Board of Directors

Credit Aspects of Mass Transition

Credit Exposure (primarily QSEs)

- Credit Exposure – 3 primary components
  - Outstanding Invoices
  - Uninvoiced items (historical)
  - Expected Forward Liability
- Focus of this discussion - Expected Forward Liability (both QSEs and LSEs)
  - Provided for “exit” scenarios
  - There is currently unmitigated credit exposure in the market in this area
  - Even with current mitigation plans, there is still expected to be unmitigated credit exposure

Credit Exposure – How much?

- Questions for the market and the BOD:
  - What is an acceptable level of unmitigated credit exposure?
  - How does the market get to that level of credit exposure?

Credit Exposure – Expected Forward Liability

- Credit exposure related to a troubled entity centers around that entity's use of the Balancing Energy Service (BES)
  - A troubled entity that has been "cut off" for credit reasons from its bilateral energy providers still serve its end users
  - By default, energy requirements come from the BES, creating liability for remaining market participants
- Credit exposure related to a QSE or LSE exists as long as end users are associated with that entity
  - Energy continues to flow to end users

Credit Exposure – around Mass Transition

- Credit exposure can only be eliminated by moving end users to another entity (e.g. the Mass Transition process)
- Credit exposure is currently mitigated (although not fully) with
  - Collateral
  - Mass Transition process
- Collateral covers approximately 2 weeks forward for “exit” process
  - ***at historical levels of BES usage***

Credit Exposure – Mitigation Shortfalls

- Based on recent experience (with smaller players), it takes longer than 2 weeks for "exit" process
  - Including notice periods and Mass Transition
  - To relieve majority of liability – close to 3 weeks

- Market losses have been experienced (and are likely to continue) due to a combination of
  - How collateral is calculated per Protocols
  - How long it currently takes the market to transition end users

Approx Timeline to Remove a Troubled QSE

Identify problem and make collateral call	BDay 0

Notice periods (6 BDays)

Collateral due	BDay 2
Notice of default given	BDay 3
3 BDays to cure default	BDay 6

Mass transition (9-11 BDays)

Conference call to begin Mass Transition	BDay 7
POLRs initiate switches (5 BDays allowed, switches to date have taken, on avg 3 BDays)	BDay 9
Time until switch complete by TDSP	BDay 15

(Note: 15 business days + 6 weekend days = 21 days of liability)

Potential loss in exit scenario

Potential loss (simplified example)

Collateral held

1,000 MWh/day x $100/MWh x **10%** x **14** days = $ 140,000

At default

1,000 MWh/day x $100/MWh x **100%** x **21** days = $ 2,100,000

Potential loss to the market $ 1,960,000

For 100 MWh/day $ 196,000

For 10,000 MWh/day $ 19,600,000

Open question: Is 21 days a reasonable estimate if the MP is a larger entity?

Potential loss range

(assume MCPE = $100/MWh)

Collateralized based on	**BES 10%**	**BES 100%**
At Default	**BES 100%**	**BES 100%**
For 100 MWh/day	$ 196,000	$ 70,000
For 1,000 MWh/day	$ 1,960,000	$ 700,000
For 10,000 MWh/day	$ 19,600,000	$ 7,000,000

Market Statistics

of LSEs by average daily MWh for August 2005

MWh/day	CR	NOIE	Tot	%	Potential Loss by cat
< 200	23	25	48	31%	**$ 200k ea**
200-2,000	21	41	62	40%	**$ 2,000k ea**
2,000-20,000	24	12	36	23%	**$20,000k ea**
> 20,000	7	3	10	6%	
Total	**75**	**81**	**156**	**100%**	

Market Statistics

Average daily MWh for August 2005

MWh	CR	NOIE	Total	%
< 200	1,569	2,291	3,860	0.4%
200-2,000	16,504	27,828	44,332	4.3%
2,000-20,000	182,528	76,488	259,016	25.1%
> 20,000	578,401	148,377	726,778	70.3%
Total	**779,002**	**254,984**	**1,033,986**	**100.0%**

Estimated losses in 2005 to date

Entity	Type	Size	Est Exposure
LSE 1	LSE	350 MWh/day	$ 400,000
QSE A	QSE	50 MWh/day	$ 25,000
QSE B	QSE	65 MWh/day	$ 200,000+

Options available to mitigate credit exposure

- For QSEs, increase collateral requirement
  - Market liquidity concerns
  - Inadvertently incent use of BES
  - Credit Working Group is evaluating options
- For LSEs being dropped by their QSE, increase notice period from QSE
  - PRR 625 in process will increase notice from 5 BDays to 20 days
- Make sure Protocol language is clear about consequences
  - PRR 624 in process to clarify Payment Default language

Options available to mitigate credit exposure

- ***Reduce Exposure Period***
  - Identify risk earlier
    - —Not comprehensive
    - —ERCOT evaluating tools
  - Reduce number of notice days (6 BDays)
    - —PRR begun to take 2 BDays out of process
    - —Involves changing contracts to reduce cure period from 3 BDays to 2 BDays
  - Reduce the number of days it takes to do Mass Transition (9 – 11 BDays)
    - —Still in process
    - —Challenges to further streamline process
- ***Combination of above – no "silver bullet"***

Challenges – Reducing # of days for Mass Transition

Risk Type	Mitigation Strategy	Obstacle
POLR ability to rapidly initiate transactions at volume.	Develop dedicated TX SET transaction.	❑No test of POLR ability to act in transition event (at volume). ❑POLR designations change every two years.
TDSP ability to rapidly read large number of dispersed meters.	"Estimated read" to effectuate switch.	❑Cost to implement.
Transition time.	Transactional/automated solution.	❑PUCT customer protection rules. ❑POLR ability to procure resource for load. ❑TDSP ability to obtain meter reads.
Uncooperative defaulting CR	Customer information repository. (billing vs premise)	❑CR dedication to populate/maintain. ❑Cost to maintain.

Next

- Determine from market the level of acceptable unmitigated credit exposure
- Work with market to implement changes to get to desired level of risk

Input, Questions, and Wrap-up