PJM Surety Bond Education

Agenda

- PJM and Surety Bond Evolution
- Surety Bond Basics
- Surety Bond/LC Similarities and Differences
- Exelon’s View of the Pros and Cons

PJM and Surety Bond Evolution

Where were we?

- Early 2000's, surety bonds were acceptable form of financial assurance in the PJM market. Why?
  - Less complexity
  - Fewer market participants
  - Smaller collateral obligations
- In 2001, a couple of load serving entities did not have proper financing to cover collateral obligations. Although these entities were not posting bonds, PJM believed bonds at the time were not secure enough to cover defaults
- Therefore, PJM revamped its credit policy to only allow LC's and cash to cover credit exposure

Where are we now?

- Two ISO's, ERCOT and NYISO, allow for the use of surety bonds as financial assurance to cover credit exposure
- Surety bond language over the years has become more aligned with letters of credit
- Surety companies are willing to underwrite structured bond language

Where are we going?

- With the shift in the ISO and surety landscape, surety bonds have emerged as an additional option for financial assurance
- As market participants/ISO's, and surety companies become more informed on surety bonds and energy obligations respectively, we believe there will be a growing desire to utilize this instrument moving forward
- Today we plan to provide background on Surety Bonds and discuss the potential benefits they could afford market participants as well as PJM

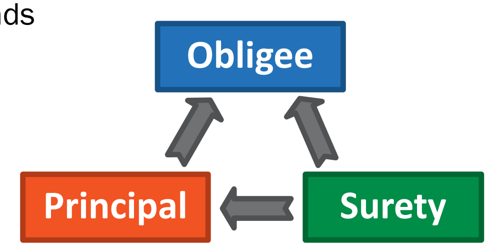
Surety Bond Basics

What is a Surety Bond?

- A written agreement where a *surety* guarantees the *principal* will live up to or perform a specific obligation with the *obligee*
- Surety bond language must be agreed upon by all three-parties, but can be structured in various ways
- Surety bonds are issued by surety companies, who are generally subsidiaries of insurance companies. A surety company must receive the approval from the U.S. Department of Treasury to issue bonds domestically

How is a Surety Bond underwritten?

- Each surety bond is evaluated by the surety on an individual basis
- Surety's consider the principal's financial profile, the bond terms (type, tenor), the principal's bond portfolio risk profile, and the bond underlying obligations. This process allows the principal and surety to develop a better understanding with each other and surety to provide more competitive pricing than LCs



Relevant Surety Bond Types [1]

- **Contract Bonds** are exclusively secured by firms guaranteeing a contract which guarantees that contract will be fulfilled
  - **Payment Bond** is an agreement between the obligee, the principal, and the surety bond company underwriting the bond
  - **Performance Bonds** guarantee that a contract will be completed per the specifications of the contract. It protects the obligee in case of principal defaults

Surety bonds are a secure form of financial assurance, which are underwritten and priced based upon criteria of the Principal's financial health and underlying obligation

[1] Other surety bond types exist, however, we have limited our focus to the relevant ones for ISO collateral

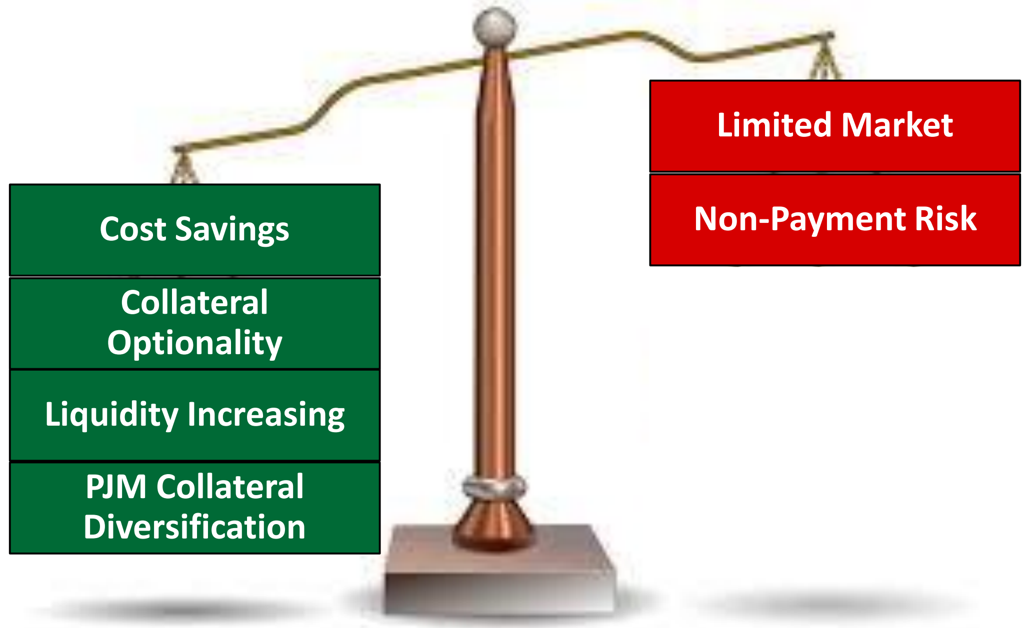
Surety Bond/LC Similarities and Differences

	Surety Bonds	Letters of Credit (LC)
Definitions	• A legally binding contract that ensures obligations will be met between the principal, obligee, and the insurance company	• A letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount
Borrowing Capacity	• Bonds are usually issued on an unsecured basis, and <u>do not diminish</u> a company's borrowing capacity	• The issuance of LCs <u>diminish</u> the borrowing capacity on the line of credit that a company has been extended
Duration	• Surety bonds typically remain in force for the duration of the underlying contract they support and/or are determined by the terms and conditions of the bond	• An LC expiration date is specified within the LC language and is generally one year • LCs may also contain "evergreen" or "auto-renew" clause which allow the LC to automatically renew for a specified amount of time
Claims	• The obligee must declare the principal in default by filing a claim with the surety • The surety has the option to investigate the claim to ensure the terms and conditions of the bond were met, but must ensure to make the obligee whole within the timeframe set within the bond	• The beneficiary must submit a draw certificate, per the LC language, to the bank. Depending on the size of the draw, the bank will then work to have the funds transferred to the beneficiary as soon as possible

A surety bond and LC are comparable forms of financial assurance. Both are legally binding contracts that support an obligation for a specific timeframe

Exelon.

Exelon's View of the Pros and Cons



Pros

- Since the 2008 financial crisis and agreement of Basel III, the cost of LCs have increased while surety premiums have remained stagnant [1]
- The more robust underwriting process an insurance company goes through allows them to more competitively price bonds
- Increasing collateral optionality enhances market participants ability to strategically manage their collateral portfolios to align with their needs
- The use of surety bonds frees up liquidity capacity and can be viewed as a credit enhancement
- Accepting surety bonds will mitigate PJM's concentration exposure to big banks by diversifying their collateral portfolio with Sureties

Cons

- **Risk**: non-payment or delay in payment
- **Mitigant**: Structure bond language similar to LC's

- **Risk**: Limited market of insurance companies willing to underwrite ISO bonds
- **Mitigant**: Educating the sureties on low risk nature of the obligations

The pros of using surety bonds as collateral to cover ISO obligations clearly outweigh the cons

 [1] Commercial Surety., 3rd Edition. 2017, at pg. 29

Issue Charge Reminder

Key Work Activities

- Provide background on Surety Bonds and discuss the potential benefits they could afford market participants as well as PJM
- Discuss benefits and risks associated with allowing surety bonds as a form of financial security in PJM
- If necessary, discuss associated changes to the PJM Credit Policy and other documentation

Other Details

- Expected to be completed within 6 – 9 months
- Seeking Tier 1 Consensus

Appendix

NYISO & ERCOT Surety Bond Snippets

NYISO Surety Bond Language

(1) Payment Language

4. Time and Form of Payment. Surety shall pay amounts owed pursuant to this Surety Bond in full not later than the first business day following receipt of NYISO's written demand for payment to the account designated therein.

(2) Surety Requirement

WHEREAS, Surety is U.S. Treasury-listed with a minimum "A" rating from A.M. Best and has agreed, in exchange for compensation provided by Principal, to provide this Surety Bond on behalf of Principal in accordance with NYISO's credit requirements;

(3) Governance

16. Choice of Law; Jurisdiction; Venue; and Service of Process. This Surety Bond shall be governed by the laws of the State of New York without regard to conflict of laws principles. Surety irrevocably submits to the jurisdiction of any New York court or any United States court sitting in New York over any action or proceeding arising out of or relating to this Surety Bond and irrevocably agrees that all claims in such action or proceeding may be heard and determined

(4) Link to full Surety Bond Language

http://www.nyiso.com/public/webdocs/markets_operations/services/financial_services/credit/Credit/Credit/NYISO_Standard_Surety_Bond_final_FINAL.doc

ERCOT Surety Bond Language

(1) Payment Language

2.03 Payment. Surety is responsible for and shall pay to ERCOT all or any portion of the Obligations, in an aggregate amount that is not greater than Amount of this Bond, and shall make any and all required payments, on or before 5:00 p.m., local time in Austin, Texas, on the first (1st) Business Day after receiving notice from ERCOT that the Principal has failed to meet any of the Obligations or a breach or default has occurred under the Standard Form Agreement. Business Day means any day other than a Saturday, Sunday or a day on which banks in Austin, Texas, are authorized or required by law to close.

(2) Surety Requirement

4.01 Credit Rating. As of the Date of Issuance and for so long as this Bond shall remain in effect, the Surety has, and expects to continue to satisfy and maintain, a minimum corporate credit rating of "A-" with S&P, "A-" with Fitch, or "A3" with Moody's or as otherwise required under the ERCOT Protocols. Surety shall notify Obligee immediately if its credit rating is decreased.

(3) Governance

6.08 Governing Law and Venue. This Bond is executed and delivered as an incident to a transaction(s) negotiated and consummated in Travis County, Texas, and shall be governed by and construed in accordance with the laws of the State of Texas, without regard to conflict of laws principles.

(4) Link to full Surety Bond Language

http://www.ercot.com/content/wcm/lists/89582/Surety_Bond.docx

Frequently Asked Questions

Why are surety bonds cheaper than letters of credit?

- Surety bonds are cheaper than letters of credit (LCs) because of Basel III and a more robust underwriting process
  - Since 2008 and the passing of Basel III (Third Basel Accord), banks now must realize LCs as a liability on their balance sheet, which affects their capital ratios for regulatory purposes
  - Similar to LCs, Surety's take the principal's financial standing or creditworthiness into consideration. In contrast to LC's, each surety bond is reviewed on an individual basis, which requires due diligence from the surety company to understand the bond's underlying contract and any potential default scenarios. With this in consideration, the underwriters will assign a different level of risk for each bond reviewed

Does the ISO's risk of non-payment or delay in payment increase with the use of surety bonds?

- The risk of non-payment or delay of payment ("payment risk") is alleviated by structuring strong payment term language
  - The level of payment risk associated with surety bonds is completely determined by the way that the surety bond language is structured and the understanding between the principal and surety. Within each surety bond there are various terms and conditions that all three parties must agree upon; one very important one being "Payment Terms." The payment terms outline the time which the surety has from point of receiving a claim, to paying the obligee for that claim

Why is this beneficial for market participants and PJM?

- Acceptance of surety bonds as collateral will bring market participants increased collateral optionality, cost efficiencies, and additional borrowing capacity. With the acceptance of these instruments, PJM will also find themselves with a more diversified collateral portfolio, limiting their concentration risk

Is there a market of Sureties willing to underwrite these obligations?

- Yes, by educating the surety companies on the underlying obligation, it gives them a better understanding of the risk profile of these obligations for market participants (i.e. overview of ISO operations to understood why market participants view these obligations as high priority/low risk items)

What regulations/laws apply to surety bonds?

- Surety bond's are subject to both federal and state laws and regulations. Federal laws and regulations are specified within the United States Code, Title 31, Chapter 93[1.] Similarly, LCs are primarily governed by rules put in place by the International Chamber of Commerce