

## Revised Comments of Financial Marketers on PJM Verification Process Proposal and Officer Certification Form

In considering what verification process should be adopted by PJM it is important to begin with the FERC requirements. In its Order on Compliance dated September 15, 2011 (the “Compliance Order”) the Commission found that PJM’s submission was insufficient, “without independent verification that risk management policies and procedures are actually being implemented.” Compliance Order at p.39. The FERC did not prescribe any specific provisions for this verification, but suggested “a periodic verification could include periodic review of risk management policies, practices, and procedures, and their implementation, conducted on a random basis or directed to certain market participants based on identified risk.” Id. fn 98.

We have reviewed the revised PJM language describing a proposed verification process, as posted on the PJM website on November 10, 2011, and respectfully submit the following comments on behalf of the listed Financial Marketers. Although the recently revised PJM proposal offers significant improvements over the prior draft, it fails to address a number of issues. As set out in our initial Comments, Financial Marketers support a verification process that is transparent, non-discriminatory and focused on practices that create high risks for the PJM markets and Participants. The approach advocated by Financial Marketers also follow the path set by the Commodity Futures Trading Commission (“CFTC”).

Financial Marketers continue to object to the proposed modifications to the FTR carve out for load serving entities and generators on the Officer Certification form. The proposed language would eliminate any meaningful distinction between load serving entities and generators engaging in FTR trading to hedge physical load and all other FTR Participants. It would also continue to grant such traditional companies undue, preferred treatment.

**PJM's Selection Process Should Specifically Target the Actual Risk Posed by Participant Trading Activities**

The proposed verification process remains overbroad because it permits a Participant's selection for verification on a random basis rather than based on identified risk criteria that are designed to identify practices and procedures that create high risks for the market. Additionally, random selection offers no transparency and invites arbitrary behavior at best and undue discrimination at worst. A verification process that is not based on identifying the most significant areas of risk would also be a waste of resources, creating costs that are borne by market Participants with no resulting benefit in risk reduction for the PJM markets.

The resources of PJM and its members are only well spent if they are targeted to the trading activities that pose an actual and meaningful threat to the markets. While we do not necessarily endorse the CFTC's approach, their recent findings highlight the need for a targeted approach to risk management assessment and verification. In a recent final rule, the CFTC responded to comments about requiring a clearinghouse to engage in overbroad reviews of its members' risk management policies. The CFTC determined that the review should be limited to the members' risk management policies and procedures "which address the risks that such clearing members may pose to the derivatives clearing organization." Derivatives Clearing Organization General Provisions and Core Principles, (approved as a final rule Oct. 18, 2011, to be codified at 17 CFR Parts 1, 29, 31 and 140). The same approach should be used by PJM: verification should be focused on risks that pose a danger to the organization.

Further, if the verification selection criteria are not transparent and objective, they could be used to unfairly target specific trading sectors, or single out specific Participants for unfair or disparate treatment. The PJM policies should require the use of objective criteria for verification that are directly related to the risk a Participant presents to the market, and are non-discriminatory. We believe PJM should develop standards that assess actual risk, including the varying risks of specific trading products. For example, the FTR Option product (in which the maximum loss is the cost to purchase the option) poses far fewer risks to PJM and the market than the FTR Obligation product. Although distinctions such as this are admittedly quite granular; it is

just such an approach that assures a proper measure of the risk to the market that is presented by a Participant's trading activities.

Finally, we continue to object to the use of a random verification process. As noted above, random inspections do not focus on assessing actual market risk. The only benefit from a random selection process is that it seeks to inject enough uncertainty that--at least in theory--all Participants will be more careful. The reality, however, is that the same "fear of inspection" can be provided with a risk factor based approach, and with the obvious benefit of devoting PJM's limited resources to identifying the practices that most threaten the market. The other clear problem with a random verification process is that specific sectors and specific companies can be unfairly targeted-- and not because they are engaging in risky market behavior, but simply because they are disfavored.

Although Financial Marketers oppose the use of random verifications, to the extent it forms any part of the risk verification process, the PJM policy and Tariff should specifically provide that: 1) the selection of any Participant for verification screening shall be non-discriminatory; 2) random verifications will target all market sectors fairly and equally (e.g. 3 companies selected from each sector annually); and 3) PJM will post at least annually the number (or percentage) of companies selected for random verification from each market sector.

### **An Appeal Process Is Needed**

Before any Participant is barred from trading due to a PJM finding that its risk management procedures or policies are inadequate, an explicit appeal right and due process protections should be provided. If an appeal is not provided then Participants will have no meaningful way of challenging adverse findings that may be based on inaccurate or incomplete information. Additionally, because any exclusion from the PJM markets can be a financial death sentence to a Participant, or in the case of load serving entities and generators can directly endanger electricity service to consumers, no market exclusion should be implemented while an

appeal is pending. An appeal could be handled through the dispute process provided under the PJM Tariff or be submitted to FERC.

**Risk Management Standards Must Be Considered And Approved By Stakeholders Before They Are Adopted By PJM**

In the latest PJM draft it states that “if principles or best practices relating to risk management in PJM-type markets are published, as may be modified from time to time, by a third party industry association, PJM settlement may apply such principles or best practices in determining the sufficiency of the Participant’s risk controls.” Although Financial Marketers agree that industry best practices are needed to guide Participants in their own planning, the FERC requirements are that ISOs establish “minimum” risk management requirements. PJM should not be in the business of deciding the internal management policies of Participants beyond the “minimum” standards needed to protect the market.

Financial Marketers believe any future changes to PJM’s verification requirements must include procedural protections. First, any new practices that may be adopted by PJM need to be written and made available to all Participants in advance of their application. Second, before adopting new principles PJM should assure that such proposed changes are considered and supported by PJM stakeholders, and that they are then included in the Attachment Q Credit Provisions.

These limited changes to the PJM proposal will assure that Participants know what is expected of them in advance, and are able to provide their input on what requirements are workable and effective. Financial Marketers also urge PJM to be mindful that policies that may not be unduly burdensome for a large corporation may be completely unworkable and counter-productive for smaller market Participants.

**Documentation Requests Should Be Protected from Release by Third Parties**

As noted in our prior comments, without more significant limits on the rights of third parties to review Participant data, highly confidential, competitive information could easily be released. A request by PJM for

documents and other information could present an opportunity for the theft of trade secrets by “third parties” who would have access to a Participant’s proprietary analytics, decision-making process and trading activities. A simple confidentiality agreement, which only extends to nondisclosure of a company’s actual data and identity, would not adequately protect Participants from a third party who has seen information about the business practices and trading activity of a Participant and then uses that data in the market, or makes that information available to others. As with most confidentiality breaches, there would be no adequate remedy.

In short, the real threat is not the actual release of a Participant’s identity or specific trading data but the knowledge that a third party reviewer gains from seeing that information. To the extent third parties are given access to this highly valuable proprietary information, the PJM policies and procedures must protect against the reviewer’s use of this data in the market.

Although we appreciate that a third party’s expertise might be helpful in developing objective risk identification metrics, Financial Marketers believe it is not appropriate for PJM to use third parties in this verification process beyond the development of risk identification metrics. To the extent any third party is given access to confidential Participant data, however, our Proposal would bar such third parties from becoming a Participant in PJM or from becoming a consultant for, or otherwise advising, a Participant in PJM for at least two years following such an engagement.

#### **Proposed Change to the Officer Certification Form**

Financial Marketers also continue to object to the changes in paragraph 3a of the Officer Certification Form, which serve to establish a favored class of Participants who are not required to submit risk management policies, and are therefore effectively excluded from much of the proposed verification process. This favored class is based on the questionable distinction that such Participants are trading in the FTR Markets “with the sole intent” to hedge physical congestion risks. As many Participants have noted, the physical versus financial nature of a Participant’s business is not a legitimate basis for establishing different risk management standards.

It also lays the groundwork for undue discrimination between traditional market Participants and all others. The proposed new language in paragraph 3a makes this discrimination worse, gutting even the distinction between true physical hedges and all other FTR trading by adding standardless and easily evaded requirements. In particular, a Participant's "intentions" are inherently subjective and therefore represent a completely unenforceable standard. Certainly PJM has no way of assessing a Participant's intent. Further, the most recent changes to the PJM language make this provision even murkier. The 3a language now adds that the favored Participants' FTR activity must merely "endeavor to ensure" that the FTR positions are "either generally proportionate to or generally do not exceed" their physical transactions. What does "endeavor to ensure" or "generally proportionate" even mean? Nothing that can be objectively ascertained. The result of this language is that traditional market players can escape any meaningful review of their risk management practices simply by claiming their "sole intent" and "general endeavors" were to hedge. This language is unreasonable on its face and should be rejected.

Submitted by:

Carol A Smoots  
Noha S. Sidhom  
Pierce Atwood LLP  
900 – 17<sup>th</sup> Street, NW, Suite 350  
Washington, DC 20006  
Telephone: (202) 470-6427  
Email: csmoots@pierceatwood.com

On behalf of:

City Power Marketing, LLC

Great Bay Energy, LLC

The Highlands Energy Group, LLC

Monterey, LLC

Twin Cities Power, LLC

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