



Mark Takahashi
Chair, PJM Board of Managers

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VIA Electronic Delivery

Commissioner David Ober
President, Organization of PJM States, Inc.
PNC Center
101 W. Washington Street, Suite 1500E
Indianapolis, IN 46204

Dear President Ober,

Thank you for your correspondence dated March 18, 2022, wherein the Organization of PJM States, Inc. (OPSI) reiterated its view that a 99% confidence interval (CI) should be utilized to calculate collateral requirements for participants in the Financial Transmission Rights (FTR) market. PJM had previously taken a position that a 99% CI was the more appropriate initial margin based upon industry best practices for commodity markets.

Members have expressed their desire for PJM to perform a cost-benefit analysis comparing a 97% CI and a 99% CI. Following the Members' most recent vote, which seemed counterintuitive because PJM fundamentally seeks to protect Members and consumers from the risk of potential default allocations, PJM internally committed to performing the requested cost-benefit analysis. PJM's cost-benefit analysis indicates that, while a 99% CI may represent best practices within commodity exchanges, the use of 99% CI in PJM's historical simulation model (HSIM) is not currently supported. Simply put, the increased cost associated with the increased amount of collateral is not justified by the default risk when viewed in aggregate across the membership. Indeed, because load serving entities (LSEs) use FTRs to hedge and can have a more correlated portfolio of FTRs, the analysis suggests that LSEs tend to bear a disproportionate share of the incremental cost of a 99% CI (compared to a 97% CI), which does not in aggregate appear cost-effective even when recognizing LSE's share of the expected monetary default in the FTR market.

In the recent FERC order denying PJM's Federal Power Act Section 205 filing on this subject, FERC questioned whether a 97% CI will protect against the riskiest of entities and the riskiest of FTR portfolios. PJM recognizes this concern, although the movement to a 99% CI would not eliminate this issue. However, the PJM credit reforms approved by FERC since 2019 will greatly assist in addressing the concern. These reforms included enhancing PJM's ability to implement know-your-customer best practices, accelerating demand for collateral-call payments, enhancing material adverse change language, implementing industry-specific financial risk models, requiring audited financials, limiting or suspending high-risk participants from participating in PJM's FTR market, and identifying/protecting against unreasonable credit risks. While it is impossible to avoid all defaults (and PJM believes it is appropriate to consider the cost of mitigating defaults when determining risk management policies), we want to try to ensure we avoid defaults resulting in significant allocations. Thus, PJM plans to utilize existing and potentially additional credit tools to mitigate tail risks – both entity and portfolio risks – and will seek stakeholder feedback in doing so.

In the near term and to address the FERC's concerns, PJM believes it needs to further enhance utilization of its unreasonable credit risk determination modeling to hold, in some instances, more collateral from those Members who represent the highest counterparty risk and also have high portfolio risk. PJM plans to seek stakeholder feedback on a methodology for issuing unreasonable credit risk collateral calls to ensure transparency in the process. Also, given some additional data showing updated collateral changes that would result moving from status quo to HSIM, PJM intends to conduct some more confirmatory analysis to ensure the HSIM model is working as intended and is risk reducing compared to the status quo.¹

In summary, PJM intends to file a new Section 205 proposal including a 97% CI and addressing the evidentiary issues raised by FERC in its Feb. 28 Order.² Again, despite 99% CI being industry best practice in commodity exchanges, the use of 99% CI in PJM's HSIM model does not appear cost-effective based upon our analysis at this time. In order to respond to FERC's concerns around the riskiest counterparties and portfolios, PJM plans to include in its 205 filing its intention to enhance its utilization of its already approved unreasonable credit risk tool. PJM will seek stakeholder feedback on the method and implementation of this tool. Last, PJM will ask the FERC to hold the Federal Power Act Section 206 proceeding opened by FERC in abeyance (for approximately 60 days) as we work through this discussion and analysis.

PJM would like to thank OPSI for its thoughtful correspondence and engagement in this matter. OPSI's advocacy in this area on behalf of its constituents has been consistent and ardent. We are grateful for your voice in our discussions at PJM, and we remain mindful of your expressed concerns as we work through this issue.

Sincerely,

Mark Takahashi
Chair, PJM Board of Managers

¹ See Special Members Committee meeting materials: <https://www.pjm.com/-/media/committees-groups/committees/mc/2022/20220414-special/20220414-item-01-fr-credit-requirements.ashx>

² Subject to the confirmatory analysis referenced above.