

FIEG

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Board of Managers
PJM Interconnection, LLC
Valley Forge Corporate Center
955 Jefferson Avenue
Norristown, PA 19403-2497

Re: Credit Enhancement Proposal

To PJM Board of Managers:

These comments are filed by and on behalf of the Members of the Financial Institutions Energy Group (FIEG). We offer these comments to PJM in support of steps that PJM has proposed to protect its members from the default by one or more PJM members. However, we urge PJM to take additional steps to ensure that PJM remains a vibrant marketplace. We will be suggesting that similar steps be taken by other RTOs whose credit policies are similar to those currently in place at PJM.

Background on FIEG

FIEG is a group of investment and commercial banks that play a vital role in the PJM market.¹ These entities, or their parent companies or affiliates, are extensively engaged in businesses outside of the energy sector, providing a wide array of financial services to all segments of the U.S. and global economy. The perspective afforded by these involvements provides FIEG Members with insights regarding practices in financial markets that are analogous to PJM's FTR markets and enables us to suggest ways in which practices from these markets might be applied to PJM. FIEG believes that adoption of its recommendations would result in improved risk management and provide greater protection to PJM members from defaults of the type recently caused by holders of counterflow FTRs.

The businesses of the Members of FIEG and their affiliates as they relate to the energy sector are diverse. The Members or their affiliates are directly involved in the purchase and sale of power and related instruments throughout the country and in PJM in particular.

¹ The following is a list of FIEG members: Bank of America, N.A., Barclays Bank PLC, Bear Energy LP, Citigroup Energy Inc., Credit Suisse Energy LLC (a subsidiary of Credit Suisse), DB Energy Trading LLC (a subsidiary of Deutsche Bank AG), Fortis Energy Marketing & Trading GP, J. Aron & Company (a subsidiary of The Goldman Sachs Group), JPMorgan Chase & Co., Lehman Brothers Commodity Services Inc. (a subsidiary of Lehman Brothers Holding Inc.), Merrill Lynch Commodities, Inc., Morgan Stanley Capital Group Inc. (a subsidiary of Morgan Stanley), Société Générale and UBS Energy LLC (a subsidiary of UBS AG).

The Members of FIEG will be directly affected by PJM's evaluation of its credit policies and will be directly impacted by the changes that PJM implements.

Summary of Comments

First: We encourage PJM to review and ensure that each proposed member—not only those who specifically apply for an unsecured credit line—satisfies minimum credit standards.

Second: We urge PJM to improve the methodology for collecting margin in relation to FTRs, including both initial and variation margin that protects against the risk that the aggregate of initial and variation margin held at a particular time is insufficient to cover changes in the value of positions from the most recent margin posting.²

Third: We urge PJM to adopt rules and a practice, subject to systems requirements, of terminating and liquidating member positions promptly after a default has occurred and not been rectified within the applicable cure period so as to limit the risk that members would otherwise face increasing losses.

Fourth: We urge PJM to consider procuring insurance or some other form of third party protection to absorb member default losses up to specified levels, the cost of which would be borne by the membership based on pro rata participation in PJM.

Fifth: We recommend that audits of the application of revised credit policies be conducted by PJM's independent auditors on an annual basis.

Our detailed comments are set forth below.

Under current rules, the losses arising from the default by any member are borne by each PJM member largely in proportion to the participation that such member transacts in the PJM market. This structure poses potentially significant risk to PJM members. As was demonstrated by the recent defaults by PJM members involving losses in excess of \$80 million, the current rules and practices of PJM do not adequately protect PJM members from the risk of default by other members.

Minimum Requirements for Membership

Under its current rules, PJM conducts credit reviews only for those members who specifically seek an unsecured line of credit. However, products such as financial transmission rights ("FTRs") that may be traded by any PJM member have inherent

² In considering implementation of a robust initial and variation margin regime, consideration should be given to the question whether PJM will need to establish a clearinghouse or enter into a clearing services agreement with an unaffiliated clearing house, taking into account the regulatory issues that may be raised thereby.

volatility that creates credit exposures, and members are permitted to trade such products without having to undergo the review associated with obtaining a line of credit. In light of this, and the mutualized nature of PJM risk, we encourage PJM to adopt a rule that requires all participants have a net worth above a material minimum to provide some confidence that they will be able to meet financial obligations. Further, we would encourage PJM to require prospective members to certify that they have the appropriate sophistication to engage in trading activity within PJM. One way to implement both of these requirements would be to require all participants to certify that they satisfy the criteria of certain statutory or regulatory definitions that confirm requisite trading sophistication and creditworthiness.³

Initial Margin to Cover Potential Exposure between Margin Calls with High Confidence

Financial exchanges on which members share risk of default generally employ robust initial margin requirements as a mitigant. Initial margin requirements are established in amounts to cover the worst possible move in the value of a contract between successive variation margin calls with a high level of confidence. Requirements are established using a variety of inputs including worst-case historical price movements, stress tests, historical volatility, and implied volatility. PJM's bid and hold collateral for FTRs are similar to the initial margin requirements of financial exchanges, but differ in three key aspects.

- First, collateral requirements for FTRs are currently based on historical average values for FTR paths. While PJM intends to bolster collateral requirements by using monthly values for FTR paths, the basis will still be historical and not necessarily reflective of a worst-case scenario or a high confidence level. The discount of 10% is helpful but does not ensure the level of confidence that is required when members share in uncollateralized defaults. In order to arrive at an effective initial margin requirement, PJM should reapply the concept of contingency analysis that is used in the day-ahead reliability assessment. PJM could require that bidders pre-submit planned bids to determine the scope of the required study and then run a contingency analysis to establish prices for all relevant nodes which would forecast the maximum expected monthly counter flow liabilities and minimum prevailing flow value for each path with a high level of confidence. The bid initial margin requirement for each month would then be set equal to this value. Once the actual auction is completed, the contingency analysis would be repeated on a portfolio basis for each participant's awarded portfolio to determine the amount of initial margin held, which would likely be lower for a diversified portfolio.

³ Various definitions that have been established by the Securities and Exchange Commission and the Commodity Futures Trading Commission may be used as a basis for these standards.

- Second, like other exchanges and clearinghouses, PJM should retain flexibility to modify initial margin requirements as market conditions warrant. PJM should continuously monitor changes in price levels, volatility, and open interests and make adjustments as may be necessary to ensure that the sum of initial and variation margin held is sufficient. PJM should repeat the contingency analysis periodically or upon the occurrence of events which change the dynamic of the grid flows.
- Third, initial margin requirements must be maintained without any erosion due to changes in position value for as long as the corresponding position is open. If a position decreases in value, additional margin is required to return the available collateral balance to the level that is required to protect against a worst-case move in value. Exchanges achieve this through daily calls for variation margin.

Variation Margin Ensures that Initial Margin is Not Eroded

While PJM may make margin calls at its discretion, variation margin calls need to be a mandatory element in PJM's credit risk management policy. Making variation calls requires that each position be revalued by the market with the same frequency as the variation margin calls. PJM should use existing monthly auctions to determine the current value of each member position, call each member for variation margin on the net change in the value of its portfolio on a monthly basis and then collect margin from such member to the extent that the change in value of a position creates an exposure to such member.

Act Quickly to Limit Losses

We encourage PJM to adopt rules and practices to liquidate defaulting members immediately following expiration of an appropriate opportunity to cure the relevant default subject to PJM's overarching requirement to maintain system balance. As much as anything, acting quickly in a time of uncertainty is critical to mitigating the risk of potential increased losses.

Additional Layer of Protection before Uncollateralized Losses are Mutualized

Financial exchanges employing each of the tools described above rarely face uncollateralized losses from market participants. In order to further protect their membership, we would encourage PJM to consider adopting an additional level of risk protection such as the procurement of credit insurance to absorb losses exceeding defaulting member collateral. Only those losses which exceed this additional layer of protection would be mutualized among the membership. We recommend that PJM pursue credit insurance funded by the membership which would provide a payout in the event of an uncollateralized default. Members are likely to find the known costs required to fund such insurance more palatable than unpredictable allocations of member defaults. Further, we believe that the costs of such a policy would be reduced to the extent PJM acts to enhance its other credit mitigation policies and procedures.

Periodic Audit of Credit Policies

Finally, we recommend that following the adoption of enhancements to its credit policies, independent audits be conducted by PJM's independent auditors.

Conclusion

In sum, we appreciate the focus that PJM has applied to addressing the deficiencies in its current credit policies and encourage PJM to take the steps outlined herein. The members of FIEG would be pleased to further discuss these recommendations and comments with you as you continue to address these issues.

Respectfully submitted,

The Financial Institutions Energy
Group