Proposed “Activity Suspension”

November 2019 CWG

We are proposing a suspension mechanism to complement ERCOT's credit policy

- ERCOT's credit policy is necessarily complex, to handle a wide array of risks
- This complexity can lead to counterintuitive outcomes under certain market conditions
- We believe a suspension mechanism will better align the credit policy with actual participant behavior while further reducing risk to the market

The credit policy assumes invariant behavior

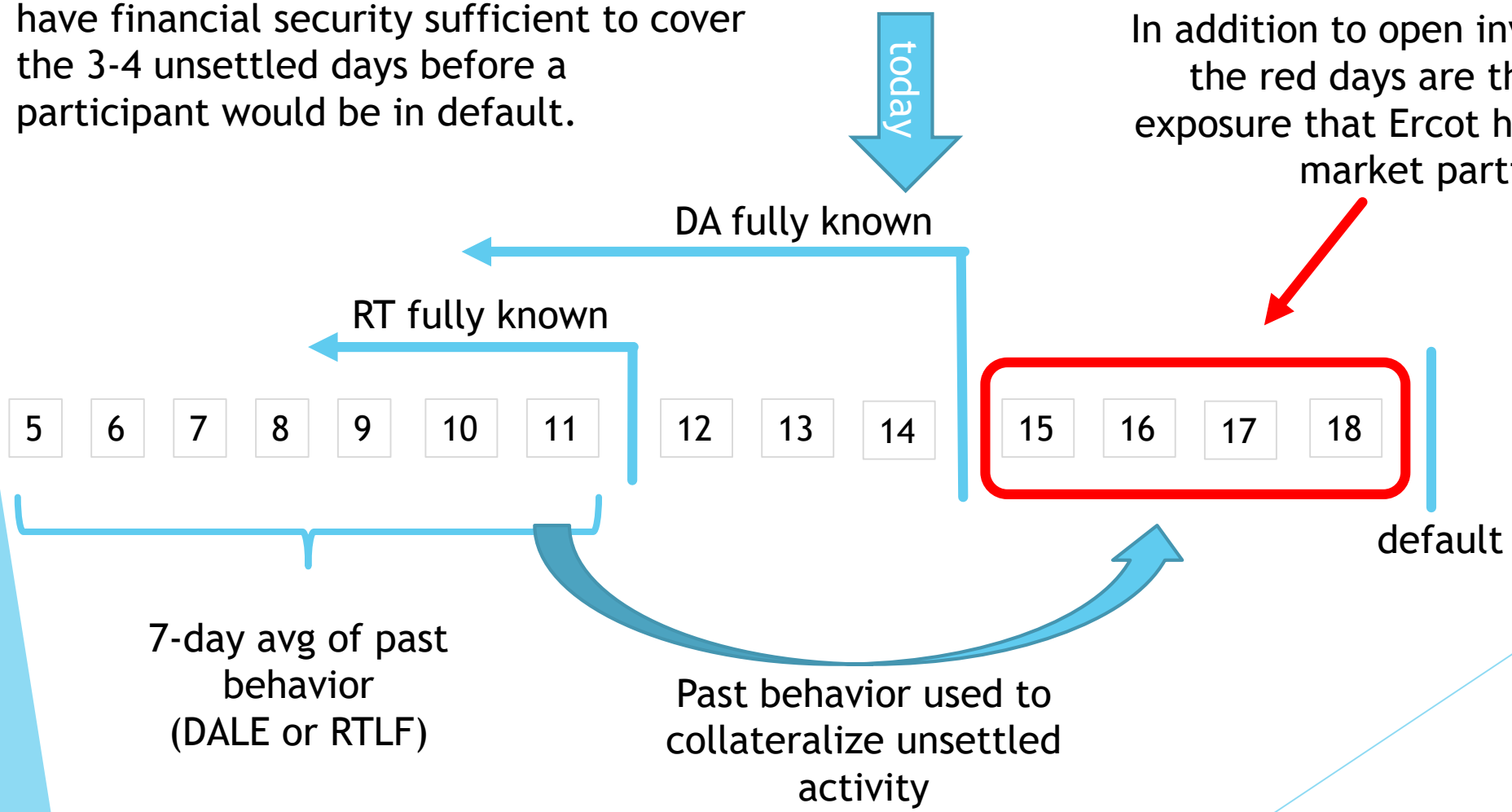
- In order to ensure Ercot is adequately collateralized on risky days, the credit policy (loosely) applies "future correction" multipliers to past behavior.
  - This assumes participant behavior in the coming week will look like the past week
  - For many market participants (i.e. load), this is a very reasonable assumption
  - For other market participants (i.e. generators or traders), this assumption is less ideal
- ICE Forward Adjustment Factors (DFAF & RFAF) appropriately make credit very responsive to anticipated volatility – we are not proposing any changes to DFAF or RFAF
  - Our proposal is a narrow mechanism, intended to be used (1) only by market participants with more variant behavior and (2) only to address the very rare short-term DFAF/RFAF spikes.
  - Additionally, our mechanism can only serve to reduce risk to the market

Background: Settlement Timeline Example

The credit system ensures, if past behavior is indicative, that participants have financial security sufficient to cover the 3-4 unsettled days before a participant would be in default.

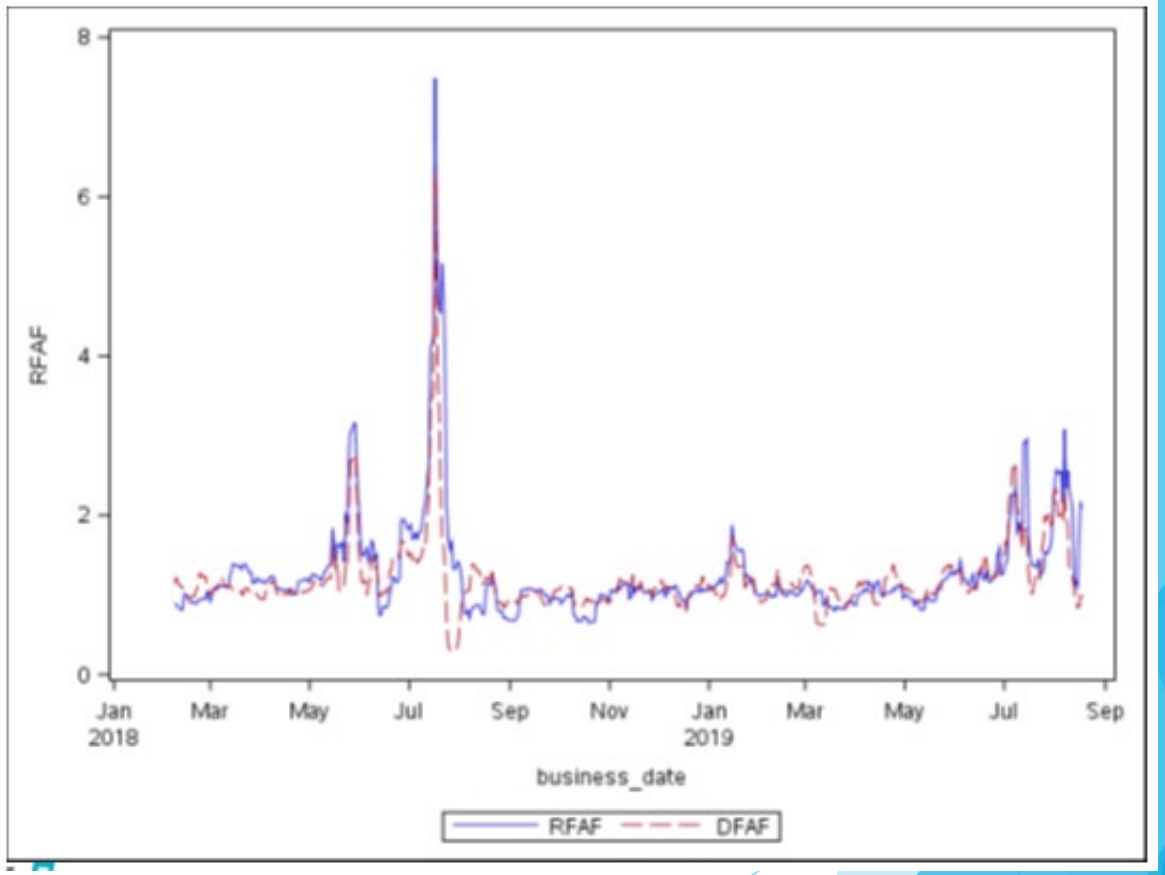
Illustrative

In addition to open invoices, the red days are the only exposure that Ercot has to a market participant



Problem: short-term RFAF & DFAF spikes

- DFAF & RFAF have positive effects
  - For example: they often decrease participants' average credit requirement
- However, a short-term spike in RFAF & DFAF (as a multiplier on past behavior) could cause a large and sudden increase in a participant's future credit requirement
  - We have seen RFAF & DFAF values almost reach 8 (which could multiply credit requirements by 4-5x), but the future could bring even higher values
  - This is appropriate if participant behavior remains unchanged under changing conditions



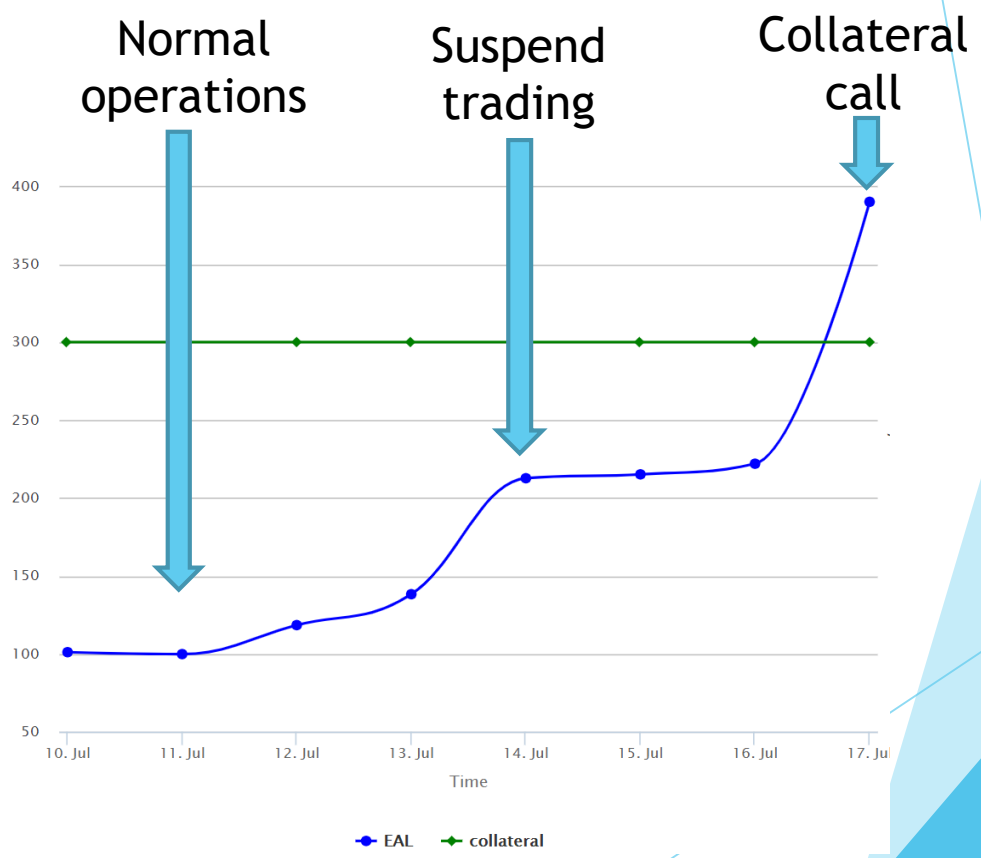
From: Credit Impacts of 2019 Summer Price Event, CWG, August 21, 2019, Slide 4

Example: DFAF spike causes 4x credit jump

- A participant that consistently purchases in the DA market may have a credit requirement based largely on the (DFAF * DALE) component.
- Below, despite having almost no outstanding exposure to the market due to Suspended Trading, the participant faces a Credit Call or Default

Suppose posted collateral of $300k

- **2018-07-11: DFAF = 1.61**
  - Credit requirement (EAL) = $100k
- **2018-07-14: DFAF = 3.47**
  - Credit requirement (EAL) = $215
  - Market participant stops trading
- **2018-07-17: DFAF = 6.29**
  - Credit requirement (EAL) = $389



This is a counter-intuitive outcome: suspended trading operations *reduce* risk to the market, but the credit policy does not reflect that

Nodal Protocol 16.11.4.3(1)

Proposal: allow a manual “activity suspension” to freeze a participant’s EAL value at the current value

Allow participants to affirmatively (1) suspend trading and (2) immediately pay all outstanding invoices (zeroing out future risk to Ercot), after which the “Financial Security Obligation” would be frozen at a prior value until participants affirmatively contact Ercot to resume operations.

- With no future positions, Ercot faces zero financial risk until activity resumes
- Intended to allow fully solvent participants to ride out short-duration extraordinary market periods without defaulting, while insuring that Ercot bears no additional financial risk

Recommended Protocol Addition:

- After a market participant has zeroed out all exposure to Ercot and suspended operations, the credit policy is no longer needed to protect Ercot from default
- The very existence of this mechanism would allow market participants (and their risk auditors) a great deal of comfort, even if never actually utilized

DRAFT Protocol Section 16.11.4.1(3)(a):

If a QSE demonstrates that they have suspended activities and pre-paid coming invoices (such that Ercot faces no ongoing financial exposure to that QSE), ERCOT will cap the corresponding Counter-Party's TPEA and TPES values at their existing values until such time that the QSE resumes activities.

Reference Protocol Sections

Protocol Section 16.11.1

A Counter-Party must, at all times, maintain its Financial Security at or above the amount of its Total Potential Exposure (TPE) minus its Unsecured Credit Limit.

Protocol Section 16.11.4.1

A Counter-Party's TPE is the sum of its "Total Potential Exposure Any" (TPEA) and TPES

Protocol Section 16.11.4.1(3)

If ERCOT, in its sole discretion, determines that the TPEA or the TPES for a Counter-Party calculated under paragraphs (1) or (2) above does not adequately match the financial risk created by that Counter-Party's activities under these Protocols, then ERCOT may set a different TPEA or TPES for that Counter-Party.