



**Southwest Power Pool**  
**FINANCE COMMITTEE MEETING**  
**July 27, 2012**  
**Dallas, Texas**

**• Summary of Action Items •**

1. Approved recommendation from Credit Practices Working Group on approach to comply with netting/offset provisions of FERC Order 741.

**• Schedule of Follow-up Items •**

1. Impact of depreciation schedules on property taxes and balance sheet



**Southwest Power Pool**  
**FINANCE COMMITTEE MEETING**  
**July 27, 2012**  
**Dallas, Texas**

• M I N U T E S •

**Agenda Item 1 – Administrative Items**

SPP Chair Harry Skilton called the meeting to order at 10:00 a.m. The following members of the Finance Committee were in attendance:

Harry Skilton	SPP Director
Larry Altenbaumer	SPP Director
Sandra Bennett	Southwestern Power Company
Kelly Harrison	Westar Energy
Tom Dunn	SPP

Others attending included:

Traci Bender	NPPD
Terri Wendlandt (telephone)	Westar
Jayne Clarke (telephone)	Sunflower
Al Taylor (telephone)	ETEC
Scott Smith	SPP

**Administrative Items**

Minutes from the July 10, 2012 meeting were reviewed. Kelly Harrison motioned to approve the minutes. The motion was seconded by Larry Altenbaumer and approved by unanimous voice vote.

**Credit Practices Working Group**

Members of the Credit Practices Working Group (“CPWG”) and SPP staff led a detailed discussion on the requirements of FERC Order 741 specifically around the RTO’s ability to net/offset in default and bankruptcy scenarios. The CPWG recommended establishing SPP as a central counterparty to all market transactions. This recommended course results in several advantages to SPP and its market participants:

- Creates mutuality between SPP and the market participants allowing SPP to represent the market in bankruptcy situations
- Does not limit participation or stifle competition in the market
- Does not result in an increase in collateral required of market participants
- Consistent with other organized RTO markets

Legal ramifications of establishing SPP as a central counterparty were investigated by SPP’s in-house legal department. SPP will proceed with requesting a determination letter from the U.S. Internal Revenue Service which will ensure establishing SPP as a central counterparty will not impact SPP’s not for profit tax status.

Sandra Bennett motioned to approve the recommendation. The motion was seconded by Kelly Harrison and approved by unanimous voice vote.

Harry Skilton thanked the members of the CPWG for their efforts in responding to all of the requirements of FERC Order 741.

### **Investment Management**

The Committee members participated in an open dialogue session focused on selection/evaluation of managers of SPP's pension and post-retirement funds and investment objectives of those funds.

Important considerations on investment manager selection/evaluation included:

- Asset size of firm
- Firm's historical returns
- Consistency of investment style
- Types of clients the firm is engaged by
- Scope of firm's operations
- History of firm

Important considerations on fund investment objectives included:

- Overall portfolio rating – this should be identified explicitly
- Return objective for portfolio and individual manager/investment type
- Diversification requirements – limit investment in individual names to <X%

Action items from this session included:

- Invite SPP's actuary to present at the late September meeting a report on expected return assumptions used by defined benefit pension sponsors
- Invite Stephens, Inc. to provide a review of existing SPP structure around investment management and solicit input/ideas for improvement
- NPPD offered to share the investment policy statements used to manage their decommissioning funds

### **Future Meetings**

The next meeting of the SPP Finance Committee is scheduled for September 13, 2012 beginning at 3:00 pm central time and finishing at 5:00 pm central. This meeting will be held at the Doubletree Dallas in Dallas, TX. The sole agenda item will be sharing initial thoughts/questions regarding the SPP 2013 budget.

There being no further business, Harry Skilton adjourned the meeting at 1:30 p.m.

Respectfully Submitted,

Thomas P. Dunn  
Secretary



**Southwest Power Pool, Inc.  
FINANCE COMMITTEE MEETING**

**July 27, 2012**

**DFW Hyatt Regency  
Dallas, Texas**

**• A G E N D A •**

10:00 a.m. – 3:00 p.m.

1. Administrative Items (*5 minutes*) ..... Harry Skilton
2. Credit Practices Working Group Report (*90 minutes*) ..... Scott Smith
3. LUNCH (*45 minutes*)
4. Investment Management
  - a. Investment Policy Statement Review (*30 Minutes*) ..... Tom Dunn
  - b. Investment Manager Evaluations (*30 minutes*) ..... All
5. Future Meetings ..... All
6. Adjourn ..... Harry Skilton



**Southwest Power Pool**  
**FINANCE COMMITTEE MEETING**  
**July 10, 2012**  
**Little Rock, Arkansas**

**• Summary of Action Items •**

1. Approved by consensus the report from the Finance Committee Task Force on Order 1000 detailing the financial requirements of participants in the SPP Competitive Solicitation Process for regionally funded "green field" transmission.

**• Schedule of Follow-up Items •**

1. Impact of depreciation schedules on property taxes and balance sheet



**Southwest Power Pool**  
**FINANCE COMMITTEE MEETING**  
**July 10, 2012**  
**Dallas, Texas**

• M I N U T E S •

**Agenda Item 1 – Administrative Items**

SPP Chair Harry Skilton called the meeting to order at 8:15 a.m. The following members of the Finance Committee were in attendance:

Harry Skilton	SPP Director
Larry Altenbaumer	SPP Director
Sandra Bennett	Southwestern Power Company
Kelly Harrison	Westar Energy
Tom Dunn	SPP

Others attending included:

Brian Lawson	ETEC
Scott Noble	SPP
Nick Brown	SPP
Bruce Rew	SPP
Antoine Lucas	SPP
Scott Maple	SPP
Greg Hartz	Foundation Resource Management
Mark Millsap	Foundation Resource Management
Jay White	Smith Capital Management
Linda Lockwood	U.S. Bank
Larry Lucy	U.S. Bank
Bill Bussey	Stephens Insurance
Kevin McBride	Stephens Insurance

**Administrative Items**

Minutes from the April 17, 2012 meeting were reviewed. Kelly Harrison motioned to approve the minutes. The motion was seconded by Sandra Bennett and approved by unanimous voice vote.

The “follow-up” items from the agenda were reviewed with the following items being removed from the list:

- SPP President to review metering in SPP region and suggest opportunities for improvement
- Provide updates on Integrated Marketplace project along with Internal Audit reports on Integrated Marketplace at each regularly scheduled Finance Committee meeting
- Distribute copy of PCAOB report on BKD, LLC to Finance Committee members

**May 2012 Financial Report**

SPP staff reviewed SPP’s May 2012 financial reports. As of May, SPP is forecasting an over-collection of approximately 2¢/MWh due primarily to lower expenditures on outside service providers and greater than budgeted NITS load.

**Investment Policy Statement Review**

Investment Policy Statements (“IPS”) were reviewed for both the defined benefit pension plan and the post retirement healthcare plan. The Committee had significant dialogue on the structure of the plans, particularly along two main areas:

- Extent of detail prescribed for asset allocation
- Limitations on investment in non-U.S. domiciled issuers

The Committee will discuss these issues at its next meeting

#### **Investment Manager Reviews – Defined Benefit Pension Plan**

**Performance Reports:** Mark Millsap and Greg Hartz with Foundation Resource Management reported on the performance of the defined benefit pension plan fund assets under their management. Foundation Resource Management generated returns of -6.35% for the 2011 calendar year and 4.46% annualized since their engagement in January 2005. The firm continues to adhere to a value investment strategy as they have since engagement. There has been no turnover in the individuals directly responsible for management of the assets of the plan.

**Performance Reports:** Jay White with Smith Capital Management reported on the performance of the defined benefit pension plan fund assets under his management. Smith Capital Management generated returns of -2.55% for the 2011 calendar year and 1.75% annualized since their engagement in August 2006. The firm continues to manage the assets of the plan with a focus on growth oriented investments. There has been no turnover in the individuals directly responsible for management of the assets of the plan.

#### **Investment Manager Reviews – Post-retirement Healthcare Plan**

**Performance Reports:** Larry Lucy and Linda Lockwood with U.S. Bank Institutional Trust and Custody reported on the performance of the post-retirement healthcare plan fund assets under management. U.S. Bank generated returns of -4.53% for the 2011 calendar year and 1.93% annualized since their engagement in January 1999. The firm continues to manage the assets of the plan with using a balanced portfolio allocation model. The current investment manager has been assigned to the SPP account for less than one year.

#### **Business Process Improvement**

SPP staff advised the Committee on the year to date results for the business process improvement initiative. The company is currently tracking slightly ahead of plan due to the addition of a few newly identified initiatives.

The Committee was presented with a proposal which details the “sun setting” of BPI initiative tracking. SPP proposes to track initiatives based on policy changes for up to 2 years, staffing reductions for up to 3 years, and those requiring meaningful capital investments for up to 5 years.

Finally, SPP staff reviewed the ongoing implementation plan for BPI which is expected to be fully implemented in 2015.

#### **FERC Order 1000 Task Force**

The Committee reviewed the report of the task force outlining the financial criteria and other financial requirements to be considered in compliance with FERC Order 1000. A new topic not previously included in the report regarding the obligation an incumbent TO has to construct transmission assets in the event the selected TO fails to perform. Following significant dialogue the Committee recommended adding a requirement for the selected TO to fund a deposit equal to 2% of the bid amount with SPP upon acceptance of the notice to construct. This deposit would be forfeited if the selected TO were unable to complete the project.

#### **2012 Insurance Stewardship Report**

SPP’s insurance broker, Stephens Insurance, presented a report on SPP’s 2012 corporate insurance program and outlook for 2013. With SPP’s change to a non-calendar year program Stephens was requested to make a follow-up report in December 2012 in advance of the 2013 renewal.

Finance Committee  
July 10, 2012

**Integrated Marketplace Review**

SPP staff provided a brief overview of the status of the Integrated Marketplace project focusing on the plans to return to “green” status.

**Future Meetings**

The next meeting of the SPP Finance Committee is scheduled for July 27, 2012 beginning at 10:00 am central time and finishing at 3:00 pm central. This meeting will be held at the DFW-Hyatt Regency in Dallas, TX

There being no further business, Harry Skilton adjourned the meeting at 3:30 p.m.

Respectfully Submitted,

Thomas P. Dunn  
Secretary



**Southwest Power Pool, Inc.**  
**CREDIT PRACTICES WORKING GROUP**  
**Recommendation to the Finance Committee**

**July 27, 2012**

**Recommendation on Netting and Offsetting Provision of FERC Order 741**

**Organizational Roster**

The following persons are members of the Credit Practices Working Group:

Terri Wendlandt (Chairman), Westar Energy	Vanisha Patel, The Energy Authority
Jayne Clarke (Vice-Chair), Sunflower Electric	James Goforth, Xcel Energy
Gina Wilson, ITC Holdings	William Thompson, American Electric Power
Jacqueline Humphrey, Golden Spread	Willie Brooks, Arkansas Electric Cooperative
Mark Holler, Tenaska Power Services	Paul Krebs, Kansas City Power & Light

**Background**

On October 21, 2010, the Federal Energy Regulatory Commission (FERC) issued Order 741 mandating reforms to credit policies used in organized wholesale electric power markets. To date, SPP has adopted tariff language and business practices to comply with six of the seven requirements. The seventh requirement addresses the risk that ISOs/RTOs may not be allowed to use netting and set-off in bankruptcy situations. FERC has directed each ISO/RTO submit a compliance filing including tariff revisions that incorporate one of the following options:

- Establish a central counterparty to market transactions
- Require market participants to provide a security interest in their transactions in order to establish collateral requirements based on net exposure
- Propose another alternative, which provides the same degree of protection as the two above-mentioned methods
- Choose none of the three above alternatives, and instead establish credit requirements for market participants based on their gross obligation

FERC determined that merely including the ability to net in ISO/RTO tariffs would not provide sufficient protection to ensure the right of an ISO/RTO to net in the bankruptcy context.

**Analysis**

*The attached white paper 'SPP Report on FERC Order 741 - Central Counterparty Discussion' describes each of the options in more depth as well as provides further analysis of the options.*

The Credit Practices Working Group (CPWG) has engaged in much discussion and deliberation as to how SPP may best comply with the Commission's netting and set-off requirement and ultimately identified the central counterparty option as the preferred methodology to satisfy the mandate. In essence, the central counterparty option would: 1) not limit market participation and competition, 2) not require significant increase in collateral, 3) provide benefits at a lower cost than the other three options, and 4) provide some consistency to market participants who participate in multiple markets.

Additionally, the CPWG determined that SPP Inc. should become counterparty to all "pool" market transactions including: 1) Day-Ahead, 2) Virtual, 3) TCR, and 4) EIS Resettlement transactions, effective as of the Integrated Marketplace go-live date. CPWG research determined establishment of SPP as the counterparty will not impact SPP's status as a non-taxable entity or SPP's credit rating and loan covenants.



**Recommendation**

The CPWG recommends the SPP Finance Committee approve the central counterparty option to satisfy FERCs mandate for netting and set-off. SPP is required to submit its compliance filing with the FERC by December 31, 2012. Changes to tariff language must be filed with FERC prior to go-live of the Integrated Marketplace.

**Approved:** Credit Practices Working Group July 18, 2012  
Approved Unanimously

**Action Requested:** Approve Recommendation



# **SPP Report on FERC Order 741 – Central Counterparty Discussion**

07/11/2012

SPP Credit and Risk Management

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## Revision History

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Date or Version Number	Author	Change Description	Comments
06/21/2012	Scott Smith	First draft distributed	
07/11/12	Scott Smith	Revised for publication and presentation to CPWG	Revisions and edits incorporated from SPP Staff and CPWG Chair
07/18/12	Scott Smith	Revised for publication and presentation to Finance Committee	Revision incorporated for footnote related to coop tax exemption on page 8

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## Executive Summary

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FERC Order 741 represents a significant mandate for ISOs/RTOs with regard to credit and risk management practices. The goal of Order 741 is “to improve the management of risk and the subsequent use of credit in the organized wholesale electric markets”. The Order has seven requirements which must be met to achieve full compliance. To date, SPP has adopted tariff language and business practices to comply with six of the requirements. The seventh requirement addresses the risk that ISOs/RTOs may not be allowed to use netting and set-off in bankruptcy situations. FERC has established four options to fulfill this requirement:

1. *Establish a central counterparty to market transactions.* A central counterparty takes flash title to each transaction by interjecting itself as the buyer to the seller and the seller to the buyer. FERC believes this option would allow the ISO/RTO to establish mutuality of obligations enabling the set-off of amounts owed to and from a market participant in a bankruptcy proceeding. To date, all other ISO/RTOs have chosen the central counterparty option to satisfy FERCs mandate.
2. *Require market participants to provide a security interest in their transactions.* A security interest is a property interest created by an agreement or by operation of law to secure performance of an obligation, usually the payment of a debt. The security interest must be properly created and perfected to remain enforceable in a bankruptcy proceeding. Many market participants have noted their specific lending agreements prohibit the granting of liens against assets.
3. *Propose another alternative, which provides the same degree of protection as the two above.* FERC also granted ISOs/RTOs the flexibility to propose alternative solutions that provide the same degree of protection as the central counterparty and security interest options. To date, no other ISO/RTO has proposed such an option, and SPP’s Credit Practices Working Group (“CPWG”) has not identified or developed a solution for SPP’s consideration.
4. *Choose none of the above, and instead establish credit on gross obligations.* To comply with this option, the market administrator would not allow a market participant’s unfavorable positions to be offset by their favorable positions in the calculation of both secured and unsecured credit. While this option would likely provide sufficient collateral in most bankruptcy situations; it would likely result in a reduction of market transactions by reducing participants’ liquidity.

Since the issuance of Order 741, the CPWG has engaged in much discussion and deliberation as to how SPP may best comply with the Commission’s netting and set-off requirement and ultimately identified the central counterparty option as the preferred methodology to satisfy the mandate. The CPWG determined the benefits of SPP becoming a central counterparty to be more advantageous than the security interest or gross obligation options. In essence, the central counterparty option would: 1) not limit market participation and competition, 2) not require significant increase in collateral, 3) provide benefits at a lower cost than the other three options, and 4) provide some consistency to market participants who participate in multiple markets.

For these reasons, the CPWG is recommending that Southwest Power Pool, Inc. become the central counterparty to all pool market transactions as described in the sections above. Specific tariff language will continue to be developed and the appropriate FERC filings will be made by December

31, 2012, with compliance beginning with the implementation of the Integrated Marketplace in early 2014.

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## Background on FERC Order 741

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### **Overview of Order 741**

On October 21, 2010, the Federal Energy Regulatory Commission (FERC or the Commission) issued Order 741 mandating reforms to credit policies used in organized wholesale electric power markets.<sup>1</sup> Order No. 741, among other things, reformed the Commission's existing credit policies by requiring the adoption of steps to address the risk that Independent System Operators (ISOs) and Regional Transmission Organizations (RTOs) may not be allowed to use netting and set-off in the event of a market participant bankruptcy. On February 17, 2011, the Commission issued Order No. 741-A, which, among other things, extended the deadline to comply with the Order No. 741 netting and set-off requirement.

Order 741 represents a significant mandate for ISOs/RTOs with regard to credit and risk management practices. In the Order, FERC explains that if access to credit in wholesale electric markets is too restrictive, competition suffers. Conversely, if more risk is tolerated and access to credit is too easy to obtain, the market is more susceptible to defaults. Defaults not supported by collateral are socialized among all other market participants. In essence, FERC's goal is to promote competition and efficient markets while attempting to limit default risk. To address this balancing effort, FERC Order 741 contains requirements for:

1. Shortened billing and settlement cycles (no longer than seven days each);
2. Limits on the amount of unsecured credit for individual market participants and corporate families;
3. Elimination of unsecured credit in all financial transmission rights or equivalent markets;
4. Establishment of minimum criteria for market participation;
5. Clarification regarding the circumstances in which a market administrator may invoke a "material adverse change" clause in regard to collateral calls or other credit action;
6. Standardized grace period for "curing" collateral calls (two days); and
7. Steps to address the risk that ISOs/RTOs may not be allowed to use netting and set-off in instances of bankruptcy.

To date, Southwest Power Pool, Inc. (SPP) has incorporated language within its Open Access Transmission Tariff (Tariff) to comply with the first six requirements set forth above.

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<sup>1</sup>*Credit Reforms in Organized Wholesale Electric Markets*, Order No. 741, FERC Stats. & Regs. ¶ 31,317 (2010), *order on reh'g*, Order No. 741-A, FERC Stats. & Regs. ¶ 31,320, *order denying reh'g*, Order No. 741-B, 135 FERC ¶ 61,242 (2011).

SPP has filed for and received approval from FERC to delay the decision to address the netting and set-off provision until December 31, 2012, and to begin compliance with the netting and set-off requirement when the Integrated Marketplace commences on March 1, 2014. Currently, SPP is collaborating with its stakeholder groups to address the issue and determine the best course of action.

## **Justification of the Netting and Set-off Requirement**

In Order 741, FERC presents its rationale for imposing the netting and set-off requirement and identifies four options for ISO/RTO compliance, discussed in more detail below: (1) establishing a central counterparty, (2) requiring market participants to provide a security interest, (3) proposing an alternative with the same degree of protection, and (4) establishing credit requirements for market participants based on their gross obligations. The terms “netting” and “set-off” relate to an ISO’s/RTO’s ability to protect itself and its market participants in bankruptcy litigation. For instance, if a particular market participant were to file bankruptcy, it may seek to recover all funds owed to it from the energy market while simultaneously seeking to withhold its obligations to the energy market. The energy market, as administered by an ISO/RTO, would seek to set-off (*i.e.*, offset or net) any accounts receivable against any accounts payable related to the specific market participant in an effort to reduce or possibly eliminate loss to the collective energy market. Under SPP’s Tariff, these losses are socialized among market participants.

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## **Mandated Options for Netting and Set-Off**

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### **FERC Mandated Options**

In Order 741, the Commission determined that merely including the ability to net in ISO/RTO tariffs would not provide sufficient protection to ensure the right of an ISO/RTO to net in the bankruptcy context.<sup>2</sup> Therefore, the Commission has directed each ISO/RTO submit a compliance filing including tariff revisions that incorporate one of the following options:

1. Establish a central counterparty to market transactions.
2. Require market participants to provide a security interest in their transactions in order to establish collateral requirements based on net exposure.
3. Propose another alternative, which provides the same degree of protection as the two above-mentioned methods.

**“While RTOs and ISOs may propose such tariff language as an additional measure, the Commission believes that it is not sufficient protection to simply direct the ISOs and RTOs to include the ability to net in their tariff.”**

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<sup>2</sup> Order 741 at P 121.

4. Choose none of the three above alternatives, and instead establish credit requirements for market participants based on their gross obligations.<sup>3</sup>

A more detailed description of each of FERC’s mandated options is presented in the sections that follow.

## Central Counterparty

A central counterparty is an entity that identifies the obligations of both parties in a transaction and interjects itself as the buyer to the seller and as the seller to the buyer. The counterparty then settles each transaction separately. By taking “flash title” to each transaction, the central counterparty has established mutuality in the transactions, creating legal standing to enable the set-off of amounts owed to and from a market participant in a bankruptcy proceeding. To date, all other ISOs/RTOs have chosen the central counterparty option to satisfy FERC’s mandate.

This option will not require changes to the collateral requirements specified in SPP’s Tariff or necessitate any significant changes to the Credit Management System (CMS), currently in development to support Integrated Marketplace trading. CMS functional requirements were identified by SPP’s Credit Practices Working Group (CPWG) in preparation for the new Integrated Marketplace products. Early indications suggest that establishing a central counterparty would represent the lowest cost option of those mandated by FERC.

To date, all other ISOs/RTOs have chosen the central counterparty option to satisfy FERCs mandate

Although the central counterparty option may present significant advantages, a number of questions arise as to the most appropriate form of implementation, including, among others: (1) identification of the types of transactions to which SPP would become a counterparty; (2) whether establishment of a central counterparty would jeopardize SPP’s non-profit status; and (3) whether it may be necessary or beneficial to establish a wholly-owned subsidiary to function as the central counterparty. These and other questions identified in collaboration with stakeholders will be addressed below in further discussion of the central counterparty option.

## Security Interest

A security interest is a property interest created by an agreement or by operation of law to secure performance of an obligation, usually the payment of a debt. In order to enforce a security interest against the other creditors in bankruptcy, the security interest must be properly created and perfected. Perfecting a security interest requires that all necessary requirements for achieving priority over other security interests be satisfied.

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<sup>3</sup> Order 741 at P 117.

In relation to wholesale energy markets, the underlying asset to which a security interest would attach is a market participant's accounts receivable, which it has pledged as a form of collateral against its accounts payable to the market. FERC has evidenced its belief that the security interest option may enable the set-off of amounts owed to and from a market participant in a bankruptcy proceeding. This option will not require changes to collateral requirements specified in SPP's Tariff or necessitate any significant changes to the CMS.

Although the security interest option would likely provide the benefits desired, FERC and all other ISO/RTOs recognize the substantial administrative burdens in obtaining perfected security interests from all market participants. During the FERC technical conference for Order 741, many participants noted that their lending agreements prohibit the granting of liens and some entities, such as municipalities, cannot utilize the security interest approach. Given these issues, it is likely the security interest option may have the unintended consequence of reducing the number of market participants, therefore limiting competition in the marketplace. This option would also likely necessitate additional annual expenditures for legal services for local, state and federal expertise.

**In relation to wholesale energy markets, the underlying assets represent a market participant's accounts receivable for which it has pledged as a form of collateral against its accounts payable to the market.**

## **Gross Obligation**

In lieu of the central counterparty, security interest, or other suitable alternative, FERC directed market administrators to establish credit requirements for market participants based on the market participants' gross obligations. In essence, the market administrator would not allow a market participant's unfavorable positions to be offset by their favorable positions in the calculation of both secured and unsecured credit.

The clear advantage to this option is that sufficient collateral should be available upon most bankruptcy situations since both favorable and unfavorable positions are not netted. However, this would also require either a significant increase in collateral posted by many market participants and/or a significant decrease in marketplace activities by those participants. In either case, it is clear that certain market participants will be excluded from certain transactions, therefore limiting competition in the marketplace.

The gross obligation option would necessitate significant change to SPP's credit policy and the current development of the CMS. Additionally, this option was widely criticized by the CPWG in numerous discussions due to the expected increase in collateral needs among members and customers.

**The clear advantage to the gross obligation option is that sufficient collateral should be available upon most bankruptcy situations since both favorable and unfavorable positions are not netted.**

## **Other Alternatives**

FERC also granted ISOs/RTOs the flexibility to propose alternative solutions that would provide the same degree of protection as the central counterparty and security interest options. To date, no other ISO/RTO has proposed such an option, and the CPWG has not identified or developed an alternative solution for SPP's consideration.

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# **Recommended Course of Action**

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## **CPWG Activities**

Since the issuance of Order 741 in October 2010, the CPWG has engaged in much discussion and deliberation as to how SPP may best comply with the Commission's netting and set-off requirement. The CPWG weighed the advantages and disadvantages of each option and ultimately identified the central counterparty option as the preferred methodology to satisfy FERC's mandate. The CPWG determined the course of SPP becoming a central counterparty to be more advantageous than implementing the security interest or gross obligation options. Moreover, the central counterparty option will:

- Not limit participation and competition in the marketplace, unlike the security interest and gross obligations options;
- Not require any significant increase in collateral (capital), unlike the gross obligation option;
- Provide benefits at a lower cost than the security interest option; and
- Provide some consistency to market participants who participate in multiple markets.

SPP is in a unique position in that all other ISOs/RTOs have already performed their due diligence and indicated their preferences. As noted above, each has independently chosen to pursue the central counterparty option. Below is a discussion of certain issues which have been (or will be) addressed as it relates to SPP becoming the central counterparty. These issues are presented in a Q&A format for ease of reference.

## Questions and Answers

### Counterparty Transactions

Question: *To which types of transactions will SPP become a counterparty?*

Answer: Once the Integrated Marketplace is operational, SPP will settle and become a counterparty to the following types of transactions<sup>4</sup>:

- Energy Imbalance Service (EIS) Market – SPP currently settles EIS Market transactions on a weekly basis. Upon the implementation of the Integrated Marketplace, there will be no new EIS transactions, only resettlements, which will last for up to one year. These transactions are considered “pool” transactions in that a specific market participant may buy or sell into the pool of energy-related assets and there is no clear counterparty to each singular transaction. Currently, any default is uplifted to all market participants who will be receiving funds from SPP for that weekly settlement cycle. For this reason, SPP will become a counterparty to these resettlement transactions upon the implementation of the Integrated Marketplace in early 2014.
- Day-Ahead (DA) Market – Upon implementation of the Integrated Marketplace, SPP will begin settling DA transactions on a weekly basis. Like the EIS, these transactions will be considered “pool” transactions to which SPP will become a counterparty per FERC’s mandate.
- Transmission Congestion Rights (TCR) – TCR transactions will be settled in conjunction with DA transactions on a weekly basis. In Order 741, FERC mandated that all TCR transactions require the commitment of secured credit given the speculative nature of these products. SPP will become a counterparty to TCR transactions per FERC’s mandate.
- Virtual Market – Virtual transactions will also be settled in conjunction with DA and TCR transactions on a weekly basis. These transactions are intended to act like DA transactions but without the transfer of physical load. SPP will become a counterparty per FERC’s mandate.

SPP will become a counterparty to:

- ✓ EIS
- ✓ Day-Ahead
- ✓ TCR
- ✓ Virtual

SPP will not become a counterparty to the following types of transactions:

- Transmission Service – In accordance with its Tariff, SPP settles transmission-related transactions on behalf of its membership on a monthly basis, independent of market-related transactions. Both parties and specific amounts of each scheduled transaction are known at the time of settlement; therefore, any defaulted amount is uplifted to the specific and existing counterparty(s) of the transaction per the SPP Tariff. SPP will not insert itself as a counterparty to these transactions given the fiduciary nature of SPP’s settlement responsibilities and the fact that any defaulted amounts are not typically socialized among all

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<sup>4</sup> The central counterparty proposal is not intended to endanger cooperative tax exemptions, and language intending to safeguard this tax exempt status will be included in the tariff and/or membership agreement language developed to effectuate the central counterparty proposal.

transmission owners. These transactions also fall outside the scope of FERC’s mandate in Order 741.

- Transmission Congestion Rights (TCR) Secondary Market – SPP will administer a secondary market for the express purpose of bilateral TCR transactions. The secondary market will not be considered as having “pool” transactions, and SPP will not become a counterparty to any secondary trading of these products.

## Subsidiary Company

Question: *Will this central counterparty effort require the creation of a subsidiary?*

Answer: Although creating a subsidiary has the potential to provide an additional layer of protection to SPP, as a not-for-profit corporation, it is not necessary for SPP to create a separate entity to perform the central counterparty function. Furthermore, creating a subsidiary would present an additional level of complexity and cost that may not be offset by any benefits to be realized.

SPP’s Tariff provides that SPP will be revenue neutral to all transactions and both EIS and Integrated Marketplace defaults will be socialized (uplifted) among market participants receiving funds on a pro-rata basis. Each market participant will have acknowledged this through their signing of the Market Participant Service Agreement (Attachment AH to the SPP Tariff) prior to their ability to transact in the market. The agreement states that the market participant agrees to abide by and satisfy all obligations under the terms and conditions of SPP’s Tariff.

**To date and with the exception of PJM, all other ISOs/RTOs have designated their primary operating entity as the central counterparty.**

To date, with the exception of PJM, whose parent entity is a for-profit limited liability company; all other ISOs/RTOs have designated their primary operating entity as the central counterparty to marketplace “pool” transactions.

## Tax Status

Question: *Will SPP’s tax-exempt status be affected if SPP takes “flash title” to marketplace transactions?*

Answer: Southwest Power Pool, Inc. is classified as a 501(c)(6) organization and is exempt from federal (and state) income taxes. The Internal Revenue Service (IRS) has previously recognized that ISOs/RTOs have been mandated by the federal government to provide market administration services. In addition, the role of the central counterparty will not affect the clearing/settlement prices of the underlying assets because SPP will not impose any premium or spread on the initial offer or bid. This results in no net profit or loss to SPP as the central counterparty. For reasons such as these (and a few others), the IRS has made determinations that ISOs/RTOs who have become a central counterparty will not have their status as exempt organizations adversely affected. SPP will seek to have a specific determination made for its own entity.

## Default Provisions

Question: *With SPP becoming the central counterparty, will defaults in the marketplace be insured by SPP?*

Answer: Southwest Power Pool, Inc., acting as the central counterparty to pool transactions, will remain revenue neutral in all transactions and will not insure market participants against payment default risk. Currently, the Integrated Marketplace protocols state: “Each Market Participant with a net debit balance will pay any net debit whether or not there is any settlement and billing dispute regarding the amount. Each Market Participant with a net credit balance will receive the balance shown on the Settlement Invoice, adjusted for balances not collected from Market Participants with net debit balances.” The intent of the language is to describe how SPP, as the market administrator, will allocate non-payments among market participants. This language is not expected to change in substance solely due to SPP becoming the central counterparty to pool transactions. Any late payments, short payments or non-payments of market invoices will continue to be distributed among remaining market participants. However, SPP will continue to apply the credit standards developed and approved by SPPs stakeholders in an attempt to mitigate default risk for all market participants.

SPP will remain revenue neutral and any non-payments will continue to be distributed among remaining market participants

## Debt Rating and Loan Compliance

Question: *Will SPP’s credit rating and/or loan covenants be affected if SPP takes “flash title” to Marketplace transactions?*

Answer: Currently, Fitch Ratings has awarded SPP’s senior unsecured debt with an A (investment grade) rating. This is primarily due to the strong credit profile of SPP’s membership (80% at investment grade) and the contractual terms with its members to provide for recovery of all operating costs. Preliminary discussions with Fitch Ratings indicate that SPP has little risk in its debt being downgraded solely due to SPP becoming a central counterparty and taking “flash title” to transactions. As well, existing loan covenants and financial arrangements will not be affected by SPP becoming the central counterparty.

## Tariff and Membership Agreement Revisions

Question: *Will SPP’s Tariff and membership agreements be affected by SPP becoming a counterparty to marketplace transactions?*

Answer: Certainly, SPP will be required to clearly identify itself in its Tariff as a counterparty to each applicable type of transaction as well as identify transactions in which it is not a counterparty (see prior discussion above). Currently, SPP staff is in the process of identifying those sections of the Tariff and membership agreement that will merit revision. It is expected that only a few sections will be impacted and any proposed tariff revisions or additions will be vetted through the appropriate SPP stakeholder groups. However, SPP’s language and methodology for the uplift of defaulted payments will not change as a result of SPP becoming the central counterparty.

## **Operational Impacts**

Question: *What operational functions will be impacted by SPP becoming a counterparty to Marketplace transactions?*

Answer: Once all specific Tariff language has been identified and filed with the Commission and the Integrated Marketplace has been implemented, SPP expects very few operational impacts as a result of becoming a central counterparty. There will be no significant changes to the market operations or settlements business processes beyond those already approved through SPP's open stakeholder processes. Preliminary investigation into the accounting methodology for treatment of receivables and payables does not appear to be different from those also currently contemplated. Without the addition of a subsidiary company, any financial transactions would come within SPP's existing annual audit and not require a separate set of books and audit.

# *SOUTHWEST POWER POOL RETIREMENT PLAN*

## **INVESTMENT POLICY STATEMENT**

~~July 22, 2010~~ July 10, 2012

### **1.01 PURPOSE OF THIS STATEMENT**

The ~~Human Resources~~Finance Committee (“the Named Fiduciary”) of the Southwest Power Pool, Inc. Board of Directors, on behalf of Southwest Power Pool, Inc. (“the Plan Sponsor”), hereby establishes the following policy for administering the Southwest Power Pool Retirement Plan (“the Plan”) investment program. The Investment Policy Statement (“the Statement”) sets forth the investment objectives and guidelines that will be applied within the investment program to insure the assets of the Plan are managed in a manner consistent with the Plan document and applicable statutory requirements. In addition, the Statement is to provide a framework for management of the assets of the Plan within levels of risk acceptable to the Named Fiduciary and the Southwest Power Pool, Inc. Board of Directors. The Statement provides the investment manager(s) with a written statement of specific quality, quantity and rate of return standards. By establishing and communicating clear investment guidelines and objectives, the Plan Sponsor can enhance the effectiveness of the Plan’s investment program and thereby contribute to the overall goal of retaining and recruiting employees by delivering an attractive, low-cost retirement program.

This Statement is based on the “prudent expert rule” to ensure all fiduciaries under the Plan act with skill, care, prudence, and diligence. It is expected that decisions related to management of the Plan and its assets will follow a careful, skillful, prudent and diligent process.

### **1.02 AMENDMENTS TO THE STATEMENT**

The Named Fiduciary reserves the right to amend this Statement at any time as deemed prudent or necessary. Should any amendment to this Statement be required due to changes in the Plan document or a change in applicable law, the Named Fiduciary shall have due time to review such changes and prepare and implement an appropriate amendment. Because of the dynamic nature of the economic environment, developments in financial theories, and advances in technology, this Statement will be examined by the Named Fiduciary from time to time on a formal or informal basis and may, as a result of such examination, be revised by the Named Fiduciary.

### **1.03 BACKGROUND OF THE FUND**

The Plan was established by the Southwest Power Pool, Inc. Board of Directors effective January 1, 1996. The purpose of the Plan is to provide annuity payments to qualified retirees of the Plan Sponsor.

### **1.04 PLAN PROFILE**

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~~July 22, 2010~~ July 10, 2012

The Plan was established to receive assets from the Plan Sponsor. Thereafter, assets in the Plan are used to provide annuity payments to retired employees of the Plan Sponsor meeting the qualification guidelines detailed in the Plan. The Plan is regulated by the Employee Retirement Income Security Act ("ERISA"). Earnings or losses of the Plan are not subject to taxation. Distributions of benefits to retirees are taxable to the retiree/beneficiary.

## **1.05 PLAN FUNDING**

The Named Fiduciary has established a minimum allowable funding level of the Plan equal to the Accumulated Benefit Obligation and a maximum funding level equal to the Projected Benefit Obligation. The Plan Sponsor contributes periodic funds to the Plan based on guidance provided by the Plan's actuary and decisions made by the Named Fiduciary and accepted by the Southwest Power Pool, Inc. Board of Directors. It is expected that the Plan Sponsor will continue to make periodic contributions to the Plan into the foreseeable future.

## **2.01 INVESTMENT OBJECTIVES**

The overall objective of this Statement is to provide guidance for the investment of contributions and other Plan assets and to help maintain adequate funding for Plan liabilities. It is crucial the investment philosophy follow the guidelines of ERISA, primarily that the funds are managed solely in the interest of plan participants. The Named Fiduciary will utilize a portfolio approach when evaluating Plan return, risk, and cost.

## **2.02 RETURN OBJECTIVES**

The primary goal is to obtain a return annualized over the preceding five calendar years equal to or exceeding the actuarially assumed rate of return (currently 7%). Long-term returns above the actuarially assumed rate may serve to reduce the periodic funding required of the Plan Sponsor.

## **2.03 RISK OBJECTIVES**

The Plan assets will be managed with an average to above average risk profile. Currently the pension liabilities are relatively long-term in nature with minimal near term liquidity requirements, allowing for volatility above what one would expect from a portfolio with shorter term investment horizon.

Investments held by the Plan should at all times have readily available prices and sufficient trading volume so that investments can be bought and sold easily without significantly impacting the price of the investments.

## **2.04 COST OBJECTIVES**

The Named Fiduciary will strive to maintain the costs of funding and administering the Plan at a reasonable level and consistent with market costs for engaging qualified professionals to provide asset management and administration services.

## 2.05 ASSET ALLOCATION

The assets of the Plan will be invested in one or more of the following asset classes:

**Cash:** Comprised of demand deposit accounts, savings accounts, money market accounts, debt instruments with maturities of 3 months or less

**Debt Securities:** U.S. Dollar denominated fixed income securities with maturities in excess of 3 months including, but not limited to, Government and Agency issues, mortgage and asset backed securities, and corporate issues, or investment in professionally managed funds investing in the previously mentioned types of securities. Although fixed income investments rated less than investment grade are permitted, the average credit quality of the aggregate fixed income allocation should be investment grade.

**U.S. Equities:** Common and preferred equity securities of companies domiciled in the United States or in professionally managed funds investing primarily in the previously mentioned securities

**International Securities:** Direct investment or investment in professionally managed funds investing in common and preferred equity securities and debt securities of companies domiciled outside of the United States. Security issues of non U.S. domiciled entities may be acquired either through U.S. exchange traded American Depository Receipts or directly through non U.S. based exchanges. In no event will the market value of International Securities holdings exceed 20% of the market value of the Plan Assets. The Named Fiduciary will review the total international security holdings of the plan annually and determine if the level of holdings is appropriate. The Named Fiduciary may direct the investment managers to increase or reduce international security holdings at any time.

**Derivative Instruments:** No direct investment in derivative instruments is permitted, although investment is permitted in professionally managed funds that do use derivatives. Funds making use of derivatives must specifically prohibit the use of derivatives to achieve leverage.

In aggregate, the assets of the Plan shall target the asset allocation ranges listed below:

<u>Security Description</u>	<u>Lower Limit</u>	<u>Target</u>	<u>Upper Limit</u>
Cash	0%	5%	15%
Debt Securities	15%	25%	35%
Equity Securities (growth)	30%	35%	40%
Equity Securities (value)	30%	35%	40%

The Named Fiduciary will take appropriate action should the invested assets of the Plan stray more than 10% outside of the established allocation range.

## 2.06 PROHIBITED INVESTMENTS

The assets of the Plan shall not be used to invest in any investment not specifically permitted by this Statement. The Named Fiduciary does not limit investments in specific entities except as noted above. Investment managers are allowed to invest in electric utilities, including members of the Named Fiduciary, should they wish without restrictions. The Named Fiduciary shall not be permitted to direct any investment manager to invest in any particular individual security nor require the investment manager to provide notice to the Named Fiduciary prior to making investments permitted by this Statement.

### **3.01 SELECTION OF MONEY MANAGER(S)**

The Named Fiduciary shall select investment managers and, where appropriate, investment options based on the evaluation of qualitative and quantitative factors. The manager selection process will focus on the following five key aspects of an investment management firm and investment option:

1. **Organization** – evaluate the key elements of an efficient and successful investment management organization such as stable firm ownership, clear business objectives, industry reputation, and experienced and talented investment staff.
2. **Investment Philosophy and Process** – evaluate the key elements of a valid and well-defined investment approach such as unique sources of information, disciplined buy/sell decisions, systematic portfolio construction, and adequate risk controls.
3. **Resources** – evaluate the state of current and proposed resources supporting the investment process including the quality and depth of research and the adequacy of information management, compliance and trading systems.
4. **Performance** – evaluate historical returns and risks relative to passive indexes, peer groups, and other competing firms.
5. **Management Fees** – evaluate the proposed fee structure relative to the industry and other competing candidates.

These factors are chosen to insure manager/option selections are made with a prudent degree of care, and excessive risk is avoided. Notwithstanding the above, the Named Fiduciary may also include other factors that may be appropriate to a specific manager/option selection exercise.

### **3.02 ACKNOWLEDGEMENT OF FIDUCIARY RESPONSIBILITY**

Any and all investment managers selected to invest the assets of the Plan will be required, as a condition of their selection, to acknowledge their fiduciary status and responsibility to the Plan, in writing. This requirement shall not require the investment manager of a mutual fund in which the Plan invests to acknowledge fiduciary status.

### **3.03 MONITORING THE INVESTMENT MANAGER**

The objective of the investment manager monitoring process is to identify on a timely basis any adverse changes to the investment manager's organization or investment process by periodically evaluating a number of qualitative and quantitative factors. In addition, once adverse changes are identified, the monitoring process shall also dictate the timing and manner of response.

The Named Fiduciary shall evaluate the investment managers/options at least annually using the framework in 3.01 above, in addition to using any other factors the Named Fiduciary believes are appropriate to the inquiry. These factors are intended to insure that decisions to retain investment managers/options are made with a prudent degree of care and excessive risk is avoided.

If results from the monitoring process indicate substandard investment performance or a potentially adverse change in the investment manager's organization or investment process, the Named Fiduciary may choose one of several courses of action including assigning the investment manager/option a temporary probationary status known as the Watch List, undertaking an in-depth review, or terminating the investment manager/option.

Being placed on the Watch List is meant to convey the Named Fiduciary's increased level of concern about a particular issue or event, which if left unresolved, could endanger the future relationship. An in-depth review may be undertaken as a result of the manager/option failing to rectify the issues that led to their placement on the Watch List, or in response to a major adverse change in the investment manager's organization or investment process to the extent the Named Fiduciary seriously questions the firm's ability to manage the portfolio going forward. The purpose of the in-depth review is to determine whether terminating the manager/option is an appropriate course of action.

### **3.04 TERMINATION/REPLACEMENT OF INVESTMENT MANAGERS**

The Named Fiduciary may eliminate or replace the investment manager/option any time the Named Fiduciary deems it in the best interests of the Plan.

# *SOUTHWEST POWER POOL RETIREE HEALTHCARE FUND*

## **INVESTMENT POLICY STATEMENT**

July ~~22, 2010~~, 2012

### **1.01 PURPOSE OF THIS STATEMENT**

The ~~Human Resources~~Finance Committee (“the ~~HRC~~FC”) of the Southwest Power Pool, Inc. Board of Directors, on behalf of Southwest Power Pool, Inc. (“the Fund Sponsor”), hereby establishes the following policy for administering the Southwest Power Pool Retiree Healthcare Fund (“the Fund”) investment program. The Investment Policy Statement (“the Statement”) sets forth the investment objectives and guidelines that will be applied within the investment program to insure that the assets of the Fund are managed in a manner designed to meet the objective of funding postretirement healthcare benefits for eligible retirees of Southwest Power Pool, Inc. In addition, the Statement is to provide a framework for management of the assets of the Fund within levels of risk acceptable to the ~~HRC~~FC and the Southwest Power Pool, Inc. Board of Directors. The Statement provides the investment manager(s) with a written statement of specific quality, quantity and rate or return standards.

This Statement is based on the “prudent expert rule” to ensure all fiduciaries under the Plan act with skill, care, prudence, and diligence. It is expected that decisions related to management of the Plan and its assets will follow a careful, skillful, prudent and diligent process.

### **1.02 AMENDMENTS TO THE STATEMENT**

The ~~HRC~~FC reserves the right to amend this Statement at any time as deemed prudent or necessary. Should any amendment to this Statement be required due to actions of the Southwest Power Pool, Inc. Board of Directors or a change in applicable law, the ~~HRC~~FC shall have due time to review such changes and prepare and implement an appropriate amendment. Because of the dynamic nature of the economic environment, developments in financial theories, and advances in technology, this Statement will be examined by the ~~HRC~~FC from time to time on a formal or informal basis and may, as a result of such examination, be revised by the ~~HRC~~FC.

### **1.03 BACKGROUND OF THE FUND**

The Fund was established by the Southwest Power Pool, Inc. Board of Directors effective January 1, 1996. The purpose of the Fund is to cover a specific portion of the costs associated with providing postretirement healthcare benefits to eligible retirees of Southwest Power Pool, Inc.

### **1.04 FUND PROFILE**

The Fund was established to receive assets from the Fund Sponsor. Thereafter, assets in the Fund are used to offset a specific portion of the health insurance premium payments attributable to eligible retirees of Southwest Power Pool, Inc. remaining in the Southwest Power Pool, Inc. Group Health Insurance Plan following retirement. Earnings or losses of the Fund are not subject to taxation.

## **1.05 FUND FUNDING**

The ~~HRC-FC~~ has established a desired funding level of the Fund equal to the Accumulated Benefit Obligation. The Fund Sponsor contributes periodic funds to the Fund based on guidance provided by the Fund's actuary and decisions made by the ~~HRC-FC~~ and accepted by the Southwest Power Pool, Inc. Board of Directors. It is expected that the Fund Sponsor will continue to make periodic contributions to the Fund into the foreseeable future.

## **2.01 INVESTMENT OBJECTIVES**

The overall objective of this Statement is to provide guidance for the investment of contributions and other Fund assets and to help maintain adequate funding for Fund liabilities. The ~~HRC-FC~~ will utilize a portfolio approach when evaluating Fund return, risk, and cost.

## **2.02 RETURN OBJECTIVES**

The primary goal is to obtain a return annualized over the preceding five calendar years equal to or exceeding the actuarially assumed rate of return (currently 7%). Long-term returns above the actuarially assumed rate may serve to reduce the periodic funding required of the Fund Sponsor.

## **2.03 RISK OBJECTIVES**

The Fund assets will be managed with an average to above average risk profile. Currently the Fund liabilities are relatively long-term in nature with minimal near term liquidity requirements, allowing for volatility above what one would expect from a portfolio with an allocation of 70% equity and 30% fixed income.

Investments held by the Plan should at all times have readily available prices and sufficient trading volume so that investments can be bought and sold easily without significantly impacting the price of the investments.

## **2.04 COST OBJECTIVES**

The HRC will strive to maintain the costs of funding and administering the Fund at a reasonable level and consistent with market costs for engaging qualified professionals to provide asset management and administration services.

## **2.05 ASSET ALLOCATION**

The assets of the Fund will be invested in one or more of the following asset classes:

**Cash:** Comprised of demand deposit accounts, savings accounts, money market accounts, debt instruments with maturities of 3 months or less

**Debt Securities:** U.S. Dollar denominated fixed income securities including, but not limited to, Government and Agency issues, mortgage and asset backed securities, and corporate issues, or investment in professionally managed funds investing in the previously mentioned types of securities. Although fixed income investments rated less than investment grade are permitted, the average credit quality of the aggregate fixed income allocation should be investment grade

**U.S. Equities:** Common and preferred equity securities of companies domiciled in the United States or in professionally managed funds investing in the previously mentioned securities

**International Securities:** Direct investment or investment in professionally managed funds investing in common and preferred equity securities and debt securities of companies domiciled outside of the United States. Security issues of non U.S. domiciled entities may be acquired either through U.S. exchange traded American Depository Receipts or directly through non U.S. based exchanges. In no event will the market value of International Securities holdings exceed 20% of the market value of the Plan Assets. The HRC-FC will review the total international security holdings of the plan annually and determine if the level of holdings is appropriate. The HRC-FC may direct the investment managers to increase or reduce international security holdings at any time.

**Derivative Instruments:** No direct investment in derivative instruments is permitted, although investment is permitted in professionally managed funds that do use derivatives. Funds making use of derivatives must specifically prohibit the use of derivatives to achieve leverage.

In aggregate, the assets of the Plan shall target the asset allocation ranges listed below:

<u>Security Description</u>	<u>Lower Limit</u>	<u>Target</u>	<u>Upper Limit</u>
Cash	0%	5%	15%
Debt Securities	15%	25%	35%
Equity Securities	60%	70%	80%

The HRC-FC will take appropriate action should the invested assets of the Fund stray more than 10% from the desired allocation.

## 2.06 PROHIBITED INVESTMENTS

The assets of the Plan shall not be used to invest in any investment not specifically permitted by this Statement. The HRC-FC does not limit investments in specific entities except as noted above. Investment managers are allowed to invest in electric utilities, including members of the HRCFC, should they wish without restrictions. The HRC-FC

shall not be permitted to direct any investment manager to invest in any particular individual security nor require the investment manager to provide notice to the HRC-FC prior to making investments permitted by this Statement.

### **3.01 SELECTION OF MONEY MANAGER(S)**

The HRC-FC shall select investment managers and, where appropriate, investment options based on the evaluation of qualitative and quantitative factors. The manager selection process will focus on the following five key aspects of an investment management firm and investment option:

1. **Organization** – evaluate the key elements of an efficient and successful investment management organization such as stable firm ownership, clear business objectives, industry reputation, and experienced and talented investment staff.
2. **Investment Philosophy and Process** – evaluate the key elements of a valid and well-defined investment approach such as unique sources of information, disciplined buy/sell decisions, systematic portfolio construction, and adequate risk controls.
3. **Resources** – evaluate the state of current and proposed resources supporting the investment process including the quality and depth of research and the adequacy of information management, compliance and trading systems.
4. **Performance** – evaluate historical returns and risks relative to passive indexes, peer groups, and other competing firms.
5. **Management Fees** – evaluate the proposed fee structure relative to the industry and other competing candidates.

These factors are chosen to insure that manager/option selections are made with a prudent degree of care, and that excessive risk is avoided. Notwithstanding the above, the HRC-FC may also include other factors that may be appropriate to a specific manager/option selection exercise.

### **3.02 ACKNOWLEDGEMENT OF FIDUCIARY RESPONSIBILITY**

Any and all investment managers selected to invest the assets of the Plan will be required, as a condition of their selection, to acknowledge their fiduciary status and responsibility to the Plan, in writing. This requirement shall not require the investment manager of a mutual fund in which the Plan invests to acknowledge fiduciary status

### **3.03 MONITORING THE INVESTMENT MANAGER**

The objective of the investment manager monitoring process is to identify on a timely basis any adverse changes to the investment manager's organization or investment process by periodically evaluating a number of qualitative and quantitative factors. In

addition, once adverse changes are identified, the monitoring process shall also dictate the timing and manner of response.

The HRC-FC shall evaluate the investment managers/options at least annually using the framework in 3.01 above, in addition to using any other factors the HRC-FC believes are appropriate to the inquiry. These factors are intended to insure that decisions to retain investment managers/options are made with a prudent degree of care and that excessive risk is avoided.

If results from the monitoring process indicate substandard investment performance or a potentially adverse change in the investment manager's organization or investment process, the HRC-FC may choose one of several courses of action including assigning the investment manager/option a temporary probationary status known as the Watch List, undertaking an in-depth review, or terminating the investment manager/option.

Being placed on the Watch List is meant to convey the HRC's-FC's increased level of concern about a particular issue or event, which if left unresolved, could endanger the future relationship. An in-depth review may be undertaken as a result of the manager/option failing to rectify the issues that led to their placement on the Watch List, or in response to a major adverse change in the investment manager's organization or investment process to the extent that the HRC-FC seriously questions the firm's ability to manage the portfolio going forward. The purpose of the in-depth review is to determine whether terminating the manager/option is an appropriate course of action.

#### **3.04 TERMINATION/REPLACEMENT OF INVESTMENT MANAGERS**

The HRC-FC may eliminate or replace the investment manager/option any time the HRC-FC deems it in the best interests of the Fund.