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NEW YORK INDEPENDENT SYSTEM OPERATOR SM

February 17, 2005

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Honorable Magalie R. Salas
Secretary
Federal Energy Regulatory Commission
888 First Street, NE
Washington, DC 20426

Report of New York Independent System Operator, Inc.
in Docket No. PL05-3-000

Dear Ms. Salas:

Pursuant to the Commission's November 19, 2004, Policy Statement on Credit-Related Issues for Electric OATT Transmission Providers, Independent System Operators and Regional Transmission Organizations[1] ("Policy Statement"), the New York Independent System Operator, Inc. ("NYISO") hereby submits this report.

I. Communications

Communications regarding this proceeding should be directed to:

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[1] 109 FERC ¶ 61,186 (2004).

II. Background

In the Policy Statement, the Commission recognized that major changes in the electric power industry have meant that the credit policies of both non-independent Transmission Providers and Independent System Operators ("ISOs")/Regional Transmission Organizations ("RTOs") are increasingly significant.[2] To that end, the Policy Statement revisited Commission policy concerning various credit-related issues.

The Policy Statement stressed, among other things, the importance of increased transparency of credit policies and, as pertains to ISOs and RTOs, the need to implement policies that reduce mutualized default risk. The Policy Statement noted that the credit risk in ISO and RTO markets is generally spread among all market participants and, therefore, when one market participant defaults on its obligation, the loss affects all other market participants and not generally the ISO or RTO itself.[3]

The Commission expressed its expectation that ISOs and RTOs report to the Commission within 90 days of its issuance of the Policy Statement. The Commission specifically instructed that ISOs and RTOs should report on their progress toward implementing shortened settlement periods, netting, or any other measures that they determine might serve to reduce the mutualized default risk in their markets or their reasons for not yet adopting such measures.

III. NYISO's Report

The NYISO has substantially revised its credit policies over the past several years in response to Commission orders and with extensive stakeholder input. These revisions have resulted in significant improvements, both from the point of view of individual customers and the marketplace as a whole. The NYISO has amended its tariffs to include detailed customer credit requirements, providing greatly increased transparency. Through this process, the NYISO has better defined the specific credit risks it faces and the most effective means of addressing them, resulting in improved credit protections without unduly burdening customers. The NYISO also has worked to develop new means of allowing customers to meet the credit requirements for participating in the markets it administers, including through netting, prepayment and paydown programs, and provisions for granting unsecured credit to creditworthy customers that would not have qualified under the NYISO's previous rules, thereby lowering the barriers to entry without unduly increasing the risk of mutualized credit losses.

The NYISO believes that its current credit policies largely reflect the principles established by the Commission in its Policy Statement, as discussed in further detail below. The NYISO continues to work with its stakeholders, however, to ensure that its credit policies evolve along with its markets and to adopt additional improvements where possible to increase transparency and lower customer credit requirements without increasing mutualized credit risk.

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[2] Policy Statement at P 1.

[3] *See* Policy Statement at P 17-18.

A. Transparency and Predictability

In the Policy Statement, the Commission emphasized the need for transparency and predictability in customer credit requirements. As the Commission noted, it is important that customers be able to determine *ex ante* the credit requirements for participating in ISO markets and that they have sufficient information to know that credit policies are being applied in a reasonable, non-discriminatory manner.

The NYISO's credit requirements are contained in its tariffs and provide significant transparency and predictability to customers. These tariff provisions, comprising 28 pages of detail, establish: (i) financial reporting requirements, (ii) operating requirements for participation in each of the NYISO-administered markets, (iii) the criteria and method of calculation for unsecured credit, (iv) acceptable forms of security, (v) available netting options, (vi) shortened settlement cycle alternatives, and (vii) credit default and termination rules. These provisions enable customers to largely determine their own credit requirements for participating in the NYISO-administered markets and the available means of satisfying those requirements.

The NYISO recognizes that, as it has continued to work with stakeholders to lower individual credit requirements without unduly increasing mutualized credit risks, its credit requirements have necessarily grown more detailed and complex. While it views this as a worthwhile tradeoff, the NYISO also recognizes that for credit policies to be truly transparent, customers must be able to understand them. Upon request, the NYISO will provide written detail regarding the calculation of an individual customer's credit requirements. In addition, NYISO staff works closely with individual customers to answer questions regarding the determination each customer's operating requirement and the amount of unsecured credit granted to each customer.

In an effort to further increase the transparency of its credit policies, the NYISO is adding a session to its market training program (the New York Market Orientation Course) to familiarize customers with its credit requirements and the associated calculations. The NYISO may also offer this training as a stand-alone course if there is sufficient customer interest.

B. Quantitative and Qualitative Factors

The Commission indicated in the Policy Statement that ISOs should consider qualitative as well as quantitative factors when assessing customer creditworthiness. While the NYISO agrees, and uses both qualitative and quantitative factors in determining the amount of unsecured credit to extend to a customer, the NYISO also believes that a rule-based approach emphasizing quantitative factors generally provides the greatest transparency and consistency. The NYISO has therefore sought a blended approach whereby qualitative considerations are formally incorporated into its credit rules, as described below, rather than applied *ad hoc*. This allows the NYISO to recognize unique customer attributes or circumstances without sacrificing a transparent, rule-based approach to administering its credit policies.

The NYISO's "credit assessment" methodology, which is used to adjust the starting point for unsecured credit that may be extended to a customer, includes a qualitative component weighted at 15%, as established in the NYISO tariffs. In addition, the unique qualitative characteristics of certain customer classes are taken into account under the NYISO's tariffs.

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Municipals and cooperatives, for example, are presumptively granted an unsecured line of credit of $1,000,000 each under the NYISO credit policies on account of the uniquely low risk profile presented by these entities. In addition, certain state entities for which a meaningful tangible net worth calculation cannot be derived are permitted to use substitute measures.

The Commission also stated that customers without a credit rating should not automatically be denied unsecured credit. The NYISO agrees that such a rule would be unduly restrictive and therefore has incorporated into its credit polices provisions that allow an unrated customer to request an "equivalency rating" from the NYISO to qualify for unsecured credit. The NYISO uses Risk Calc, a Moody's KMV product that is commercially available to calculate equivalency ratings.

C. Shortened Settlement Period

The Commission stressed its interest in shortened settlement cycles as a means of reducing mutualized credit risk and customer credit requirements. The NYISO recognizes the benefits of a shortened settlement cycle for reducing default risks and is carefully examining ways to make those benefits available to its customers. In the meantime, the NYISO has developed voluntary programs that are the functional equivalent of a shortened settlement cycle for the individual customers that opt into the programs.

The NYISO's prepayment program offers the functional equivalent of a shortened settlement cycle for the customers that participate in it. This program allows a customer to prepay weekly for its purchases of energy and ancillary services, effectively shortening its settlement cycle from one month to one week. This shortened settlement period reduces the credit risk posed by the customer, which in turn allows the customer to enjoy a reduced credit requirement. On average, customers participating in the prepayment program have been able to reduce their credit requirements for purchases of energy and ancillary services by approximately 88%.

In addition, the NYISO has implemented a "paydown" mechanism that allows a customer to pay down its obligations to the NYISO as it approaches the amount of its unsecured credit and any security it has already provided. This allows the customer to manage its credit requirement for energy relative to its usage in a given month in exchange for its agreement to make payments to the NYISO upon demand after incurring charges exceeding a specified amount. On average, customers participating in the paydown program have been able to reduce their credit requirements for purchases of energy and ancillary services by approximately 50%.

The NYISO also retained an independent consultant, R.J. Rudden Associates, to examine possibilities for shortening the NYISO settlement system. The consultant's report was posted on the NYISO's website and distributed to market participants. The NYISO then convened a stakeholder working group to discuss the various issues associated with a shortened settlement cycle. While there is widespread recognition of the potential benefits of a shortened settlement cycle, there are also a number of concerns and open issues to be addressed. The NYISO is continuing to examine the near-term feasibility of a shortened settlement cycle.

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D. Netting

In the Policy Statement, the Commission indicated that, to the extent practicable, ISOs should adopt netting procedures to reduce customer collateral requirements. Specifically, the Commission identified three types of netting: (1) netting accounts payable and accounts receivable within one product class, (2) netting accounts payable and receivable across products, and (3) netting internal bilateral energy contracts. The first two types of netting, within and across markets, are already permitted under the NYISO's credit policies, and these practices significantly reduce customer collateral requirements. In addition, the NYISO is planning for the study and development of a program to allow the third type of netting.

The NYISO has applied netting within the energy and ancillary services markets since it began operations in 1999, significantly benefiting customers. The NYISO implemented netting across markets in early 2004, resulting in approximately a 60% reduction in the collateral required to be provided by participating customers. Finally, the NYISO has added the study and development of a program that would allow netting of internal bilaterals to its project development list. Resources permitting, the NYISO will begin work on this initiative this year.

IV. Conclusion

WHEREFORE, the New York Independent System Operator, Inc. respectfully requests that the Commission accept this progress report.

Respectfully submitted,

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