group (CWG). Although specific details related to the charter, membership and responsibilities of such a group remain to be worked out, the ISO sees such a group as advising, guiding and developing recommendations on credit policy matters for stakeholder review and approval. It was suggested that such a group consider credit professionals outside of the power industry as a means of incorporating best practices and facilitating the exchange of ideas. Another recommendation was that the CWG could expedite the ISO's existing stakeholder process by providing robust credit policy recommendations and skipping directly to the straw proposal phase.

Where some of the eastern ISOs have highly structured CWGs with sector voting as part of a mixed stakeholder/independent Board governance structure, the ISO is not prepared to adopt a wholesale change to the current governance structure. The ISO relies heavily on stakeholder input through a series of stakeholder meetings and comment periods. Although the ISO strives to satisfy the interests of its stakeholders, sometimes the ISO must balance competing interests and must ultimately use good business judgment in choosing the best alternative that meets the interests of the ISO market as a whole. Ultimately, the ISO Board of Governors (BOG) must approve any change to the ISO Tariff. Therefore, any working committee requiring independence, authority and control over credit policy is unlikely to be acceptable. However, a working committee of credit and risk management professionals from inside and outside the industry raising credit issues, reviewing the associated costs and benefits of alternative proposals and developing the recommended proposal for stakeholder comment and BOG approval may be a very workable solution.

Because a CWG does not require ISO Tariff changes and, therefore, BOG and FERC approval, a CWG may be put in place for the next round of credit policy enhancements. It would be useful as a means of getting the CWG "off the ground" for stakeholders to share their vision of how the CWG could augment the ISO's existing stakeholder process including membership, structure, frequency of meetings, etc. Comments may be sent to CreditPolicyComments@caiso.com.

4 Enhancements Being Deferred until after MRTU Rollout

An alternative credit risk mitigation strategy discussed in the proposed credit policy enhancements whitepaper and presented to stakeholders in the September 22, 2008 stakeholder meeting was the proposal to redefine the loss sharing mechanism when a payment default occurs. Support for this proposal is largely divided along supplier and buyer lines as one might expect. The ISO is interested in balancing the interests of all Market Participants while being mindful that the ISO is the only ISO/RTO the subjects suppliers to all the risks of a payment default. The ISO has not taken a position on this proposal and it appears we are far from any agreement at this time. The best next step may be for the parties on both sides of this argument to present their positions and to describe various scenarios that could impact the stability of the ISO market. Because any changes to the current loss sharing mechanism would have settlements and/or other ISO system implications and cannot be implemented prior to the rollout of MRTU, the ISO is recommending that any such changes be deferred until after the

rollout of MRTU. The ISO invites continued development of alternatives and rationales to support the benefits of each alternative.

5 Enhancements No Longer Under Consideration

Because of the upfront cost and perceived lack of benefits, stakeholders were generally opposed to the proposals of a market funded reserve account and credit insurance. This stakeholder response is consistent with PJM members' response to a recently concluded study by PJM of the same proposals. As a result, the ISO recommends eliminating these proposals from further consideration during this stakeholder process. These proposals could be reevaluated at a later date if situations warrant such a review.

APPENDIX A: ISO Guaranty Form (Affiliate Guaranty)

Following is the ISO's Guaranty form for discussion purposes only.

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GUARANTY

This Guaranty ("**Guaranty**") dated as of _____, 200__ is made by _____ Corporation ("**Guarantor**") for the benefit of the California Independent System Operator Corporation (the "**ISO**"). All capitalized terms not herein defined shall be given their meaning as set forth in the ISO Tariff.

RECITALS

A. Guarantor is the "Affiliate", as defined in the ISO's Tariff and Protocols, as in effect and promulgated from time to time (the "**Tariff**") of one or more persons (such Affiliates, collectively, the "**Market Participants**") that have entered into, desire to enter into or may in the future desire to enter into transactions in the ISO markets and/or schedule energy over the ISO-controlled transmission grid (collectively, "**Transactions**") under various agreements, including but not limited to the Scheduling Coordinator Agreement, Congestion Revenue Right Agreements, and the Tariff (collectively, "**Agreements**");

B. The Market Participants include the persons listed on Schedule 1, and all other Affiliates of Guarantor, whether or not named or presently existing, that become parties to Transactions or Agreements, or both, from time to time;

C. One or more Market Participants do not have a sufficient Aggregate Credit Limit to adequately secure its Estimated Aggregate Liability required under the Tariff to enter into Transactions;

D. Guarantor will directly or indirectly benefit from the Agreements and the Transactions to which any of its Affiliates become a party; and

E. Accordingly, in order to minimize the financial exposure of the ISO and its markets, Guarantor shall guarantee the prompt payment and performance of the obligations of each of the Market Participants to the ISO and its markets under the applicable Agreements, on the terms of this Guaranty.

NOW, THEREFORE, to induce the ISO to allow Market Participants to enter into Transactions and in consideration of the ISO agreeing to conduct business with Market Participant in accordance with the Agreements, Guarantor hereby covenants and agrees for the benefit of the ISO as follows:

1. GUARANTY. Subject to the provisions of this Guaranty, Guarantor hereby irrevocably and unconditionally guarantees the full and timely payment and performance when due of the obligations of Market Participants under the Agreements, whenever and by whomever incurred (the "**Obligations**") in accordance with the terms of the Agreements. In furtherance, and not in limitation of the foregoing, if any Market Participant fails to pay or perform any Obligation, Guarantor shall pay to or perform for the benefit of the ISO the amount or performance due in the same currency and manner and at the times provided for in the Agreements. This Guaranty constitutes a guarantee

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of payment and performance and not of collection. The liability of Guarantor under the Guaranty is subject to the following:

(a) Guarantor's monetary liability under this Guaranty is specifically limited to payments expressly required to be made in accordance with the Agreements (even if such payments are deemed to be damages), together with the Costs (as set forth in Section 14 (*Costs and Expenses*)) and, except to the extent specifically provided in the Agreements or elsewhere in this Guaranty, in no event will Guarantor be subject under this Guaranty to consequential, exemplary, equitable, loss of profits, or punitive damages.

(b) Notwithstanding Section 1(a), the aggregate liability of the Guarantor under this Guaranty will not exceed \$ _____ at any one time, plus Costs, which amounts may be allocated among the Market Participants and Obligations in such amounts as the ISO, in its sole discretion, determines.

2. DEMANDS AND NOTICE. If any Market Participant fails to pay or perform any Obligations, the ISO may enforce Guarantor's liability without first proceeding against that Market Participant or any other Market Participant or resorting to any collateral, security or other guarantors or obligors, if any, or pursuing any other remedy. Guarantor shall pay to the ISO any and all amounts due by a Market Participant immediately upon delivery of notice from the ISO stating that such failure has occurred and the total amount then owing. No further detail shall be required in the ISO's notice, Guarantor agreeing herby to look to the Market Participant for any and all relevant information regarding Market Participants' performance and liability. The liability of Guarantor to the ISO will in no way be diminished or delayed on account of any failure or delay in delivering such notice. If more than one Market Participant has failed to pay or perform any Obligations, the ISO may proceed against such Market Participants in such order and for such Obligations, or portions thereof, as the ISO, in its sole description, determines.

3. TERM. This Guaranty will remain in full force and effect until the earlier of (i) _____ or (ii) the date it is terminated by thirty (30) days Notice from Guarantor to ISO. When this Guaranty is terminated in accordance with the foregoing, Guarantor will have no further liability hereunder, except as provided in the last sentence of this paragraph. No such termination will affect Guarantor's liability with respect to any Obligations arising from Transactions occurring prior to termination, or to pay any related Costs, regardless of when such Costs are incurred.

4. REPRESENTATIONS AND WARRANTIES. Guarantor represents and warrants that:

(a) it is a corporation duly organized and validly existing under the laws of _____ and has the corporate power and authority to execute, deliver and carry out the terms and provisions of this Guaranty;

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(b) no authorization, approval, consent or order of, or registration or filing with, any court or other governmental body having jurisdiction over Guarantor is required on the part of Guarantor for the execution and delivery of this Guaranty; except for approval as to the giving of this Guaranty under the _____, which approval has been obtained;

(c) Guarantor understands and acknowledges that it is a condition of ISO's willingness to accept this Guaranty and allow one or more Market Participants to participate in the benefit of Transactions that Guarantor undertake to guaranty the Obligations of all of its Affiliates entering into Transactions, whether or not (i) such Affiliates exist or are Market Participants as of the date of this Guaranty, (ii) Guarantor has actual knowledge of a Market Participant's participation or of specific Transactions, (iii) such Affiliates are specifically identified in this Guaranty or in Schedule 1, or (iv) any Market Participant at any time has sufficient Aggregate Credit Limits to adequately secure its "Aggregate Liability" or "Estimated Aggregate Liability" as such terms are defined in the Tariff; and

(d) this Guaranty constitutes a valid and legally binding agreement of Guarantor enforceable against Guarantor in accordance with its terms, except as the enforceability of this Guaranty may be limited by the effect of any applicable bankruptcy, insolvency, reorganization, moratorium or similar laws affecting creditors' rights generally and by general principles of equity.

5. NOTIFICATION OF MARKET PARTICIPANT STATUS. For the convenience of the parties, and not as a condition to any of the ISO's rights and remedies under this Guaranty, the ISO may from time to time notify Guarantor of those persons that the ISO believes to be Market Participants, provided that no errors in or failure to deliver such notice will in any way diminish any of the obligations of Guarantor with respect to any satisfying the definition of Market Participant under this Guaranty, whether or not such person was so identified in any such notice.

6. EFFECT OF BANKRUPTCY BY MARKET PARTICIPANT AND AS APPLICABLE, ALL AFFILIATES OF GUARANTOR. The Guarantor's obligation to pay under this Guaranty will not be affected in any way by the institution with respect to any Market Participant of a bankruptcy, reorganization, moratorium or similar insolvency proceeding or other relief under any bankruptcy or insolvency law affecting creditor's rights or a petition for any Market Participant's winding-up or liquidation.

7. AMENDMENT. No term or provision of this Guaranty may be amended, modified, altered, waived, or supplemented except in a writing signed by the Guarantor and the ISO.

8. WAIVERS. Guarantor hereby waives

- (a) notice of acceptance of this Guaranty;
- (b) presentment and demand concerning the liabilities of Guarantor;

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(c) any right to require that any action or proceeding be brought against any Market Participant or any other person, or to require that the ISO seek enforcement of any performance against any Market Participant or any other person, prior to any action against Guarantor under the terms hereof;

(d) Guarantor's rights of subrogation, reimbursement, indemnification, and contribution and any other rights and defenses that are or may become available to the Guarantor by reason of California Civil Code Sections 2787 to 2855, inclusive, or any other source of law; and

(e) Any rights or defenses the Guarantor may have in respect of the Obligations as a guarantor or other surety by reason of any election of remedies by the creditor, regardless of whether such election has destroyed Guarantor's rights of subrogation and reimbursement against any Market Participant.

9. RIGHTS OF THE ISO. In furtherance, and not in limitation of the waivers in Section 7 (*Waivers*), Guarantor acknowledges and agrees that: (i) any collateral, security or obligations of any other guarantors or obligors relating to the Obligations, if any, may be sold, released, surrendered, exchanged, settled, compromised, waived, subordinated or modified, in each case without consideration and on any terms or conditions, without notice to or further assent from Guarantor; (ii) all remedies, rights, powers and privileges granted to the ISO pursuant to this Guaranty are cumulative and not alternative; (iii) the exercise of any or all such rights by the ISO will not reduce, limit, impair, discharge, terminate, or otherwise affect the liability of Guarantor; (iv) except as to applicable statutes of limitation, no delay of the ISO in the exercise of, or failure to exercise, any rights hereunder will operate as a waiver of such rights, a waiver of any other rights or a release of Guarantor from any Obligations.; (v) no partial exercise of any such rights will preclude the further exercise of such rights or the exercise of any other remedy or right by the ISO; and (vi) Guarantor consents to the renewal, compromise, extension, acceleration or other changes in the time of payment of or other changes in the terms of the Obligations or any changes or modifications to the terms of the Agreements.

10. GUARANTOR'S OBLIGATIONS INDEPENDENT. Guarantor's obligations under this Guaranty are independent of those of any Market Participant. Guarantor's obligations under this Guaranty are also several and independent of any other guarantees in effect with respect to any part of the above obligations and may be enforced regardless of the existence of any other guarantees. The ISO may bring an action against Guarantor without first proceeding against any Market Participant or any other person or security held by or for the benefit of a Market Participant and without pursuing any other remedy. The ISO's rights under this Guaranty will not be exhausted by any action of the ISO until all of the Obligations have been fully paid and performed.

11. RIGHTS OF SUBROGATION. Guarantor will have no right of subrogation with respect to any payments it makes under this Guaranty until all of the Obligations of the Market Participant are paid in full.

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12. ASSIGNMENT. The Guarantor may not assign this Guaranty without the express written consent of the ISO. The ISO may assign its rights under this Guaranty in its sole discretion.

13. NOTICE. Any notice, request, instruction, correspondence or other document to be given hereunder by any party to another (each, a "**Notice**") must be in writing and delivered by nationally recognized overnight courier, or mailed by certified or registered mail, postage prepaid and return receipt requested, or by telegram or telecopier, as follows:

To the ISO: California Independent System Operator Corporation
PO Box 639014
151 Blue Ravine Rd.
Folsom, CA 95630-9014
Attn: Treasury Department
Fax No.: (916) 351-2259

To Guarantor:

With a copy to:

Notice given by courier or mail will be effective upon actual receipt. Notice given by telegram or telecopier will be effective upon actual receipt if delivered during the recipient's normal business hours, or at the beginning of the recipient's next business day after receipt if not received during the recipient's normal business hours. All notices by telegram or telecopier will be confirmed promptly after transmission in writing by certified or registered mail or personal delivery.

14. COSTS AND EXPENSES. Guarantor shall pay all reasonable costs and expenses (including, without limitation, reasonable attorneys' fees) incurred by the ISO to enforce this Guaranty (collectively, "**Costs**") provided that the Guarantor shall not be liable for any Costs if no payment under the Guaranty is due.

15. MISCELLANEOUS. THIS GUARANTY WILL IN ALL RESPECTS BE GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH, THE LAWS OF THE STATE OF CALIFORNIA, WITHOUT REGARD TO THE PRINCIPLES OF CONFLICTS OF LAWS. This Guaranty will be binding upon Guarantor, its successors and assigns and inure to the benefit of and be enforceable by the ISO, its successors and assigns. Any action or litigation of any kind initiated by Guarantor or a representative of the ISO will be brought in a State or federal court within Sacramento County, California. Guarantor and the ISO irrevocably consent to the personal jurisdiction of such courts solely in connection with actions arising from this Guaranty, and to service of process by any means authorized by California law, and hereby waive the right to transfer the venue of any such litigation. The Guaranty embodies the entire agreement and

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understanding between Guarantor and the ISO and supersedes all prior agreements and understandings relating to the subject matter hereof. The headings in this Guaranty are for purposes of reference only, and will not affect the meaning hereof.

16. TARIFF IMPLICATIONS. The making of this Guaranty will not subject Guarantor to the requirements of any provisions or protocols of the ISO Tariff that would not apply to Guarantor in the absence of this Guaranty.

EXECUTED as of the day and year first above written.

Name: _____

Title _____

Date: _____