Markets & Reliability Committee
Surety Bonds
Discussion Paper

Kathy McElwaine

Corporate Insurance Manager

PJM Interconnection, LLC

April 8, 2020

For Public Use

I. Purpose

This paper examines the subject of surety bonds as a form of collateral for all market purposes, and more specifically, the inclusion or exclusion of the use of surety bonds by Market Participants within Financial Transmission Rights (FTR) markets.

II. Summary of Problem Statement

In January 2018, a Problem Statement and Issue Charge were brought forth and presented to the Credit Subcommittee by Sharon Midgley from Exelon. In summary, it stated that the current PJM Credit Policy does not allow the use of surety bonds as an acceptable form of collateral, resulting in limited optionality of financial instruments and potentially elevated costs for participants in PJM Markets. Market Participants are required to provide PJM with collateral, either cash or letters of credit, as security in order to participate in the PJM Markets or purchase Transmission Service in the region. Depending on the makeup of a Market Participant's generation and load position, collateral postings can be significant. With the limited optionality of instruments as acceptable collateral, participants may be burdened with higher than desired costs.

Exelon further stated that generally, surety bonds are quoted at a discounted price to letters of credit, and may result in an immaterial change to PJM's risk of non-payment. This can give Market Participants the ability to capture the cost spread between these instruments in order to reduce collateral costs and optimize their collateral portfolio, while leaving PJM's non-payment risk profile unchanged.

The goal of the problem statement was to initiate discussion regarding PJM's Credit Policy and collateral definition within the PJM Open Access Transmission Tariff that prohibits the use of surety bonds as an acceptable form of collateral. The problem statement expressed Exelon's view that allowing the use of this instrument warrants discussion and analysis, as it will help Market Participants manage and optimize their collateral costs, while having minimal effect on PJM's non-payment risk profile.

III. Proposed Solutions

The Credit Subcommittee polled two stakeholder proposals put forth and presented to the Market Implementation Committee as a first read in September 2018:

- Proposal 1 - Accepting Surety Bonds as collateral for all market purposes, except FTRs, with a $10 million cap per issuer for each member, and a $50 million aggregate cap per issuer.
- Proposal 2 - Accepting Surety Bonds as collateral for all market purposes, including FTRs, with a $20 million cap per issuer for each member, and a $100 million aggregate cap per issuer.

In October 2018, the Market Implementation Committee endorsed the two packages with 61% in support of Package A.

- Package A received greatest support and will move to the Markets & Reliability Committee (MRC) as the main motion with 107 in favor (61%), 69 opposed (39%) and 46 abstentions.

- Package B was also endorsed with 95 in favor (58%), 69 opposed (42%) and 42 abstentions.
- The committee also preferred Package A over Status Quo with 114 in favor (66%) and 58 opposed (34%) and 7 abstentions.

Surety Bonds	Stakeholder 1 Package A	Stakeholder 2 Package B
Acceptable for FTRs	No	Yes
Individual Issuer Cap	$10 million	$20 million
Aggregate Issuer Cap	$50 million	$100 million
CS Poll	61%	53%
MIC Vote	61%	58%

At the December 2018 Markets & Reliability Committee, PJM presented the two stakeholder packages presented by the Credit Subcommittee related to the use of surety bonds as an acceptable form of collateral. After discussion of the two packages, the committee approved a motion to defer voting on these packages until the first MRC meeting following issuance of the report of the consultants retained by the PJM Board of Managers to review the GreenHat Energy default.

At the April 2019 MRC meeting, PJM provided an update on the surety bond topic and a review of the proposals related to the use of surety bonds as an acceptable form of collateral.

Corresponding meeting materials for the April 2019 MRC surety bond endorsement item are as follows:

Item 5 – Surety Bond Proposals – Presentation

Item 5 – Surety Bond Attachment Q - Redline

Item 5 – Surety Bond Draft Standard Form

Item 5 – Exelon Alternative Surety Bond Proposal – Presentation

At the April 2019 MRC meeting, stakeholders voted in favor of deferring a vote on the surety bond proposal until no later than two MRC meetings after the new PJM Chief Risk Officer and Chief Financial Officer begin working at PJM. At that meeting, PJM agreed to provide a recommendation to the MRC as to the efficacy of the proposed surety bonds.

Additional information can also be referenced on PJM's Issue Tracking page for Surety Bonds Opportunity.

IV. Advantages and Disadvantages of Surety Bonds

Advantages for Market Participants

- Bond can be less expensive than letters of credit but is dependent upon the credit and risk profile of the market participant.
- Surety bonds do not tie up PJM Member's letter of credit facility.

Disadvantages for Market Participants

- Market Participant would have to meet Surety companies' underwriting standards for them to issue bonds which may be more costly.
- An impact of the Coronavirus pandemic is that sureties may become weaker and develop a loss of appetite for these types of bonds.
- Sureties would have to be willing to comply with PJM's bond form and the bond company AM Best rating requirements.

Advantages for PJM

- The credit quality of the surety providers is on par with the banks that typically post letters of credit to PJM.
- The surety industry has a reliable claims paying history. Like the banking industry, sureties work in a heavily regulated market with strong government oversight.
- More flexibility for PJM members to meet PJM collateral requirements.

Disadvantages for PJM

- There is very little experience drawing on these instruments to pay ISO/RTO Market Participant bills.

V. Efficacy of the Use of Surety Bonds in Other Markets

While PJM has no first-hand experience in accepting surety bonds as a form of collateral for commodity transaction, we independently reached out to NYISO and ERCOT, both of which currently accept surety bonds as a form of collateral. We also reached out to both Nodal Exchange and ICE, and neither of those exchanges accept surety bonds as a form of collateral.

NYISO surety requirements do not have a set dollar amount on the surety bond per cap or per issuer; whereas, ERCOT has a $10 million cap per bond and $100 million cap per issuer. Both apply to all market activities. Their bond form payment requirement is a one-day payment. ERCOT has experienced requesting a draw down payment twice and received the payment in one day. NYISO has not had any experience in requesting a one-day payment.

VI. List of Surety Carriers

Requirements for surety bond acceptance, if approved:

- Surety Bond Company must be on the Department of U.S Treasury's certified list (see below).
- Minimum credit rating of "A" with S&P; "A" with Fitch, "A2 "with Moody's or "A" with AM Best.
- Must be licensed in the state the bond is issued.
- Accept One Day Payment Demand Terms
- Automatic Annual Renewal Provision

The Department of U.S of Treasury provides a list of certified surety companies: Surety Carrier List

VII. PJM's Position

In addition to the information gathered above, PJM learned from its research that there is limited experience in the use of surety bonds in the FTR markets and historically, FTR defaults have been large.

PJM will support Package A - Accepting Surety Bonds as collateral, using a form of surety bond acceptable to PJM, for most products in the PJM Markets, excluding FTR, with a $10 million cap per issuer for each member, and a $50 million aggregate cap per issuer.

Next Steps

A. At the April 30th Markets & Reliability Committee, Package A will be presented for a second first read.

B. At the May 28th Markets & Reliability Committee, endorsement will be sought for the prevailing proposal to use of surety bonds as collateral.

C. At the June 2020 Members Committee, endorsement will be sought for the prevailing proposal to use of surety bonds as collateral.