

MEMORANDUM

To: Susan Riley, PJM CEO and
Nigeria Bloczynski, CRO

From: Neal Wolkoff and Robert Anderson, Independent Consultants

Re: Proposal (9/24/19) by Nodal Exchange concerning FTRs

Dated: November 7, 2019

We have been asked to review and comment upon the proposal by Nodal Exchange (“Nodal”) contained in a presentation document dated September 24, 2019 for the trading and clearing of certain FTR positions executed in a PJM regular auction. The following presents our views some of which are positive, but a number of which highlight concerns that need to be considered or further evaluated with Nodal before deciding to enter into any formal negotiations.

MAJOR POSITIVE OPPORTUNITIES WE SEE:

(1) **Valuable Stand-Alone Services** -- Nodal Exchange indicates it will calculate and collect an initial margin requirement and also calculate and collect (or pay out) the daily mark to market on each open position. In addition, Nodal is prepared to offer clearing services and a continuous auction market for positions placed on the Nodal system. If PJM could contract with Nodal to buy these margin and mark to market services on a stand-alone basis, i.e. without the rest of the EFTR position transfers, position limits, and continuous trading, we see a very useful service for PJM and its members. A service that could greatly enhance the safety and integrity of the PJM FTR auction markets. Further, given such a service PJM might not be so urgently pressed to increase the number of FTR auctions to better mark to market outstanding FTR positions.

(2) **Market Development and Revenue Opportunities for PJM** -- Although we do not recommend the Nodal proposal as-is, we do see a way for PJM both to garner revenue and expand the use of its FTR market with Nodal’s help. This would involve transforming the current PJM bilateral FTR market from a posting board to a futures contract block trade platform. Once open interest is established on Nodal and continuous trading occurs, Nodal may also become an excellent venue to operate an options market in PJM FTR products. This would create additional trading opportunities for PJM members, and create a more reliable market-driven method to create daily settlements or mark-to-market prices for PJM to use as well.

MAJOR CONCERNS WITH THE PROPOSAL AS-IS:

(1) **Regulatory Uncertainty** -- The Nodal presentation does not adequately discuss the regulatory uncertainty of relying on EFTR transactions to move positions executed during the PJM auction onto a futures clearinghouse and exchange. To our knowledge, the CFTC has not provided the necessary approval to Nodal or any other clearinghouse that clears trades executed exclusively off-exchange (meaning not on a registered futures market; PJM’s auction market is

considered off-Exchange). The proposed mechanism to transfer FTR positions from PJM to Nodal would require the CFTC to abandon a long-held hostility to off-exchange transactions that are transient and dependent on one another to form the basis for creating a futures contract. Transitory EFPs that create or net out futures positions in other commodity markets have been targets of CFTC actions, and expressly prohibited since 2014.¹

NYMEX (now part of CME Group) used a similar model similar to Nodal's current EFTR proposal to start the Clearport™ platform at NYMEX. Clearport™ accepted swap trades that were executed away from the exchange. The buyer and seller agreed to post a futures trade for clearing when they executed the swap. The buyer of the swap agreed to immediately sell the swap to the original seller and then in the same transaction buy the futures contract equivalent of the swap from the original seller. The buyer and seller owned the swap for an instant, exchanged offsetting trades to extinguish the swap, and assumed the same position of buyer and seller – this time of futures – which were then posted to and cleared by the NYMEX (CME) clearinghouse. The simultaneous or near-simultaneous execution of swaps and equivalent futures were considered to be a “transitory” EFP, a similar instrument to Nodal's EFTR. After expressing frustration with the use of transitory EFPs – long illegal in non-clearing situations – in 2014 the CFTC prohibited them as a mechanism to post an off-exchange trade to an exchange clearinghouse. This is a bit inside baseball, but the nub of it is that you could not hold an FTR auction and afterwards decide to convert some FTRs into cleared futures by reversing the FTR trade and replacing it with a Nodal trade and position. The prohibited “transitory” EFP (EFTR) is the mechanism Nodal intends to use for its clearing service. How will Nodal succeed in doing that given the CFTC's well-established position against?

(2) **Costs** – The Nodal model relies on PJM to be the sole counterparty of Nodal Exchange. Although the identity of the original FTR buyers and sellers will remain known, PJM becomes the buyer to every seller and the seller to every buyer, in essence clearing the trades before the trades are cleared. Transaction fees (see below) remain the responsibility of the original PJM members who executed the FTR trade, PJM is on the hook for each member's financial obligations to the futures market. As such, PJM will need a large line of credit to participate on the Nodal Exchange, and it will undoubtedly impose a fee in addition to Nodal's fee to compensate for the risk. In addition, PJM would likely have the right to exclude participation by certain members deemed high risk. It is unclear what, if any, fees are charged by Nodal's clearing members which are offering the financial guaranty, and would presumably be unwilling to do that without a revenue stream. These costs need to be specifically explored.

Nodal sets forth its own fees and states they are discounted by 75%. These fees are payable by PJM's members who transact in the FTR market and choose to clear trades on Nodal. Any participant interested in transacting on a platform with a fee discount or holiday would consider the potential for a time when the discount goes away or is reduced to pose a risk of an unknown future price increase. Unless Nodal makes the discount to regular fees permanent, the discount is not a reliable indicator of future cost as members will believe that prices would rise to the standard level after an introductory period.

¹ <https://www.cmegroup.com/rulebook/files/cme-group-Rule-538.pdf>

Even so, with the discount, a fee of \$.01/MWh could add significant costs to what a member now pays for an FTR trade. (Nodal quotes the fee as \$.005, but it seems likely that both the buyer and seller would each pay a half cent per MWh, for a total cost of a penny). If the parties to the original trade then liquidate their respective positions, each would pay a penny for the full round turn. If a party leaves the position open until final settlement, it will pay 3/4 cent per MWh.

For example, let's consider a trade for 100MW. If a party buys and ultimately sells that contract it will pay \$1.00 per hour times 16 peak hours (\$16.00) times 22 peak days for a total of \$352 per month. A position held for 12 months would cost \$4224 at a discounted rate of 75% off the standard rate. If the FTR future is placed on the exchange and allowed to go to settlement, the same 100MW would cost \$3168. This is not a small cost to impose on a marketplace, and we believe participants could strongly object to the prospect of fees going up.

(3) Limited Risk Mitigation – In order to manage the risk posed by the ISO as its sole counterparty, Nodal has the right to force PJM to reduce cleared positions and return trades to the original buyers and sellers (Nodal Clear Rule 3.10). Would Nodal choose which trades belonging to which customers are chosen, or would PJM, and could either do so in a non-discriminatory way? Would Nodal Exchange and/or PJM really be mitigating the worst risks or just accepting the easiest risks to bear? If the use of Nodal is voluntary, and trades can be returned to PJM, both PJM and its members retain significant conditional risk. In addition, PJM will need to adopt and monitor rigorous risk management standards since PJM is the actual holder of the trades. Clearing through Nodal does not relieve PJM of its duties and risks.

(4) Small guaranty fund - A fund under \$200 million to guaranty against default seems thin.

(5) Role and risk of PJM - Unclear in the presentation is just what is the size of a PJM line of credit (which may get called on for what?), and how might PJM be allowed to manage the risk of allowing trades to be cleared. Of course, since PJM's liabilities might ultimately be socialized among its members, these questions affect the membership as well as PJM.