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PJM FTR External Clearing Regulatory Issues

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External Clearing of FTRs

- The proposal for external clearing of FTR positions will affect:
 - The CFTC Order, dated April 2, 2013, exempting PJM (and other RTOs and ISOs) and PJM Market Participants from the Commodity Exchange Act and CFTC regulations (except anti-fraud and anti-manipulation provisions) with respect to financial transmission rights (“FTRs”) and other PJM products;
 - The CFTC’s jurisdiction over FTRs once they are cleared via an EFTR;
 - The CFTC’s jurisdiction over holders of cleared EFTRs;
 - The extent of FERC’s jurisdiction over cleared EFTRs and over holders of EFTRs; and
 - General concerns regarding the bifurcation of the FTR/EFTR markets and jurisdictional oversight.

Summary of Regulatory Issues Raised by External Clearing of FTRs

- CFTC

- It is highly unlikely that PJM can implement the external clearing proposal under the current CFTC Exemption obtained by the RTOs and ISOs
- The external clearing proposal raises issues under the CFTC Exemption obtained by RTOs warranting review
- Reopening the CFTC Exemption in an attempt to permit external clearing could create uncertain timing and outcome risks
- CFTC regulatory status of FTRs, PJM and/or PJM Settlement may change (the CFTC would have exclusive jurisdiction over cleared FTRs -- EFTRs)
- PJM capitalization and collateral concerns (proposal is that PJM Settlements would post variation margin funded, at least initially, through a combination of a \$x million letter of credit and a \$y billion line of credit)

Summary of Regulatory Issues, *cont'd*

- FERC
 - Would be divested of jurisdiction over FTRs once cleared (i.e., EFTRs); concerns regarding fulfillment of its jurisdictional responsibilities (e.g., undue discrimination)
 - Reopening the CFTC Exemption could affect FERC's jurisdiction over the FTR market and PJM more broadly
 - Could disrupt FERC's current regulatory alignment with CFTC
 - Market surveillance concerns with the proposed bifurcation; IMM role
 - FERC's jurisdictional oversight of financial exchange participants may be constrained
- Independence
 - CFTC Clearing House market participant representation requirements

CFTC Exemption Does Not Contemplate External Clearing of FTRs

- CFTC granted a single exemption for all RTOs. Revisiting the exemption process to implement the clearing proposal could affect all RTOs and ISOs.
- PJM made a number of representations in its Application for the Exemption that either would, or may, no longer be true if the FTR clearing proposal is adopted. This means that PJM would have to modify its application for the Exemption. The impacted representations include the following, among others:
 - a. “The Requestor *serves as the market administrator for the market* on which the FTRs are transacted.” App. at 6 (Would still be true only for the auction);
 - b. “*Each party to the transaction is a member of the Requestor (or is the Requestor itself)* and the transaction is executed on a market administered by that Requestor.” App. at 7 (Not true after the EFTR);

- c. “Each of the Transactions is part of, and inextricably linked to, the organized wholesale electricity markets that are subject to FERC’s . . . regulation and oversight.” App. at 11 (Not true after the EFTR);
- d. “Congestion management. The ISO/RTO must ensure the development and operation of market mechanisms to manage transmission congestion which accommodate broad participation by all market participants, and *provide all transmission customers with efficient price signals that show the consequences of their transmission usage decisions.*” App. at 14 (Not true after the EFTR);
- e. “As a result of FERC . . . oversight, the ISOs/RTOs have established comprehensive and integrated credit policies *to manage the credit risk and protect the financial integrity of the organized wholesale energy markets.* These credit policies consider the creditworthiness of market participants, *update exposure calculations on a regular basis* and establish credit limits for market activity.” App. at 18 (Not true after the EFTR);

representations cont'd

- f. “At least one ISO/RTO, PJM, has already formed a separate legal entity to *act as the central counter party (CCP) to each transaction* made by market participants in the PJM markets.” App. at 19 (Not true after the EFTR);
- g. “The ISOs/RTOs ensure financial integrity, in part, through the risk management requirements that apply to their market participants.” App. at 20 (Unclear how the EFTR affects this representation);
- h. “As part of the comprehensive regulatory oversight that FERC exercises over the ISO/RTO markets, FERC has the power to impose remedies, including significant civil penalties, for violations such as fraud and other abusive practices. App. at 22 (After the EFTR, the remaining futures transactions will be subject to the CFTC’s exclusive jurisdiction);

- i. “The Requestors, Transactions and Participants are subject to comprehensive enforcement regimes pursuant to their tariffs . . . and FERC . . . oversight.” App. at 22 (Not true after the EFTR).
- There also are representations in the Appendices to the Application that would be impacted by the FTR clearing proposal. They relate principally to how PJM satisfies the Core Principles that apply to DCOs.
- Examples include:
 - Attachment B - DCO Core Principle B: Financial Resources: “PJM does not require financial resources to cover member defaults. Instead, member defaults in excess of posted collateral are mutualized amongst the non-defaulting members per Section 15.2.2 of the PJM OA.” Appendix at 20.

- “An FTR Participant (as defined in Attachment Q to the PJM Tariff) must make either of the following 3.a. or 3.b. additional representations: 3.a. relating to intent to hedge and monitoring of FTR market activity; 3.b. “On no less than a weekly basis, Participant values its FTR positions and engages in a probabilistic assessment of the hypothetical risk of such positions using analytically based methodologies, predicated on the use of industry accepted valuation methodologies.” Appendix at 48.
- All of PJM’s representations concerning its risk management of the FTR market would no longer be true after an EFTR. Appendix at 85 - 90.
- The same is true for PJM’s representations concerning the limitation of exposure to potential losses from FTR-related defaults. Appendix at 91 – 92.

CFTC questions regarding PJM Financial Risk

- Will PJM be able to satisfy requirements for being a clearing member?
- Is PJM's capitalization sufficient?
- How will PJM be able to meet a margin call if it needs to obtain FERC approval to increase indebtedness?
- What happens if the Letter of Credit is called upon to meet a margin call?
- Is PJM pledging credit on behalf of its Members and how will socialization of costs impacts Members?

Does PJM become CFTC Jurisdictional?

- Currently PJM is effectively exempt from CFTC regulation because of the Exemption.
- If the Exemption is reopened, PJM FTRs may be regulated by the CFTC as swaps or futures contracts, and PJM could become a swap execution facility (or possibly even a futures exchange).
- Financial exchange cleared EFTR positions are futures contracts that unquestionably are subject to the CFTC's exclusive jurisdiction, and financial exchange would have to self-certify any new rules applicable to the clearing of EFTR positions.
- Post-clearing, the CFTC (and the financial exchange) would have jurisdiction over persons who trade and hold futures contracts (which would include PJM Settlement if the clearing proposal is implemented).

CFTC Conclusions

- PJM’s prior Application for the CFTC Exemption would need to be revisited because, as noted above, many of PJM’s existing representations concerning FTRs would no longer be true if the clearing proposal is implemented.
- This could be a difficult and lengthy process with an uncertain outcome.
- It also is uncertain how the CFTC would view an arrangement that disclaims jurisdiction over FTRs and PJM’s auction process, but then once they are exchanged via an EFTR for futures contract positions they become subject to the CFTC’s exclusive jurisdiction.
- This would require extensive coordination with FERC and a clear delineation of the regulatory and oversight responsibilities of each agency.

Optional Clearing Creates Additional Complexity

- Yes. It would mean that cleared and uncleared FTRs would comprise separate risk pools and be subject to different regulatory and risk management regimes.
 - Uncleared FTRs would be exempt from all but the anti-fraud and anti-manipulation provisions of the CEA and the CFTC’s jurisdiction, and subject to FERC’s jurisdiction and PJM’s Tariff;
 - Cleared FTRs would be subject to the CFTC’s exclusive jurisdiction and the rules of the clearing entity.
- For this reason, it may be that both the CFTC and the FERC may have concerns about an optional clearing model.

FERC Concerns

- Amending the Exemption could create concerns on the part of FERC and other RTOs and ISOs.
- At best, external clearing bifurcates / limits FERC's jurisdictional scope.
 - Credit authorization from FERC needed by PJM to incur indebtedness to provide margin for transferred/cleared FTR positions.
 - FERC approval for any revisions for default allocation risks outside of its jurisdiction may raise concerns.
 - Optional external clearing could create additional market surveillance risks.
 - Mandatory external clearing could create burdens and barriers for certain PJM Members, particularly possibly public power.

Independence Concerns

- Regional Transmission Organization must be independent
 - 18 CFR Section 35.34(j)(1) - Independence
 - See, e.g., Operating Agreement, Section 7.2 - Independence
- The Commodity Exchange Act and CFTC regulations require that the governing boards of designated clearing organizations include market participants.
 - See, e.g., Section 5b, (c)(2)Q, of the Commodity Exchange Act (CEA), 7 USC § 7a-1(c)(2)Q (Composition of governing boards); CFTC Rule 39.26, 17 C.F.R. § 39.26.

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