FEDERAL ENERGY REGULATORY COMMISSION
CREDIT AND CAPITAL ISSUES AFFECTING THE ELECTRICITY POWER INDUSTRY
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Summary of Comments of Robert Ludlow, Vice President and CFO
Panel II: Credit Issues in Short-Term Electricity Markets

History

ISO New England was formed in 1997 and initially administered access to the transmission system and related billings for approximately 115 participants

To guarantee performance, participants were given the option of either 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

Any default that was not backed by secured credit would be socialized, so that all participants would 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

There were about 150 participants

Current Situation

The markets have evolved with the advent of Standard Market Design and other improvements

"Financial" markets like "virtual" incs/decs and financial transmission rights were added in 2003

More Recently, the Long Term Transmission Rights market has been added which significantly amplifies risks

The advent of these markets brought more and varied market participants, including financial traders – currently there are more than 400 participants – see chart

The dollars cleared in the markets also exploded, with the energy markets currently clearing nearly $10 B/year – see chart

The ISO's role is to clear the energy trading markets- we are not a purchaser or seller in the markets and should not be considered as a counter-party extending credit

While ultimate recovery of charges is important in reducing the credit cost of defaults, the immediate receipt of all invoiced charges is critical for the ISO to successfully perform its role while maintaining market participant's confidence in ISO's clearing function

The recent financial crisis has clearly demonstrated the challenge faced by the most sophisticated of credit risk professionals in evaluating the financial condition of Participants

Recently there have been "near misses" and one of the largest investment grade players in the region publicly announced that without financial relief it would have declared bankruptcy

ISO-NE's Proposal

In its role as a market clearing agent, combined with the changes in the magnitude and types of electricity markets and participation in those markets, it is not prudent to offer participants unsecured credit

Said otherwise, we believe that all participants in the markets should back their obligations with a form of secured credit like cash or a letter of credit

This merely mimics the best practices utilized in other markets, as other panelists will discuss

To continue to offer unsecured credit risks socializes defaults – among other things, this exposes sellers to risk of defaults of buyers

It also encourages unmitigated risk taking by using the ISO markets and its participants to provide collateral for bilateral transactions, rather than having the transacting parties ensure sound credit for the transaction

We have taken all of the alternative steps available to us to minimize the risk, like going to weekly settlements and accelerating the settlement of the energy markets, thereby permitting us the ability to minimize the amount of financial assurance required

Stakeholder Process

We have actively engaged with stakeholders on these issues over the last ten months, at the plenary level, subcommittee level and working group level

We have been able to agree with stakeholders to take certain steps to bolster FTR market qualification criteria and ISO bankruptcy protections, although, we believe more protections are required

However, we have yet to reach consensus on the provision of unsecured credit

Stakeholder Concerns

Some stakeholders believe that requiring security will decrease participation in, and liquidity of, the energy markets. Unfortunately, this is already occurring because of the current financial situation.

Furthermore, we believe this has a much higher likelihood of occurring if a major, uncovered default occurs – like in 2000-2001 in California

Certain stakeholders express concerns about the cost of collateralization – the ISO believes that this cost is very low given that many competitive standard offer RFPS are won by those posting collateral

However, "small" participants are already required to post collateral; currently, approximately 90% of non-municipal participants are required to post secured collateral. These participants represent 80% of the total FA requirements of NEPOOL

In any case, we have taken steps to ensure that full collateralization of risks will not represent a serious barrier to entry into the markets

As noted above, we have accelerated settlement of the energy markets and minimized financial assurance calculations to prevent over-collection of collateral

We are committed to engaging the stakeholder process in taking further steps 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
- Considering opportunities to bill more frequently (e.g., bi-weekly bills),
- Continuing to pursue accelerated settlements of non-hourly markets
- Working to introduce more precise FA calculations conducted at the market level, thereby eliminating certain excess collateralization conditions

As we capitalize on the efforts toward shrinking the settlement cycle time, it becomes more critical to ensure that funds are available to ensure the clearing of the markets in a timely manner

While we believe it important to swiftly and judiciously mitigate the risks posed by the extension of unsecured credit, we also believe a phase-in to full collateralization is an appropriate approach

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 the evolution in the size and type of markets, increased participation in those markets, and the best practices of other markets dictate that we move away from unsecured credit