Exelon Surety Bond Proposal

October 25, 2018 MRC

Exelon Proposal – Surety Bonds

Surety Bonds Can Cover All Credit Requirements

- No increased risk of non-payment relative to letter of credit, so applicability should be the same
- Bank and insurance company minimum credit rating to be synonymous
- ERCOT and NYISO allow for use on all credit requirements

$20M Cap on Individual Surety Bond for Individual Member from an Individual Surety and $100M Cap on Aggregate Amount from an Individual Surety

- PJM's larger market size relative to ERCOT supports need for higher caps
- Active discussions going on at ERCOT Credit Working Group to expand existing caps
- Letters of credit currently have no caps despite comparable security and issuer ratings relative to surety bonds

With the appropriate provisions and language structure, surety bonds are as secure as letters of credit and should cover the same obligations.

Appendix

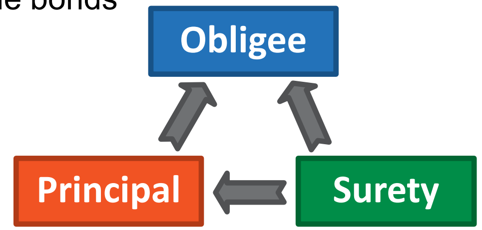
Surety Bond Basics

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 *oblige.*
- 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.
- Sureties 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.



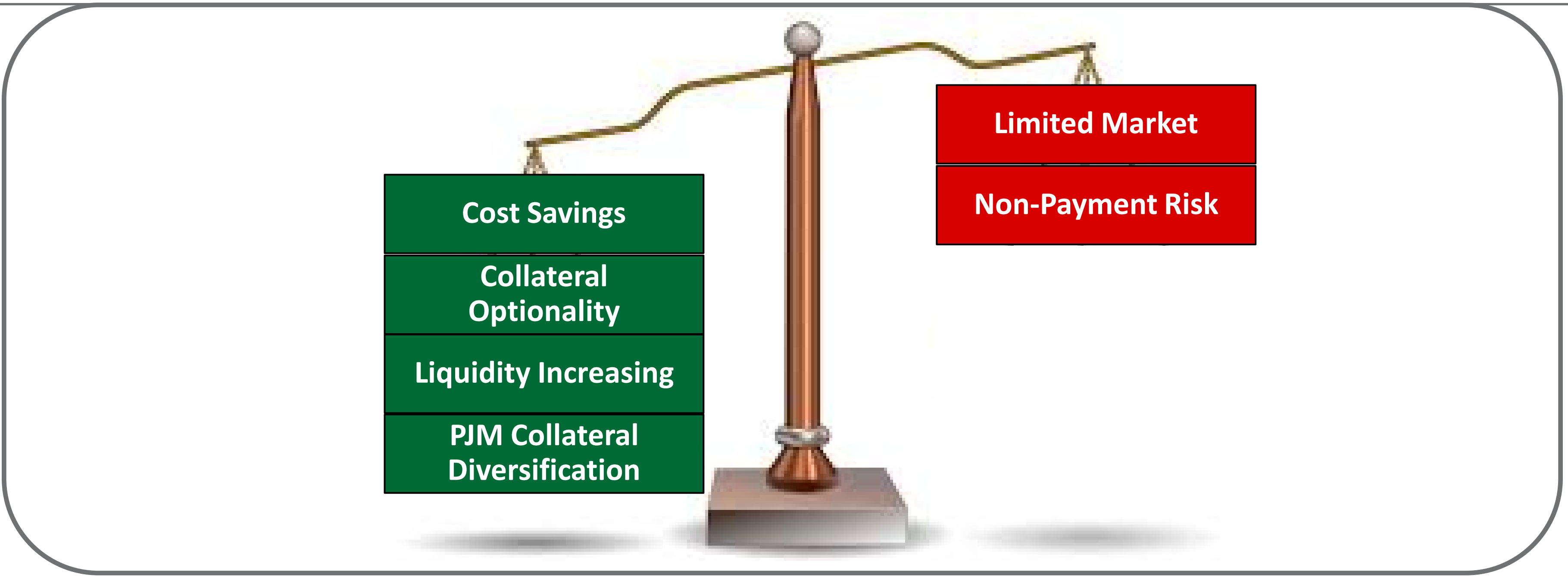
Relevant Surety Bond Types [1]

- 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.

Exelon’s View of the Pros and Cons



Pros	Cons

Pros

- Since the 2008 financial crisis and agreement of Basel III, the cost of LCs has 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 LCs

- **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

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 do not diminish a company's borrowing capacity.	• The issuance of LCs diminish 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.

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, sureties take the principal's financial standing or creditworthiness into consideration. In contrast to LCs, 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 (i.e., a 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 bonds 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.

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