Subject: Credit Policy Enhancements

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Introduction

Pacific Gas and Electric Company (PG&E) appreciates the opportunity to provide these comments on the CAISO's September 8, 2000 white paper outlining various proposed credit policy reforms.

The timing of implementation of revised CAISO credit policies is a key issue for PG&E since major changes to the CAISO's markets are expected to take place on February 1, 2008 with the initial implementation of MRTU. As a major change in the markets overseen by the CAISO, MRTU can be viewed as increasing credit risk to market participants. This change, combined with increasing credit risks resulting from the ongoing credit crisis in financial markets leads PG&E to conclude that credit policy reforms should be implemented as soon as is reasonably practical and no later than the go live date for MRTU. To be clear, the current proposal to implement credit reforms in March of 2009 does not align with the current MRTU go live date. Therefore, the CAISO should align implementation of enhanced credit policies with implementation of MRTU.

Comments

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"?)

PG&E Supports: PG&E supports replacement of 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 spot credit category when available. This methodology should allow for more timely and accurate assessment of credit risks based on changes in credit ratings of market participants. However, the CAISO should consider using the lower of Moody's or S&P long-term debt rating rather than averaging the S&P and Moody's ratings since the KMV score is highly sensitive to the equity value. PG&E also recommends that the CAISO consider tariff language which allows it to call for collateral if there is a material adverse change in the financial condition of a Market Participant. This will allow the CAISO to react to rapidly changing market conditions not picked up in its rating methodology.

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?

PG&E Supports: PG&E supports expanding the current definition of Tangible Net Worth to be specific as to the assets that would be excluded in the calculation. As PG&E understands the proposal, it would specifically expand the existing definition as follows:

> "Tangible Net Assets equals total assets ***minus assets reserved for a specific purpose (e.g., restricted assets or assets invested in or received from Affiliates)*** minus intangible assets ***(i.e., those assets not having a physical existence such as patents, trademarks, franchises, intellectual property and*** goodwill) minus total liabilities."

Subtracting assets reserved for a specific purpose and better defining the term "intangible assets" should result in a more accurate value for Tangible Net Worth.

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?

PG&E Supports: Based on a review of actual Estimated Aggregate Liabilities since the rollout of CAISO's current credit policy and other ISO/RTO maximum unsecured credit limits, the CAISO is proposing to reduce the maximum Unsecured Credit Limit to $100 million. PG&E supports this change.

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?

PG&E Supports: Alternative 2, which would limit non-US based entities to posting cash in the form of prepayment to the CAISO or post another form of Financial Security through a rated, US-based Affiliate that reports its own financial information is a reasonable accommodation for non-US based entities provided that any Guarantees negotiated with the CAISO are reasonable and enforceable.

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?

   PG&E Supports: PG&E agrees 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 a useful proposal to help mitigate the risk of a payment default by an under-secured and thinly capitalized Affiliate.

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?

   PG&E Supports With Modification: PG&E supports a policy change that would reduce the time allowed to post additional security in the event of a collateral call. However, PG&E believes that even three business days is an excessive time to respond to a collateral call, particularly in light of the increased potential for price volatility and collateral calls under MRTU's more complicated market structure. Three days also seems excessive since four of the other six ISOs/RTOs have a two-day requirement. PG&E recommends that the CAISO reduce the time that market participants have for posting required Financial Security to one (preferred) or two business days (acceptable).

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?

PG&E Supports With a Lower Threshold: PG&E supports changing the current policy that would allow a market participant apply 100% of its available credit to participation in a Congestion Revenue Rights (CRR) auction. PG&E supports the CAISO limiting the amount of available credit for a CRR auction to 90% of total available credit to ensure a credit margin is available for other market activities.

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?

PG&E Does Not Support: This alternative method of risk socialization is limited in its benefits, would increase CAISO costs to administer, and increase Market Participant's working capital cost.

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?

PG&E Does Not Support Credit Insurance as an Alternative Strategy: PG&E has not identified additional cost effective default risk mitigation strategies. Credit insurance has not been shown to be cost effective as a means to mitigate default risk.

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?

PG&E Does Not Support: The CAISO has proposed to change the existing loss sharing/chargeback mechanism to include a pro rata allocation of payment defaults to all Market Participants. PG&E is not persuaded that the existing methodology, which allocates any payment defaults to net creditors, creates a disincentive for suppliers to participate in CAISO markets nor does it believe that net creditors bear a disproportionate share of the risk under the existing methodology.

PG&E observes that suppliers bear default risks under bilateral trading and sales arrangements. In fact, for most markets it is the seller, and not the buyer, who assumes the credit risk whenever a credit sale is made. This commercial practice has not discouraged sellers from entering into bilateral contracts; PG&E sees no reason why bearing a similar default risk for sales into CAISO markets would discourage participation in those markets. The existing loss sharing/chargeback mechanism has been in effect for several years. If the CAISO has evidence that the existing practice discourages participation in its markets, it should present those findings to stakeholders.

PG&E believes that other credit policy reforms being proposed through this stakeholder process – many of which PG&E supports - will be effective reducing default payment risks for net creditors. Given this, PG&E is not yet convinced that a change in the current loss sharing /chargeback mechanism is warranted.

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?

PG&E Supports With Modifications: PG&E generally agrees with the CAISO's proposal to assess financial penalties on Market Participants who are late in paying their invoices. PG&E suggests that the CAISO consider reducing a Market Participants Unsecured Credit Limit to zero if the Market Participant is late in paying two times during a rolling 12 month period. PG&E also suggests that the CAISO examine the underlying reasons for placing a $10,000 cap on the penalty for late payment.

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?

PG&E Supports with Modifications: The CAISO is proposing 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. PG&E suggests that the CAISO establish a policy that would assess a financial penalty on a Market Participant who is late in posting additional collateral on the second and each subsequent time in a rolling 12 month period. The CAISO should have the authority to reduce the unsecured lines to zero for failure to post - the first time - and consider suspending that participant from any transactions until they post collateral.

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.)?

    PG&E Supports: PG&E supports the creation of a Credit Working Group ("CWG") as a means to formalize the CAISO's approach to managing credit policy change. A Credit Working Group could add value to the existing process by leveraging the expertise of technical experts for the purpose of revising and updating CAISO credit polices as market and credit conditions change. A CWG could also provide technical input concerning any necessary changes to the BPM for Credit Management.