

PJM Participant Payment Defaults and Implications for New England

NEPOOL Participant Committee Meeting

Updated February 5, 2008

Robert C. Ludlow
Vice President, CFO
ISO New England

Topics To Be discussed

- Summary of PJM FTR participant payment defaults
- Review of Power Edge affiliates' ISO-NE FTR activity
- Highlighted differences between PJM & ISO-NE FTR Credit Policies
- Actions ISO-NE plans to take in light of recent events

Overview of PJM Customer Payment Defaults*

- Four FTR customers defaulted on margin calls and payment obligations
 - Exel Power Sources, LLC
 - Power Edge, LLC
 - Del Light, Inc.
 - PJS Capital, LLC
- Forecasted combined default exposure presently @ \$87MM (thru 5/08)
 - Exel Power Sources, LLC
 - Cleared 8,600 MW counter-flow portfolio in annual auction w/ \$0 financial assurance (margin) required
 - PJM used discretionary ability to require “super margin” to cover summer month exposure - \$14.7MM
 - Required to liquidate portfolio when unable to meet super margin
 - Current positions acquired in monthly & quarterly auctions
 - Expected losses (9/07 – 5/08) = ~\$5.5MM
 - Posted collateral at time of initial default = \$300k
 - Power Edge, LLC
 - 9,000 MW from auction w/ \$6.4MM margin required (PJM suggests responsible for ~50% of losses)
 - 8,600 MW from Exel Power through bilateral (PJM suggests responsible for ~50% of losses)
 - PJM applied incremental super margin of \$3.1MM to cover acquired portfolio (total of \$9.5MM)
 - Expected losses (11/07 – 5/08) = ~\$79MM
 - Posted collateral at time of initial default = \$800k
- Portfolios are net counter-flow
 - Counter-flow bids represent price bidder is willing to be paid in exchange for taking future congestion risk
 - Positively priced “flow” FTRs are also susceptible to “unlimited” exposure

*Note: All information pertaining the PJM defaults has been sourced from public information provided by PJM.

Notable Points Concerning Exel Default

- New market participant, thinly capitalized
- PJM Credit Policy permitted Exel to obtain initial portfolio with no margin
- After the auction cleared, PJM exercised its discretionary rights provided under its Tariff to require additional “super-margin” of \$14.7MM
- Exel could not post this amount and sold portfolio to PowerEdge
- Permitted to continue market activity subsequent to forced liquidation
- Exel subsequently reconstituted FTR portfolio in monthly auctions (amounted to less than 1/3 of its initial annual portfolio)
- Unable to find buyer for defaulted open positions (2nd portfolio)
- Defaults pre-date those of Power Edge

Notable Points Concerning Power Edge Default

- Obtained Exel portfolio via bilateral requiring \$3.1MM of margin
- First default was margin default just prior to initial payment default
- PJM reports losses primarily a result of congestion conditions not reflective of historic norms
- Power Edge has 6 affiliates in PJM's markets
- PJM Market Monitor evaluating bid behavior of affiliates
- PJM filed @ FERC in attempt to claim returns owed to affiliates in PJM's markets

Review of Power Edge Affiliates' FTR Activity in ISO-NE

- Four of Power Edge's affiliates are ISO-NE Participants
 - Franklin Power, LLC (FTR Only – FTR Holder)
 - Accord Energy, LLC (MP - FTR Holder)
 - BJ Energy, LLC (MP - No FTRs)
 - GLE Trading, LLC (MP - No FTRs)
- Review of Customers' FTR bid behavior has revealed nothing extraordinary
- ISO-NE credit personnel have maintained contact with these entities and have found them to be cooperative
- As permitted by the Financial Assurance Policy, ISO-NE requested and received financials from all affiliates – currently under review
- Presently in good standing under Billing and Financial Assurance Policies
- Other than general concerns regarding variability of FTR returns, ISO-NE does not, at present, view the Power Edge affiliates as elevated default risks
- ISO-NE is continuing to monitor these entities
 - Pending PJM Market Monitor review, ISO-NE has no reason to believe that the events leading to Power Edge's payment default indicate anything other than unfortunate market decisions on behalf of Exel/Power Edge management

Highlighted Differences Between PJM & ISO-NE FTR Credit Policies

- PJM
 - Expected congestion based on avg annual returns over prior 3 yrs (50% expected value)*
 - Prevailing-flow FTRs assume 30% discount on expected congestion returns
 - Expected congestion credits are permitted
 - Do not discount expected congestion for counter-flow FTRs
 - “Sell” transactions result in incremental margin requirements
 - No ability to force liquidation of defaulted portfolio
 - 12/21/07 filing modified methodology
 - Utilize monthly average returns (as opposed to annual averages)
 - 10% reduction on expected Flow returns
 - 10% adder to expected Counter-flow losses
 - 01/31/08 filing serves to increase margin requirements for flow and/or geographically undiversified counter-flow portfolios

*ISO-NE, PJM, NYISO, MISO all utilize different methodologies reliant upon historical congestion rents to forecast forward FTR congestion returns

Highlighted Differences Between PJM & ISO-NE FTR Credit Policies (cont'd)

- ISO-NE
 - Expected congestion losses based upon 75% worst monthly return over prior 3 years
 - Use of monthly returns better addresses variable congestion patterns
 - Flow & Counter-flow paths treated in same manner
 - Flow/counter-flow designation does not necessarily signify increased/decreased loss exposure
 - Expected congestion returns are set to \$0 (forecasted credits are not permitted)
 - ISO utilizes forward risk component (expected value) as a means to add incremental margin requirements rather than as a mechanism to also provide anticipated credits
 - “Sell” transactions have a \$0 margin requirement
 - Not required to post additional collateral if attempting to close-out positions
 - No ability to force liquidation of defaulted portfolio

ISO-NE Evaluating Improvements Across Several Fronts

- Budget & Finance Subcommittee
 - Financial Assurance Policy
 - ISO has identified numerous possible enhancements to current FTR FA methodology:
 - Integrating risk management methodologies commonly used in commodities markets
 - Utilizing a forward forecast of congestion to supplement historical based margin calculations
 - More frequently marking-to-market as well as modifying mark-to-model approach
 - Improve Market Participant protections from exposure to FTR Participant bankruptcies
 - Extensive review of opportunities for improving FTR market design with eye toward minimizing default risk
 - Introduce more frequent auctions?
 - Create “balance of planning period” auctions?
 - Opportunity to enhance ISO supported secondary market functionality?
 - Other, including:
 - Review auction v. allocation of FTRs;
 - Investigate merits of limiting market participation based upon certain qualifying criteria
 - ISO in process of evaluating improvements to overall margin methodology
 - Effort began in earnest November 2007

ISO-NE Evaluating Improvements Across Several Fronts (Cont'd)

- Budget & Finance Subcommittee (cont'd)
 - Billing Policy
 - ISO is in process of accelerating the billing of certain monthly line items (including FTR congestion) to become weekly billed
 - Will review current default allocation methodology to assess whether there are opportunities for enhancement - particularly in relation of FTR defaults
ISO-NE's Credit Department has been focused on FTR risk during much of 2007
- Membership Committee
 - Will be asked to evaluate the merits of eliminating the FTR-Only sector (requiring full Market Participant status to participate in FTRs)
 - Evaluate best practices in an effort toward strengthening the new membership qualification process
 - Assess merits of additional qualification criteria to participate in Financial markets
 - Investigate options for addressing concerns pertaining to multiple affiliate participants active in financial markets (i.e., FTR, Virtual)

ISO-NE Evaluating Improvements Across Several Fronts (Cont'd)

- Market Monitoring
 - Actively working on report assessing FTR market design
 - Evaluate opportunities to enhance systems designed to monitor bidding behavior in FTR/Virtual markets particularly as it may relate to affiliate FTR bidding
- NEPOOL Markets Committee
 - Work with Credit to evaluate possible options for liquidating defaulted positions
 - Information Policy:
 - Modify (as necessary) information policies to permit the ISO increased flexibility to share relevant information to Participants in event of default
 - Clarify ISO/RTO Council information policy to promote increased transparency among ISO/RTOs concerning Participants' market and financial information
- Other
 - Closer review of LTTR market design and feasibility in light of recent events