

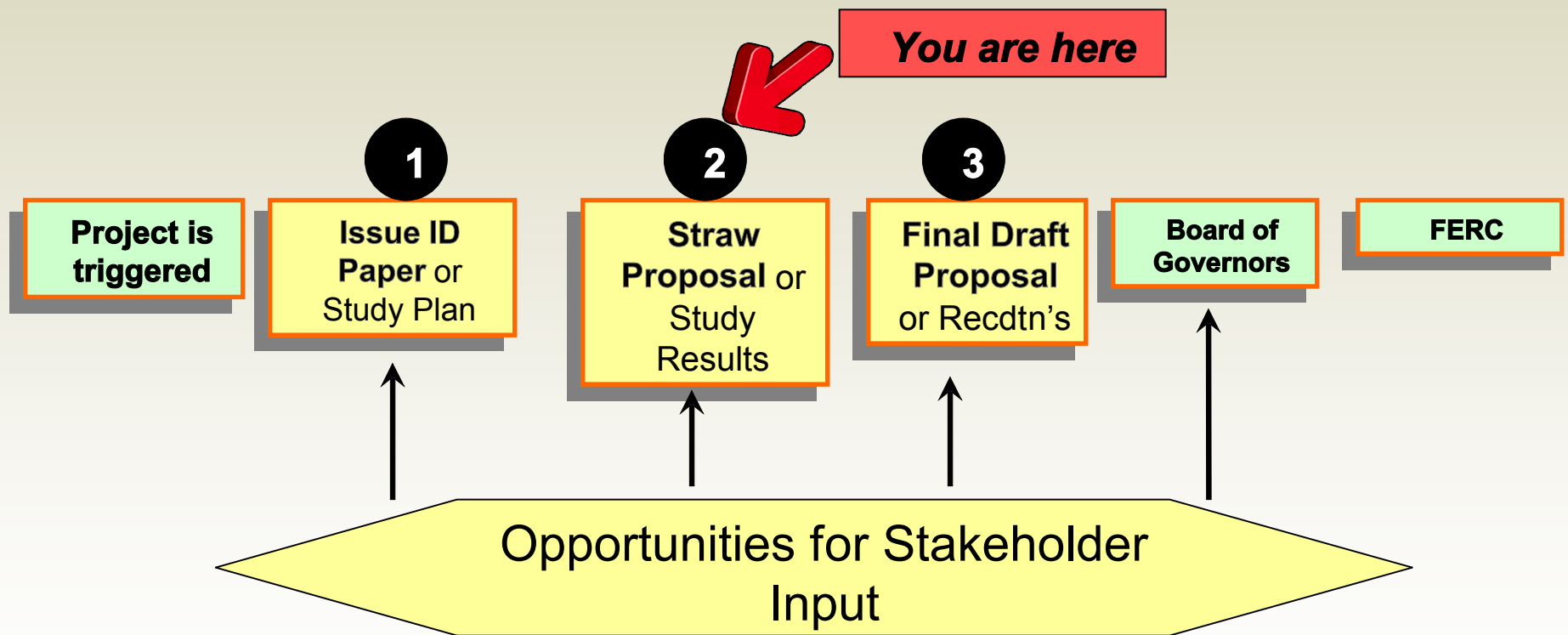


# Credit Policy Enhancements Straw Proposal

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Credit Policy Enhancements Stakeholder Call  
October 27, 2008

# The CAISO credit policy stakeholder process is comprised of the following steps



# Following is the agenda for today's meeting

| <b>TIME</b>   | <b>TOPIC</b>   | <b>PRESENTER</b> |
|---------------|--|------------------|
| 10:00 – 10:05 | Welcome  | M. Parker-Helget |
| 10:05 – 11:30 | Credit Policy Enhancement Straw Proposals <ul style="list-style-type: none"><li>• Tangible Net Worth Methodology</li><li>• Definition of Tangible Net Worth</li><li>• Maximum Unsecured Credit Limit</li><li>• Non-U.S. Financial Security</li><li>• Affiliate Guarantees</li><li>• Financial Security Posting Time</li><li>• Available Credit for CRR Auctions</li><li>• Financial Penalties for Late Payments</li><li>• Financial Penalties for Failing to Post Collateral</li></ul> | K. King          |
| 11:30 – 11:35 | Credit Working Group   | K. King          |
| 11:35 – 11:50 | Other Credit Policy Enhancements <ul style="list-style-type: none"><li>• Loss Sharing Mechanism</li><li>• Market Funded Reserve Account</li><li>• Credit Insurance</li></ul>   | K. King          |
| 11:50 – 12:00 | Wrap Up  | M. Parker-Helget |

## The objectives for today's meeting include

- Developing stakeholder understanding of the straw proposals and the implementation timeline
- Soliciting additional stakeholder comments regarding the structure, makeup and charter of the Credit Working Group
- Developing stakeholder awareness of issues surrounding the loss sharing proposal and agreeing on path forward

# We remain on target to implement many of the credit policy enhancement in early 2009

| 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             |
| <b>Conduct on-site stakeholder meeting (stakeholder meeting 1 of 3)</b>   | <b>9/22/2008</b>      |
| <b>Obtain stakeholder written comments resulting from on-site stakeholder meeting</b>   | <b>10/7/2008</b>      |
| 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            |
| <b>Conduct stakeholder conference call (stakeholder meeting 2 of 3)</b>   | <b>10/27/2008</b>     |
| <b>Receive stakeholder written comments resulting from stakeholder conference call</b>  | <b>11/4/2008</b>      |
| 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  | <b>11/14/2008</b>     |
| <b>Conduct final stakeholder conference call (stakeholder call 3 of 3)</b>  | <b>11/18/2008</b>     |
| <b>Receive stakeholder written comments resulting from stakeholder conference call</b>  | <b>11/25/2008</b>     |
| 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              |

# Stakeholders largely support the ISO's proposed credit policy enhancements

- Commenters favor a strong underlying credit policy
  - Lower unsecured credit limits to reduce credit risk
  - Strict enforcement rules to ensure compliance
- Overwhelming support for Credit Working Group
- Divided on changing loss sharing mechanism
  - Strong support among suppliers; opposition among PTOs
  - Need to balance conflicting interests and share risks equally
- A market funded reserve account and credit insurance will be dropped from consideration
  - Potential high upfront cost with lack of clear benefits
  - Could revisit later as part of continuous improvement process

# CAISO proposes to modify how Unsecured Credit Limits are established

- Calculation of Percent of Tangible Net Worth or Net Assets
  - Use Moody's KMV equivalent rating
  - Use lowest credit agency issuer rating
  - Assign fixed percent based on blending of two (if both available)
- Definition of Tangible Net Worth
  - Expand definition to include other intangibles
  - Consider restricted and highly volatile assets as part of qualitative assessment
- Maximum Unsecured Credit Limit \$150 million
  - An increase from original proposal
  - Reassess with Payment Acceleration and after MRTU experience

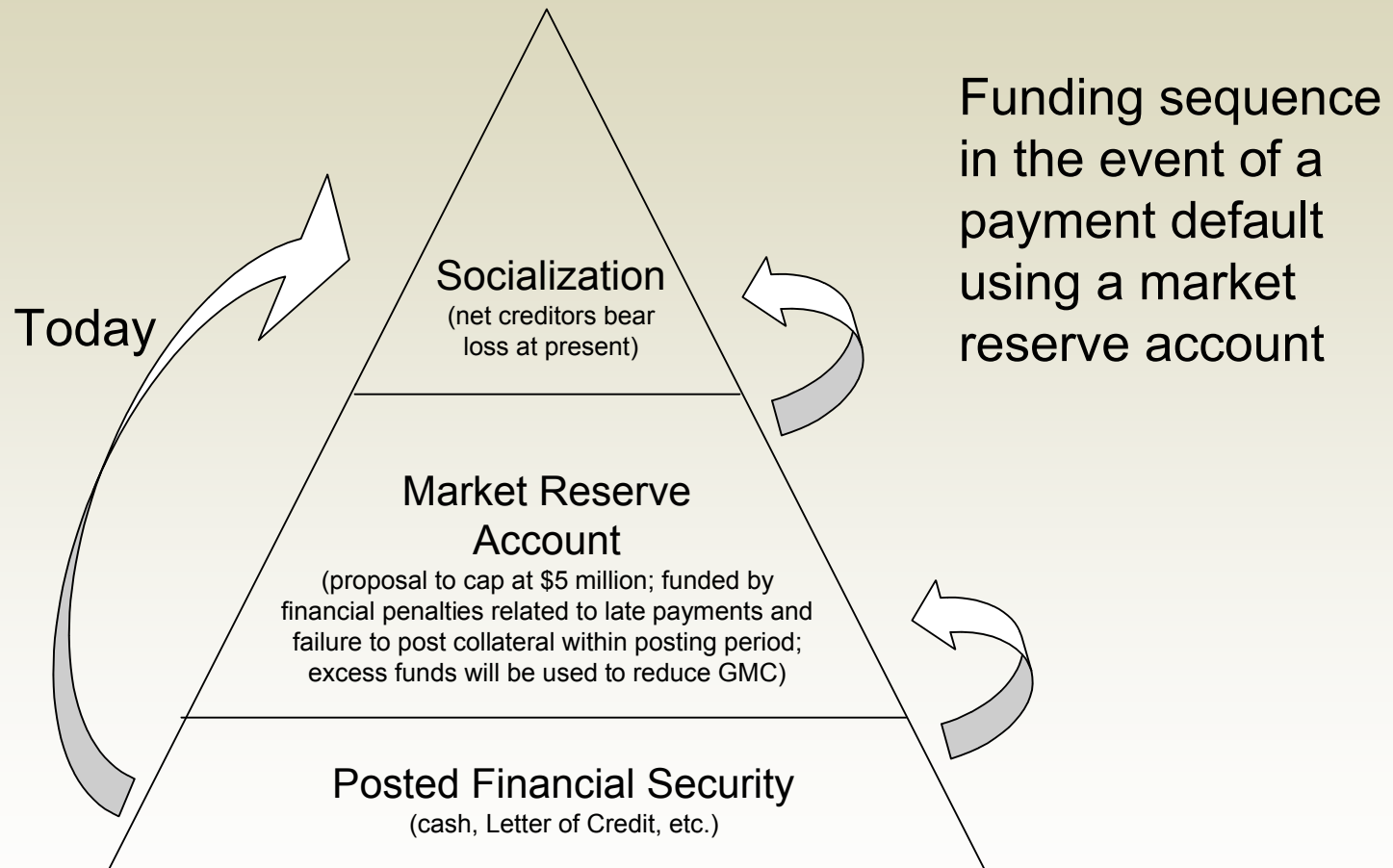
# The ISO recommends changes to its guaranty form of Financial Security

- Financial Security from Non-U.S. Based Entities
  - Accept guarantees from non-U.S./Canadian corporations
  - Use PJM criteria and MISO limits
  - Proposal does not extend to other forms of Financial Security
- Affiliate Guarantees
  - Not required; may still post other forms of Financial Security
  - If Guaranty backs one Affiliate, must back all Affiliates in market
  - Unresolved stakeholder concerns about possible regulatory issues

## A number of other straw proposals will enhance credit policy and may further reduce credit risk

- Reduce collateral posting period to 3 business days
- Limit Congestion Revenue Rights (CRR) Auction collateral to 90% of available credit
- Implement financial penalties for late payments and failure to post Financial Security within posting period
  - Complements an active progressive discipline policy
  - Penalties will fund a market reserve account to a predetermined limit
  - Excess funds will reduce GMC
  - Implement progressive discipline now; financial penalties after MRTU

# A penalty funded market reserve account will provide some protection from a socialized payment default



# Stakeholders believe a Credit Working Group can add value to the existing stakeholder process

- Must be interwoven into existing stakeholder process
- Details must still be worked out; additional stakeholder input encouraged
- Initial stakeholder comments include:
  - Monthly calls and quarterly face-to-face meetings
  - Limit membership to Market Participants in a credit role (or with credit experience) or risk management experience
  - Consider members outside the power industry
  - Expedite existing stakeholder process by skipping directly to the straw proposal
- Possible forum to further develop loss sharing proposal

# Stakeholders are divided in how losses should be shared among Market Participants

- Divided along supplier/buyer lines
- Risk is not shared equally among all Market Participants
- Suppliers propose a model used by other ISOs/RTOs
  - Aligns interests of all Market Participants
  - Current model is disincentive to participate in the market
  - Potential reliability issues if participation curtailed in response to an expected default
  - Risk premium to compensate for uncertainty drives up prices
  - Stricter credit policies such as full collateralization would be required to offset risk of continued participation

## PTOs on the other hand are not persuaded that a change to the loss sharing methodology is needed

- Existing methodology does not create a disincentive nor do net creditors bear a disproportionate share of the risk (same risk as bilateral trading and sales arrangements)
- A change may result in adverse incentives to reduce exposure by individual Market Participants
- Current tariff language provides protection to limit exposure by allowing entities to net purchases and sales together
- Continued MRTU support hinges on the existing loss sharing mechanism

## Regardless if consensus can be achieved, implementation cannot occur until after MRTU

- Current loss sharing methodology is manual but being automated in MRTU
- A change has settlements and market clearing implications unless a manual process can be implemented
- Final design and implementation timeline of any change is constrained by resource availability
- Provides time to develop and assess alternative proposals
- May be topic for Credit Working Group to tackle
- Will likely require additional, on-site stakeholder meetings

## Two other enhancements will not be pursued at this time based on stakeholder comments

- Market funded reserve account
  - Any additional protection does not justify the costs
  - Unnecessary due to other credit policy enhancements
  - Market Participant cost far outweigh the benefits
- Credit insurance or similar protection
  - Any additional protection does not justify the costs
  - Other markets found no clear benefits
  - Market Participant cost far outweigh the benefits
  - Has not been shown to mitigate default risk
  - No other cost effective default risk mitigation strategy found
  - Limited support for full collateralization, a line of credit or using a clearinghouse model

# Stakeholders are encouraged to submit comments regarding the straw proposal

- Please submit written comments by November 4, 2008 to [CreditPolicyComments@caiso.com](mailto:CreditPolicyComments@caiso.com) using the stakeholder comment template for Credit Policy Enhancements posted at <http://www.caiso.com/docs/2003/04/21/2003042117001924814.html>
- To be posted by close of business after the stakeholder meeting