NYISO Virtual Credit Requirements

Presentation to

Scheduling & Pricing Working Group

In Response to

NYISO Virtual Collateral Proposal

October 2006

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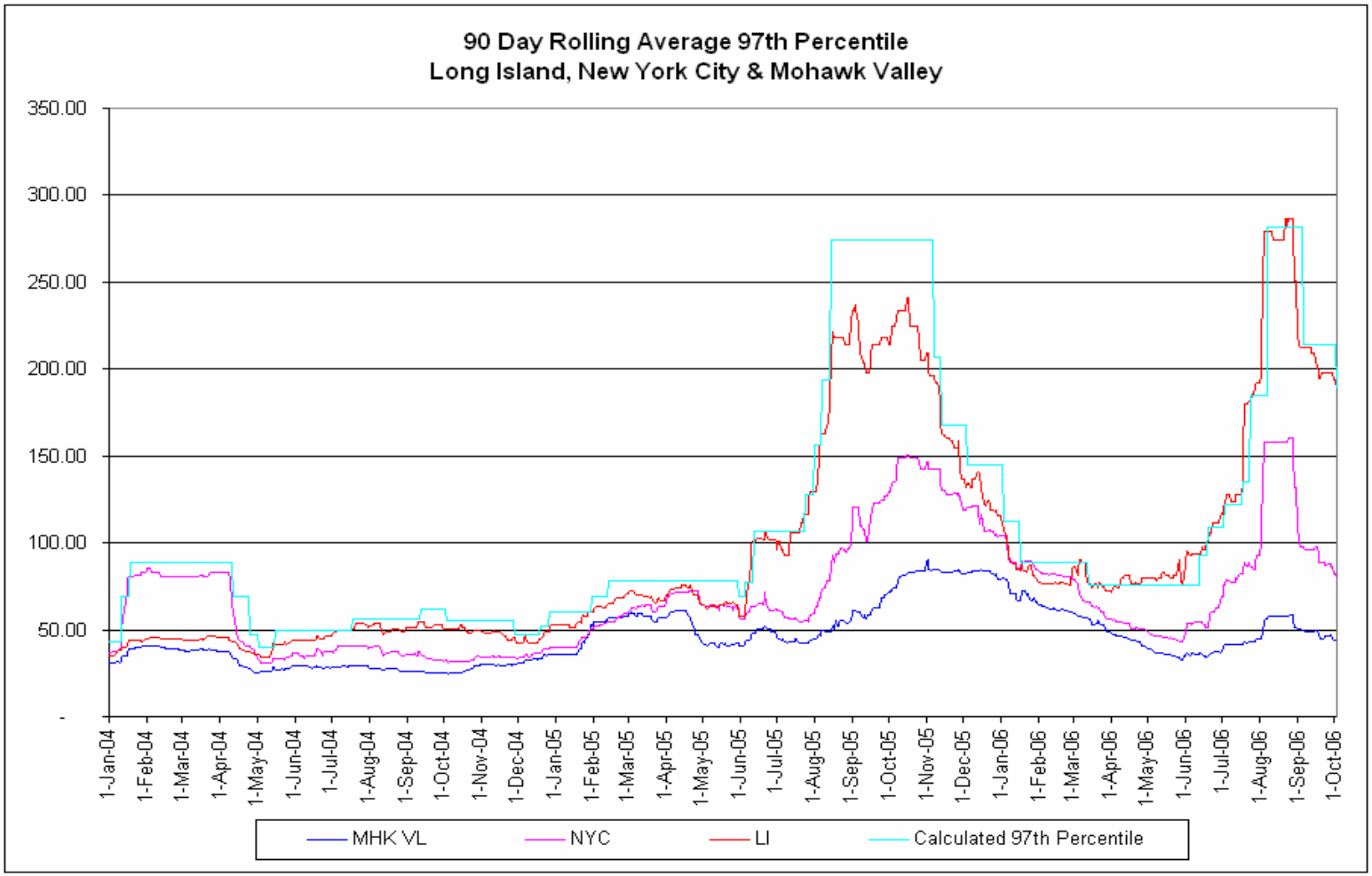
NYISO Virtual Credit Requirements

- Changes to the Virtual Trading collateral should:
  - Appropriately reflect market risks;
  - Fix previously known shortcomings in the collateral requirements;
  - Not be discriminatory, favoring one segment of market participants with different collateral as the market risks are the same for all participants; and
  - Not increase collateral capriciously in response to past market results or defaults.

One Size Fits All

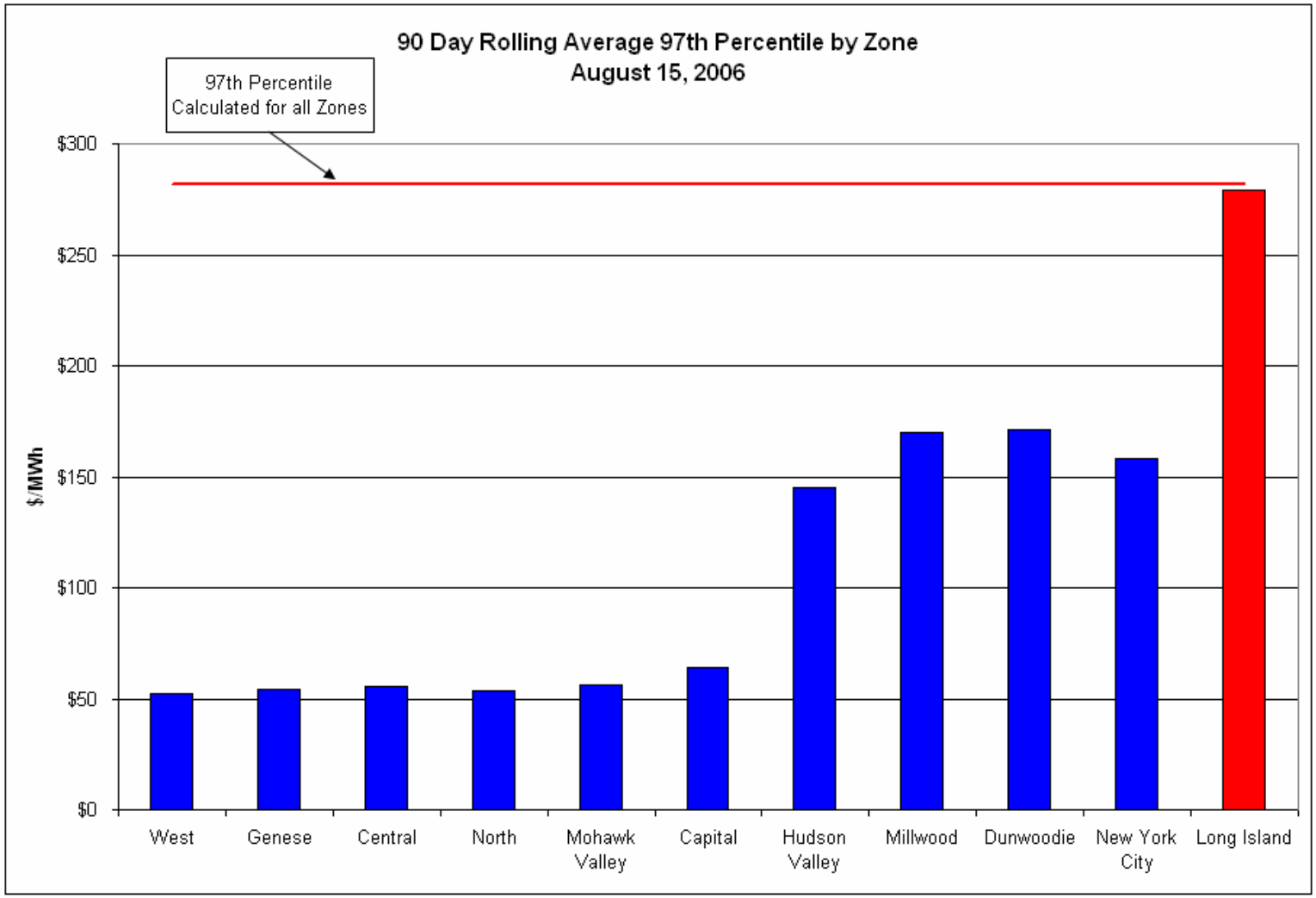
- The current Collateral Requirements take a “One Size Fits All” approach to virtual market risks
  - Since 2004, Long Island has consistently set the highest price differences in New York with large discrepancies compared to the other zones.
  - During the summer 2006, the 97th percentile on Long Island reached $282/MWh with other zones significantly lower.
  - Virtual trades outside of Long Island are effectively over capitalized by as much as 5 times for the upstate zones and nearly 2 times for the other downstate zones.
  - Changes to the virtual collateral should consider the adoption of collateral based on zonal trading activities, recognizing that the risks of virtual transactions differ by zone.

NYISO Virtual Credit Requirements



Note: Prior to 2006 the Collateral calculations used only peak hours.

NYISO Virtual Credit Requirements



Shortening the Lag Does Not Remove Risk

- Changing the 90 day rolling average calculations to a 30 day does not remove the lag in prices, only shortens it and creates greater volatility in the collateral requirements.
  - May remains a poor indicator for June as does August for September.
  - The reduction from 90 days to 30 in combination with a 99% percentile would double the number of times the collateral would change, requiring significant efforts by both NYISO and market participants.
  - The shorter duration of 30 days also increases the volatility of collateral as price spikes jump in and out of the rolling average.

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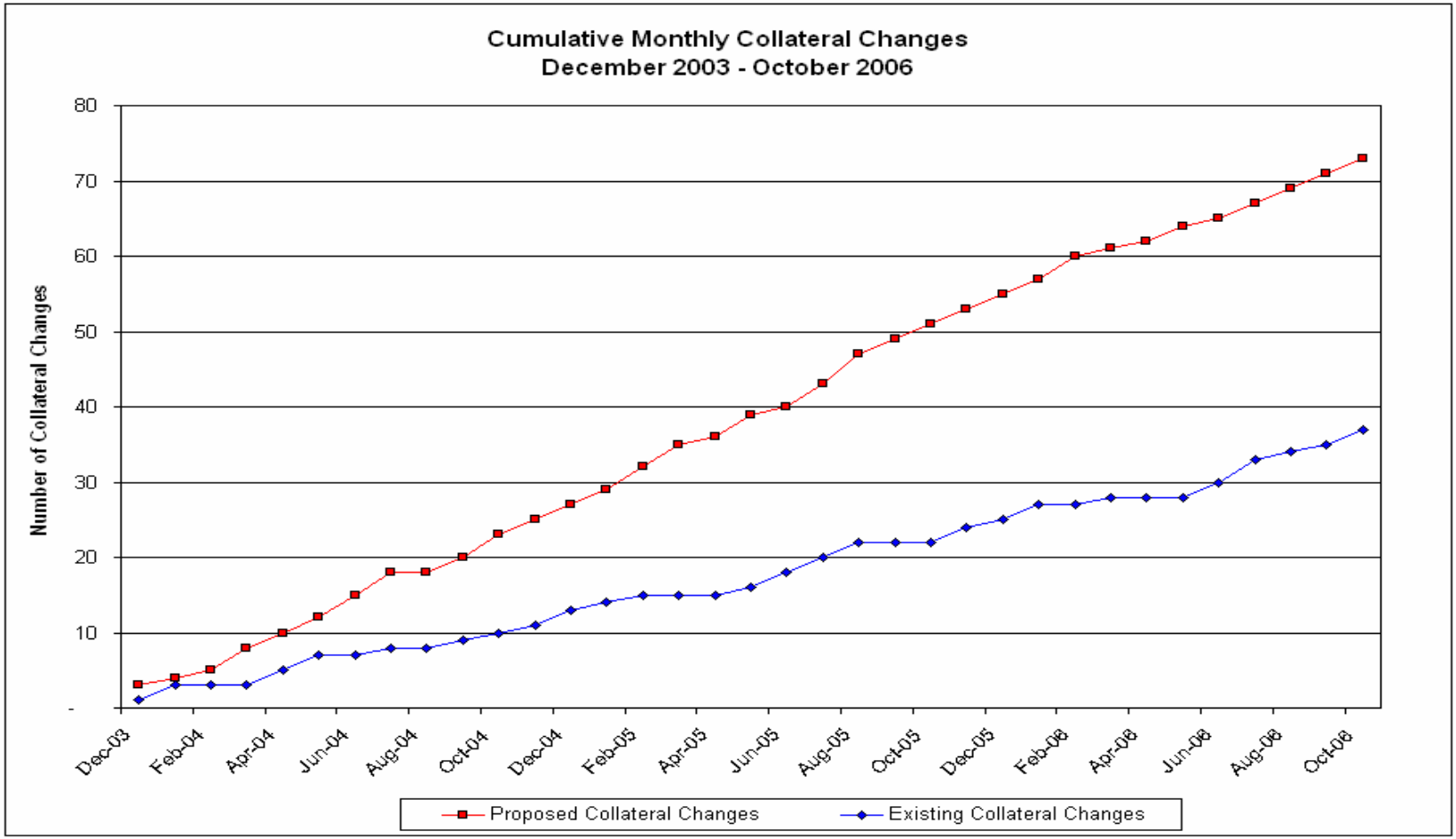
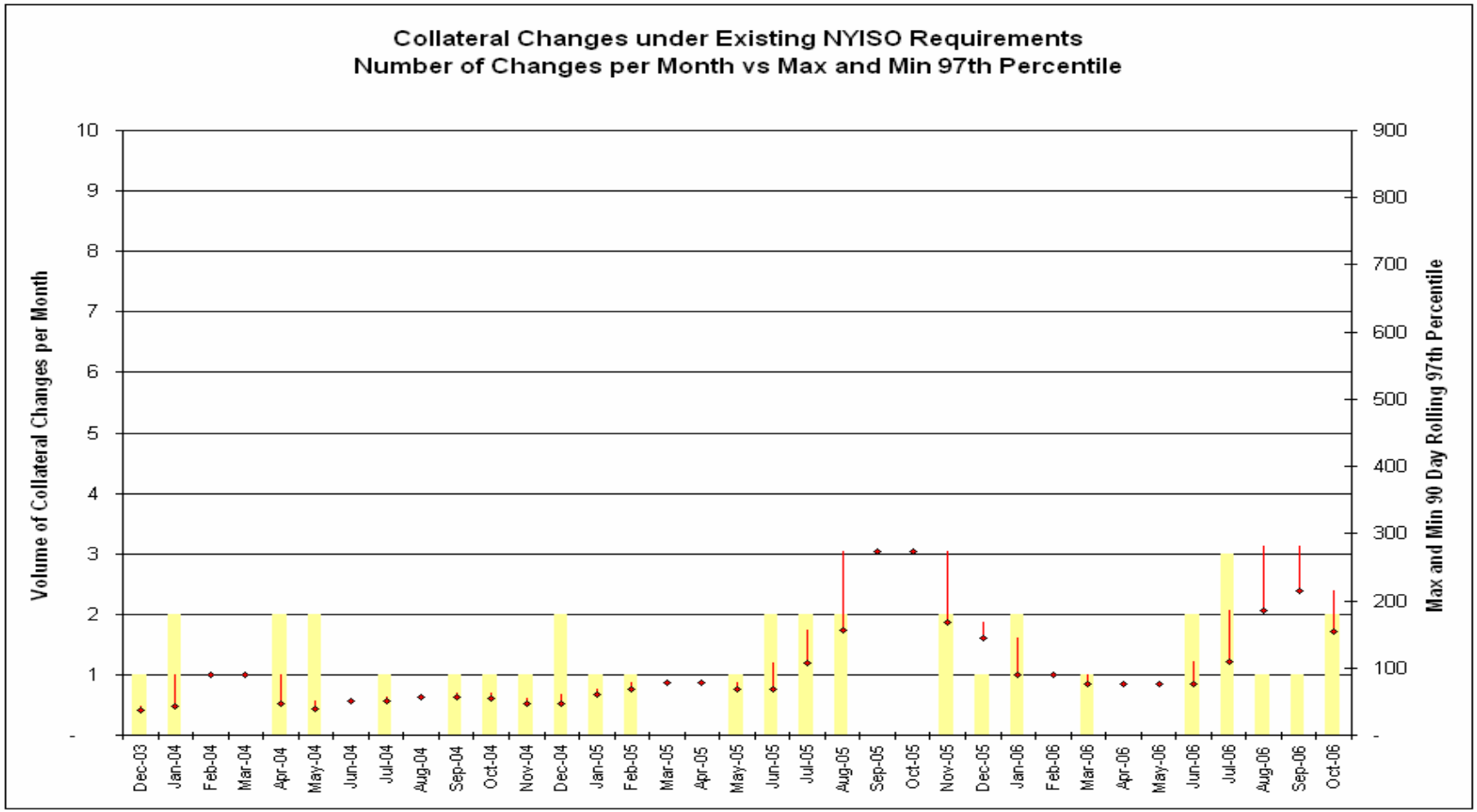


Number of Proposed Collateral changes based on 30 day Rolling Avg and 99% Percentile

Shortening the Lag Does Not Remove Risk



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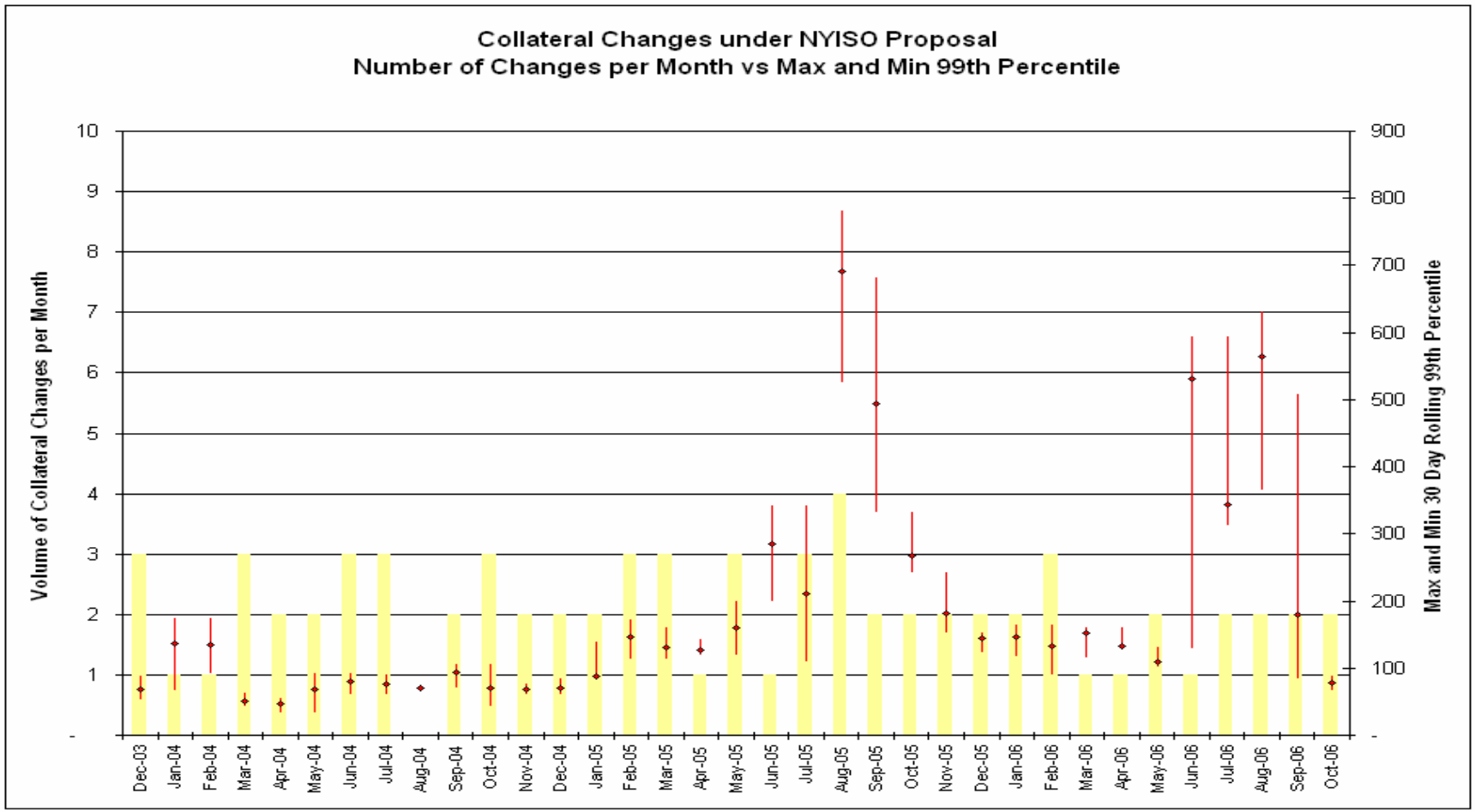

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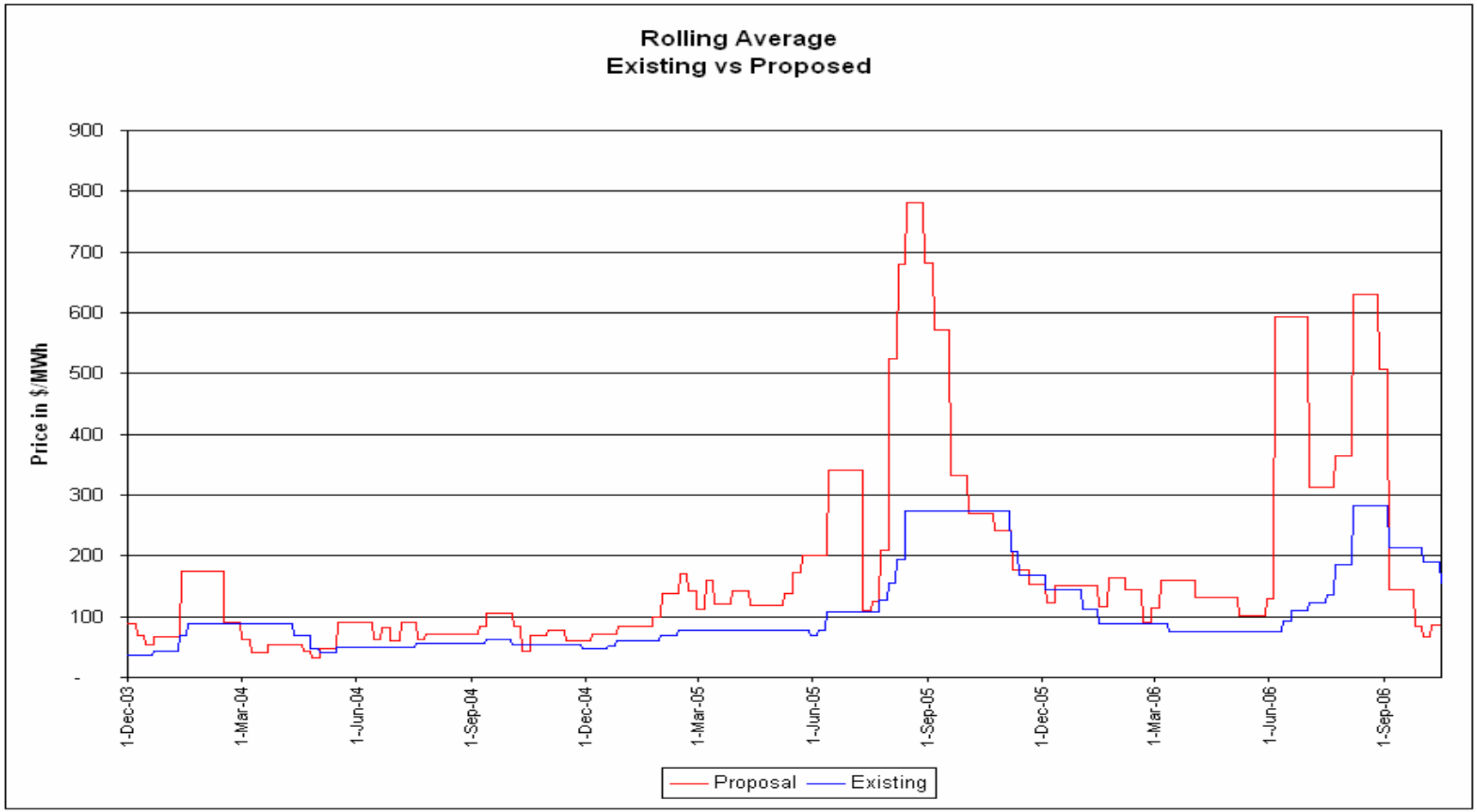


Proposal based on 30 day Rolling Avg and 99% Percentile

Shortening the Lag Does Not Remove Risk

- The Rolling average price should be replaced with a calculated monthly price difference based on past years historical data.
  - Previous years August prices are a better indicator of next year's August prices.
  - A weighted average methodology could be used to value more recent historical months greater than previous months.
  - This would reduce the numerous collateral changes per year and would create collateral certainty for market participants.

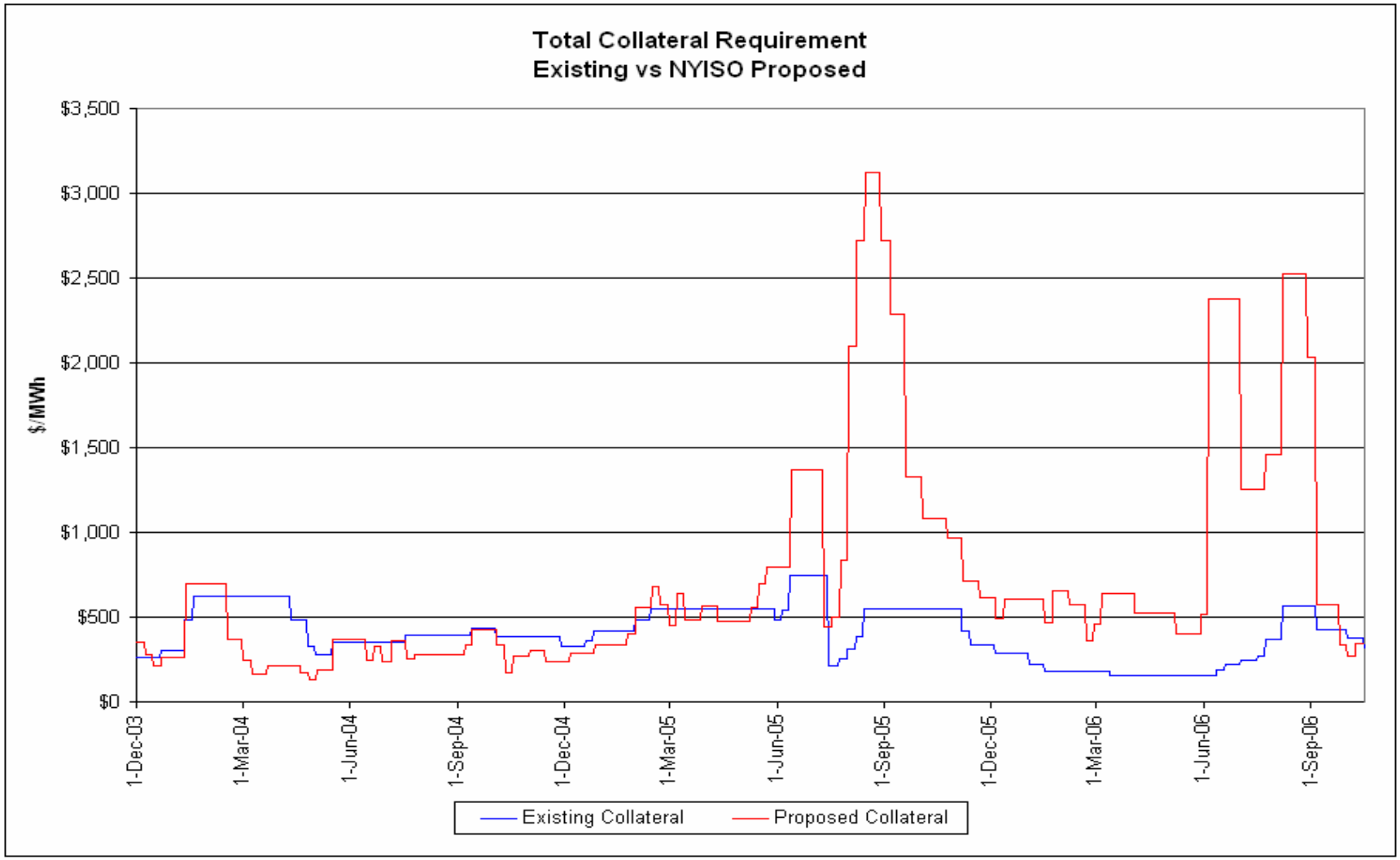
Shortening the Lag Does Not Remove Risk

- Benefits of this approach:
  - Creates a transparent and predefined collateral requirement by month at the beginning of each year;
  - Market participants can plan their collateral requirements accordingly;
  - Removes the risk of lagging prices; and
  - Frees NYISO staff and market participants time from requesting and funding increases or decreases collateral requirements due to fluctuating prices.

Decreasing available MWh by 50%

- There is no reason behind NYISO's proposal to decrease the available MWh by 50% (or essentially increasing the existing multiplier from 2 days to 4) other than to increase collateral requirements unnecessarily.
- This is a capricious change which goes against the previous FERC ruling stating that the previous 7 days multiple was onerous.
- This change in combination with the 30 day rolling 99th percentile would effectively increase the cost of collateral by 6 times during the summer months, a significant barrier of entry to the virtual market place.

Decreasing available MWh by 50%



Decreasing available MWh by 50%

- The effect of such a change would likely:
  - Exit of many of the smaller market participants which could not shoulder significant increases in collateral requirements;
  - Decrease the available virtual trading MWh for many of the remaining market participants by up to 80% during the summer months; and
  - In order to maintain the same level of return on investment, the remaining virtual traders would have to take significantly riskier positions in order to overcome the increased investment of a collateral requirement 6 times the existing level during the summer months. The riskier positions could in turn create larger risks of default.

Non Discrimination

- The Proposal to create two classes of market participants for the virtual market based on their ability to provide secure credit is discriminatory and does not address the underlying risks of the market place.
- While large financially secure market participants might be less likely to default, the potential cost of a default is significantly higher than unsecured participants.
- Both Enron and as well as Amaranth in the gas markets this past month should prove sufficient examples of the potential liabilities of large secured commodity traders.

Shortened Suspension Timeframes

- The NYISO proposal to shorten the suspension timeframes of those market participants who have incurred significant losses as a means to reduce the default risk is an appropriate action and should reduce the NYISO exposure to bad-debt losses significantly.
- This measure should also reduce the need for increasing the multiple from 2 to 4 days (or reduce the available MWh by 50%) as NYISO staff can effectively take action within a single day.