CALIFORNIA ISO

California Independent
System Operator

SC Credit Policy: Proposed Changes

April 2005

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Scheduling Coordinator Credit Policy Review

1 Executive Summary and Changes from November 2004 Proposal

The California Independent System Operator (CAISO) Tariff requires that SCs either maintain an Approved Credit Rating or provide financial security at least equal to the SC's maximum outstanding financial obligation. The Tariff also specifies responsibilities of the ISO to ensure that the market is adequately financially secured, including monitoring and taking appropriate enforcement steps to ensure the participation of only creditworthy participants.

Over the past two years, the ISO has reviewed potential changes to its Scheduling Coordinator (SC) Credit Policies, both internally and with external stakeholders. Initial recommendations were shared with stakeholders in November 2004. Comments were received from stakeholders in December 2004 and January 2005. The Team continued to refine these proposals during February and March 2005. This document outlines the proposed resolution of the issues examined. The following tables summarize the current proposal and highlight changes from the November 2004 recommendations. The numbered references indicate the section of this document that contains the full proposal.

Creditworthiness: addresses issues relating to the amount of unsecured credit to be extended to SCs, and other collateral posting requirements.

Item	Description	Changes from November 2004 Recommendation	Implementation Timeline (Phase I =2005 Phase II =2006)
4.1	Setting Credit Limits	The November recommendation was modified slightly, reflecting the stakeholder input received and additional review of available service providers, internal resource considerations, and the FERC policy statement on credit. However, the core elements of the proposal remain: credit limits will be set for each entity, based on credit ratings, other third party credit assessments and entity specific financial data. Specific approaches have been developed for: 1. Rated Public / Private Corporations, 2. Unrated Public / Private Corporations, 3. Rated Governmentally Owned Utilities, and 4. Unrated Governmentally Owned Utilities. Other changes include: providing additional granularity in the calculation of credit limits, replacing a 35% concentration cap with a $250 million cap, eliminating the use of short-term credit ratings.	Phase I
4.2	BAID / SCID specific security postings Issue	None. Collateral posted by an SC with the ISO is to be used to secure obligations of all SC IDs of that SC.	Already implemented
4.3	CAISO Approved Security Agreements	None. CAISO will move in the direction of requiring the use of standard agreements to the greatest extent possible. Legal has continued to evaluate the various agreements, and it intends to finalize any significant changes to the agreements prior to	Phase I

		Phase 1	
4.4	Security Agreement Expiration and Liability Obligation Coverage Limitation	None. The ISO will flag instruments as "expired" 30 days prior to the stated expiration to trigger renewal by SCs.	Phase I
4.5	Credit Insurance	Discussions continue with Aon Risk Services on various insurance proposals. SCs will be updated as the proposals are finalized.	Possibly Phase I, or Phase II.

Liability Obligation Calculations and Security Posting Requirements: addresses SCALE and other liability obligation calculation and security posting requirement issues.

Item	Description	Changes from November 2004 Recommendation	Implementation Timeline (Phase I =2005 Phase II =2006)
5.1	Liability Obligation Requirements for New SCs	None. Unchanged from current practice: estimate charges with SC, and permit the SC to post an initial amount and add security as required.	Already implemented
5.2	SCALE Process Overview	None. SCALE tool is used to estimate SC liabilities.	Already implemented
5.3	Refinements to SCALE	None. Several refinements have already been made, but no additional changes are planned prior to the implementation of the SCALE function in the new Settlements system.	Already implemented
5.4	Accuracy of SCALE	None. No additional changes are planned at this time.	Already implemented
5.5	Number of Days Included in Liability Calculation	The revised proposal will eliminate the "Weekly Period" posting option and will require a security posting based on a level number of days outstanding and light of the move to accelerated payments planned for Q1 2006.	This recommendation will be implemented in Phase I.
5.6	Price Volatility and Forecasted Liabilities	None. No changes planned at this time given the relative stability of market prices.	Already implemented
5.7	Liability Obligation Calculation and Security Posting Requirements for Special Circumstances	None. All liabilities of an SC, to the extent practical, will be considered in the liability estimates, particularly with the implementation of the new Settlements system.	Phase II
5.8	Security Posting Requirements by Individual Trade Months	None. The current approach of netting across months will continue.	Already implemented
5.9	Liability Obligation Calculations and the New Settlement and Market Clearing System	None. CAISO staff are working on building the liability estimation tools into the new Settlements system.	Phase II.
5.10	Payment Acceleration Effects on Liability Obligation Calculations and Security Posting	None. This issue will be addressed after payment acceleration is implemented.	Phase II.

	Requirements		
5.11	Adjustments to Security Postings	This section was added since the November 2004 report was made public. The suggested change was implemented to reduce the variability in security requests from week-to-week and provide a better assessment of the amount of security to release.	This recommendation has been implemented.

Enforcement: addresses mechanisms to promote adherence to credit policy and payment terms.

Item	**Description**	**Changes from November 2004 Recommendation**	**Implementation Timeline (Phase I =2005 Phase II =2006)**
6.1	Unsecured Obligation Penalties	None. CAISO will continue to study how penalties might be implemented. Implementation will not be possible until the completion of the SaMC project.	Phase II
6.2	Late Payment Penalties	None. Implementation will not be possible until the completion of the SaMC project due to a freeze on Settlements system changes.	Phase II
6.3	SC Suspension, Disconnection and Termination Policy Revision	None. No substantive changes were proposed or are planned at this time.	Phase II or later.

Other Issues

Item	**Description**	**Changes from November 2004 Recommendation**	**Implementation Timeline (Phase I =2005 Phase II =2006)**
7.1	Risk of Loss for funds held by the ISO on behalf of Market Participants	This issue was not addressed in the November 2004 document. At the February 2005 Board meeting, the Board directed Management to review the issue of risk of loss associated with the ISO holding market participant funds. The ISO has proposed to modify the ISO Tariff to specifically address this issue. A section will be added to the ISO Tariff that address the risk of loss of funds held and invested by the ISO on behalf of Market Participants. Market Participants will bear any risk of loss of principal and/or interest of such funds. The ISO investment policy will specify that such funds will only be invested in a bank account, high-quality money market fund, or US Government security unless a specific agreement between the ISO and SC specifies another type of investment.	Phase I

2 Objectives

In January 2004 the California Independent System Operator Corporation (CAISO) created a Credit Policy Review team (the Team) tasked with achieving the following goals and objectives:

- Confirm and/or revise the CAISO's standards for Scheduling Coordinator (SC) financial security to minimize credit risk and enhance Market Participants' and Financial Markets' confidence in the CAISO's markets; and
- Establish meaningful, fair and transparent mechanisms to enforce credit standards to maintain the energy market's financial integrity.

3 Process

To meet these objectives, the Team:

- Compiled a list of issues to be addressed, including outstanding issues from previous examinations of the credit policy
- Reviewed other ISO/RTOs credit policies;
- Developed a list of initial recommended changes to the CAISO credit policy;
- Requested input from stakeholders on proposed changes;
- Developed a final recommended list of changes, as specified in this document.

The Team developed this document to provide a record of the investigation of various credit issues.

3.1 Issues identified from previous examinations of the credit policy

In April 2003, the CAISO issued a "Draft Credit Policy and Procedures Guide" to document current credit practices. Shortly thereafter, the CAISO released the "Supplement to the Draft Credit Policy and Procedures Guide" to elicit comments on potential changes that might be made to the credit policy.

During 2003, the CAISO staff developed a proposal to post on the CAISO web site the names of SCs that did not maintain adequate financial security, according to the provisions of the CAISO Tariff. The procedure was not implemented given concerns that any changes to credit procedures should be implemented only after a comprehensive review of the credit policy. In January 2004, a Team was formed to conduct this review. The team compiled a list of issues to be addressed in the review process.

3.2 Issues Examined

Issues to be considered were grouped into several categories:

1. Creditworthiness -
    a. Unsecured Credit and Unsecured Credit Limits,
    b. BAID / SCID specific security postings,
    c. ISO Approved Security Agreements,
    d. Security Agreement Expiration and Liability Obligation Coverage Limitation, and
    e. Credit Insurance.

2. Liability Obligation Calculations and Security Posting Requirements -
    a. Liability Obligation Requirements for New SCs,
    b. SCALE Process Overview,

c. Refinements to SCALE,
d. Accuracy of SCALE,
e. Number of Days Included in Liability Calculation,
f. Price Volatility and Forecasted Liabilities,
g. Liability Obligation Calculation and Security Posting Requirements for Special Circumstances,
h. Security Posting Requirements by Individual Trade Months,
i. Liability Obligation Calculations and the New Settlement and Market Clearing System, and
j. Payment Acceleration Effects on Liability Obligation Calculations and Security Posting Requirements.

3. Enforcement -
    a. Unsecured Obligations Penalties,
    b. Late Payment Penalties, and
    c. SC Suspension, Disconnection and Termination Policy Revision.

4. Other –
    a. Risk of Loss of Market Participant Funds Held and Invested by the ISO.

Sections 5-7 of this document contain results of the examination of these issues, including issue statements, a list of questions for initial consideration by stakeholders, and CAISO recommendations.

3.3 Benchmarking

The Team gained insight into several of the above issues through a benchmarking study that conducted during the fall of 2003. The benchmarking study provided a high level comparison of various ISO/RTO credit policies, and included recommended changes to the CAISO credit policy.

The Team conducted a further detailed review of the credit policies and procedures of other ISOs / RTOs, such as ERCOT, the IMO, NEISO, NYISO and PJM, to understand how peers addressed certain issues. In many instances, the provisions of other ISOs' credit policies substantially guided the recommended changes proposed in this document.

3.4 Stakeholder Involvement

As the Team worked through the issues discussed below, it considered using the services of a consultant to help develop credit policy change recommendations, but decided that it would be more cost effective to develop the recommendations internally to the extent possible and then rely on substantial stakeholder input to finalize each proposed change. The primary issues on which the CAISO requested stakeholder input were:

- Setting Credit Limits,
- ISO Approved Security Agreements,
- Credit Insurance, and
- Unsecured Charges Penalties.

The Team appreciates the feedback received from stakeholders thus far in helping to develop the proposal. Appendix D contains a record of stakeholder responses to the originally proposed recommendations and the CAISO's responses to the stakeholder feedback.

Because of the importance of credit issues, CAISO appreciates continued stakeholder input on these matters and in the near term will look to formalize a process to obtain continued input on this topic.

3.5 Next Steps and Implementation Timeline

After additional stakeholder review of the proposed changes, the ISO Management plans to present the changes to the ISO Governing Board for initial consideration in May 2005, and for approval in June. Changes to the ISO Tariff will be needed and developed after Board approval. FERC approval of the Tariff changes would require at least 60 days.

The recommendations discussed in this document have been developed in recognition of resource constraints and other pressing priorities that CAISO faces, and accordingly we plans to implement the credit policy changes in two phases:

1. Phase I – Specified recommendations will be implemented during late summer or fall of 2005, upon completion of stakeholder review, CAISO Board action, Tariff filing, FERC approval of proposed changes, and implementation of systems for setting credit limits.

2. Phase II – Specified recommendations will be implemented not earlier than implementation of the new Settlement and Market Clearing System (SaMC), which is currently scheduled for completion during the first quarter of 2006. Phase II changes could be implemented later in 2006 subsequent to the Tariff filing related to the planned "Accelerated Payments" project. In the event that unforeseen circumstances cause a delay in the SaMC system implementation beyond first quarter 2006, then Phase II credit changes would likely need to be deferred as well.

4 Creditworthiness

The issues discussed in this section relate to SCs that have Approved Credit Ratings, the amount of credit to be extended to SCs, and SCs' collateral posting requirements.

4.1 Setting Credit Limits (Supplemental Information in Appendix A)

Issue

At present, an SC with an Approved Credit Rating (ACR) is granted unlimited credit with the CAISO. However, this exposes CAISO market creditors to substantial potential default risk for any obligations incurred by that SC. As illustrated by the financial consequences of the energy crisis of 2000-2001, this policy requires modification. The Team believes that it would be prudent to establish credit limits on any SC with an ACR. An SC would need to provide additional collateral to cover any charges above its established credit limit.

If the CAISO does establish credit limits, it must address the following questions:

1. How should the credit limits (or caps) be developed? Should tiered limits be used?
2. Should the decision to extend unsecured credit to an SC consider factors other than their credit rating (as assigned by a national credit rating agency), such as liquidity ratios? Should CAISO consider rating agency credit watch notices?
3. Should a credit scoring method be developed for those participants that do not have credit ratings issued from S&P, Moodys, Fitch, etc.?
4. Should the CAISO continue to use a separate credit standard for GMC obligations?

Recommendation

Calculate and implement unsecured credit limits for Public / Private Corporations and Governmentally Owned Utilities.

Unsecured Credit Limits

This Unsecured Credit Limits (UCL) proposal is based on considerations of peer ISO credit limit practices, the November 2004 FERC credit policy statement, CAISO stakeholder comments, CAISO resource constraints, and capabilities of credit software tools CAISO has evaluated.

The CAISO will consider credit ratings of the National Credit Rating Agencies, and other company specific factors in setting unsecured credit limits. The company specific factors we consider may evolve over time, but will stay within the scope of company specific considerations set forth in the November FERC Policy Statement. We plan to rely on fewer company specific factors initially, but might expand the list of company specific factors later. In any event, the factors that CAISO would consider will be posted on the CAISO website to provide transparency.

Public / Private Corporations and Governmentally Owned Utilities have different characteristics, and have different information available from third parties on their credit attributes. Accordingly, the approach used to set the UCL for these entities necessarily differs to some extent. The current expectation of how credit limits would be set for these various types of entities follows[1].

[1] See Appendix A Section V for a detailed explanation of the UCL calculation process for each entity group and detailed definitions of terms utilized in the recommendation (i.e. "Tangible Net Worth", "Net Assets", "SC Agency Rating")

1. ***Rated Public / Private Corporations*[2] –** the UCL is equal to the SC's Tangible Net Worth (TNW) multiplied by an allowable percentage of TNW. The allowable percentage of TNW is based on an SC's blended Agency Ratings (long-term issuer credit ratings from Standard & Poor, Moody's, Fitch and Dominion) and Moody's KMV Expected Default Frequency (EDF) percentage. The maximum percentage of TNW is 7.5 percent (based largely on practices at peer ISOs).

2. ***Unrated Public / Private Corporations*** – the UCL is equal to the SC's Tangible Net Worth (TNW) multiplied by an allowable percentage of TNW. The maximum allowable percentage of TNW would be 7.5 percent. The allowable percentage of TNW is based on a Moody's KMV EDF probability calculated using an SC's financial data.

3. ***Rated Governmentally Owned Utilities*** – the UCL is equal to the SC's Net Assets (NA) multiplied by an allowable percentage of NA. The allowable percentage of NA is based on an SC's blended Agency Ratings (long-term issuer credit ratings from Standard & Poor, Moody's, Fitch and Dominion). The maximum allowable percentage of NA would be 7.5 percent.

4. ***Unrated Governmentally Owned Utilities*** – the UCL is equal to an allowable percentage of the SC's Net Assets if certain financial ratios (Times Interest Earned, Debt Service Coverage and Net Assets to Total Assets) comply with minimum standards. For Unrated Governmentally Owned Utilities, the maximum percentage of NA will be 5 percent, which may be reduced based on SC specific issues that may affect its credit worthiness (i.e. negative news regarding the SC's operations). In order to implement the above recommendation, SCs will be required to provide their most recent quarterly financial data. CAISO has investigated using third party provided software and services to assist in this process. Global Credit Services (GCS) of New York has been identified as a likely service provider to maintain a website and other software to assist in this process. GCS would also provide access to Moody's KMV EDFs scores[3] through its website. CAISO will access the software through a secure web-connection to obtain the UCL for each SC.

We recognize that other approaches to setting credit limits are possible, and some may prove to be better measures of an entity's ability to meet its obligations to the ISO market. This proposal is not intended to preclude further consideration of such alternate measures, and we might modify this proposed approach in the future based on such analysis.

Other elements of the proposal include:

- Initially, the CAISO proposed to limit an individual SC's unsecured credit limit to no more than 35 percent of total CAISO accounts receivable. Upon further review of other ISO practices and further evaluation of the suggested methodology, the CAISO is proposing to instead set a specific $250 million hard-cap on individual unsecured credit limits in lieu of a concentration cap.

- The caps are estimated to cover a maximum of 110 days of outstanding charges. Upon implementation of payment acceleration, it is projected that the maximum days of outstanding charges will decrease by at least one half. When payment acceleration is implemented, we may review the size of the $250 million cap. Lastly, any hard-cap implemented can be changed / waived upon CAISO Governing Board review and approval.

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[2] Public / Private Corporations is inclusive of Partnerships, Limited Liability Companies and other Non-Governmentally Owned Utilities.

[3] CAISO would pay Moody's KMV for the EDF probabilities. EDF's are generated by Moody's KMV based on two different models. Moody's KMV "Credit Edge" EDFs scores are available for publically-traded companies. CAISO would use such scores for those entities that are the CAISO SC, or for entities that provide a guarantee to a CAISO SC. Another type of Moody's KMV EDF scores (from the "Risk Calc" model) would be used for other companies. Risk Calc EDF scores are calculated with company specific financial data that would be updated on a quarterly basis. "Risk Calc" EDF scores would be used for all other companies except Governmentally Owned Utilities.

- The separate credit standard for Grid Management Charges and market charges would be eliminated for the following reasons:

    - A separate standard for GMC is unnecessary to protect the financial adequacy of the CAISO given other safeguards which proved effective during the crisis of 2000/2001;
    - The administrative burden to both the CAISO and market participants will be substantially reduced by moving to one set of credit rating rules for all CAISO charges; and
    - One set of credit rating rules used for all charges will reduce credit management software implementation costs.

- For entities on credit watch with negative implications, we may reduce such ratings by one notch (for example: from A to A-).

- Short-term ratings will not be included in the Agency Rating calculation because default probabilities are not readily available from rating agencies for these ratings. Also, a given short-term rating covers a wider range of credit quality than a long-term rating (for example, a P2 Moody's short-term rating may be assigned to a company with a long-term rating in the range of A3 to Baa3.) If only a short-term rating is available, it would be mapped to a long-term rating in the middle of the corresponding range, and then to a default probability.

The November 2004 FERC Policy statement on credit indicated that both quantitative and qualitative factors should be considered in establishing unsecured credit limits. We believe this proposed approach is consistent with the spirit of the FERC policy statement. For rated entities, the National Credit Rating Agencies consider both qualitative and quantitative factors in assigning ratings. Further, the Moody's KMV EDFs for public companies are also dependent on both quantitative and qualitative factors. Company stock prices are an important element of the EDF calculation[3], and company stock prices move based on the entire market's assessment of a company's qualitative and quantitative attributes.

For other entities such as unrated privately held companies or unrated subsidiaries of publicly traded companies, our proposed approach is quantitative as it relies on financial data processed by Moody's KMV to arrive at a EDF probability. The EDF is then used determine the entity's UCL. We believe this approach will be appropriate and effective.

4.2 BAID / SCID specific security postings Issue

The CAISO's credit policy currently specifies that security postings are to apply to a SC, and not to individual SC IDs in the event aSC has multiple IDs. When the CAISO began permitting SCs to establish multiple SC IDs to cover various business relationships, it did accept SC ID specific security instruments in a few instances. Upon further consideration and in light of the relevant Tariff sections, the CAISO believes that it must require SCs to post sufficient security to cover its entire net obligations and may not accept security instruments exclusively for specific SC IDs. The CAISO does not object to an SC providing several different instruments securing an SC's liabilities, but each such instrument must be unconditional. In addition, the CAISO would attempt to be responsive to an SC's request to draw upon a specific credit instrument in the event default.Recommendation

<u>Require each SC to provide appropriate financial security for all SC IDs for which it is responsible on a "net" basis. The current policy outlined in the Credit Policy and Procedure Guide would remain unchanged.</u>

The CAISO will continue to permit a single legal entity to obtain multiple SC IDs. However, because an SC executes a single SC Agreement, that single legal entity is ultimately responsible for all charges for any SC IDs. The CAISO will determine the security posting requirement by aggregating all such SC IDs into a single Scheduling Coordinator Aggregate Liability Estimate, which will result in a single posting requirement for the legal entity. As noted above, the CAISO will nonetheless accept multiple security instruments, provided that each is unconditional.

4.3 CAISO Approved Security Agreements (Supplemental Information in Appendix B)

Issue

The CAISO has posted recommended pre-approved forms of security including letter of credit, escrow agreement and guaranty agreement, but allows Market Participants to submit their own forms, which the CAISO reviews for acceptability. As a result, the CAISO has accepted a wide variety of security instruments, some of which are subject to the laws of (and must be enforced in) other states. The acceptance of a non-standard security instrument could result in higher enforcement costs.

Recommendation

Require the use of pre-approved forms for certain types of security, i.e. letters of credit guaranty, and escrow agreement.

The CAISO may evaluate unique forms of security on a case-by-case, and may consider developing more than one form of guaranty to meet customer demand. For those SCs that propose a non-CAISO approved form, the form would be subject to review and approval by the ISO Finance and Legal Departments. The consideration of such forms may take up to 10 working days.

4.4 Security Agreement Expiration and Liability Obligation Coverage Limitation

Issue

Currently, those SCs that have posted security in a form other than an escrow account or prepayment have been allowed full credit for the security amount of the agreement up to the expiration date. If SCs do not renew their agreements timely, the agreements could expire and become unavailable to support the SC's obligations, putting market creditors at risk of payment default.

Recommendation

Set the value of a security agreement to zero 30 days prior to its expiration.

The CAISO proposes to implement Tariff language similar to NEISO, which states that "30 days prior to the expiration of any security agreement, the agreement's value will be zero, and the NEISO will consider the SC in default of its obligation to post adequate security." This default event will then, if necessary, allow the CAISO to draw upon the security agreement, thereby converting the form of security to cash. SCs could avoid this lapse by renewing such security agreements at least 30 days prior to their expiration, or by providing "evergreen" agreements without a stated expiration date. This would not necessarily indicate that other enforcement actions would be taken at that "30 days prior to expiration" point, such as the Phase II penalties for under-secured obligations or the rejection of schedules.

4.5 Credit Insurance (Supplemental Information in Appendix C)

Issue

In late 2003, the CAISO began an assessment of credit insurance as an alternative to or as a supplement to posted security for SCs. The Team has worked with Aon Risk Services to develop alternative credit insurance structures, and has also reviewed concepts with another insurance broker.

Credit insurance is one way to provide additional assurance of payment to suppliers to the CAISO markets. A credit insurance policy could be structured as follows:

1.) **Structure 1** - The first structure would pay creditors in the event of certain defaults in the CAISO markets. Covered defaults would be for parties that have a CAISO "Approved Credit Rating", who nonetheless do not pay their bills and potentially other participants whose obligations exceed their posted collateral. The policy would be subject to an annual loss limit, or limits by participant. Cost recovery for this insurance would be a key issue to be resolved.

2.) **Structure 2** - The ISO would work with an insurer to structure an alternative form of financial security for SCs that choose to procure it in lieu of other current collateral options. SCs that choose to participate would bear the costs of this coverage. The insurance broker believes that the cost of this insurance coverage would be significantly lower than the cost of letters of credit or surety bonds, so may represent an attractive alternative for many SCs. The structure of this program is still under development.

Recommendation

Receive proposals from insurers to offer credit insurance to CAISO market participants using either structure noted above.

The CAISO will provide additional details to stakeholders on credit insurance as they are available. We expect to receive a quotation in April/May 2005. If credit insurance costs under option 1 are reasonable (for example, under $300,000), CAISO may proceed with the procurement of such insurance, with costs covered by the ISO O&M budget (and funded through the GMC). If costs are higher, then more consideration of an appropriate cost recovery mechanism may need to be undertaken.

5 Liability Obligation Calculations and Security Posting Requirements

The CAISO recently improved liability obligation calculations with the implementation of the Scheduling Coordinator Aggregate Liability Estimation (SCALE) process. This section addresses SCALE and other liability obligation calculation and security posting requirement issues.

5.1 Liability Obligation Requirements for New SCs

Issue

When a new entity without an "Approved Credit Rating" is certified as an SC, it must post an initial security amount. In most cases, the SC asks the CAISO either to determine the posting amount or to provide a method for determining an amount. In the past, the CAISO has provided SC applicants a spreadsheet that contains a simple method for determining the initial security posting amount.

Issues to be addressed include:

1. How should an SC's initial posting requirement be calculated? and

2. How many Trade Days should the initial posting requirement cover? Should the CAISO allow ramping to the maximum obligation or require "up-front" posting of 102 days security requirement?

Recommendation

Continue to use the simplified spreadsheet to estimate an SC's daily charges and require the SC to post security to cover 14 days of estimated charges.

The current process of using a simplified spreadsheet model to determine the initial security request is reasonable. The ISO will update the calculations periodically to reflect current market conditions.

With the implementation of SCALE (which calculates liabilities approximately nine days after the trade date), it is acceptable to use 14 days for the initial posting requirement and then allow the new SC to increase its security posting as additional obligations are incurred. This approach has the following benefits for SCs:

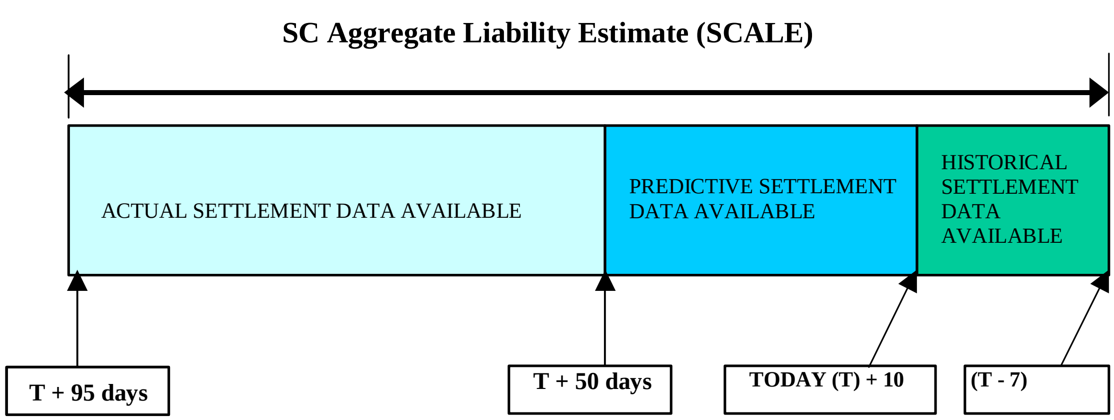
- Reduced financial burden on new SCs;
- Assurance that the CAISO will closely monitor the new SC's actual performance based on the SCALE results; and
- Adequate security for market creditors to cover a new SC's market obligations.

5.2 SCALE Process Overview

Issue

Earlier in 2004, the CAISO developed, discussed with SCs and implemented SCALE as the new tool for determining SCs' financial liabilities on a weekly basis. SCALE uses current data from CAISO market and operational systems, rather than just historic data, to estimate an SC's liabilities during the "blind period" when settlements data is not yet available.

The SCALE calculation incorporates outstanding obligations, actual settlement charges, predictive settlement obligations (definition follows) calculated between seven and ten days after the trade date, and average historical predictive settlement obligations. The illustration below provides a representative example of what periods the different obligation types cover in the SCALE calculation.



Predictive Settlement Obligations are the obligations calculated by the CAISO settlement system using estimated generation, load and intertie MWhs (see Appendix 2 of the Credit Policy and Procedures Guide posted on the ISO website for a description of the MWh estimation process).

Recommendation

Continue using SCALE as the tool for estimating SCs financial obligations.

The SCALE process was implemented in early 2004. The SCALE reporting tool has been developed and implemented so that CAISO Client Relations staff have real time access to the liability estimates and supporting data to provide to SCs.

5.3 Refinements to SCALE

Issue

The CAISO believes that SCALE is an effective tool for estimating SCs' liabilities. However, as with any software tool, it is worthwhile to consider periodic enhancements.

Recommendation

After implementation of the following minor modifications, use SCALE as is until / unless other changes are required.

During April 2004, a market participant questioned the values that were being produced by SCALE. As a result, all the MFDP process was reevaluated to determine whether improvements could be made. The CAISO implemented the following changes:

1. Load adjustment percentages were originally calculated as daily values. These percentages are now calculated and applied on an hourly basis. The hourly values more accurately reflect historical variances. This change improved the accuracy of the load deviation calculations.
2. Generation adjustment percentages are calculated and applied to the MWhs that are derived from the CAISO's PI system and Schedules. Upon further review of the Generation MWh estimation process, it was determined that the variance between metered and scheduled generation for certain participants was substantially smaller then what was originally calculated. The problem resulted from the PI and Scheduled MWhs used in the estimation process. The MWhs are now adjusted to an amount that creates an hourly variance that is equal to the participant's historical generation variance percentage.

   This change only affects a few participants, however it has greatly improved the accuracy of generation deviation calculations for these participants.
3. Intertie MWhs derived from PI or estimated load are now adjusted to reflect the variance between actual and estimated intertie MWhs. The variance implementation should improve the accuracy of the estimated intertie MWhs.
4. Most recently, the CAISO, through the configuration of the SaMC project, has worked on the development of a permanent solution for the current Measurement File Development ("MFDP", which generates estimated meter data) and SCALE processes. As the processes are re-evaluated and configured, some changes may be implemented. For example, the MFDP is currently an MS Access based process that has to be manually operated. CAISO is developing a more automated MFDP prototype that will be implemented in SaMC. When the prototype is completed, the CAISO may replace the MS Access process with the newly developed prototype.

If other substantive changes are made to SCALE processes, CAISO will update the SC Credit Policy and Procedure Guide on its website.

5.4 Accuracy of SCALE

Issue

The accuracy of SCALE vs. Settlement charges is important, particularly in avoiding "underestimating" participant liabilities. Should adjustments be made to the SCALE calculations to minimize the likelihood of this?

Recommendation

Generally freeze development of the current SCALE process, and consider this issue further when SCALE incorporated into CAISO's new Settlements System

The SCALE calculation methodology has consistently proven to be more accurate than using historical data to estimate current liabilities. In order to further reduce the likelihood of underestimated liabilities, the CAISO may refine the SCALE calculations to consider historical deviations between SCALE estimates and actual Settlements data. However, given current resource constraints and the need to focus on implementation of SCALE into the new Settlements system, further SCALE adjustments are likely to be deferred until beyond 2005.

5.5 Number of Days Included in Liability Calculation

Issue

Collateral requirements are based on the number of days of outstanding obligations to the CAISO markets. The number of days of outstanding obligations is not constant, because it decreases on the invoice payment date and steadily increases until the next payment date. Security posting requirements could be allowed to vary with the number of days outstanding, or be held constant to reflect the maximum number of days of outstanding charges.

The CAISO's current "SCALE" process produces liability estimates for each participant based on a varying number of days (Variable) and a fixed number of days (Level). The Variable posting period ranges from approximately 70 days to 102 days and the Level posting period is 102 days.

Over the past five years the CAISO has encouraged SCs to post security based on a Level period, and many of them have done so. On occasion some SCs have elected to posted security using a Variable period. The CAISO has found that allowing the use of the Variable period increases:

1. CAISO security posting administration,

2. Risk of SCs having unsecured charges, and as a result

3. Risk to other market participants.

Also, a Variable posting period is not a posting period used by other ISOs.

a. NEISO – Participants with charges greater than $50,000 were required to post 3 1/2 months' of charges. (Based on Tariff prior to its implementation of weekly settlements.)

b. NYISO – Participants must post security to cover a constant 50 days of charges.

c. PJM – Participant must post security to cover its highest two consecutive months of estimated market charges during the next 12 months.

Recommendation

Require collateral postings for a Level period

The Level posting period will be the maximum number of days of outstanding charges based on the preliminary settlement calendar, on which approximately 98 percent of all CAISO charges are paid, plus seven days for administration purposes. Currently, the Level posting period is 102 days = 95 days of outstanding charges + an extra seven days of estimated charges.

The Level posting period does not include all potentially necessary collateral to cover the need to transition customers to another SC in the event of a default and the subsequent termination of an SC agreement. The CAISO does not at this time propose an increase the number of days in the posting period to address this issue. However, the CAISO will revisit this issue in the future, *i.e.*, when payment acceleration is implemented, to consider the need for additional collateral to cover a default termination period.

In considering the above recommendation, CAISO believes it has balanced several concerns in determining whether a Variable or Level posting period is appropriate. CAISO recognizes that collateral posting entails costs to SCs, and that SCs do not desire to post more collateral than is necessary. Conversely, there are costs involved to both the CAISO and SCs in frequent collateral adjustments. The CAISO already provides more flexibility than some other ISOs in permitting ongoing collateral adjustments, versus relatively static measures such as requiring collateral sufficient to cover the highest two consecutive months of estimated charges for the next 12 months. Further, the plan to implement payment acceleration in 2006, collateral requirements will be reduced due to the decrease in the number of days outstanding.

5.6 Price Volatility and Forecasted Liabilities

Issue

The SCALE tool estimates liabilities approximately nine days after the trade date. This requires an estimate of liabilities for the nine days where no operational data is available and the forecasted administrative action period (defined in 5.5 above). During this period, there can be significant price volatility as a result of fluctuating market conditions.

Recommendation

SCALE currently estimates the charges for this period by using an average of charges over the latest 15 days. The CAISO believes this approach is reasonable, given the relative stability of market prices. In the event of significant volatility in market prices, it may be necessary to change these assumptions to adequately reflect liabilities.

5.7 Liability Obligation Calculation and Security Posting Requirements for Special Circumstances

Issue

The CAISO's goal is to ensure that active as well as inactive SCs post adequate security to cover all known and reasonably estimated potential liabilities. The CAISO has implemented Tariff language and created some tools to help achieve this goal. However, upon further review, the Tariff language and tools may not be adequate for the accomplishment of the stated goal.

Pursuant to CAISO Tariff Section 2.2.7.3, a Market Participant ("MP") may reduce its CAISO Posted Security with 15-days notice to the CAISO, provided the MP is not in breach of the posting requirement (i.e. sufficient security to cover the MP's outstanding liability for either GMC and/or Imbalance Energy, A/S, Grid Ops Charge, Wheeling Access Charge, High Voltage Access Charge, Transition Charge, Usage Charges and FERC Annual Charges.) The SCALE process is currently used to calculate these charges. The process currently includes charges attributed to adjustments, refunds, disputes or good faith negotiations only when the charges are available in the settlement system. Thus, the process does not estimate such potential charges if the charges have not yet been entered into the settlement system.

This Tariff Section must also be interpreted in light of Tariff provisions applicable to departing MPs. Pursuant to Section 2.2.4.5, the CAISO can maintain an MP's security until it is satisfied that no sums remain owed by the MP. As set forth in the Credit Policy and Procedure Guide, the CAISO may consider potential liabilities such as known settlement reruns and other financial considerations such as pending or actual bankruptcies. These potential charges and circumstances are not currently considered when determining the amount of security required to be posted for ongoing market activity pursuant to Section 2.2.7.3. Thus, an active market participant may be entitled to return of security if its SCALE estimate was zero, but an inactive MP would not be entitled to return of its security with a zero SCALE estimate if the CAISO was aware of other potential charges that might affect the MP in the future.

The following are issues that require special consideration:

1. Daily adjustments to historical charges;
2. Refund orders that adjust historical charges[4];
3. Disputes that cause adjustments to historical charges;
4. Good faith negotiations (GFN) that affect historical charges;
5. Debtor SCs leaving the market that are / will be responsible for paying adjusted charges;
6. Debtor SC business practice changes that decrease its security posting requirement, and in which the SC is still responsible for prior period adjusted charges. For example, a debtor becoming a creditor and the CAISO has released all posted security back to it, or a debtor that has a significant reduction in current charges calculated by SCALE, resulting in a decreased security requirement; and
7. Creditor SCs that either decrease their business with the CAISO or are leaving the market and do not have any security posted to cover prior period adjustments.

Recommendations

Include the following charges in the SCALE calculation and require SCs to post security accordingly:

Daily Adjustments and Disputes – Charges associated with daily adjustments and disputes that are regularly calculated by the settlement system will be included in the SCALE calculations as the charges are calculated. There should generally be no need to attempt to forecast these amounts since they are typically relatively small and usually affect many SCs.

Refund Orders – Excluding the current FERC refund, the CAISO will assess its ability to reasonably calculate the charges associated with a refund before the settlement system is rerun. If the ISO can reasonably apportion the refund to specific SCs, it will include the amounts in the SCALE process and request security accordingly. If the CAISO deems that complexities of a refund order preclude it from reasonably assessing the liabilities, it will not make a security request until the refund is processed through the settlement system. However, the CAISO will make available an aggregate forecast of the refund liabilities, if at all possible, to SCs for informational purposes only.

[4] Excluding the current refund proceeding

Good Faith Negotiations – In general, Good Faith Negotiations (GFN) tend to affect the transactions of an individual SC, which in turn may affect a few or many other SCs. Transactions associated with GFNs will be handled in the same manner as transactions associated with Refund Orders.

Debtor / Creditor SCs leaving the market or with substantial activity level changes – Those SCs that are exiting the CAISO markets or have changed their business practices resulting in substantially reduced participation in the CAISO markets will be required to post security equal to five percent (5%) of the absolute value of the net charges from their beginning participation date to their last participation date or the date the substantial change occurred. The CAISO will use this security posting requirement as a base calculation and reserves the right to increase or decrease the base amount depending on the number of settlement reruns in the queue and the estimated value of those settlement reruns. The 5% residual security posting will be retained for a period of one year, unless specific circumstances warrant a change in this retention period (for example, pending FERC ordered adjustments).

The importance of these issues is magnified by the size of the backlog of settlement reruns that currently exists. As this rerun backlog is reduced, the CAISO expects the level of risk associated with these issues to decrease substantially. Also, the CAISO is confident that implementing the new settlement system in early 2006 will result in a significant improvement on its ability to account for charges associated with these issues in a more timely and accurate manner, which will further reduce the level of risk associated with these issues.

5.8 Security Posting Requirements by Individual Trade Months

Issue

The SCALE calculation considers three months of outstanding obligations. During that period any individual SC may be a net creditor or a net debtor. Some SCs tend to be creditors (*e.g.*, generators) while others tend to be debtors (*e.g.*, load serving entities). However, it is possible that an SC could be either a net creditor or a net debtor during any month within the posting period. There are two options for addressing cases where an SC is both a creditor and a debtor for months within the posting period:

1. Consider only the months when the SC was a net debtor in determining posting requirements; or
2. Allow "net creditor" months to offset "net debtor" months to reduce the SC's overall posting requirement.

The argument in favor of option 1, above is that it would allow each month to be settled independently. That is, were an SC to default on its payment obligation during an invoicing cycle, there would be enough funds to pay all creditors if the defaulting SC had actual security that could be drawn upon. If a portion of the defaulting SC's security requirement were provided by a net from the market in a subsequent (unsettled) month, those funds would not be available to settle the market in the current month, though there would be no ultimate credit risk to the market as funds could be withheld from the defaulting SC from future distributions

At present, the CAISO follows the second option and allows outstanding credits to offset outstanding obligations.

Recommendation

Continue to allow "net creditor" months to offset "net debtor" months.

The CAISO recommends maintaining its current policy. Although the CAISO recognizes that the policy can create payment issues, the risk of non-payment to the market is relatively small. Also, implementing an accelerated payment plan in the near future will further mitigate this issue.

In order to ensure that the Accounting Department is holding sufficient market credit to cover market debits, the Finance Department will create a report for the accounting department that shows those SCs with monthly credit balances that are used to offset monthly debit balances. The accounting department will then determine whether the credit balances should be retained in an escrow account as security postings to cover the debit balances.

5.9 Liability Obligation Calculations and the New Settlement and Market Clearing System

Issue

The CAISO is currently implementing a new Settlement and Market Clearing (SaMC) system. The specifications for the new system include:

- A settlement system estimated liability run at T+2, which will replace the SCALE process;
- New credit management tools integrated with the settlement and accounting functionality;
- A new web interface to be used by client representatives and market participants to access all credit requirement information.

Recommendation

<u>The CAISO Finance Department will oversee the development of the credit management functionality in the SaMC system to see that it will reflect the requirements of the revised credit policy discussed by this document.</u>

5.10 Payment Acceleration Effects on Liability Obligation Calculations and Security Posting Requirements

Issue

Approximately six months after the new settlement system is implemented (scheduled for Fall 2005), the CAISO expects to implement accelerated payments, with the goal of reducing the number of unsettled Trade Days from the current 65 - 95 days to approximately 30 - 50 days. This will require consideration of the following issues:

- How will payment acceleration affect SC security requirements?
- How many days will be included in the liability calculation process?

<u>Recommendation</u>

<u>Revisit SC posting requirements as details of Payment Acceleration are finalized.</u>

The current Level posting period is approximately 102 days, which does not include collateral to cover the period over which an SC that is being terminated may continue to incur liabilities. With payment acceleration implementation, the number of days outstanding will likely fall to between 30 to 50 days.

(However, we will consider providing for an increased security posting to cover a terminating SC from incurring additional liabilities.)   The amount of security postings and the total numbers of days covered by security postings should significantly decrease with payment acceleration implementation.

Number of days covered by security postings

	Month 1	Month 2	Month 3	Month 4	Total
Current Level 102 day period	31	31	30	10	102
Monthly Settlements	31	27			58
Weekly Settlements	28				28

5.11 Adjustments to Security Postings

Issue

CAISO uses the SCALE liability estimates as the basis for security adjustments, either requesting additional security, or permitting reductions to posted security. In reviewing the administration of this process, we have noted the following:

- Week-to-week.SCALE estimates are volatile at times. If security posting adjustments are based solely on these changing weekly estimates, frequent adjustments to collateral may be required. Further, this can leave an SC unsecured over the course of a year, even if the SC responds in a reasonably prompt manner to adjustments.
- Releasing security based on the latest SCALE estimate is not a prudent practice given the inherent volatility in the SCALE estimates.   The collateral postings should instead be sufficient to provide adequate coverage at all times.
- There is some inherent uncertainty in the liability estimation process.

We have considered various methods to address these concerns. These methods have included:

1. Basing the security posting request on a moving average of the most recent SCALE estimates over the past month;
2. Basing the security posting request on the lesser of (1) the most recent SCALE figure and (2) a moving average of the most recent SCALE estimates over the past month;
3. Reviewing a chart of recent SCALE estimates and requesting collateral to cover the peaks over the past several months.

Recommendation

Use approach 2 to retain some flexibility, particularly regarding security returns.

6 Enforcement

The enforcement section deals with issues associated with SC adequate security postings, invoice payments and remedies for noncompliance.

6.1 Unsecured Obligation Penalties

<u>Issue</u>

The Tariff requires SCs to post adequate financial security for their obligations in excess of any amounts covered by an Approved Credit Rating. The Tariff also provides potential CAISO enforcement actions including rejection of schedules and termination of an SC agreement for SCs that do not comply with the posting requirements. These enforcement actions may in certain instances be ineffective, and this section addresses whether the CAISO should establish additional non-compliance penalties to help create incentives for compliance with the CAISO's credit policies.

The CAISO calculates each SC's estimated liabilities weekly, and then sends security request notifications to those SCs that need to post additional security. The CAISO requires posting of additional security within five business days of the request. In most instances, this process works as intended, with the SC either posting additional security or providing the CAISO with data that supports a lower posting requirement. Unfortunately, there are instances when SCs do not respond on a timely basis to these security requests. When this occurs, the Tariff provides only one immediate remedy: rejecting that SC's schedules. This approach is often inappropriate as: (1) for relatively small security requests, rejecting schedules may be too harsh a penalty, particularly if the CAISO has not reason to believe that the SC is at risk for defaulting and more significantly, (2) for load-serving entities, rejecting schedules does not reduce, but can increase, liabilities to the CAISO market.

Establishing penalties for exceeding credit limits would help to address the above issue and create an incentive for SCs to comply with CAISO security requests.

<u>Recommendation</u>

<u>Implement a penalty based on the positive variance between an SC's actual charges and posted security with a "safe-harbor" to waive penalties if the SC complied with ISO security posting requests.</u>

The ISO will assess a penalty upon on those SCs that have settlement charges that were not secured by either an approved credit limit and / or financial security for a given period. The daily penalty will be calculated as:

Daily Unsecured Charges Penalty = (Period Charges – Posted Security) * Daily Penalty Rate

Definitions:

Authorized Unsecured Credit – Total unsecured credit calculated using the methodology defined in Section 4.1 above.

Daily Penalty Rate – (The FERC Interest Rate + 5 percent) / 365

Posted Security – The sum of Authorized Unsecured Credit and other Posted Financial Security (e.g. Letters of Credit, Guaranties, Surety Bonds and Prepayments) as of a specified trade date such as March 15, 2004.

Total Settlements Charges – The sum of charges (market, grid management or a combination thereof) for a calendar month.

Period Charges[5] – The sum of Total Settlements Charges for two consecutive calendar months plus the sum of the third month's daily average charges through a specific trade date. For example, if the unsecured charges are calculated as of March 15, 2004, the Period Charges are estimated as the sum of January 2004 and February 2004 charges plus March 2004 daily average charges times 15 days.

A significant issue is whether the penalty should be waived if the SC complied with the ISO's security posting requests. Such a Safe-Harbor Provision (penalty charge exemption) would provide that those SCs that are notified of a security posting requirement based on the 90 percent utilization notification process and post the requested security in accordance with the credit policy provisions[6] will not be subject to a penalty for the period of time that the security posting requirement covered. Arguments in favor of a safe-harbor provision include:

A penalty levied on Total Settlements Charges might include charges that are difficult for SCs to predict (for example reruns/retroactive charges). Without a safe-harbor for complying with ISO security requests, an SC might face penalties for unsecured liabilities that were difficult to anticipate.

Arguments against a safe-harbor provision include:

The Tariff indicates that determination of a required security amount is the SC's responsibility. Although the CAISO has developed a tool (SCALE) to assist in liability estimation, there are times when the ISO tool underestimates the liabilities, as SCs are in the best position to monitor their activity levels. SCs should have the primary responsibility to ensure that their posted security is adequate to cover their outstanding charges at all times. If the penalty was assessed as simply the difference between Period Charge and Posted Security (without a safe-harbor provision), SCs would have the appropriate incentive to determine their own positions in the CAISO markets and provide timely and adequate security prior to receiving CASO requests.

Because of other pressing work related to the ISO's new Settlements and Market Clearing System, these penalties may be implemented during 2006, later than the effective date of other elements of these proposed changes to the Credit Policy.

6.2 Late Payment Penalties

Issue

The Settlements and Billing Protocol defines the process used at the CAISO for clearing the market. In summary, net debtor SCs are required to have their payments in the CAISO's Clearing Account by 10:00 a.m. Pacific Time on the payment due date. Then, at 2:00 p.m. Pacific Time on the same day, the CAISO transmits payments to net creditor SCs. Only if all net debtor SCs make their payments timely can the CAISO clear the market timely. Receipt of less than full payments triggers the need for complex calculations to determine allocation of the proceeds, and can result in a delay of up to five days in the distribution of payments. These delays can have an adverse impact on the cash-flow requirements of SCs, and have been the subject of significant criticism.

[5] This method is recommended because many settlement charges (GMC, TAC, Wheeling, and Adjustments) are calculated at the end of each month. As soon as the new settlement system is implemented and most charges are calculated daily, the Period Charges will be the sum of outstanding charges through a particular trade date.

[6]" > 90% Security Utilization Action - The ISO requests that an SC increase the posting amount within five business days so that the security utilization does not exceed 90 percent. If the SC takes no action in response to the recommendation to post additional security, upon reaching 100 percent security utilization, they will be subject to the enforcement provisions of the ISO Tariff as described in Section D, Enforcement, including potential rejection of schedules." (CAISO Credit Policy & Procedures Guide Pg.18)

The CAISO Tariff does not now provide for penalties for late payments. The CAISO believes that establishing a penalty structure for late payments could be an effective incentive for net debtor SCs to transmit payments timely. Late payment penalties were to be included in the Oversight and Investigations (O&I) Tariff filing in 2003, but were excluded as not specifically covered by the FERC order on O&I.

Recommendation

Establish penalties for late payments.

Each Scheduling Coordinator is required to remit to the CAISO Clearing Account the amount shown on the invoice as payable by that Scheduling Coordinator not later than 10:00 a.m. on the Payment Date.

The CAISO recommends that an SC that transmits its payment after the deadline be assessed interest on the late payment and penalties, as described below:

1. Interest shall be calculated in accordance with the methodology specified for interest on refunds in the regulations of FERC at 18 C.F.R. §35.19(a)(iii)(1996). Interest on delinquent amounts shall be calculated from the due date of the bill to the date of payment, except as provided in SABP 6.10.5. When payments are made by mail, bills shall be considered as having been paid on the date of receipt.
2. As stated in Section 2.2.3.3 of the CAISO Tariff, an SC with an Approved Credit Rating that submits a late payment shall lose its credit rating for one year. The CAISO proposes to enforce this provision as specified in 3 below.
3. Late Payment penalties will be assessed as follows:
    a. Upon the first Late Payment in a calendar year the Scheduling Coordinator will be sent a violation letter.
    b. Upon the second and subsequent Late Payments per calendar year the Scheduling Coordinator will be assessed a penalty equal to $100 plus one percent of the invoice amount, the total of which is not to exceed $10,000, for each 24-hour period the payment is late.
    c. Upon the third Late Payment in a calendar year the SC will have to post cash security in the amount of the late payment with the CAISO and incur no Late Payments for a 12-month period before the security can be released. Also, an SC with an Approved Credit Rating will be subject to enforcement of Tariff Section 2.2.3.3. Upon enforcement of Section 2.2.3.3, an SC must post cash security and have no late payments for a one-year period in order to have its Approved Credit Rating restored.

Because of other pressing work related to the ISO's new Settlements and Market Clearing System, these penalties may be implemented during 2006, later than the effective date of other elements of these proposed changes to the Credit Policy.

6.3 SC Suspension, Disconnection and Termination Policy

Issue

Currently under Tariff section 2.2.7.4, the CAISO has the right to reject an SC's schedule in the event that the SC does not provide adequate financial security. Rejecting SCs' schedules may not be an effective remedy, particularly if the SC serves load. If a load serving SC has its schedules rejected, the load served becomes invisible to the CAISO and is then accounted for as unaccounted for energy, unless the SC's load can be disconnected. The adoption of monetary penalties (Section 6.1) may provide an additional and, in many circumstances, more effective tool for enforcing the CAISO's credit policies and reducing default risk for market creditors.

Current Tariff sections 2.2.4.5 through 2.2.4.7.2 address termination of an SC's Service Agreement and are directed primarily at SCs with retail customers (i.e. Energy Services Providers (ESPs) in locations served by the state's Investor Owned Utilities (IOU)s. These Tariff sections address transferring a terminated SC's eligible customers to other SCs that have been placed on a list that is developed and maintained by the CAISO. The eligible customers can choose a new SC, or default to service from the appropriate IOU. These Tariff provisions are anachronistic, given that retail competition has not developed in California as originally anticipated, and do not directly address SCs that do not serve retail customers at all or that serve retail load located within service areas of publicly-owned utilities, or address defaults by municipal utilities.

Recommendation

The CAISO does not currently have a recommendation to address this issue. We invite stakeholder discussion of the current tools to address non-compliance with the collateral requirements including suspension of scheduling privileges and termination of an SC agreement, and how they might be made more effective for all types of SCs. Suspension/termination and disconnection process should include the following:

1. Due process - notice and opportunity to be heard prior to adverse action;
2. The right to cure;
3. Notice to other affected parties, including regulatory authorities and utilities; and
4. Maintenance of obligations. Any suspension/termination and disconnection process should expressly provide that SC obligations under the SC Agreement remain (e.g. obligation to pay any amounts due under SC agreement and/or Tariff) even if the SC is suspended/terminated.

7 Other Issues

7.1 Risk of Loss of Investment on Funds Held by ISO on behalf of Market Participants

This issue was not addressed in the November 2004 document.

At the February 2005 Board meeting, the Board directed Management to review the issue of risk of loss associated with the ISO holding market participant funds. Currently, this issue is not specifically addressed by the ISO Tariff or other agreements between the ISO and market participants.

The ISO proposes to address this issue with the addition of a section to the ISO Tariff specifying that Market Participants will bear any risk of loss of principal and/or interest of such funds. The ISO investment policy will specify that such funds will only be invested in a bank account, high-quality money market fund, or US Government security unless a specific agreement between the ISO and SC specifies another type of investment. Consistent with this approach, the ISO intends to present proposed changes to the ISO investment policy to the ISO Governing Board in May or June 2005.

8 Appendix A - Credit Limit Caps MKMV Method

Supplements section 4.1 of this document.

9 Appendix B - Legal Forms

Supplements section 4.3 of this document.

10 Appendix C - Credit Insurance

Supplements section 4.5 of this document.

11 Appendix D- Stakeholder Responses

This document provides a record of stakeholder responses to the originally proposed recommendations and the CAISO's responses to the stakeholder feedback.