TO: Phil Leiber, Byron Woertz, CAISO

FROM: Ann Hatcher, Division Manager – Risk Analysis,
City of Santa Clara (Silicon Valley Power)

DATE: December 17, 2004

RE: Comments to the SC Credit Policy: Changes Under Consideration

The City of Santa Clara, doing business as Silicon Valley Power ("SVP"), appreciates this opportunity to comment on the California Independent System Operator Corporation's ("CAISO") Scheduling Coordinator Credit Policy review, dated November 10, 2004, ("Credit Policy Review").

SVP supports the creation of a CAISO credit policy that is meaningful, transparent and equitably applied to all similarly situated market participants.

General: Shortening Settlement Periods is Key:

The Federal Energy Regulatory Commission's ("FERC") Policy Statement on Credit-Related Issues for Electric OATT Transmission Providers, Independent System Operators and Regional Transmission Organizations, Docket No. PL05-3-000 ("FERC Policy Statement") issued on November 19, 2004, gives significant discussion to shortening settlement periods as a key, if not the key, method for reducing the size of credit risk exposure in an ISO/RTO setting. CAISO currently has the longest average settlement period of any of the existing ISOs and RTOs.

SVP supports the highest priority being given to reducing the numbers of days for which settlement is outstanding. We would extend the priority to not only shorting the outstanding settlement period, but also to improving the system for allocating partial payments, such that it does not require "up to 5 days" to re-allocate.

4.1 Setting Credit Limits:

There should not be unlimited credit granted to a Scheduling Coordinator (SC) even with an Approved Credit Rating. Credit limits should be tiered limits based on a calculated ISO-specific and transparent credit rating. Unsecured credit limits should only be available to investment grade rated entities or unrated, but otherwise clearly determined to be credit-worthy, public power agencies which possess greater ability to pass-through cost to customers. All entities with Agency Ratings below investment grade and/or one step from non-investment grade (i.e., BBB- or Baa3) should be required to provide security or collateral.

The CAISO discussion of the use of Moody's KMV default probability models for publicly-traded entities in setting initial (and ongoing) unsecured credit limits is intriguing and deserves more discussion. We believe that the large rating agencies already include some qualitative factors (management style, etc.) in their long-term ratings. This should for the most part satisfy the FERC's recent Policy Statement and in a manner that is considered more impartial than may occur if the CAISO was to attempt that analysis. It would appear that the KMV default probabilities provide a more rapid but yet completely quantitative analysis of default risk.

Given that public power agencies serve in excess of 30% of the load within the State of California, (and though a lesser percentage is within the CAISO control area there will remain availability from out-of-control-area resources for use within the CAISO control area,) and since the Moody's KMV default probability models do <u>not</u> apply to public power entities, there needs to be more specific discussion of how municipal utilities will be treated in a CAISO credit review. The default method appears to be that instead of a blended rating comprised of 50 percent of the Agency Rating and 50 percent of the rating implied by the KMV default probability, public power agencies would be rated strictly on the Agency Rating. This would still provide a transparent and objective method of determining the CAISO's Approved Credit Rating (ACR).

SVP would support a limitation on any one individual participant's unsecured credit to no more than some percentage of the CAISO's total market accounts receivable. Something in the 30% range should be a reasonable cap. (With lower cap for unrated agencies.)

SVP strongly supports one set of credit rating rules used for all charges that eliminates the separate treatment for GMC obligations.

4.2 <u>BAID/SCID specific security postings</u>

SVP supports the CAISO's recommendation for each SC to provide appropriate financial security for all SC IDs for which it is responsible for on a "net" basis.

<u>4.3/4.4 Security Agreements</u>

It is reasonable for the CAISO to require that security agreements all conform to California law and venue, and to accept fewer deviations from standard forms.

It will be the market participants who pay the legal cost of enforcement of security agreements by the CAISO, and it is reasonable that any such necessary action be arbitrated or litigated in a California venue, thus reducing the expense to CAISO staff and attorneys in such a situation. Why should the CAISO be forced to go to New York to enforce security agreements for business that was conducted within the State of California?

A question for CAISO staff: Prior to a security agreements expiration, is the CAISO monitoring to determine if a guarantor is still viable on an on-going basis (i.e. between expirations)?

4.5 Credit Insurance

In the FERC Policy Statement, the FERC recommends the consideration of credit insurance only to remove any ***residual*** mutualized credit risk. (Paragraph 31, emphasis added.) In other words, this should not be CAISO's first consideration, but should only be considered *after* more effort has been made to shorten settlement periods and consider other security requirements. Shortening the settlement period should reduce collateral requirements and reduce the amount of insurance required, with resultant lower costs to market participants.

It is premature for CAISO to be seeking insurance quotes, as appears to be the case, before implementing any of the other credit policy improvements. This is not a cost-effective approach as it insures that the quotes procured from insurers will be in excess of what is necessary because it is based on old and admittedly poor credit policies. SVP's concern is Structure 1 discussed in the Credit Policy review would become just another past-through GMC charge anchored at a high price quote that then voids the serious effort of improving CAISO settlement structure and credit policy.

The FERC's Policy Statement recognizes as a concern that any credit policy with high collateral requirements may create barriers to market entry. SVP would submit that unnecessarily high GMC costs also create barriers to market entry.

Buyers in the CAISO market, namely the IOUs who previously defaulted, benefit by having willing suppliers in the market. The value of credit insurance is to encourage more suppliers into the CAISO market *for the benefit of buyers*. It is inappropriate for the cost of any credit insurance to *only* be recovered from suppliers as suggested by Alternative 2b in Appendix C. It is extremely inappropriate for the cost of any procured credit insurance to be paid by *only* entities that have the audacity to have an "Approved Credit Ratings" as suggested by alternative 2c. Mutualized default risk applies to all market participants and thus such cost should be recovered from all market participants, as appears to be the practice of the NYISO and NEISO. However, as stated above, any cost of this type should be minimized by a reduction of the level of insured risk through other methods such as shortened settlement periods.

5. Liability Obligations

Many of the questions put forth by the CAISO in this section are the type of issues that would be best considered and addressed by a stakeholder advisory group on credit issues.

SVP would recommend the creation of a well-represented stakeholder advisory group to discuss the refinements to and accuracy of SCALE, the number of days to include in a liability calculation, the price volatility problems, and what level of security postings above the estimated aggregate liability is still appropriate if SCALE is refined. CAISO should be prepared to provide empirical evidence related to the different recommendations to the stakeholder advisory group.

The advisory group would also be able to assist the CAISO Finance Department develop the credit management functionality in the SaMC system.

[5.1 When a new entity without an ACR is certified as an SC, it is reasonable to allow the new SC to ramp up its obligation at the current number of days of participation plus 30 initial days, eventually ramping to the maximum obligation.]

6. Enforcement

Any enforcement discussion should include a discussion of the market participants due process rights. Some market participants have been subject to grossly incorrect calculation mistakes (overestimated liabilities) by the CAISO related to security requests. Other charges may be too difficult for a market participant to estimate before settlement. Penalties without a cure or "safe-harbor" right may be too harsh.

That said there should be more appropriate remedies than rejecting an SC's schedule. A charge penalty could reasonably be assessed if an SC were to exceed its approved credit limit and /or financial security in excess of a reasonable bandwidth percentage. This would also be another topic area that a stakeholder advisory group would be beneficial.

With respect to Late Payment Penalties, the question not being discussed in this section is why there is a "delay of up to five days in the distribution of payments" because of a failed payment by any SC. Has the system become so convoluted that what should be an automatic recalculation and pro-rata takes days to run?

The three-step process in assessing Late Payment penalties is reasonable by allowing plenty of warning to any SC.

What will the CAISO do with the Late Payment penalties, above and beyond interest, collected? Will it be used to fund a reserve account or some other offset to the benefit of all the market participants?

Conclusion

SVP thanks the CAISO for this opportunity to provide comments and looks forward to further participation in the stakeholder process.