

# Stakeholder Comments Template

## Subject: Credit Policy Enhancements

Submitted by	Company	Date Submitted
<i>Michael Kramek (626)-302-7455</i>	<i>Southern California Edison</i>	<i>10/7/2008</i>

This template has been created for submission of stakeholder comments on the topics covered in the September 22, 2008 Credit Policy Enhancements stakeholder meeting. Upon completion of this template, please email your comments (as an attachment in MS Word format) to [CreditPolicyComments@caiso.com](mailto:CreditPolicyComments@caiso.com). All comments will be posted to CAISO's Credit Policy Stakeholder Process webpage at <http://www.caiso.com/docs/2003/04/21/2003042117001924814.html>.

Submissions are requested by close of business on **October 7, 2008 or sooner**.

Southern California Edison Company ("SCE") hereby submits its initial comments on the California Independent System Operator's (CAISO's) Proposed Enhancements to California ISO Credit Policy white paper, dated September 8, 2008.

SCE appreciates the opportunity to submit comments regarding the CAISO's white paper proposal. Given the extraordinary events taking place in the financial markets SCE believes continuous review of credit policy is critical to the overall health and success of the California energy market and commends the CAISO on its efforts in proposing specific credit policy enhancement for stakeholder comments. Based on the CAISO's credit policy enhancement white paper, SCE will provide specific comments on each of the items listed below.

Please submit your comments to the following questions for each topic in the spaces indicated.

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”?)

The CAISO’s proposal modifies the eight step process, described in section 12.1.1.1.2 of the MRTU tariff, which is used to determine a market participants Unsecured Credit Limit (UCL). Specifically, the proposal replaces the use of Moody’s, Moody’s KMV spot, and S&P’s credit rating default probabilities with the use of Credit Agency Issuer Ratings and Moody’s KMV spot credit rating. The proposal keeps the blending percentages currently used to calculate a participants TNW percentage. The blended percentage is equal to 50% of the Moody’s KMV spot credit rating plus 50% of the average of all available credit agency issuer ratings.

SCE supports the CAISO’s proposal to enhance the method of determining UCL by using a blended average of Moody’s KMV spot rate and Credit Agency Issuer Ratings. SCE agrees with the CAISO that the Moody’s KMV spot credit rating should be viewed as a leading indicator due to its ability to foresee rapid deterioration of a market participants financial conditions sooner than some of the other agency issuer ratings. SCE feels that it is important to reflect Moody’s KMV spot ratings ability to quickly identify deteriorating financial conditions in the calculation of a participants Unsecured Credit Limit.

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?

Section 3.2 of the CAISO white paper proposes to expand the MRTU tariff definition of Tangible Net Worth (TNW) to excluded items that represent assets earmarked for a specific purpose such as restricted assets and assets invested in or received from affiliated entities. In addition, at the September 22, 2008 stakeholder meeting the CAISO modified its proposal slightly too also exclude assets that are subject to excessive changes in valuation due to market fluctuations such as derivative assets.

SCE supports the CAISO's change to the definition Tangible Net Worth to exclude both assets that have been earmarked for a specific purpose and highly volatile assets such as derivatives. However, SCE request the CAISO clarify a comment that was made at the stakeholder meeting that the revised proposed definition of Tangible Net Worth matches the definition used by the Mid West ISO. The CAISO white paper references additional items that are excluded by the Mid West ISO such as net value of long-term trading book and the Nuclear Decommissioning fund. Is it the CAISO's intent to exclude these two additional types of assets as well?

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?

The CAISO white paper proposes to reduce the maximum Unsecured Credit Limit amount from \$250 million to \$100 million dollars. In its white paper the CAISO states that the revised maximum Unsecured Credit Limit value of \$100 million dollars was based in large part on a review of actual Estimated Aggregate Liabilities (EAL's) since the rollout of the CAISO's current credit policy and a review other ISO/RTO's policy on maximum Unsecured Credit Limits.

SCE is concerned that such a dramatic reduction in the maximum amount of unsecured credit, potentially up to \$150 million dollars, could have significant financial impacts on market participants, in particular if a market participant has to post an additional \$150 million dollars of collateral all at once. While SCE appreciates the CAISO's review of market participants current Estimated Aggregated Liabilities and its review of other ISO/RTO's Unsecured Credit Limit policy SCE doesn't believe that comparing the current market and other ISO/RTO's with MRTU is an apples to apples comparison.

First, SCE would like to point out that the current CAISO market does not include either a day-ahead or an active CRR market. Under MRTU these two additional markets alone will increase a market participant's Estimated Aggregated Liability significantly compared to today's market. Given the likelihood of significantly higher Estimated Aggregated Liabilities under MRTU SCE doesn't believe the CAISO should benchmark

MRTU liabilities against today's market and recommends the CAISO's credit department conduct further analysis and provide stakeholders with an estimate of the expected average Estimated Aggregated Liabilities under MRTU.

Second, while SCE thinks using other ISO/RTO's maximum Unsecured Credit Limit values as a benchmark for potential market liabilities under MRTU is a good data point we don't feel that it should be used as a substitute for performing further analysis of MRTU activities. In particular, SCE has seen some very dramatic and volatile real-time prices in market simulation that we don't believe are seen in the other ISO/RTO's. These prices can have a significant impact on a market participants Estimated Aggregate Liability and need to be considered when performing an estimation of future market liabilities.

Given the uncertainty of market exposure of stakeholders under MRTU, SCE suggests that the CAISO not change the current maximum unsecured credit policy at this time. Instead, SCE suggests the CAISO re-evaluate the need for a reduction in the maximum unsecured credit limit upon the first anniversary of MRTU go-live. This will enable the CAISO and all stakeholders sufficient time to gather the necessary data, such as actual market exposure and impacts of payment acceleration, to determine whether a reduction of the maximum unsecured credit limit is warranted.

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?

Section 4.1 of the CAISO white paper proposes clarifying the existing credit policy to permit Canadian entities, that otherwise meet CAISO's creditworthiness standards, to provide guarantees and other forms of collateral to the CAISO for participation in the CAISO administered energy markets.

SCE does not support permitting guarantees and/or other forms of collateral to be issued by Canadian entities or any other non-U.S. based entity. It is SCE's opinion that the addition risks (legal, foreign exchange, etc.) and complexities of such a provision far out way the potential benefits to the CAISO market. Foreign entities can and do provide collateral to the CAISO today for participation in the CAISO administered energy markets and SCE doesn't see a compelling reason to deviate from current CAISO practices.

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?

The CAISO is proposing modifying the existing parental guarantee agreement to include provisions that would require a guarantor backing the activities of one affiliate to back activities of all affiliates participating in the CAISO market under the same guarantee. The revised provisions will require that the guaranty must have a limit sufficient to cover the aggregated Estimated Aggregate Liabilities of all of the affiliates regardless of individual credit limits the guarantor may wish to assign. The revised provisions will also give the CAISO the authority to reallocate individual affiliate credit limits, up to the guaranty limit, to cover a potential call to an individual affiliate for additional collateral.

SCE understands that the events that took place in PJM are a main driver for the CAISO proposing to require a guarantor to provide a blanket guarantee over all its affiliates but feel that the reason for the default in PJM's FTR market was not because PJM didn't have a blanket guarantee in place but rather that PJM had significant flaws in their credit policy and credit monitoring procedures. The CAISO, working with stakeholders, has taken steps to strengthen its credit policy with respect to the CRR market and we feel those changes along with the CAISO implementing a process for marking to market the value of participants CRR portfolios should significantly reduce the potential of a PJM like default occurring in California.

SCE believes the CAISO's proposal raises a host of legal and regulatory issues, in particular how a blanket guarantee would apply to a non-regulated parent backing regulated and non-regulated affiliates. SCE does not support the CAISO's proposal of requiring a blanket guarantee and believes that a strong underlying credit policy is the best way to prevent defaults such as the one experienced in PJM from occurring in California.

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?

Section 5.1 of the CAISO white paper proposes a reduction in the required time for participants to satisfy a call from the CAISO for additional collateral from (5) business days to (3) business days.

SCE supports the CAISO's proposal to reduced the time required to respond to a collateral call from (5) business days to (3) business days. SCE does not support the idea of reducing the response time to (2) business days as some stakeholders have suggested because we feel (2) days is not enough time for market participants to perform the necessary steps to comply with a collateral call from the CAISO.

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?

The CAISO white paper proposal intends to impose a tariff limit on the use of available credit for a CRR auction to ensure that the 90% threshold for an additional call for collateral is not exceeded.

SCE supports the CAISO's proposals to limit the amount of available credit that can be used for a CRR auction at a maximum of 90% of a participant's available collateral. However, SCE asks the CAISO to provide clarification to statements made on page 27 of the white paper:

"that any changes in this are not part of the SaMC design and would require software changes to both the SaMC and NEXTANT software systems".

SCE would like clarification from the CAISO if this enhancement is dependent upon SaMC and NEXTANT software changes to be completed or is it the CAISO desire to proceed with this enhancement using manual processes until software can be modified?

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?

Section 5.2 of the CAISO white paper introduces the concept of funding a market reserve account as means to mitigate the risk of future payment defaults. The CAISO's proposal discusses the potential to fund this account through a monthly charge until a preset funding level is achieved at which time funding would cease. Should a payment default occur the CAISO would offset the default by first offsetting the default amount using the defaulting parties' collateral; then offsetting as much of the remaining balance using the funds from the reserve account; and finally, socializing the remaining balance according to CAISO's policy for socializing payment defaults.

SCE feels that the costs (cons) listed in the CAISO white paper of this proposal significantly outweigh the benefits (pros). In particular, the proposal has the potential to be very costly to market participants while not providing much additional benefit over participants individually accepting the risk of a default. Therefore, SCE does not support the creation of a process to fund a market reserve account to help offset the risk of future payment default.

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?

The CAISO white paper proposal introduces the possibility of the procurement of a line of credit and/or credit insurance as additional ways to help mitigate the risk of future

payment defaults. The CAISO's proposal discussed numerous options for procuring credit insurance such as the utilization of a Captive Insurance Company and the development of a Blended Finite Risk Program.

Consistent with our comments on question 8 above SCE is concerned that the procurement of any type of credit insurance by the CAISO is potentially very costly to market participants while not providing much additional benefit to market participants. SCE does not support the CAISO procuring these types of insurance instruments at this time but would support the CAISO investigating the costs and availability of credit insurance in order for stakeholders to get a better understanding of the true costs of such products.

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?

Section 5.4 of the CAISO white paper proposes to change the tariff methodology used to allocate payment defaults to market participants. The current tariff methodology allocates payment default to all net creditors to the CAISO in the month the default occurs. The CAISO's proposed change would allocate payment defaults to all market participants, in the month of the default, on a pro-rata basis through a supplemental billing.

SCE opposes the CAISO's proposal to modify the current methodology in which payment defaults are allocated to market participants. The current tariff language was a result of a long negotiation process during the development of the CAISO's MRTU tariff and was an important item for SCE in providing support for MRTU. The ultimate outcome of the tariff negotiation process and the resultant language was to provide market participants the ability to limit their exposure to a CAISO market default by allowing entities to net purchases and sales together. It is SCE's position that the current tariff language offers market participants such protection and feels strongly that the payment allocation methodology should remain unchanged. Any modification to the current language at this time would be viewed by SCE as a bait and switch tactic being used by the CAISO just prior to MRTU implementation.



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?

SCE supports the proposal described in section 5.6 of the CAISO's white paper to assess a penalty to market participants who are late in paying their invoice three or more times in a rolling twelve month period. SCE feels the penalties, a maximum financial penalty of \$10,000 and the reduction of a market participants Unsecured Credit Limit to zero, are sufficient enough to ensure compliance with the payment provisions of the tariff. Lastly, as previously stated in question 8 SCE does not support the creation of a market reserve account and believes the penalties collected should go to offset GMC charges.

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?

SCE supports the proposal described in section 5.7 of the CAISO's white paper to assess a penalty to market participants who fail to promptly respond to calls for additional collateral from the CAISO three or more times in a rolling twelve month period. SCE feels the financial penalty of 2% of the collateral amount or \$1,000 (not to exceed \$10,000) should ensure compliance with the collateral response provisions of the tariff. Lastly, as previously stated in question 8 SCE does not support the creation of a market reserve account and believes the penalties collected should go to offset GMC charges.

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.)?

SCE is supportive of the CAISO establishing a credit working group as a means to formalize the CAISO's approach to managing credit policy changes. SCE envisions a credit working group as the forum where the CAISO would discuss all proposed credit policy enhancements and/or new market design initiatives that have specific impacts to the CAISO's overall credit policy. SCE envisions the credit working group meeting on



an as needed basis and its membership consisting of members of stakeholders credit and risk management departments.