



**Item 11.3.2: TAC Recommendation
Opposition of ERCOT on NPRR1112,
Reduction of Unsecured Credit Limits
(URGENT) – ERCOT Position Statement**

Kenan Ögelman

Vice President, Commercial Operations

Board of Directors Meeting

ERCOT Public

April 28, 2022

NPRR1112 – Reduction of Unsecured Credit Limits

In its 4/21/2022 TAC Recommendation Opposition, ERCOT provided a detailed explanation of its reasons for requesting that the Board reject the TAC recommendation regarding NPRR1112 and instead recommend approval of the 4/13/2022 TAC Report for NPRR1112 as amended by the 3/18/2022 ERCOT comments.

In this presentation, ERCOT provides background information regarding the unsecured credit that is extended to certain Counter-Parties today and reiterates the policy considerations that prompted ERCOT to submit NPRR1112 and seek the elimination of unsecured credit.

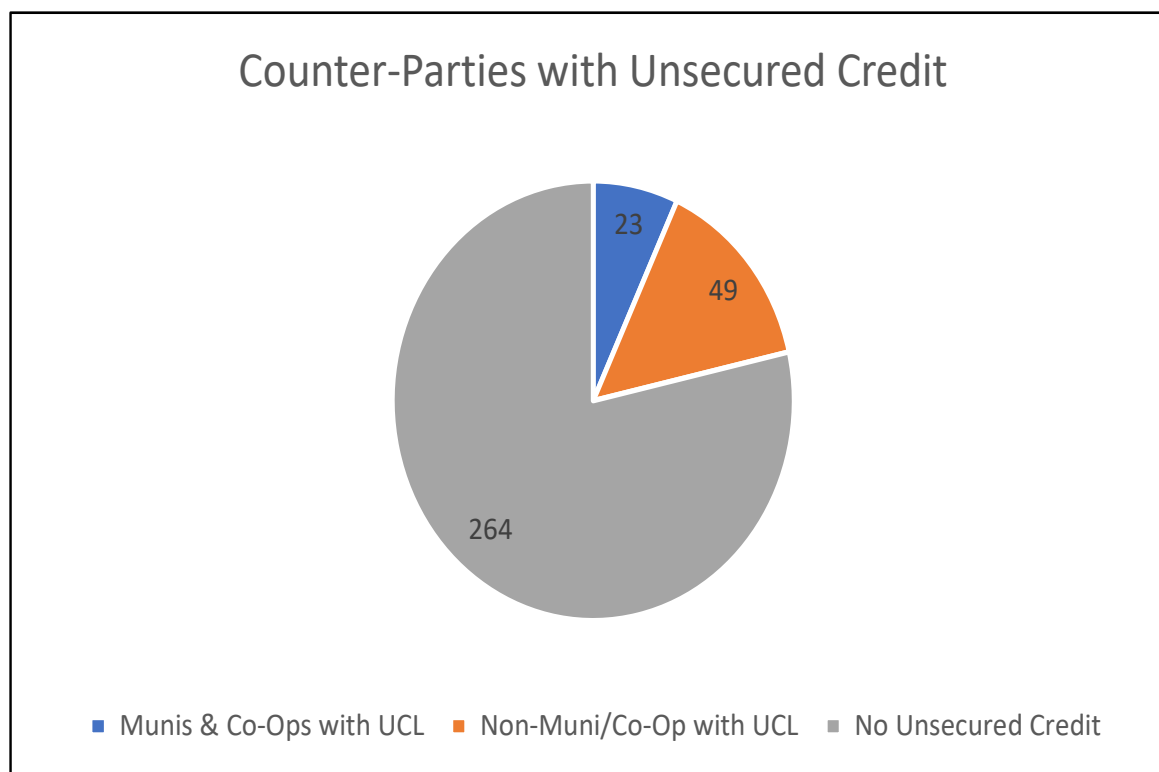
NPRR1112 – Reduction of Unsecured Credit Limits

ERCOT sets Unsecured Credit Limits in accordance with Protocol Section 16.11.2, *Requirements for Setting a Counter-Party's Unsecured Credit Limit*.

Unsecured Credit Limits are available to both agency-rated and non-rated Counter-Parties. Unsecured Credit Limits are formulaically derived. For rated Counter-Parties, the Unsecured Credit Limit is based on a sliding percentage of Tangible Net Worth. For non-rated Counter-Parties, the Unsecured Credit Limit is determined based on a percentage applied to Tangible Net Worth, once certain financial ratios are met.

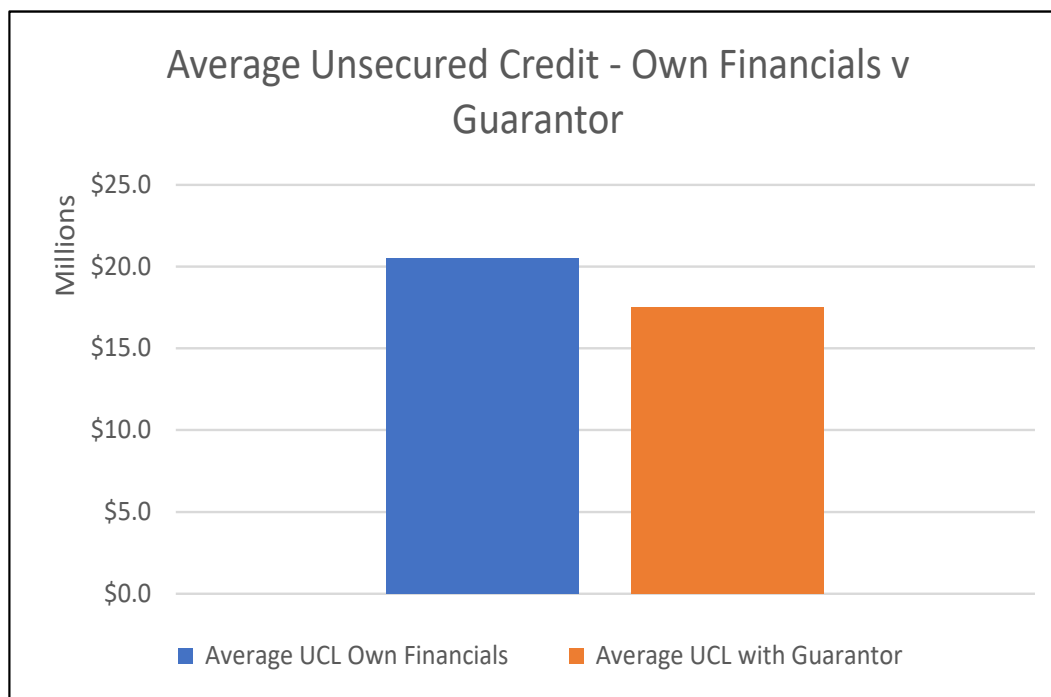
NPRR1112 – Reduction of Unsecured Credit Limits

72 out of 336 active Counter-Parties, or about 23%, receive unsecured credit. Of these, 23 are municipals or co-operatives.



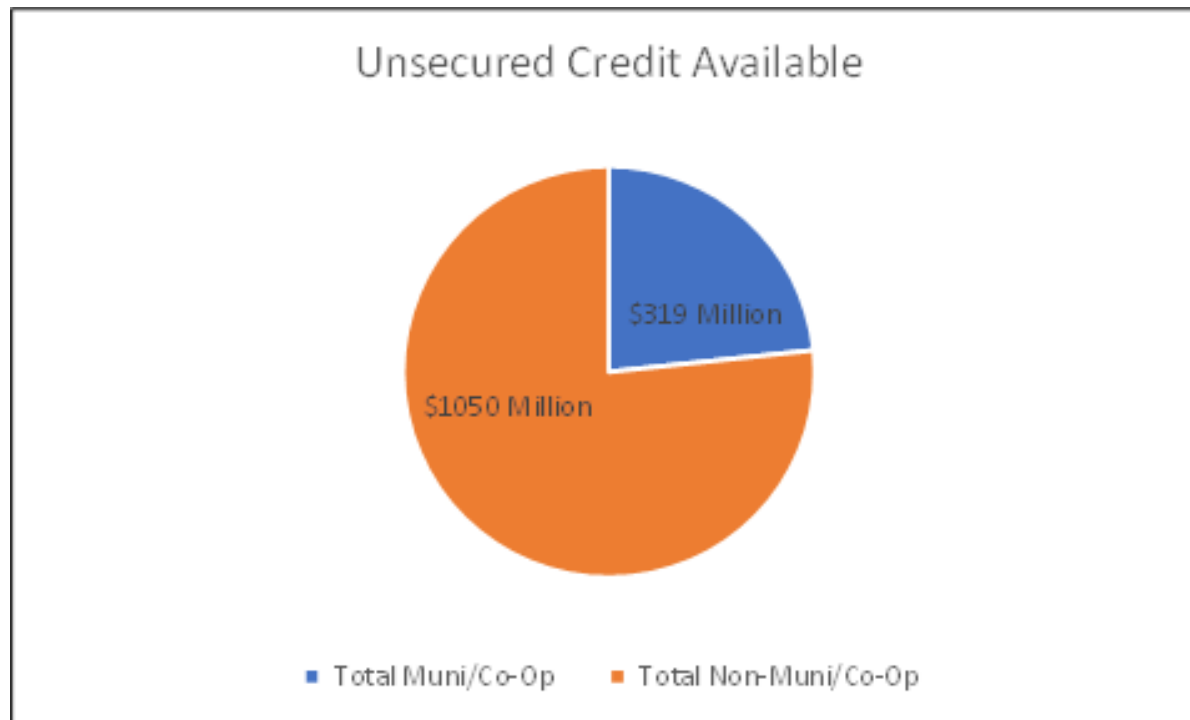
NPRR1112 – Reduction of Unsecured Credit Limits

Of the 72 Counter-Parties with unsecured credit, half receive unsecured credit based on their own financial statements, and half based on the financial statements of a guarantor. Average unsecured credit is somewhat higher for Counter-Parties relying on their own financial statements.



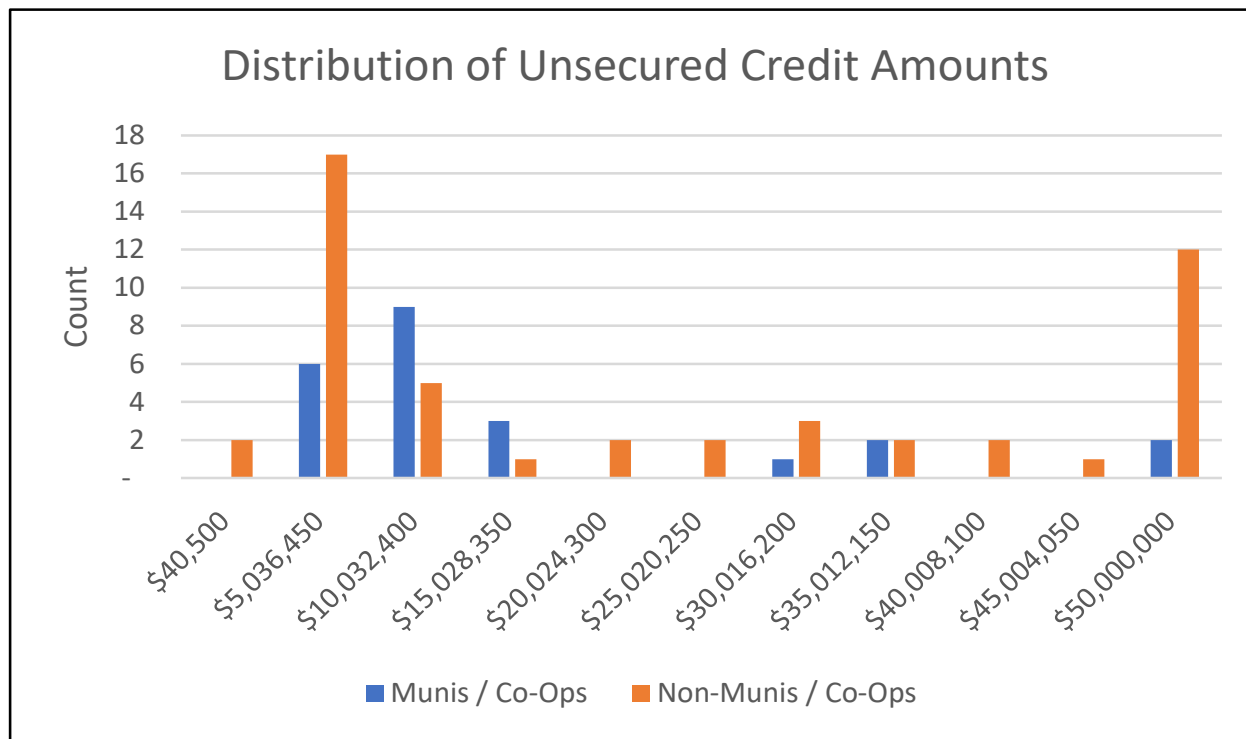
NPRR1112 – Reduction of Unsecured Credit Limits

There is currently approximately \$1.4 billion in available unsecured credit. Of this, approximately 77% is available to non-municipals / co-operatives.



NPRR1112 – Reduction of Unsecured Credit Limits

The following shows the size distribution of unsecured credit amounts. Currently, the Unsecured Credit Limit is capped at \$50 million.

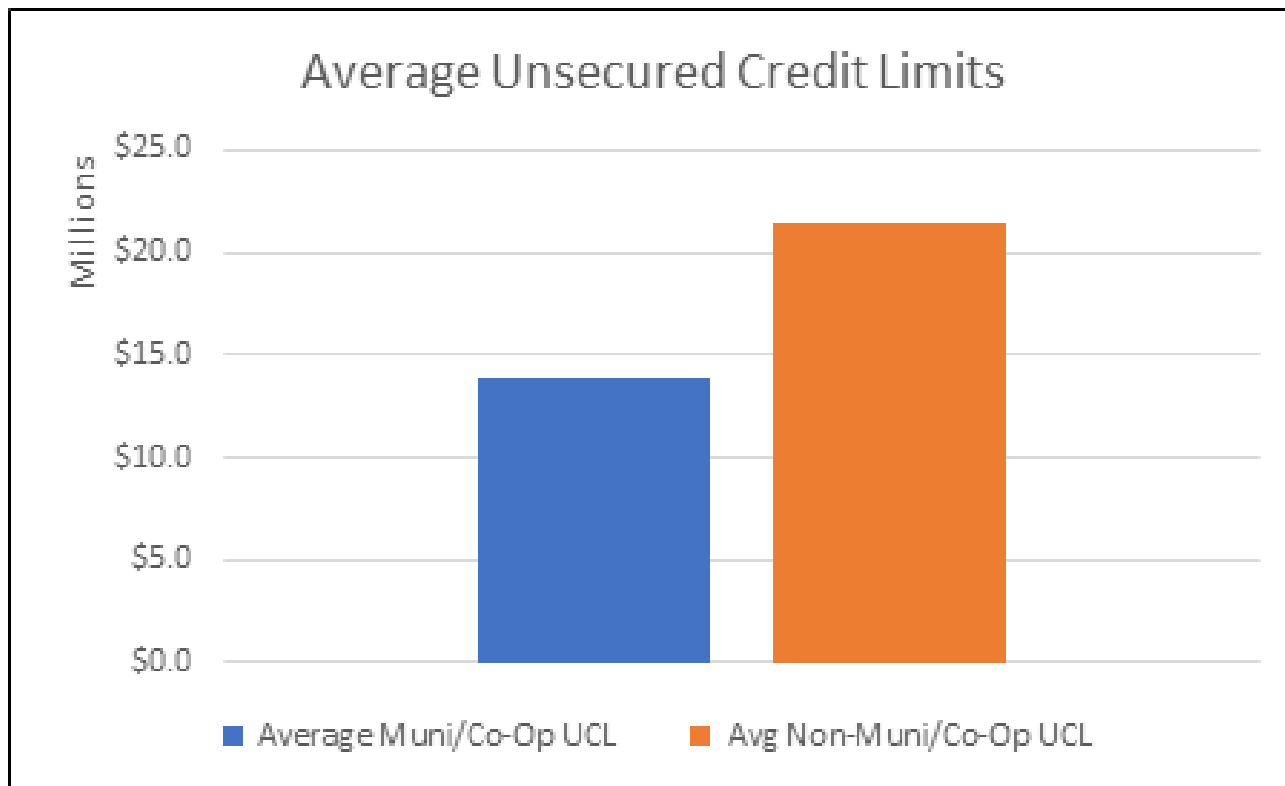


NPRR1112 – Reduction of Unsecured Credit Limits

- As will be discussed more fully later, TAC recommends that Unsecured Credit Limits be lowered to \$30 million; ERCOT recommends the elimination of unsecured credit.
- If the Board recommends approval of the TAC recommendation, 21 Counter-Parties will be affected. If the Board recommends approval of ERCOT's recommendation, 72 Counter-Parties will be affected.

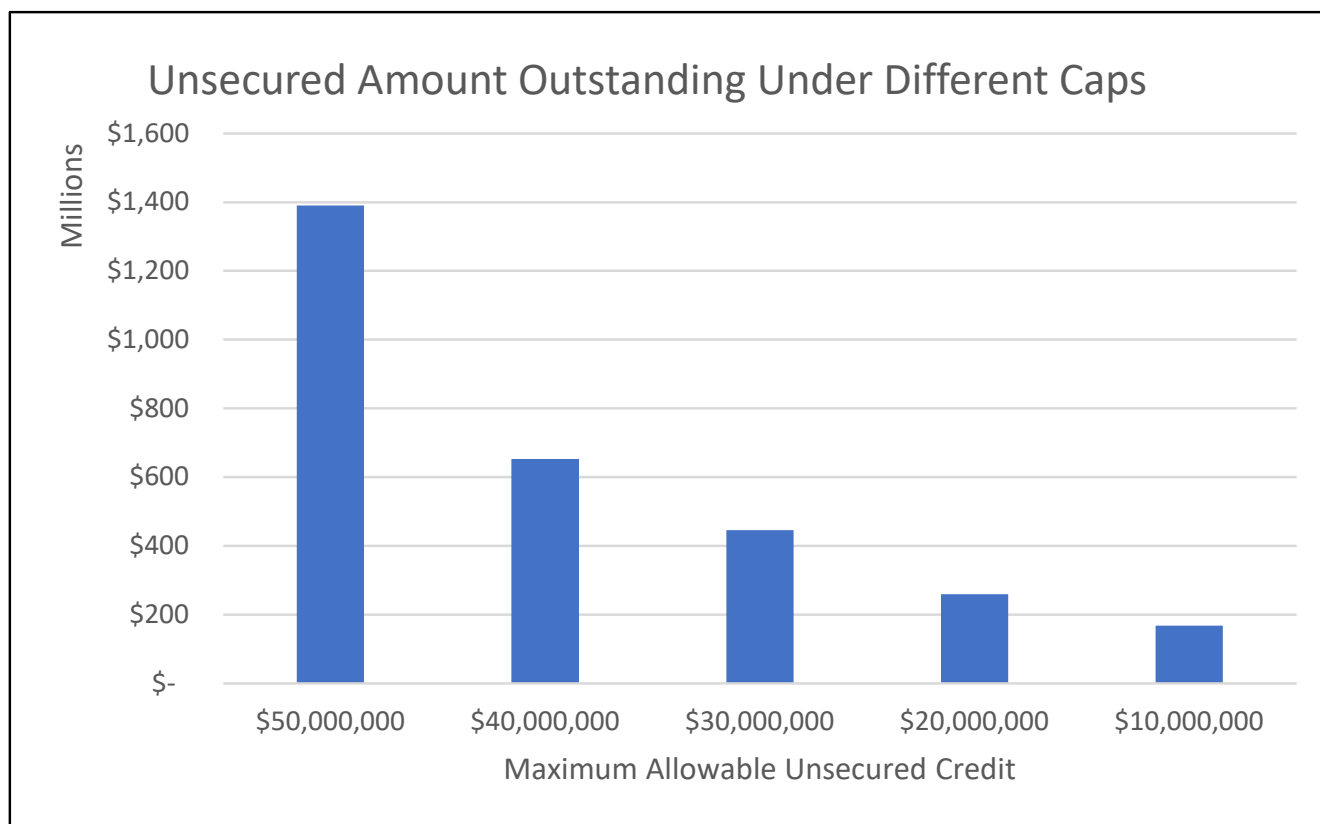
NPRR1112 – Reduction of Unsecured Credit Limits

Average unsecured credit per Counter-Party is approximately \$19 million. The average Unsecured Credit Limit is higher for non-municipals / co-operatives.



NPRR1112 – Reduction of Unsecured Credit Limits

Unsecured credit is currently capped at \$50 million per Counter-Party. This chart shows the amount of unsecured credit that would be outstanding at lower cap values.



NPRR1112 – Reduction of Unsecured Credit Limits

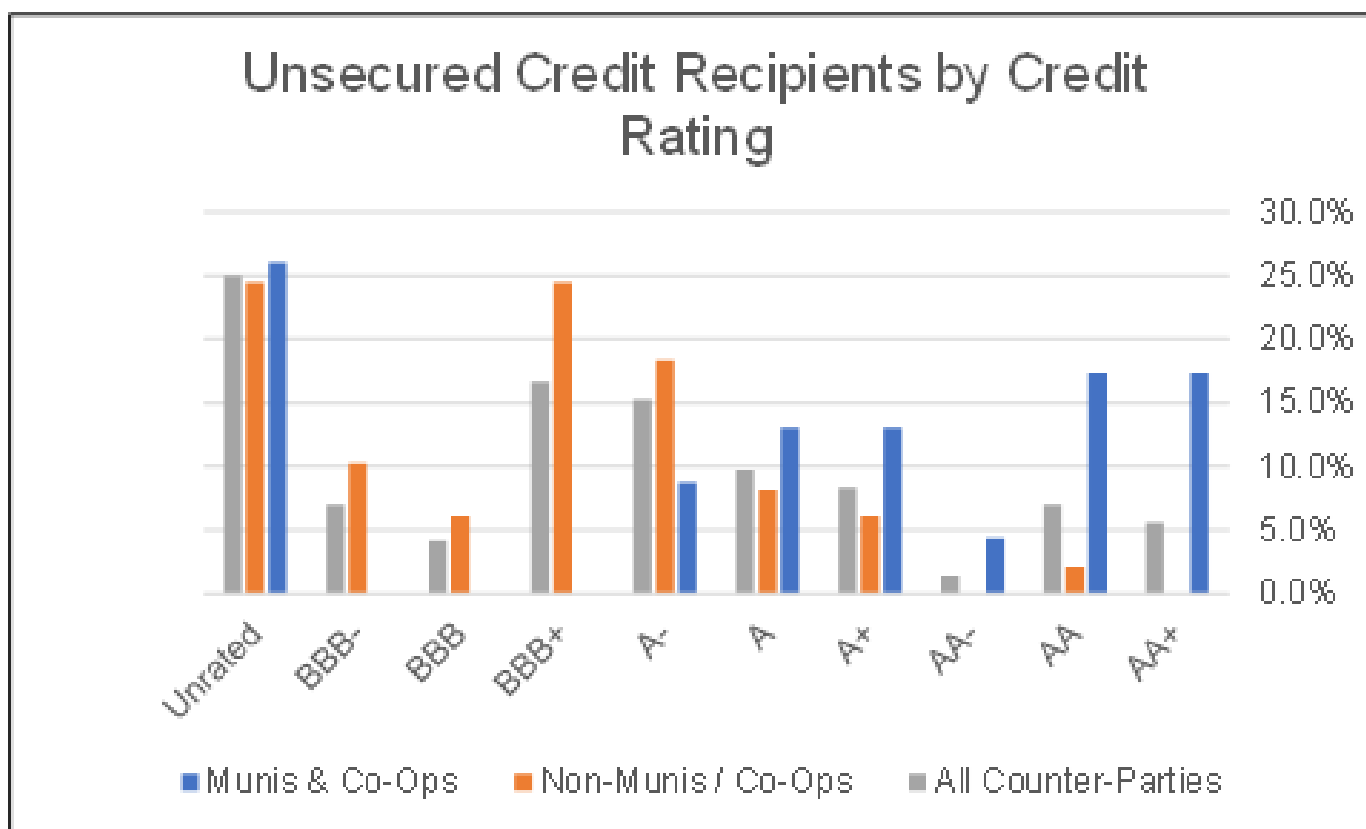
- Since ISO/RTOs function as central clearinghouses, there is no inherent reason why ISO/RTOs should provide free credit for some Counter-Parties. Since banks are in the business of understanding and pricing credit risk, they are better positioned to provide credit support for Counter-Parties.
- The assumption of credit risk is not costless. The cost of credit is reflected in bank charges for letters of credit. It is logically inconsistent to claim that the cost of obtaining letters of credit for highly-rated Counter-Parties would be burdensome, while at the same time claiming that there is no cost for the ERCOT market as a whole to subsidize the cost of credit. Provision of unsecured credit to some Counter-Parties does not make the cost of credit risk vanish; rather, it socializes the cost among other Market Participants.

NPRR1112 – Reduction of Unsecured Credit Limits

- Consistent with the above, ERCOT believes that elimination of Unsecured Credit Limits will not increase the cost of ERCOT market credit risk in the aggregate, but rather reallocate that cost in an appropriate and non-distortive manner.
- Unsecured Credit Limits also shift the cost of credit of some Counter-Parties to others in that, in the event of a default by a Counter-Party with unsecured credit, all active Counter-Parties must share in default uplift charges, including incremental default uplift attributable to unsecured credit.

NPRR1112 – Reduction of Unsecured Credit Limits

The following chart shows the distribution of Counter-Parties with unsecured lines of credit by their S&P-equivalent rating.

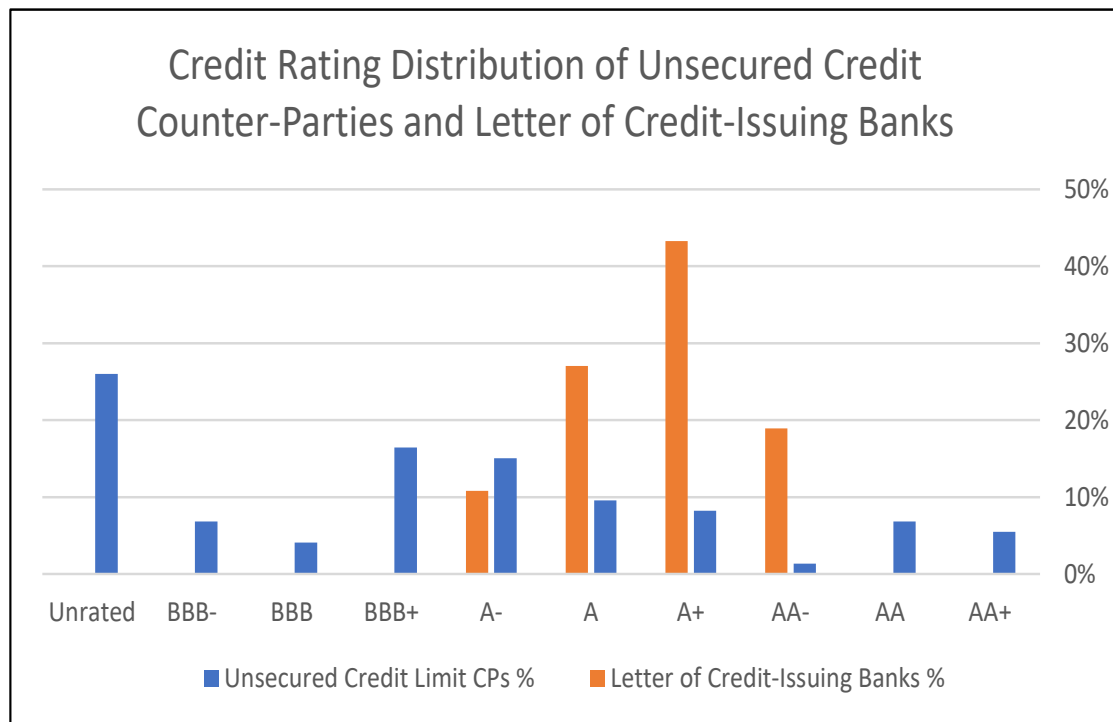


NPRR1112 – Reduction of Unsecured Credit Limits

- Counter-Parties now eligible for Unsecured Credit Limits should be able to obtain replacement financing from eligible letter of credit-issuing banks. If banks are unwilling to execute a letter of credit with one of these Counter-Parties, it is doubtful whether the ERCOT market should be financing their credit risk at no cost to the Counter-Party.
- ERCOT creditworthiness requirements for banks issuing letters of credit are, in the aggregate, more stringent than those currently used to grant Unsecured Credit Limits. Therefore, it can be expected that elimination of Unsecured Credit Limits would reduce potential default uplift and improve ERCOT's overall credit profile.

NPRR1112 – Reduction of Unsecured Credit Limits

The following chart, included in ERCOT's April 12, 2022, comments to NPRR 1112, shows the credit rating distribution of Counter-Parties receiving unsecured credit compared to the credit rating distribution of banks currently providing letters of credit for ERCOT Counter-Parties. ERCOT requires banks issuing letters of credit to have a minimum rating of A- (S&P/Fitch) or A3 (Moody's).



NPRR1112 – Reduction of Unsecured Credit Limits

- Stakeholders opposed to the ERCOT proposal have maintained that eliminating unsecured credit does not materially improve credit risk in ERCOT, and this is tied to the fact that, excluding Brazos, existing short-paying Counter-Parties did not have Unsecured Credit Limits. While this is true, NPRR1112 is intended to improve ERCOT credit policy on a prospective basis. It does not change the scope or amounts of historic defaults. Again, ERCOT believes that substitution of Financial Security for unsecured credit can only improve ERCOT's credit risk profile.
- Whether or not post-Uri reforms to ERCOT wholesale markets have significantly reduced credit risk, they have not eliminated it. A Counter-Party might default for any number of reasons that are not addressed by post-Uri reforms. For example, insufficient hedging or cash flow problems, neither of which are addressed by market reforms, would not be visible to ERCOT yet could lead to a default that affects the ERCOT market.

NPRR1112 – Reduction of Unsecured Credit Limits

Considering the above, ERCOT requests that the Board reject the TAC recommendation of NPRR1112 and recommend approval of the 4/13/2022 TAC Report for NPRR1112 as amended by the 3/18/2022 ERCOT comments.

Irrespective of the Board's decision, to provide sufficient time for Counter-Parties to obtain sufficient Financial Security, ERCOT recommends that NPRR1112 become effective no sooner than four months after approval by the PUCT.

Additionally, ERCOT is willing to sponsor a Revision Request to increase the cap on the amount of letters of credit that may be accepted from any one issuer to help ensure sufficient liquidity is available to Counter-Parties.

NPRR1112 – Reduction of Unsecured Credit Limits

Questions