



Exelon Surety Bond Proposal

May 28, 2020 MRC

Exelon Proposal – Surety Bonds

Surety Bonds Can Cover All Credit Requirements

- ERCOT and NYISO allow for use on all credit requirements
- No increased risk of non-payment relative to letter of credit, so applicability should be the same
- Bank and insurance company minimum credit rating to be synonymous

\$20M Cap on Individual Surety Bond for Individual Member from an Individual Surety and \$100M Cap on Aggregate Amount from an Individual Surety

- PJM's larger market size relative to ERCOT supports need for higher caps
- Letters of credit currently have no caps despite comparable security and issuer ratings relative to surety bonds

With the appropriate provisions and language structure, surety bonds are as secure as letters of credit and should cover the same obligations.

Surety Bond/LC Similarities and Differences

Clause	PJM Surety Bond	Standard Surety Bonds	Letters of Credit (LC)
Payment	<ul style="list-style-type: none"> • “One day pay” language 	<ul style="list-style-type: none"> • Depending on the type of bond, generally payment or performance required between 5-30 days 	<ul style="list-style-type: none"> • Letters of Credit are payment upon demand or within one business day
Unconditional Obligations	<ul style="list-style-type: none"> • Surety waives all rights available to principal • Surety liable for bond no matter what 	<ul style="list-style-type: none"> • Surety usually has similar or same rights as principal • Liability of bond contingent upon certain actions or non-actions by principal 	<ul style="list-style-type: none"> • Letters of Credit are viewed as an instrument that generally implies the bank's unconditional obligation to payout on the letter of credit as backed by the UCP 600 or ISP98.
Governance	<ul style="list-style-type: none"> • Governed by Federal and State Law • PJM governed by PA State law 	<ul style="list-style-type: none"> • Governed by Federal and State Law 	<ul style="list-style-type: none"> • LCs are generally governed by the practices/rules put in place by the International Chamber of Commerce <ul style="list-style-type: none"> • International Standby Practices (ISP98) • Uniform Customs & Practice for Documentary Credits (UCP 600)
Claims	<ul style="list-style-type: none"> • Only requires “Demand for Payment” doc • Clearly stated multiple times throughout the bond that “no other information required” 	<ul style="list-style-type: none"> • Varies based on bond • Generally, proof of default on underlying contract is required to be provided to surety and investigation period by surety commences 	<ul style="list-style-type: none"> • Banks are required to confirm that the Demand for Payment is valid for most LCs before payment, depending on the language, while others are a demand for payment and only need the original LC and a completed draw certificate to effectuate payment.

Appendix

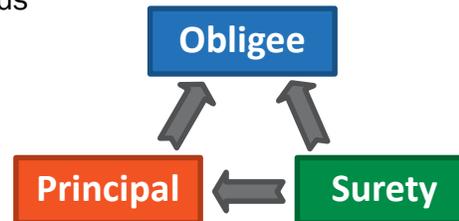
Surety Bond Basics

What is a Surety Bond?

- A written agreement where a surety guarantees the principal will live up to or perform a specific obligation with the obligee
- Surety bond language must be agreed upon by all three-parties, but can be structured in various ways
- Surety bonds are issued by surety companies, who are generally subsidiaries of insurance companies. A surety company must receive the approval from the U.S. Department of Treasury to issue bonds domestically

How is a Surety Bond underwritten?

- Each surety bond is evaluated by the surety on an individual basis
- Surety's consider the principal's financial profile, the bond terms (type, tenor), the principal's bond portfolio risk profile, and the bond underlying obligations. This process allows the principal and surety to develop a better understanding with each other and surety to provide more competitive pricing than LCs

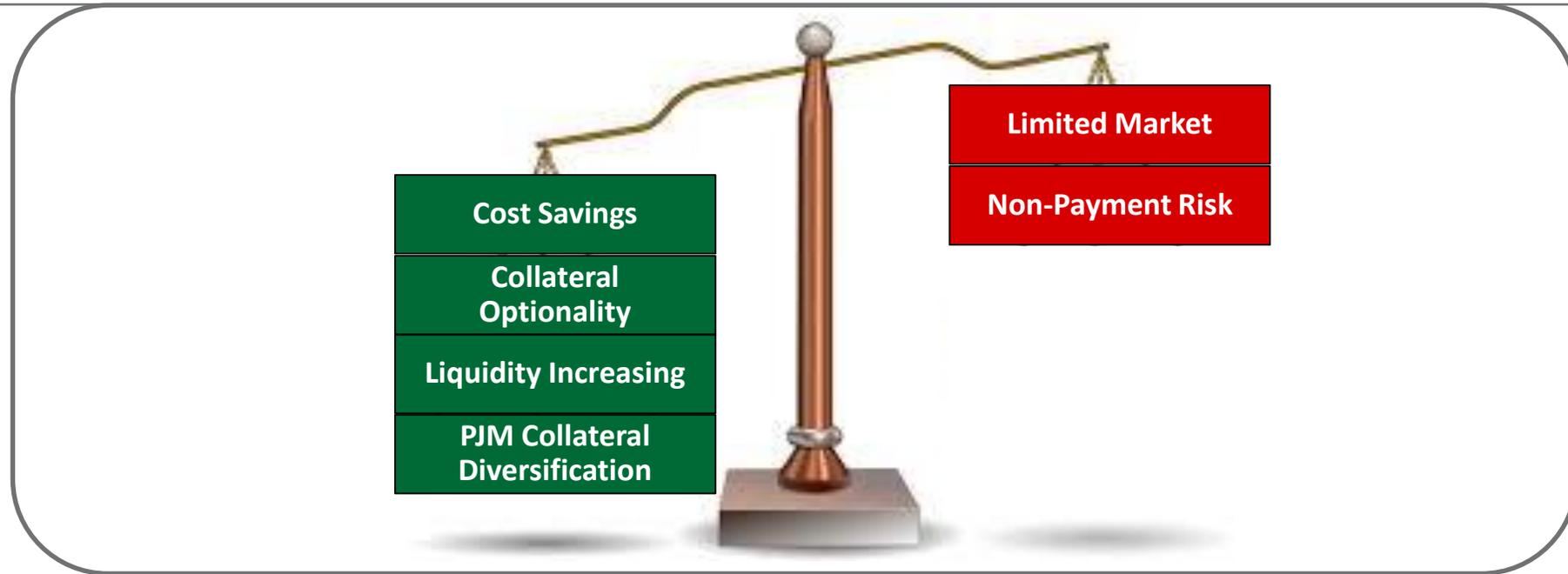


Relevant Surety Bond Types ¹

- **Contract Bonds** are exclusively secured by firms guaranteeing a contract which guarantees that contract will be fulfilled
 - **Payment Bond** is an agreement between the obligee, the principal, and the surety bond company underwriting the bond
 - **Performance Bonds** guarantee that a contract will be completed per the specifications of the contract. It protects the obligee in case of principal defaults

Surety bonds are a secure form of financial assurance, which are underwritten and priced based upon criteria of the Principal's financial health and underlying obligation

Exelon's View of the Pros and Cons



Pros

- Since the 2008 financial crisis and agreement of Basel III, the cost of LCs have increased while surety premiums have remained stagnant ¹
- The more robust underwriting process an insurance company goes through allows them to more competitively price bonds
- Increasing collateral optionality enhances market participants ability to strategically manage their collateral portfolios to align with their needs
- The use of surety bonds frees up liquidity
- Accepting surety bonds will mitigate PJM's concentration exposure to big banks by diversifying their collateral portfolio with Sureties

Cons

- **Risk:** non-payment or delay in payment
- **Mitigant:** Structure bond language similar to LC's
- **Risk:** Limited market of insurance companies willing to underwrite ISO bonds
- **Mitigant:** Educating the sureties on low risk nature of the obligations

The pros of using surety bonds as collateral to cover ISO obligations clearly outweigh the cons

Frequently Asked Questions

Why are surety bonds cheaper than letters of credit?

- Surety bonds are cheaper than letters of credit (LCs) because of Basel III and a more robust underwriting process
 - Since 2008 and the passing of Basel III (Third Basel Accord), banks now must realize LCs as a liability on their balance sheet, which affects their capital ratios for regulatory purposes
 - Similar to LCs, Surety's take the principal's financial standing or creditworthiness into consideration. In contrast to LC's, each surety bond is reviewed on an individual basis, which requires due diligence from the surety company to understand the bond's underlying contract and any potential default scenarios. With this in consideration, the underwriters will assign a different level of risk for each bond reviewed

Does the ISO's risk of non-payment or delay in payment increase with the use of surety bonds?

- The risk of non-payment or delay of payment ("payment risk") is alleviated by structuring strong payment term language
 - The level of payment risk associated with surety bonds is completely determined by the way that the surety bond language is structured and the understanding between the principal and surety. Within each surety bond there are various terms and conditions that all three parties must agree upon; one very important one being "Payment Terms." The payment terms outline the time which the surety has from point of receiving a claim, to paying the obligee for that claim

Why is this beneficial for market participants and PJM?

- Acceptance of surety bonds as collateral will bring market participants increased collateral optionality, cost efficiencies, and additional borrowing capacity. With the acceptance of these instruments, PJM will also find themselves with a more diversified collateral portfolio, limiting their concentration risk

Is there a market of Sureties willing to underwrite these obligations?

- Yes, by educating the surety companies on the underlying obligation, it gives them a better understanding of the risk profile of these obligations for market participants (i.e. overview of ISO operations to inform why market participants view these obligations as high priority/low risk items)

What regulations/laws apply to surety bonds?

- Surety bond's are subject to both federal and state laws and regulations. Federal laws and regulations are specified within the United States Code, Title 31, Chapter 93¹. Similarly, LCs are primarily governed by rules put in place by the International Chamber of Commerce