Financial Market Reform Project
Discussion Paper
Events of Default & Market Participant Termination

August 2019

1 Purpose

PJM operates various markets for services that are integral to the reliable and efficient delivery of power through the PJM system. As a market operator, PJM has a singular view of the material risks in a marketplace connected to one or more Market Participants ("Participant"), and how and whether those risks may reasonably be anticipated to affect other market participants, or the market as a whole. Given its unique vantage point over the entirety of a marketplace, and its responsibility to operate each market in a fair and efficient manner, PJM requires administrative tools to exercise its oversight and regulatory mandate. The following powers are designed to provide PJM with tools to maintain order and deal with significant threats to a market.

Below, we examine default and termination events that might occur in the financial power markets, (inclusive of the Financial Transmission Rights ("FTR") market) to mitigate risks associated with potential losses that may arise from a counterparty's failure to meet any and all of its material obligations in connection with its trading activity including margin and settlement requirements. The paper also details the discretionary authority that PJM requires to meet the challenges in the event a Participant fails to meet such obligations.

2 Summary

This paper recommends that PJM have the authority to:

- Demand Adequate Assurance of Performance, upon reasonable grounds for insecurity regarding the performance of any material obligation. Adequate Assurance of Performance shall mean sufficient security in the form, amount and for the term reasonably acceptable to PJM, but not limited to, cash, U.S. government securities, a standby irrevocable letter of credit, and such other readily liquid assets with appropriate "haircuts" that PJM may find acceptable from time to time. In the event that a Participant fails to provide the required Adequate Assurance of Performance in the timeframe required such failure shall be an event of default.
- Declare any participant that fails to satisfy a margin call within one day, to be in default.
- Limit or suspend trading rights in the event of a material change in the creditworthiness of a Participant
- Immediately suspend trading rights in the event of default
- Close out and liquidate the participant's portfolio, exercising judgement in the manner this is achieved.

As a preventative credit measure, PJM also recommends that it have discretion in setting and applying position limits.

3 Events of Defaults

Events of Default:

- Payment default – the failure by the party to make, when due, any payment, including but not limited to initial margin, variation margin, final settlement payment or other collateral calls.

- Breach of agreement –
    i. the failure by the party to comply with or perform any agreement or obligation (other than to make any payment, etc.…) to be complied with or performed by the party in accordance with PJM requirements if such a failure is not remedied within 1 day after notice of such failure is given to the party; or
    ii. the party disaffirms, disclaims, repudiates or rejects, in whole or in part, or challenges the validity of the PJM requirements
- Credit support default –
    i. The failure by the party or any credit support provider of such party to comply with or perform any agreement or obligation to be complied with or performed by it in accordance with the PJM Credit Policy
    ii. A false representation or misrepresentation, intentional or unintentional, made by the Member or in any credit support document that proves to have been incorrect or misleading in any material respect.

- Default under specified transactions such as bilateral FTR transactions.
- Bankruptcy, insolvency, or the inability of a party to meet its material financial obligations as they become due.
- Merger without assumption - when the party or any credit support provider of such Participant consolidates or amalgamates with, or merges with or into, or transfers all or substantially all its assets to, or reorganizes, reincorporates or reconstitutes into or as, another entity and, at the time of such consolidation:
    i. The resulting, surviving or transferee entity fails to assume all the obligations of such party or such credit support provider to which it or its predecessor was a party; or
    ii. The benefits of any credit support document, fail to extend to the performance by such resulting, surviving or transferee entity of its obligations.

In the event of a default, PJM needs to have appropriate processes and structures in place – supported by appropriate authorities – to manage the event.

3.1 Triggering an Event of Default

The Independent Consultants' report[1] recommends "within one to two business days." PJM, for the most part, already has this right, requiring satisfaction within two days, though not for the mark-to-auction component of the credit requirement, which allows a month to satisfy the collateral call (with trading rights suspended, but default not declared, until collateral is posted). Provided that PJM can calculate mark to market on a more frequent basis, it is intended that payment of variation margin – whether it be in the form of cash settlement or a collateral adjustment – should be subject to the same margin call and default procedures as all other credit requirements.

Based on the consultants' recommendations, PJM recommends no more than one Business Day to remedy any payment or credit support event before declaration of default. Given the market is settled based on transacted quantity, it is not subject to disputes concerning actuals (which might give rise to some argument, albeit tenuous, for additional time), and it is reasonable to expect a certain level of transactional sophistication from entities transacting in a financial market. By way of comparison, margin calls in futures markets must often be satisfied within a couple of hours. The Independent Consultants' report also recommends (A4.1) that "the default be declared promptly and without negotiation."

In the case of a breach of agreement, it is standard practice to provide 30 calendar days to remedy, from when notice of breach is given, before declaring default.

Events of bankruptcy, 'default under specified transactions' and 'merger without assumption' are typically not capable of being remedied and should result in immediate default, as soon as the fact has been clearly established.

3.2 Liquidation

PJM should have discretion in the way it exercises this right, including closing out, netting and auctioning off pieces of a defaulting portfolio across several regular auctions, and/or conducting one or more special liquidation auctions.

3.3 Seizure of Collateral

As per current practice, PJM should have the ability to seize collateral immediately in the event of a default, and to restore any unused portion only after all obligations are discharged. Similarly, PJM should continue to exercise its rights to pursue any residual payment shortfall through avenues available to it under administrative, civil and criminal law as applicable.

4 Market Participation Termination Events

Most events of default are likely to lead to eventual termination of the market participant, unless the participant is able to remedy and bring itself back into good standing. There are also a range of other credit-related events that could lead to termination, including:

- Credit Event Upon Significant Adverse Change in Capital Structure – Where the surviving Participant is materially weaker immediately after the occurrence of a Designated Event. A Designated Event with respect to the Participant means that
    - i. The Participant is acquired by or merges into another entity
    - ii. Any person, related group of persons or entity acquires directly or indirectly the beneficial ownership of (A) equity securities having the power to elect a majority of the board of directors (or its equivalent) of the Participant of (B) any other ownership interest enabling it to exercise control of the Participant.
    - iii. The Participant effects any substantial change in its capital structure by means of the issuance, incurrence or guarantee of debt or the issuance of (A) preferred stock or other securities convertible into or exchangeable for debt or preferred stock or (B) in the case of entities other than corporations, any other form of ownership interest.
- Additional Termination Event, as described below
    - i. Key Person event (i.e. Death, departure, or incompetency)
    - ii. Net Asset Value decline over X months

iii. Failure to report NAV
iv. Failure to deliver required financials
v. Decline in assets under management
vi. Material change in investment strategy
vii. Breach of investment restrictions, etc.

5 Preventative Measures

PJM may also have discretionary actions available to it to attempt to prevent default, or limit its impact. These include, as noted above making discretionary adjustment to collateral requirements.

Recommendation B2.3 of the Independent Consultants' report suggests "rules that give PJM discretion to deal with unanticipated market emergency events."

A common industry standard is to require "adequate assurance of performance", based on reasonable grounds for insecurity regarding the performance of any obligation. These grounds would encompass any event likely to have a material impact on an individual participant's creditworthiness, including change in credit rating, changes in market valuation, market-wide events (e.g. disruptions in physical supply). The assurance could come in forms already utilized, such as cash and irrevocable letter of credit, as well as a security interest in cash and other assets.

Such discretion would apply on a market participant by market participant basis, based on PJM's evaluation of individual circumstances.