History

• ISO New England was formed in 1997 and initially administered access to the transmission system and related billings
• To guarantee performance, participants were given the option of:
  – providing “secured” credit in the form of a letter of credit or cash, or
  – providing “unsecured” credit in the form of a corporate guaranty or based on the strength of their credit rating
• The pool agreed that any default that was not backed by secured credit would be socialized
  – all participants (and ultimately load) bear the cost of a default
• New England established “interim” markets in 1999 – primarily physical
• The credit policies established for transmission service were extended to market participation
• The markets initially cleared under $500 million and there were about 150 participants
Current Situation

• The markets have evolved with the advent of Standard Market Design and other improvements
  – Financial markets were added in 2003
  – incs/decs and financial transmission rights
  – Pending implementation of LTTR market
• With the advent of these markets came more and varied market participants
  – financial traders joined the markets
  – currently there are more than 400 participants – see next slide
• The dollars cleared in the markets also exploded, so that currently the energy markets are clearing nearly $10 B/year – see slide 5
• In clearing the wholesale energy trading markets the ISO is not a purchaser or seller and should not be considered a counter-party extending credit
• Recent financial crisis demonstrates the difficulty in evaluating the financial conditions of participants
• Several recent “near misses” with one of the largest investment grade players in the region publicly announcing that without financial relief bankruptcy was imminent
Annual Historical Market Participation, By Type of Participant

- Sector: Alternative Resources
- Non-NEPOOL / Other Market Participant (Transo-Only, DRP-Only, FTR-Only, Other)
- Sector: End User
- Sector: Supplier
- Sector: Generation
- Sector: Transmission
- Sector: Publicly-Owned Entity
Annual Historical Market Clearing Activity

Note: 1997 & 1998 are estimated data
ISO New England’s Position

• Given the ISO’s role as a market clearing agent coupled with the changes in New England, we do not believe that it is still prudent to offer participants unsecured credit
  – all participants in the markets should back their obligations with a form of secured credit like cash or a letter of credit

• Unsecured credit increases credit risk to market participants (up to $75 million per qualified participant)
  – Defaults are socialized to all participants

• Equally if not more important is the effect on markets
  – Unsecured credit encourages unmitigated risk-taking by leveraging the ISO’s “costless” credit provisions
Steps Taken to Date

• We have taken all of the alternative steps available to us to minimize the risk
  – weekly settlements
  – accelerating the settlement of the energy markets
  – minimizing the amount of financial assurance required

• With stakeholders, we will continue to work to reduce the risks of default and the costs of collateralization, e.g.:
  – shortening the bill payment grace period to 2 days from 3
  – shifting the bill issuance date to remove the weekend from the bill grace period, thereby eliminating 2 days of risk
  – billing more frequently (e.g., bi-weekly bills)
  – accelerating settlements of non-hourly markets
  – calculating FA more precisely at the market level, thereby eliminating certain excess collateralization conditions
Addressing Stakeholder Concerns

• Some stakeholders have expressed concern that requiring security will decrease participation in the ISO’s markets due to increased costs
• We have actively engaged with stakeholders on these issues over the last ten months
• We have been able to agree on certain steps but have yet to reach consensus on the provision of unsecured credit
Addressing Stakeholder Concerns (cont’d)

• We understand that stakeholders are concerned about the cost of collateralization and the impact on market liquidity
  – Unfortunately, this is already occurring due to the current financial situation.
  – Furthermore, we believe concerns of a damaging drop of market liquidity are much more likely to occur given a major uncovered default (e.g., 2000-2001 in California)
  – The ISO believes the cost to the market of largely eliminating unsecured credit is very low given that many competitive standard offer RFPs are won by those already posting collateral
  – “Small” participants are currently required to post collateral
    • About 90% of non-municipal participants exclusively post secured collateral
    • Approximately 80% of total FA requirements are met with secured collateral
  – We have taken steps to ensure that full collateralization of risks will not represent a serious barrier to entry into the markets
    • Accelerating settlement, minimizing FA, etc.
  – We are also willing to phase-in full collateralization to minimize the burden and expense
Conclusion

• We understand that we are trying to solve for an unquantifiable risk, and that to date we have been able to avoid a major default

• Nonetheless, we believe that we must move away from unsecured credit, given:
  – the evolution in the size and type of markets
  – increased participation in those markets
  – best practices of other markets