Surety Bonds Opportunity

Problem / Opportunity Statement

The current PJM Credit Policy does not allow the use of surety bonds as an acceptable form of collateral, resulting in limited optionality of financial instruments and potentially elevated costs for participants in PJM Markets.

Market participants are required to provide PJM with collateral, either cash or letters of credit, as security in order to participate in the PJM Markets or purchase Transmission Service in the region. Depending on the makeup of a market participant's generation and load position, collateral postings can be significant. With the limited optionality of instruments as acceptable collateral, participants are burdened with higher than desired costs.

Generally, surety bonds are quoted at a discounted price to letters of credit, and may result in an immaterial change to PJM's risk of non-payment. This can give market participants the ability to capture the cost spread between these instruments in order to reduce collateral costs and optimize their collateral portfolio, while leaving PJM's non-payment risk profile unchanged.

PJM and stakeholders agreed in 2002 to not allow the use of surety bonds as a form of financial security because:

(1) Concern that issuers of surety bonds would not be open to underwriting a bond with comprehensive language related to costs and events following a member default and
(2) Risk of delay or denial of payment by surety bond issuers in the event of a market participant default.

These historical concerns around the use of surety bonds can be mitigated through educating Surety Companies on the nature of ISO obligations and by PJM establishing a thorough bond language. To address the first concern, sureties have gained comfort with the comprehensive yet distinct language set forth by other ISOs because they now have a better understanding of the business and financial obligations these bonds support. As a result, we believe this shift in dynamics within the surety bond market is reason to revisit this topic. In regards to the second concern, the risk of delay or denial in payment is only relevant if the bond language is not structured properly. Surety bonds are flexible in respect to the language and can give the obligee the ability to ensure that payment is evident. Other ISOs (NYISO, ERCOT) have drafted language by which their counsel is comfortable accepting surety bonds from market participants as security. That language includes various clauses which have the sole purpose of protecting the ISO.

The goal of this problem statement is to initiate discussion regarding PJM's Credit Policy and collateral definition within the Open Access Transmission Tariff that prohibits the use of surety bonds as an acceptable form of collateral. Allowing the use of this instrument warrants discussion and analysis as it will help market participants manage and optimize their collateral costs, while having minimal effect on PJM's non-payment risk profile.