



Memorandum

To: ISO Board of Governors and Western Energy Imbalance Market Governing Body

From: Roger E. Collanton, Vice President, General Counsel and Chief Compliance Officer

Date: November 1, 2023

Re: **Decision on Billing, Payment and Credit Enhancements Phase 1**

This memorandum requires ISO Board of Governors and WEIM Governing Body action.

EXECUTIVE SUMMARY

This initiative proposes enhancements to the process of billing and paying market participants. It focuses on enhancing the ISO's ability to handle defaults on market payments, in order to reduce payment risk and costs for market participants.

Avoiding default losses is important for the success of the market. Every week, the ISO issues invoices to market participants who are net debtors for the relevant period – purchasers of energy, for example – and uses the funds collected to pay market participants that are net creditors, such as suppliers of energy and other services. In 2022, more than \$10 billion in payments cleared through this process. If a market participant were to default on its invoice to the ISO, the result could be a loss that the ISO would charge to other market participants, including participants in the Western Energy Imbalance Market (WEIM) or, in the future, Extended Day-Ahead Market (EDAM). A loss could be permanent or only a temporary delay of payment while the ISO pursues collection. The ISO has several tools to prevent defaults and collect debts, the most important of which is the credit program and the collateral that market participants must post to assure payment of their obligations.

The ISO has a strong record, paying market participants in full and on time for the last 22 years. During this period, the ISO has not needed to spread any kind of default loss to market participants, despite more than 20 market participants filing for bankruptcy or otherwise becoming insolvent.

Striving for continuous improvement, in 2021 Management began a review the rules around billing and payment, evaluating the possible effect of a period of sustained high prices for energy, as had happened in other electricity markets, and other stress on market participants' financial health. During the evaluation of these issues, a minor market participant defaulted on a payment to the ISO, which pointed to other areas for possible improvement.

Based on this review, Management proposes a set of improvements through tariff amendments to reduce the risk of payment defaults and enhance the ISO's ability to respond to any defaults that may occur. The proposed changes would also allow the ISO to authorize new methods of electronic payment and clarify relevant tariff language.

In addition to these proposed improvements, the ISO is separately considering whether additional rule changes are needed to enhance the ISO's visibility into the financial condition of load-serving entities in the ISO's balancing authority area. The ISO requested and received comments on this issue, and will continue to consider this issue in phase 2 of this stakeholder process in 2024.

Moved, that the ISO Board of Governors and WEIM Governing Body approve the proposed enhancements to the rules about billing, payment and credit as described in the memorandum dated November 1, 2023; and

Moved, that the ISO Board of Governors and the WEIM Governing Body authorize Management to make all necessary and appropriate filings with the Federal Energy Regulatory Commission to implement the change proposed in this memorandum, including any filings that implement the overarching initiative policy but contain discrete revisions to incorporate Commission guidance in any initial ruling on the proposed tariff amendment.

DISCUSSION AND ANALYSIS

Management is proposing several tariff amendments that address discrete aspects of the billing and payment process. The proposed amendments fall in four general categories:

1. Preventing payment defaults from becoming losses

Increasing financial resources available to cover potential defaults. FERC requires ISOs and RTOs to have a "minimum capitalization requirement" for any market participant that engages in settlement and billing. The ISO's basic requirement is that market participants must have either total assets exceeding \$10 million or a tangible net worth exceeding \$1 million. Smaller entities that do not meet this requirement may instead post additional cash above and beyond any collateral required based on their market activity. The ISO proposes to adjust this rule so that a small entity that satisfies the minimum capitalization requirement only by virtue of posting additional cash must maintain the full cash posting with the ISO until it is able to meet the capitalization requirement in a different way. Specifically, the rule for smaller participants allows them

to engage directly in settlement and billing by posting an additional \$500,000 cash. There is an exception to this rule, however, which allows a reduction of the posting to \$100,000 if the market participant maintains a low level of market activity for six months. Management proposes to eliminate this exception, and thus require entities that avail themselves of the posting alternative to maintain the full \$500,000 posting.

The proposal stems from the September 2022 payment default by a small market participant, which chose to walk away from its market obligations and cash deposit and cease operating. This was one indication that the current requirement is insufficient. In the process of developing this proposal, the ISO determined that its requirement is lower than other ISOs and RTOs, which generally require \$500,000 for entities that are authorized to hold congestion revenue rights (CRRs) or participate in virtual bidding. Rather than adopt a rule that imposes different financial postings for different participants, Management proposes a single rule for all market participants, which will be easier to administer.

Improving the ISO's ability to collect from bankrupt market participants. Management proposes to add tariff rules that designate one agreement between the ISO and market participant to control all settlement, billing and payment when there are multiple agreements with the ISO that could govern different aspects of the payment relationship. Designating one of these agreements as governing will improve the ISO's ability to collect amounts due from a bankrupt market participant using the doctrine of recoupment, which does not require advance authorization from the bankruptcy court. In addition, this change reduces the risk of unnecessary litigation over which contract governs the amount due.

2. Mitigating the harm to the market after a default

Enabling more effective use of reserve accounts. The tariff establishes two reserve accounts to hold funds that can be used to help clear the market after a payment default: the "CAISO Reserve Account" and the "Penalty Reserve Account." These reserve accounts have played an important role in the ISO's record of avoiding even temporary delays of payment going back to 2001, because they provide funds to pay market participants while the ISO collects from the defaulting party. The CAISO Reserve Account holds approximately \$1.8 million, and the Penalty Reserve Account holds approximately \$40,000.

Management proposes two changes that would enable the ISO to use these reserve accounts more effectively to minimize any losses. First, the use of the reserve account funds should be discretionary, unless the accounts contain funds sufficient to cover the entire default amount. The tariff currently indicates that the use of the reserve accounts is mandatory when payment is not received. This practice works well when reserve account balances are sufficient to cover the payment default and clear the market. But if there were a large default that exceeds the balance in the reserve accounts, mandatory use of the accounts would deplete the reserve accounts without preventing a payment shortfall. The ISO thus would be required to allocate the shortfall to market participants,

which would impose a significant administrative burden on both the ISO and market participants. If further defaults were expected, which is likely in certain bankruptcies, it could be more efficient for the ISO to use the reserve accounts only when they can prevent any shortfall for the weekly payment cycle, and avoid a need to allocate losses for that week. For these reasons, Management proposes that the use of the funds in the reserve accounts should be discretionary when they are insufficient to prevent a shortfall for that payment cycle.

Second, Management proposes to clarify the rules about replenishment of the reserve accounts. The CAISO Reserve Account covers cash flow problems temporarily, but does not cover losses permanently, subject to a minor exception proposed below. Accordingly, if the ISO cannot collect a debt covered by the CAISO Reserve Account, the account must be replenished by allocating the loss to market participants. The issue is the timing of this replenishment. The ISO's historical practice has been to wait to replenish the CAISO Reserve Account until it becomes clear the debt is uncollectible. This avoids the need to allocate the debt to the market, and then repay the market, which would incur significant administrative costs unnecessarily. There is tariff language, however, that could be read to require the ISO to replenish the CAISO Reserve Account within weeks after a default. Such a practice would be inefficient if the default amount remained collectible, such as when the ISO is holding collateral to cover the default but is waiting for bankruptcy court permission to apply it. To avoid both possible ambiguity and the possible need to allocate losses inefficiently, Management proposes to provide that the CAISO Reserve Account must be replenished only when the ISO concludes that the remaining debt is uncollectible.

The replenishment rule for the Penalty Reserve Account is different. While this account would be replenished if the ISO collects a debt, it is not replenished otherwise – i.e., by an allocation of the loss to market participants. This is because the Penalty Reserve Account is funded by penalties assessed to market participants that paid or posted collateral late, and replenishing it would spread these penalties to others unfairly. This intention is explained in the original FERC filings, but not reflected clearly in the tariff language. Management proposes to clarify this language.

Allocating losses among market participants fairly and efficiently. The tariff includes a process and a formula for allocating any losses to market participants according to their level of market activity. At the beginning of every financial quarter, the ISO calculates new "allocation percentages" based on data about market and payment activity. Presently, the tariff states that any losses will be allocated according to "the most current" allocation percentages. Management's review identified a possible negative outcome from this rule. In the case of an adjustment late in the two-year settlement cycle, this rule might result in allocating default losses to new market participants that entered the market only after the bankruptcy filing or insolvency event that is the cause of the loss being allocated. To avoid this possibility and help attract new participants after a period of financial stress, Management proposes to amend the tariff to specify that a loss will be allocated according to the percentages in effect at the time the bankruptcy or insolvency began.

Management also proposes to amend the tariff rules about the data to be used in calculating the allocation percentages so that the allocation is based on more current data. The current tariff rules preclude the ISO from using data from the two most recent quarters, because that data is subject to revision. Management proposes to include the data from the next-to-last quarter, even though that data is subject to revision, because it better reflects the level of market activity.

In addition, Management proposes to clarify rules about how, after a default loss is allocated to market participants, the ISO uses funds it collects from the defaulting market participant. Currently, the tariff addresses the payment priorities for such funds in several different sections that focus on different aspects of the issue. Management's proposed clarification is intended to avoid disputes about who should receive payment. The proposed rule is that, after paying any defaulted grid management charge and other internal accounts, market participants will be repaid beginning with those that were allocated losses on the oldest unpaid invoice.

Using "separate invoicing" to appropriately allocate certain types of possible losses. Two of the proposals concern "separate invoicing." Any default losses from ordinary market invoices are allocated across the entire market. In special circumstances, however, the ISO may invoice certain charges and credits separately, so that any default loss would be allocated only to specific participants. Historically, this practice has been used when the ISO is recalculating settlements from old trading days, so that any payment defaults would be allocated to the market participants from the relevant time rather than current participants, who may not have been involved in the transactions. The proposed changes would authorize separate invoicing for two types of charges:

- Penalties for late payment or late collateral posting, at the discretion of the ISO, so that any expected losses would be allocated to the Penalty Reserve Account rather than to market participants; and
- Charges for black starts services, consistent with the ISO's Black Start Agreements, which contemplate that any losses would be allocated between the parties to the agreement.

Recalculation of old trading days – authorizing write off of small uncollectible amounts. As noted just above, the ISO occasionally must issue invoices for adjustments to settlements that are more than two years in the past, and thus outside the normal settlement cycle. This happened recently after the resolution of a long-running complaint proceeding at FERC. On such "out-of-cycle" invoices, Management proposes to authorize the ISO to write off as uncollectible a small amount, up to a total of \$2,000, if the cost of further collection efforts would exceed the benefit to the market. In this case, market creditors would receive funds from the CAISO Reserve Account. Currently, the tariff requires the ISO to either collect the full amount due or allocate any uncollectible amounts to the market. Collection can be time-consuming for out-of-cycle

invoices, however, because some participants have left the market or ceased its business. The proposed change would authorize the ISO to avoid collection efforts that would be inefficient without also incurring the administrative expense, for both the ISO and market participants, of allocating a small shortfall.

3. Authorizing possible new methods of payment

Management proposes to amend the tariff to allow it to authorize payment on market invoices by any electronic means specified in a Business Practice Manual. The tariff currently requires payment by ACH or FedWire only. This change would enable the ISO to authorize new payment systems, including potentially the FedNow system which Management has been evaluating.

4. Clarifying other tariff provisions about billing and settlement

Finally, Management proposes to clarify or correct tariff language in a way that does not reflect a change in policy or practice, as follows:

- Expressly authorizing use of the CAISO Reserve Account to resolve small imbalances that result from the elimination of invoices less than \$10;
- Adjusting the definition of “settlement statement” to include new statements that become effective in 2021;
- Combining two tariff provisions that both discuss the basis of billing and payment;
- Clarifying terminology to distinguish billing and payment from settlement, which is an accounting exercise distinct from any flow of funds; and
- Deleting outdated tariff language about billing on a monthly basis.

POSITIONS OF THE PARTIES

The ISO posted its draft final proposal and issue paper on September 26, 2023. On October 3, the ISO held an online meeting with 49 stakeholder participants, during which the ISO presented the proposals and responded to questions. Stakeholders expressed no objections to these proposals either during the meeting or later, in written comments.

Written comments submitted by stakeholders were focused exclusively on the issue paper topic about visibility into the financial condition of load-serving entities in the ISO balancing authority area. As noted above, the ISO will further consider that issue in 2024.

CONCLUSION

Management requests the ISO Board of Governors and WEIM Governing Body approve the proposals described in this memorandum. The proposed rules will improve the ISO’s ability to prevent a payment default and to respond if one occurs, thereby mitigating possible losses that would be spread to market participants.