

Proposed Revisions to Investment Strategy for Market Participant Cash Collateral

NYISO

Business Issues Committee

June 10, 2005

Proposed Revisions to Investment Strategy:

Current Investment Strategy

- Investment Goals for Cash Collateral:

1. Safety of principal *(currently fully achieved)*
2. Liquidity of funds *(currently fully achieved)*
3. Earnings *(significant opportunity for improvement exists)*
4. Ease of administration *(some opportunity for improvement exists)*

- Current Practice:

- Victory Gradison Government Reserves money market fund, administered by Key Bank. Fund consists of federal agencies, with maturities approximating 30 days.

- Historical Returns on the Victory Gradison Government Reserves fund have been:

2000	5.52%	2003	0.40%
2001	3.15%	2004	0.60%
2002	1.08%	2005 (YTD)	1.66%

Proposed Revisions to Investment Strategy: **Revisions Requested by Market Participants**

MP Requests – as presented to S&P in February:

- Overall Objective: Achieve greater earnings on cash collateral deposits.
- Flexibility: Request several investment possibilities with maturities of two years or less, including treasuries, agencies, various bonds and money market instruments, all of which would be participant-directed
- Valuation: Request lender to provide NYISO with periodic statements for invested funds.
- Risk of Loss: Willing to provide “premium” as additional collateral for invested funds subject to market fluctuation.
- Timing: Request implementation as soon as possible.

Proposed Revisions to Investment Strategy: NYISO Proposal

NYISO Response to Market Participant Requests:

After researching several options, NYISO recommends transferring existing cash collateral deposits from Key Bank to BlackRock, Inc. BlackRock is the investment banking arm of PNC Financial Services, has more than \$390 billion under asset management, and has experience managing ISO MP cash collateral deposits.

Phase I – Alternate Money Market Funds:

- Replace Victory Gradison Reserves fund with two BlackRock money market funds, one taxable and one tax-exempt, with higher historical returns (generally ~70 bps higher)
- No tariff changes or MP motions are required
- Implementation targeted for August – September

Phase II – Bond Funds:

- Offer two BlackRock bond funds (one short-term and one intermediate term) for market participants who wish to invest some or all of their cash collateral into investments with potential for higher returns
- Implement “premium” concept into financial assurance requirements to offset market volatility for bond funds
- Requires tariff change – Attachment W of OATT and Attachment K of MST
- Implementation targeted for October - November

Proposed Revisions to Investment Strategy: Administrative Overview

- NYISO completes documentation with BlackRock to transfer existing collateral
- MPs notify NYISO which investment type / fund for their collateral (must be officer with authority to bind MP)
- MPs provide additional funds for premiums on bond funds, if selected
- BlackRock establishes separate account for each MP's collateral balance using tax ID of each MP. Accounts in NYISO's name for benefit of MP - only NYISO has access to funds.
- BlackRock invests in specified investment(s)
- BlackRock remits interest earnings monthly directly to MPs
- BlackRock prepares monthly statements and generates tax reporting directly to MPs (with copies to NYISO)
- Distributions made by NYISO, when necessary
- NYISO Credit department to review market value of MP investments monthly. Margin calls made if value of premium eroded by 50% or more
- Limitations will exist regarding transfers between funds in a given calendar year. Minor administrative changes may also be made to the timing of refunds and establishment of minimum balances for investment in the bond funds.

Proposed Revisions to Investment Strategy

Fund Specifics

BlackRock Fund Name	Fund Type	Ticker Symbol	Credit Rating	Average Maturity *	Fund Composition *
TempFund ***	Money market fund: taxable	TMPXX	AAA	27 days	30% Commercial Paper, 22% CDs, 20% Repos, 18% Variable Obligations, 10% Other
MuniFund	Money market fund: tax-exempt	MFTXX	AAA	28 days	81% Variable Obligations, 12% General Mkt Notes, 7% Other
Low Duration Bond Fund	Bond Fund	BFMSX	**	2.19 years	41% Treasuries, 15% Asset-Backed Securities, 13% Agencies, 13% Variable Obligations, 9% Corporate Bonds, 9% Other
Core Bond Total Return Fund	Bond Fund	BFMCX	**	6.70 years	34% Treasuries, 25% Mortgage-Backed Securities, 22% Corporate Bonds, 19% Other

* Average maturity and fund composition were as of March 31, 2005.

** Bond funds are typically not rated by either S&P or Moody's. However, the credit ratings of the underlying fund investments as of March 31, 2005 are as follows:

Low Duration Bond Fund: 93% AAA or government-backed, 4% AA, 1% A, 2% BBB

Core Bond Total Return Fund: 83% AAA or government-backed, 9% AA, 3% A, 5% BBB

*** TempFund will be the default for MP cash collateral deposits, unless MP directs NYISO to invest in other options listed above.

Proposed Revisions to Investment Strategy

Fund Specifics

BlackRock Fund Name	Expense Ratio	30-Day Yield at 3/31/05	% Return						Prem. %
			YTD through 3/05	2004	2003	2002	2001	2000	
TempFund	0.18%	2.53%	0.59%	1.26 %	1.60 %	1.74 %	4.13 %	6.45 %	N/A
MuniFund (tax-exempt)	0.20%	1.70%	0.41%	1.04 %	0.91 %	1.36 %	2.64 %	3.96 %	N/A
<i>MuniFund (as taxable-equiv. *)</i>	0.20%	2.61%	0.63%	1.60 %	1.40 %	2.09 %	4.06 %	6.09 %	N/A
Low Duration Bond Fund	0.55%	3.01%	-0.05%	1.35 %	1.89 %	5.94 %	7.73 %	8.27 %	5%
Core Bond Total Return Fund	0.55%	4.01%	-0.23%	4.53 %	4.31 %	9.68 %	8.20 %	12.23 %	10%

** Note: The taxable-equivalent presentation here is for informational comparative purposes only. The assumed tax rate used is 35%, although tax rates will vary by market participant. The rate utilized for this example is illustrative only.*

Proposed Revisions to Investment Strategy:

Summary of Benefits

- Greater Earnings:
 - * **Proposed money market fund has historically averaged ~70 bps higher than existing money market fund**
 - * **Introduction of tax-exempt money market fund provides MPs with potential for higher taxable-equivalent yields than taxable money market funds**
 - * **Introduction of bond funds provides MPs with additional opportunity for earnings**
- Additional Flexibility:

Four different options allow MPs to evaluate their own financial objectives and to select best-suited option(s)
- Improved Administration:
 - * **Separate accounts reduce NYISO administrative burdens and strengthen controls**
 - * **MPs have greater visibility to collateral deposits**
 - * **MPs receive monthly interest payments, account statements, and tax reports directly from BlackRock**
- Preservation of Primary Investment Principles:
 - * **Premium percentages applied to bond funds are conservative & preserve underlying principal for potential usage**
 - * **Investment into funds, rather than direct securities, maintains liquidity**
 - * **Proposed changes do not result in any additional fees to NYISO operating budget**

Proposed Revisions to Investment Strategy:

Timeline

	Phase I	Phase II **
	<u>MM Funds</u>	<u>Bond Funds (with Prem.)</u>
• BIC motion	N/A	June 7
• MC motion	N/A	June 21
• NYISO BOD approval	July 18	July 18
• FERC filing	N/A	July 31
• FERC ruling	N/A	September 30
• Implementation	Aug/Sept	Oct/Nov

*** Assuming adequate MP interest, Phase II will proceed under this schedule.*