UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Electric Creditworthiness Standards) Docket No. AD04-8-000

TECHNICAL CONFERENCE COMMENTS
AND MOTION TO INTERVENE OF THE
NEW YORK INDEPENDENT SYSTEM OPERATOR, INC.

Pursuant to the Notice of Technical Conference and Request for Written Comments On Credit-Related Issues for Electric Transmission Providers, Independent System Operators, and Regional Transmission Organizations issued May 28, 2004, in the above-captioned proceeding,[1] the New York Independent System Operator, Inc. ("NYISO") hereby respectfully submits these comments in response to selected questions posed in the Request For Comments regarding potential creditworthiness standards for the electric industry.

[1] *Electric Creditworthiness Standards*, Notice of Technical Conference and Request for Written Comments on Credit-Related Issues for Electric Transmission Providers, Independent System Operators, and Regional Transmission Organizations, Docket No. AD04-8-000 (May 28, 2004) ("Request For Comments").

I. COMMUNICATIONS

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II. MOTION TO INTERVENE

The NYISO is a not-for-profit corporation responsible for providing open access transmission service, maintaining transmission system reliability, and administering competitive wholesale electricity markets in New York State. The NYISO acts as the settlement agent between buyers and sellers for electric market transactions; those transactions totaled nearly $6.7 billion last year. The NYISO administers credit requirements pursuant to which each of its customers' risk profiles are determined and necessary collateral is collected and held to protect against market losses from defaults. Without the proper credit protections in place, any bad debt resulting from a default would be mutualized among the remaining market participants. By virtue of the markets it administers, the NYISO has a direct and substantial interest in this proceeding as the Commission's rulings may ultimately affect the NYISO's administration of its markets. The NYISO will not be adequately represented by any other party in this proceeding and, unless permitted to intervene and participate fully, may be bound or adversely affected by a Commission order issued herein without an opportunity to have its views heard and considered. Consequently, the NYISO's intervention, and its participation as a party in this proceeding, is in the public interest.

III. COMMENTS

The NYISO submitted comments in response to the Gas Credit NOPR[2] which included comments on creditworthiness standards for the electric industry.[3] The NYISO hereby incorporates by reference those comments into the instant docket. For ease of reference, the Executive Summary from those comments is included below:

> The NYISO strongly supports the Commission's initiative to develop creditworthiness standards for the natural gas industry and certain aspects of the electric industry. The NYISO submits that successful creditworthiness standards should be based on accepted business practices and trade credit principles. Rooting standards in this already familiar framework will help assure adequate collateral requirements to protect the market from defaults. This concept is critical because in many ISO / RTO situations market participants bear the burden of bad debts caused by inadequate collateral. The NYISO urges the Commission not to allow its commitment to reduce barriers to entry overshadow the need for adequate collateral to protect the market. To do otherwise would effectively force more creditworthy market participants to subsidize the less creditworthy market participants.
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> Further, NYISO believes that standardization is generally beneficial, but urges the Commission to continue to recognize the need for credit and security differences among the RTO/ISO markets as it has with other "regional" variations. Standardizing the evaluation of a company's financial health and consequently its unsecured credit is completely logical. Current industrial rating mechanisms (*e.g.,* S&P, Moody's ratings) recognize that for purposes of determining a company's overall financial health, geography is largely irrelevant. However, applying generic financial or risk indices to specific electricity markets and products is a more complex task. Thus, the Commission should recognize that different geographic areas have very different electricity markets and that "generic" creditworthiness standards will need to be tailored to markets and products of varying stages of development and complexity.
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> Accordingly, the NYISO strongly urges the Commission to accommodate the existing Commission-approved credit policies that some ISOs / RTOs have

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[2] *Creditworthiness Standards for Interstate Natural Gas Pipelines,* 69 Fed. Reg. 8,587 (Feb. 25, 2004), FERC Stats. & Regs., Notice of Proposed Regulations ¶ 35,573 (2004) ("Gas Credit NOPR").

[3] *Comments of the New York Independent System Operator, Inc.,* Gas Credit NOPR (April 2, 2004).

developed when it considers generic standards for the electricity industry. To the extent the Commission intends to impose creditworthiness standards in the existing competitive electricity markets, the NYISO submits that its recently-approved comprehensive credit policy would serve as a rational, workable model.[4]

IV. RESPONSES TO SPECIFIC QUESTIONS

The NYISO scheduled two teleconferences to solicit stakeholder input on the specific questions the Commission posed in its Request For Comments.[5] Stakeholders were encouraged to provide their individual comments directly to the Commission and, while the instant filing represents the NYISO's position, the input received from the stakeholders was very useful in the NYISO formulating its position. For ease of reference, these Comments adopt the same numbering of the questions as used in the Request For Comments.

<u>Question # 6:</u>

Are credit requirements and costs related to creditworthiness negatively impacting market participation in ISO/RTO markets and liquidity levels?

Credit requirements are tools which serve to protect against loss in the event of a default. As such, the extent of those requirements are fundamentally premised upon an organization's tolerance for risk resulting from a loss. As the Commission recognized in its Request For

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[4] *Comments of the New York Independent System Operator, Inc.,* pp. 3-4, Gas Credit NOPR (April 2, 2004).

[5] The teleconferences were held on June 9, 2004 and June 18, 2004 and each lasted approximately two hours. In addition to notifying the Credit Policy Task Force of those teleconferences, the NYISO also sent notifications to the Scheduling and Pricing Working Group and Business Issues Committee distribution lists to assure adequate notice to stakeholder of the invitation to participate in the teleconferences. Those forums also allowed identification of several issues for further stakeholder discussion on the NYISO credit policy as it pertains to: (i) the Transmission Congestion Contracts markets; (ii) the Virtual Bidding Market and (iii) the bidding process in the Installed Capacity market.

Comments, under typical RTO/ISO markets "if one market participant defaults, it falls upon the remaining market participants to make up the shortfall (*i.e.* the default risk is mutualized.)[6] Consequently, in such environments where default risks are mutualized among the market participants, credit requirements should reflect the market's "collective tolerance for risk from a credit loss."

While a specific level or metric to quantify the NYISO market participants' tolerance for risk resulting from credit loss has not been established, the NYISO staff has interpreted the various comments provided and actions taken by during market participant stakeholder processes over the last three years in establishing the revised credit policy to be supportive of the position that the NYISO market participants' tolerance for a credit loss is very low and the credit policy contains collateral requirements commensurate with that very low risk tolerance. Under that premise, the NYISO does not believe its credit requirements are negatively impacting market liquidity levels, but rather, that the credit requirements are commensurate with the market participant's very low risk tolerance. Should the risk tolerance change as it pertains to certain of the NYISO administered markets, the credit policy should be fully vetted and modified as required.

The NYISO respectfully recommends that any assessment of whether collateral requirements negatively impact market liquidity must include an inquiry of exactly what tolerance for loss the credit protections are designed to protect. The tolerance for risk of loss will dictate the balance between the competing concerns of protecting the market from loss with high collateral requirements, and reducing barriers to entry to improve market liquidity.

[6] Request For Comments, p. 3.

<u>Question # 7</u>

What cost-effective steps can be taken to minimize exposure to risk among market participants (*e.g.*, shortening settlement periods, or evaluating credit on a net obligation basis?

The shortening of the settlement periods is one mechanism to reduce the exposure to risk. The NYISO is working with market participants to actively explore ways to modify settlement periods in a cost effective manner in the context of the New York markets.

A second method to reduce risk of loss and lower the cost of credit worthiness would be to provide market participant's with the ability to either pre-pay for services or make a periodic "pay down" of the liability incurred to date. These payments would then be applied to the aggregate settlements via the invoicing process. The NYISO's credit policy currently offers both pre-payment and pay down options.

A third method to reduce risk of loss and lower the cost of creditworthiness would be to evaluate credit requirements on a net obligation basis. "Netting" has been implemented within the NYISO credit policy for all markets with the exception of the Virtual Transaction Markets[7] and has served to lower collateral requirements for many market participants.

<u>Question # 8</u>

Are there elements of existing market rules that can be improved to reduce unnecessary credit requirements?

The NYISO regularly works with market participants through its stakeholder process to identify elements of existing market rules that can be improved. The current NYISO credit

[7] The concept of allowing netting to apply to the Virtual Transactions Markets will be reviewed via the stakeholder process as part of the NYISO continued review of credit policies over the balance of 2004.

policy requires credit support either in the form of an allocation of a market participant's unsecured credit line or collateral held by the NYISO in order for a market participant to bid in the Installed Capacity or TCC auctions. This requirement is designed to protect the market from a market participant who is the successful bidder from refusing to pay for the product once the bid had been awarded.

The NYISO will review this process to determine if there is an alternative method to provide the market with confidence that this type of exposure can be minimized without requiring credit to be posted as part of the Installed Capacity and TCC bidding process.

Question #9

How can the mutualized default risk in ISOs/RTOs be reduced?

Any mechanism employed to reduce the mutualized default risk must involve a means to transfer the risk away from the market. This could be accomplished in several ways. For example, credit insurance ostensibly accomplishes this goal, but as the Commission has observed such insurance is "expensive and the ultimate responsibility still lies with the market participants."[8] Credit default swaps could also accomplish this goal.

While shifting the risk away from the market to reduce mutualized default risk is an attractive concept, it must be recognized that the party accepting the shifted risk will not do so without compensation.

[8] Request For Comments, p.3.

Question #13

Is there a need to allow for regional variations among RTOs/ISOs with regard to credit policies? If so, what level of standardization may be achieved?

The NYISO supports the initiative to standardize creditworthiness requirements to an appropriate extent, but the NYISO respectfully cautions that one size may well not fit all in areas within the electric industry because many of the markets, and within different control areas, are either not the same or at different stages of evolution. Not all electric control areas even have markets, of the areas that do, some areas are highly congested, and some areas have very little congestion. Some ISOs run multiple markets (such as energy and ancillary services, installed capacity, virtual bidding, transmission congestion contracts markets) while other ISOs run only energy markets. Consequently, standardization of creditworthiness requirements will have to take these very real market differences into account.

The NYISO strongly supports the standardized criteria for determining the financial wherewithal of a company without regard to the area in which the company is operating. These standards should be closely tied to the senior long-term unsecured debt ratings and default probability ratings of the major industry rating agencies such as Moodys, Fitch, and Standard and Poors or alternative substitutes for companies that do not have such ratings. The ultimate result of that consideration should be arriving at an amount, if any, of unsecured credit a company should be granted. This determination should be independent of the control area in which the company desires to operate.[9]

[9] Under the NYISO's credit policy a transmission customer's unsecured credit is not allowed to exceed market concentration cap based upon the NYISO's total accounts receivables to guard against other market participants absorbing a drastic loss in the event of a default.

The determination of a company's collateral requirement will be more difficult to standardize based upon the different markets in a particular control area. Any policy developed by the Commission must accommodate the greatly differing components of all the markets covered. In short, some level of standardization is possible, but real differences need to be recognized.

Question #14

Can Clearing be applied to the electricity industry with respect to transmission Providers and/or non-ISO/RTO markets, as it has been in other sectors (for instance, equity and fixed income clearing is performed by the Depository Trust Clearing Corporation for trading on the New York Stock Exchange, American Stock Exchange, and NASDAQ)? If so, what type of new or existing entity would provide the clearing services and does it need to be granted a franchise monopoly for any or all of its services?

The NYISO is currently investigating, along with market participant input, the feasibility of utilizing a clearing house concept. As part of that effort, the NYISO recently invited and heard a presentation by a potential clearing house corporation on this issue. Any clearing mechanism will have to be cost effective and compatible with the New York markets.

V. CONCLUSION

WHEREFORE, the New York Independent System Operator, Inc. expresses its appreciation for the opportunity to present these comments and respectfully requests that the Commission consider these comments for inclusion at the July 13, 2004 Technical Conference.

Respectfully submitted,

NEW YORK INDEPENDENT
SYSTEM OPERATOR, INC.

By *____/s/ Andrew S. Antinori____*
Andrew S. Antinori

June 25, 2004

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in Docket No. AD04-8-000 in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure 18 C.F.R. § 2010 (2003).

Dated at Albany, N.Y. this 25th day of June, 2004.

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