



# Proposed Changes to the FTR Undiversified Credit Requirement

Harold Loomis  
Credit Manager  
Credit Subcommittee  
October 31, 2016

- In the Credit Subcommittee poll on alternatives to the current FTR Undiversified credit requirement adder, "Alternative 5" received by far the most support (99% support)
  - Removes the current 3X adder for undiversified portfolios
  - Increases the historical adjustment factor for historically counterflow paths to 15% from 10%
    - Retain 10% historical adjustment for prevailing flow paths
  - Increases overall membership exposure coverage ~1% in sample period
  - Decreases overall membership credit requirement ~2% in sample period

- Subsequent to the poll, PJM identified an error in the data used for the underlying analysis
- Using corrected data, PJM found that Alternative “5a” (same as Alternative 5 but with a 25% counterflow adjustment factor) provided virtually identical overall results as Alternative 5 had originally purported to provide
  - ~1% increase in overall membership exposure coverage in sample period
  - ~4% decrease in overall membership credit requirement in sample period

- PJM performed a “back test” to see how well Alternative 5a would have performed against the two portfolios underlying the \$52 million default in 2007-2008
  - Bid credit requirements would have prevented acquisition of one of the two portfolios, and would have been more than \$35 million higher for the second portfolio
  - Cleared credit requirements would have covered around 16% of the default
  - In combination, these rules would likely have reduced the default by at least half

- Additional measures, other than the undiversified credit adder, that have been implemented since 2007 also provide more protection against FTR defaults
  - Calculation of credit by month rather than by year (better captures seasonality)
  - Adjustment of historical values that reduce credit requirement
  - Minimum capital requirements (or \$500,000 collateral alternative)
  - Risk management and Minimum Participation requirements
  - Disallowance of unsecured credit for FTRs

| Current Requirement with Undiversified Adder  | Alternative 5a  |
|---|---|
| Underlying credit requirement calculation with 10% historical adjustment for prevailing and counterflow paths;                      | Increase the historical counterflow adjustment factor from 10% to 25% in underlying calculation.  |
| Additional 3X price adder for Undiversified portfolios  | Eliminate Undiversified portfolio adder   |
| Targets exposure from higher cleared volumes and lower cleared prices due to bidding behavior reflecting anticipated future outages | Targets unanticipated but common exposures on paths that have been counterflow in the past (unplanned outages, weather-related congestion, ...) |
| Did not cover all exposures in 26-month test period   | Did not cover all exposures in 26-month test period   |
| Covered some portfolios better than Alternative 5a  | Covered some portfolios better than current requirement   |
| Would have fully covered the FTR defaults in 2007-2008  | In conjunction with other changes since 2008, would likely have prevented at least half of the FTR defaults in 2007-2008                        |
| Some collateral calls during clearing   | No collateral calls during clearing, since cleared credit requirement cannot exceed bid requirement   |
| Collateral calls sometimes cause delays in clearing   | No clearing delays from collateral calls  |
| Collateral calls can cause credit uncertainty for members   | No credit uncertainty from collateral calls   |

- PJM is asking the membership for feedback on options for moving forward
- Possible options:
  - Implement Alternative 5a with a 25% historical counterflow adjustment factor and no 3X undiversified portfolio adder in time for 2017-2018 annual auction
  - Retain the current requirements
  - Retain the current requirements but continue analysis on undiversified alternatives
- PJM will present a poll to the Credit Subcommittee after the October 31 conference call to gauge member preference for moving forward