

# **Proposed Revisions to Investment Strategy for Market Participant Cash Collateral**

Management Committee  
June 21, 2005  
Agenda #5

# 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 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 at least monthly (initially – reviews will likely be daily or at least weekly). Margin calls made if value of premium eroded by 50% or more. If MP does not comply with margin call within specified short timeframe, NYISO would be authorized to convert amounts from bond fund to money market fund.
- 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>	<i>0.20%</i>	<i>2.61%</i>	<i>0.63%</i>	<i>1.60%</i>	<i>1.40%</i>	<i>2.09%</i>	<i>4.06%</i>	<i>6.09%</i>	<i>N/A</i>
Low Duration Bond Fund	0.55%	3.01%	-0.05%	1.35%	1.89%	5.94%	7.73%	8.27%	<b>5%</b>
Core Bond Total Return Fund	0.55%	4.01%	-0.23%	4.53%	4.31%	9.68%	8.20%	12.23%	<b>10%</b>

*\* 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

	<b>Phase I</b> <b><u>MM Funds</u></b>	<b>Phase II **</b> <b><u>Bond Funds (with Prem.)</u></b>
➤ BIC motion	N/A	June 10 ( <i>unanimous approval</i> )
➤ 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 support from MC, Phase II will proceed under this schedule.*