Discussion Paper

Re-establishing Financial Transmission Rights Termination and Liquidation in the event of a Market Participant Default

1 Purpose

PJM operates various wholesale markets for energy and related services that are integral to the reliable and efficient delivery of power through the PJM bulk power system. As a market operator, PJM has a singular view of the material risks in markets connected to one or more Market Participants, and how and whether those risks may reasonably be anticipated to affect other market participants, or the PJM wholesale markets as a whole

The purpose of this discussion paper is to re-establish and advance into the Open Access Transmission Tariff (“Tariff”) and the Amended and Restated Operating Agreement of PJM (“Operating Agreement”), the ability to terminate and liquidate the market portfolios of FTR Participants that default on their obligations owed to PJM and/or PJM Settlement, with some measure of discretion.

2 Summary

In summary, this paper presents a discussion on why PJM should have discretion in the way it exercises this right, including closing out, netting and auctioning off portions of a defaulting portfolio across several regular auctions, and/or conducting one or more special Financial Transmission Right (“FTR”) liquidation auctions.

PJM waived its rights to terminate and liquidate a defaulted FTR portfolio in 2018, thereby holding all defaulted portfolios to settlement, where PJM Members are allocated any and all losses associated with the default as defined. While this was endorsed via a stakeholder process, and later approved by FERC, this paper recommends re-establishing the ability to liquidate defaulted portfolios.

PJM will also evaluate financial strength and creditworthiness based on financial statements and other information as described below. The same quantitative and qualitative factors will be used to evaluate entities whether or not they have rated debt.

3 Background

Effective December 1, 2018, PJM implemented changes to Tarff, Attachment K-Appendix, sections 7.3.1 and 7.3.9, and the identical provisions of Operating Agreement, Schedule 1, sections 7.3.1 and 7.3.9, ending the practice of liquidating a defaulting FTR Participant’s ongoing Financial Transmission Right (FTR) positions. This change represented an overwhelming consensus of the PJM stakeholder community seeking to address, on a going forward basis, how they wished to manage the disposition of a defaulting Member’s FTR portfolio. This change resulted in allowing a defaulted FTR Participant’s FTR positions to go to settlement, rather than being liquidated.

The Independent Consultants' report[1] noted weaknesses in PJM's policies and processes related to advancing credit risk management best practices into the Tariff. While the report did not specifically address the ability to liquidate an FTR portfolio, it is industry best practice to neutralize or reduce large one directional risk as soon as reasonably practical.

This paper addresses the specific topic of re-establishing the ability to liquidate a defaulted portfolio in a manner that is reasonable and allows for flexibility in managing a defaulted portfolio through a variety of methods that minimizes costs to Members and allows for closing out the positions in a prudent and orderly manner.

4 Default Management

It is recommended that we revise the Tariff and Operating Agreement to allow for the ability to manage a defaulted portfolio in such a way that allows for flexibility to liquidate positions in a manner that allows PJM to hedge and/or offer for auction the positions (with a goal to minimize costs to Members), limit significant price disruptions to the market, and manage and/or close out the defaulting FTR Participant's positions in a prudent and orderly manner, while also holding onto any applicable collateral.

In order to successfully accomplish the goals above, the language has to be flexible enough to consider the size of the defaulted portfolio, the liquidity of the market, and other factors that PJM deems appropriate.

For example, prior to the Tariff and Operating Agreement changes that became effective December 1, 2018, when a Member default was declared, the Tariff and Operating Agreement required PJM to close out and liquidate or settle the FTRs of the defaulting Member by requiring, among other things, that PJM:

- settle all of the current planning period FTR positions that become due prior to the next monthly FTR auction;

- offer for sale "all" current planning period FTR positions within the defaulting Member's portfolio in the next available monthly balance of planning period FTR auction "at an offer price designed to maximize the likelihood of liquidation of those positions;"

[1] Anderson, Wolkoff, et.al., *Report of the Independent Consultants on the GreenHat Default*, March 26, 2019

- offer any FTR positions that do not settle until the next or subsequent planning periods into the next available FTR auction where such positions would be expected to clear, and in that auction, offering the entire FTR portfolio of the defaulting Member at an offer price designed to maximize the likelihood of liquidation of those positions;

- where, based on the auction's preliminary solution, any of the closed-out FTR positions would set the market price, offering for sale only one-half of each FTR position and re-executing the auction, and then offering the FTR positions that were not liquidated in the next auction, and if there is no next auction, allowing the FTRs to go to settlement; and,

- treating the liquidation of the defaulting Member's FTR portfolio "pursuant to the foregoing procedures" as the "final liquidated settlement amount" that is included in calculating a Default Allocation Assessment.

The language was extremely prescriptive and did not allow for any flexibility other than to follow the procedural processes above. Had PJM had the discretion to offer, for example, smaller subsets of the portfolio position based on factors such as, but not limited to, the size of the specific portfolio, the FTR market's ability to absorb the positions, and with a focus on minimizing costs to the Members, PJM would have been able to align with best practices that have been established in the financial industry that are focused on unwinding a defaulted position in a prudent and orderly manner.