

Stakeholder Comments Template

Subject: Credit Policy Enhancements Straw Proposal

Submitted by	Company	Date Submitted
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This template has been created for submission of stakeholder comments on the topics covered in the October 27, 2008 Credit Policy Enhancements stakeholder call. Upon completion of this template, please email your comments (as an attachment in MS Word format) to 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 **November 4, 2008 or sooner**.

Southern California Edison Company ("SCE") hereby submits its comments on the California Independent System Operator's (CAISO's) Straw Proposal on Enhancements to California ISO Credit Policy white paper, dated October 20, 2008.

SCE appreciates the opportunity to submit comments regarding the CAISO's whitepaper 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. Are you generally in favor of the ISO establishing credit policies, such as the three enhancements presented during this stakeholder process, that result in more conservative unsecured credit limits?

SCE supports the CAISO initiative of continuous review of its current credit policy as a critical step in the overall health and success of the California energy market and commends the CAISO on its efforts in providing stakeholders with a straw proposal for stakeholder comments. While SCE is generally supportive of the CAISO's desire for more conservative unsecured credit

limits; SCE cautions the CAISO that making decisions on the proper levels of unsecured credit limits using current aggregate liability levels does not provide an accurate assessment of aggregate market liabilities under MRTU. As the CAISO has noted in its straw proposal the CAISO current market structure does not include a Day-Ahead market or include CRR settlements. The introduction of these major market features in MRTU will almost certainly increase stakeholders aggregate liabilities to levels much higher than today.

CAISO Response: The CAISO recognizes that certain MRTU market features may have an impact on Estimated Aggregate Liability levels. That is one of the reasons why CAISO reconsidered and revised the original proposal to reduce maximum unsecured credit limits to \$100 million to its most recent proposal to set the cap at \$150 million. The CAISO is attempting to reduce perceived credit risk in the CAISO market by aligning our maximum unsecured credit limit to that of the other ISOs/RTOs.. The majority of Market Participants comments expressed to CAISO thus farexpress a desire for significantly lower or even no unsecured credit as a means to reduce market risk. CAISO believes that the current straw proposal of \$150 million is a reasonable compromise between these views, and the potential impact of the day-ahead market and other MRTU features on EAL.

2. Do you support the ISO's straw proposal to use the lowest Credit Agency Issuer Rating when two or more issuer ratings are available? If only a short term rating is available, do you support the use of the lowest equivalent long term rating?

SCE supports the CAISO's proposal to use the lowest Credit Agency Issuer Rating when two or more issuer ratings are available. SCE also supports the CAISO using the lowest equivalent long term rating when a market participant only has a short-term rating.

CAISO Response: Noted.

3. Do you agree with the concept that having a large portion of Total Assets comprised of assets that are generally unavailable to settle a claim such as restricted assets, affiliate assets and derivative assets (i.e., using the net of these asset categories if an offsetting liability is reported) should result in a lower or even no Unsecured Credit Limit? If you agree, should the ISO specifically exclude these types of assets in the definition of Tangible Net Worth as originally presented or consider them as part of the qualitative assessment in step 8 of the eight-step process as presented in the straw proposal?

SCE supports the CAISO desire to exclude from the determination of a stakeholders unsecured credit limit restricted assets, affiliate assets, and derivative assets. SCE also agrees with the CAISO that the original proposal of expanding the definition to include all types of assets that might be excluded was problematic in that the definition may not have been broad enough to ensure that other, risky assets, not specifically described in the definition, would be evaluated in setting the Unsecured Credit Limits (UCL). As such, SCE supports the CAISO's revised proposal to exercise good prudent business judgment when evaluating the types of risky assets which may or may not be included in the calculation of Tangible Net Worth and ultimately in the determination of a stakeholders UCL.

CAISO Response: Noted. There has been much internal discussion on this topic. There are challenges with lowering the UCL solely on the qualitative assessment of certain assets – particularly applying this subjective analysis in a consistent manner. The final solution may require a combination of both exclusion and qualitative assessment. Exclusion, if applied by ensuring matching assets and liabilities are included in the calculation, removes the subjectivity of a qualitative assessment alone. However, because these types of assets can swing wildly from one reporting period to another – sometimes making the difference of getting unsecured credit during one reporting period or not –CAISO needs to retain the flexibility to use the qualitative assessment to reduce unsecured credit based on the uncertainty of these assets contribution to Tangible Net Worth from one reporting period to the next. Based on support for both of the proposals in this area, CAISO may ultimately incorporate both approaches in its final draft proposal.

4. Do you support the ISO's straw proposal to reduce the current maximum amount of unsecured credit to \$150 million on the condition that the ISO reassess this amount with the release of Payment Acceleration and after MRTU has been successfully running through the summer months of next year?

SCE does not support the CAISO's proposal to modify the maximum amount of Unsecured Credit a market participant can be awarded prior to observing actual market exposures under MRTU. Ultimately a reduction of the maximum unsecured credit limit to \$150 million or something lower may be prudent but without actual market results any reduction will be based upon arbitrary assumptions.

Given the uncertainty of market exposure under MRTU, SCE suggests that the CAISO not change the maximum unsecured credit policy at this time. Instead, SCE suggests the CAISO re-evaluate the need for a reduction in the maximum UCL after observing one year of MRTU market results. 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 UCL is warranted.

As stated in response to Question 1 SCE supports the CAISO initiative to continue to enhance and strengthen its overall credit policy but believes that a reduction in the maximum UCL based on current market exposure or arbitrary assumptions of future market exposures is flawed and would prefer to have a reduction in the maximum UCL based on actual market exposure under MRTU.

CAISO Response: See response to question 1 above.

5. Do you support the ISO's straw proposal to accept non-U.S. and non-Canadian guarantees if the ISO adopts strict criteria similar to PJM and MISO? In addition, do you support the straw proposal to adopt MISO's maximum unsecured credit limits based on a minimum country rating and the guarantor's credit quality?

SCE would support the CAISO's straw proposal to accept non-U.S. and non-Canadian guarantees if the CAISO adopts the strict criteria similar to what was approved by FERC in PJM. That being said, SCE does not support PJM's rule to allow a foreign company to provide a guarantee with a credit rating below A-. The CAISO should only consider foreign guarantees from companies with a credit rating of A- or higher. SCE would also support the CAISO adopting a single-tier lower guarantee limits being proposed by MISO.

SCE does not support the CAISO extending this policy to include Letters of Credit or other forms of Financial Security.

CAISO Response: CAISO's straw proposal which was based on the PJM/MISO model, allowed for some unsecured credit for all but the lowest investment grade rating. Limiting foreign guarantees to entities with a credit rating of A- or higher is worth further consideration. This is consistent with a more conservative approach to providing unsecured credit and may mitigate the residual credit risk of accepting foreign guarantees.

The CAISO concurs that this credit policy enhancement would only extend to foreign guarantees at this time.

6. Do you support the ISO's continued development of the Affiliate Guaranty? What are your legal department's concerns, if any, with the ISO's form Affiliate Guaranty?

SCE remains opposed to the CAISO's proposal to require a corporate parent who guarantees the obligation of one of its affiliates to guarantee the obligations of all of its affiliates. Based on unclear comments in the whitepaper and the straw proposal as well as other statements made through the stakeholder process, it is not entirely clear the extent to which the blanket parental guaranty would subject a regulated utility's assets to risk related to an unregulated affiliate.¹ As discussed below, a blanket parental guaranty that would allow a creditor of one subsidiary to look to the assets of another subsidiary is, in the case where one subsidiary is a regulated utility, in conflict with the purpose and requirements of affiliate restrictions on regulated utilities. Thus, SCE recommends that the CAISO either reject this proposal or modify it to create an explicit exemption for entities that include an IOU as one of the affiliates.

Both state and federal regulation forbid regulated public utilities from cross-subsidizing their unregulated affiliates. The California Public Utilities Commission's (the "Commission") longstanding regulation of inter-affiliate transactions, most recently adopted in Decision 06-12-029,² generally prohibit such cross-subsidies. In D.06-12-029, the Commission

¹ If the proposed guaranty operates as indicated by CAISO staff in the whitepaper – namely, that under the “blanket” parental guaranty, if one subsidiary of the parent (for our purposes, an unregulated subsidiary) were to default on a “guaranteed” obligation, the CAISO could resort to the collateral posted by another subsidiary (for our purposes, a regulated utility), relevant state and federal regulations prohibiting the cross-subsidization of unregulated subsidiaries by public utility subsidiaries would render this guaranty mechanism unavailable to the corporate family altogether.

² D.06-12-029, Attachment B: Revised Affiliate Transaction Rules.

specifically raised its concern about “the potential threat to a utility’s financial health and ability to meet its public service obligations unless it is adequately insulated from the financial risks and debts of its unregulated parent and affiliates.”³ The Commission further stated the “Revised Affiliate Transaction Rules have been designed to close existing loopholes ... and by ensuring a utility’s financial integrity is protected from riskier market ventures of its unregulated affiliates and holding company parent.”⁴

In SCE’s case, this general prohibition on cross-subsidization has its roots in the conditions imposed when the Commission first approved SCE’s holding company structure in Decision 88-01-063 dated January 28, 1988. Condition 11 provides:

[SCE] shall not guarantee the notes, debentures, debt obligations, or other securities of its parent holding company or any of its subsidiaries without first obtaining the written consent of this Commission.

This Holding Company condition was expanded with the Commission’s adoption of so-called “ring-fencing” requirements that “ensure that a utility is not pulled into the bankruptcy of the holding company should serious financial problems develop.”⁵ The Commission amended the Affiliate Transaction Rules to add new rules providing (in pertinent part):

Ring-Fencing. Within three months of the effective date of the decision adopting this amendment to the Rules, a utility shall obtain a non-consolidation opinion that demonstrates that the ring fencing around the utility is sufficient to prevent the utility from being pulled into bankruptcy of its parent holding company. The utility shall promptly provide the opinion to the Commission.

* * *

Changes to Ring-Fencing Provisions. A utility shall notify the Commission of any changes made to its ring-fencing provisions within 30 days.⁶

The Commission’s prohibition on cross-subsidies and requirement for ring-fencing is intended to ensure that the utility does not cross-collateralize or indemnify the obligations of its parent or unregulated affiliates. The Commission’s objective is to ensure that ratepayer funds are not put at risk by the actions of its unregulated businesses. The purpose of these affiliate restrictions appears to be directly at odds with the purpose of proposed blanket guaranty that would commingle the collateral of all affiliates and have a creditor look to the regulated utility to fulfill the obligations of its unregulated affiliate.

³ D.06-12-029, p. 10.

⁴ D.06-12-029, p. 10.

⁵ D.06-12-029, p. 29.

⁶ D.06-12-029, Attachment B, Affiliate Transaction Rules IX.C and IX.D.

SCE has obtained a non-consolidation opinion that includes representations that SCE's unregulated affiliates do not rely on SCE's credit or collateral. An EIX guaranty of an unregulated affiliate under the blanket proposal could prevent SCE from maintaining or obtaining a new non-consolidation opinion letter. Moreover, it would create on-going administrative burdens to monitor whether SCE's ring-fencing activities were still considered to be sufficient depending on changed circumstances.

The Commission's prohibition on cross-subsidization of unregulated affiliate activities by public utility affiliates is mirrored in substantial part on the Federal Energy Regulatory Commission's ("FERC") Affiliate Restrictions. In Order 707, FERC proclaimed:

[FERC's] fundamental goal . . . is to protect customers served by franchised public utilities from inappropriately subsidizing the market-regulated or non-utility affiliate of the franchised public utility or otherwise being financially harmed as a result of affiliate transactions and activities. In other words, we are concerned about the potential for the inappropriate transfer of benefits from such customers to the shareholders of the franchised public utility or its holding company.⁷

In summary, SCE continues to believe that the CAISO's focus should be to ensure that its credit policy provides sufficient protection to cover the activities of each individual market participant. However, if the CAISO continues to move forward with its current proposal, because of the significant regulatory restrictions against placing a regulated utility's assets at risk due to an unregulated affiliate's or parent company's activities, the proposed CAISO blanket guaranty would be in direct conflict with these affiliate restrictions to the extent that this proposal would put SCE's assets at risk. As such, SCE urges the CAISO to modify its proposal to exempt this requirement for entities that include a regulated utility among their subsidiaries from this requirement.

CAISO Response: CAISO is interested in understanding any valid regulatory concerns that should be considered in refining this proposal. The argument presented appears to be based on a misunderstanding of the CAISO's intent for the Affiliate Guaranty. Specifically, SCE writes

"As discussed below, a blanket parental guaranty that would allow a creditor of one subsidiary to look to the assets of another subsidiary is, in the case where one subsidiary is a regulated utility, in conflict with the purpose and requirements of affiliate restrictions on regulated utilities."

CAISO, by use of the Affiliate Guaranty, does not intend to allow CAISO to offset one Affiliate's defaulted amount due CAISO against amounts due to other Affiliates. Instead, we're asking the unregulated parent, who backs the obligations of one affiliate, to back the obligations of both affiliates.

⁷

FERC Order 707, p.28

7. With the knowledge that the ISO already has response time built into a collateral request, do you support the ISO's straw proposal to reduce the time to post additional Financial Security to three (3) Business Days?

SCE supports the CAISO's proposal to reduce the time required to respond to a collateral call from (5) business days to (3) business days.

CAISO Response: Noted.

8. Do you support the ISO's straw proposal to limit the amount of collateral for a CRR auction to 90% of available credit? Do you agree that Candidate CRR Holders that do not otherwise participate in the ISO market should be excluded from this policy?

SCE supports the CAISO's straw proposal to limit the amount of collateral for a CRR auction to 90% of a participant's available credit. SCE does not agree with the CAISO that Candidate CRR holders that do not otherwise participate in the CAISO market should be excluded from this policy. It is SCE's view that this policy should not be discriminatory but should apply to all participants that participate in the CRR auction.

CAISO Response: The rationale for excluding auction participants who do not otherwise participate in the CAISO market may have been inadvertently omitted from the discussion in the most recent stakeholder call. The thinking is that some entities may only participate in the CRR auction and have no other market activity. If they post, for example, the minimum of \$500,000 to participate in the auction, it didn't seem appropriate to limit that amount to \$450,000 (90% of \$500,000). The first problem is that this policy would result in this entity immediately violating the minimum collateral requirement to participate in the auction. Secondly, one of the purposes of this policy change was to ensure that Market Participants retained enough collateral to 1) not immediately trigger a collateral call and 2) leave a sufficient cushion for other market activity. Because this is new collateral specifically earmarked for the auction, it seems appropriate to exclude it from this policy.

Similarly, although it's not a requirement, some auction participants that are active in the CAISO market will post new collateral as a means of distinguishing that collateral from their "regular" market collateral. Like the first scenario, it doesn't seem appropriate to apply this 90% rule to them.

9. Upon finalization of all post MRTU design and implementation details of the financial penalties enhancement for late payers, do you support the ISO's straw proposal to assess Market Participants a financial penalty of an amount not to exceed \$20,000 calculated as the greater of 2% of the invoiced amount but not less than \$1,000 when a Market Participant pays an invoice late two or more times within a rolling twelve month period? Secondly, do you support the straw proposal that reduces a Market Participant's Unsecured Credit Limit to zero and require cash collateral for those Market Participants who pay late a third time within a rolling twelve month period? Thirdly, do you support funding a market reserve account with these financial penalties to a limit of \$5,000,000

with any funds in excess of this amount used as a credit toward the GMC revenue requirement in the subsequent year? Lastly, do you support the immediate implementation of the progressive discipline program, as outlined in the straw proposal document?

SCE supports the CAISO proposal to assess a financial penalty of an amount not to exceed \$20,000 calculated as the greater of 2% of the invoiced amount but not less than \$1,000 when a market participant pays an invoice late two or more times within a rolling twelve-month period.

SCE supports the CAISO's proposal to reduce a market participants UCL to zero and require cash collateral for those participants who pay late a third time within a rolling twelve month period.

SCE does not support funding a market reserve account with revenue received from late payments. SCE recommends the revenue received from financial penalties go to offset Grid Management Charge (GMC) revenue requirements in subsequent years.

SCE supports the immediate implementation of the progressive discipline program, as discussed in the straw proposal.

CAISO Response: Noted.

10. Upon finalization of all post MRTU design and implementation details of the financial penalties enhancement for not posting Financial Security within the posting period, do you support the ISO's straw proposal to assess Market Participants a financial penalty of an amount not to exceed \$20,000 calculated as the greater of 2% of the invoiced amount but not less than \$1,000 when a Market Participant fails to post Financial Security within the prescribed posting period on the third and each subsequent occurrence within a rolling twelve month period? In addition, do you support funding a market reserve account with these financial penalties to a limit of \$5,000,000 with any funds in excess of this amount used as a credit toward the GMC revenue requirement in the subsequent year? Lastly, do you support the immediate implementation of the progressive discipline program similar to the one described for late payers for failing to post on time?

SCE supports the CAISO proposal to assess a financial penalty of an amount not to exceed \$20,000 calculated as the greater of 2% of the invoiced amount but not less than \$1,000 when a market participant fails to post Financial Security within the prescribed posting period on the third and each subsequent occurrence within a rolling twelve-month period.

SCE does not support funding a market reserve account with revenue received from participants failing to timely respond to a collateral call. SCE recommends the revenue received from financial penalties go to offset GMC revenue requirements in subsequent years.

SCE supports the immediate implementation of the progressive discipline program, as discussed in the straw proposal.

CAISO Response: Noted.

11. Considering the Credit Working Group (CWG) structure and governance limitations described in the straw proposal, how would you see the CWG complementing the ISO's existing stakeholder process? Besides Market Participant credit and risk management professionals, who outside the ISO would add value and bring expertise to the CWG?

SCE envisions the Credit Working Group integrating with the existing stakeholder process. In particular, the CWG would be a central stakeholder group that would discuss credit policy enhancements and new market design initiatives that have specific impacts to the CAISO's credit policy. In addition, the CWG could be charged with developing credit policy enhancement proposals for stakeholder comment and board approval.

CAISO Response: Noted. CAISO will consider stakeholder comments on this matter, and work to arrange a CWG for future credit policy changes.

12. Please provide detailed pros and cons as well as consequences of the ISO continuing with its existing loss sharing policy. Are there certain credit policy enhancements that more equitably result in Market Participants sharing the risk of participating in the ISO market?

SCE opposes modifying the current loss sharing policy. The existing policy provides market participants with the ability to limit their exposure to a CAISO market default by allowing entities to net purchases and sales together. The existing loss sharing policy has been in effect for years and SCE sees no reason for modifying the policy at this time. SCE does not agree with some stakeholders that the current loss sharing policy acts as a disincentive for suppliers to participate in the CAISO markets.

CAISO Response: Due to widely disparate views on this issue as well as CAISO resource and system constraints as previously described during the course of this stakeholder process, the CAISO will not propose a change to the current loss allocation methodology at this time, but instead will continue discussion of this topic outside of the current credit policy enhancement stakeholder process. That being said, CAISO is of the view there is merit in bringing the current loss sharing policy into closer alignment with peers and that such a change could further align market participant interests toward the promotion of strong credit policies. However, CAISO recognizes the significant concerns that SCE and other participants have about this issue. Accordingly, CAISO is committed to a careful and thorough analysis of this issue and alternatives before potentially proceeding with any change.

13. Are you in agreement with the ISO's decision to remove the market funded reserve account and credit insurance from further consideration during this stakeholder process?

SCE agrees with the CAISO's decision to remove the market funded reserve account and the credit insurance from further consideration.

CAISO Response: Noted.