Financial Risk Management Senior Task Force
FTR External Counterparty Clearing

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Controller

Introduction: External Counterparty Framing Question

Financial Risk Mitigation Framing Question:

Should PJM outsource the credit risk management of Financial Transmission Rights (FTRs), to an external clearing house, i.e., a Commodity Future Trade Commission (CFTC)-regulated, derivatives-clearing organization?

Introduction: External Counterparty Framing Question

Under a clearing model, default risk is shifted from PJM members to external clearing house.

- A default of an FTR position at the external clearing house is isolated to, and managed by, the risk structures of the clearing house and does not impact on those trading only in other markets.
- Practically, PJM will not be able or willing to post unlimited collateral, which could cause positions to be put back to PJM in some real but remote circumstances, resulting in residual risks to members.

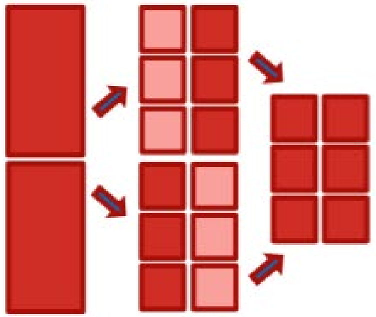
The following guiding principles have been established by PJM:

- Reduce credit risk
- Continue to be fiscally responsible
- Provide valued benefit to the membership
- Limit disruption to existing business processes

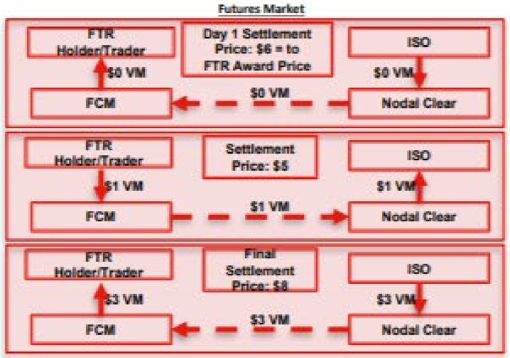
Nodal Proposal

1. ISO/RTO runs FTR Auction

2. Exchange of FTRs for futures



3. Cash flows alter as futures trade and settle at Nodal Exchange



4. Risk management that reduces likelihood and impact of defaults

Source: Nodal

PJM will operate and award FTR positions under annual, monthly and long-term FTR auctions, using the current FERC-regulated auction process

- Auction participants will submit initial margin to Nodal based on projected auction bids
- PJM will provide Nodal detail of actual bids for evaluation against Nodal's calculation of initial margin requirements

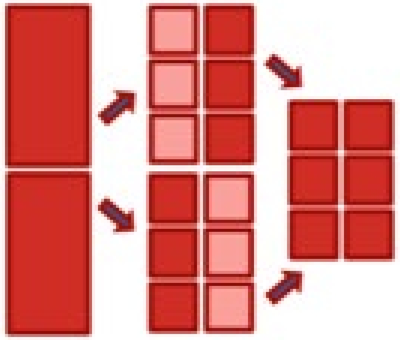
1. ISO/RTO runs FTR auction

Auction participants may not meet credit requirements set by exchange clearing members.

Auction winners (FTR holders) will exchange their awarded FTR position for Nodal futures contracts via the execution of an Exchange for Related Positions called an Exchange for FTR (EFTR)

- When FTR holders exchange their FTR position, PJM Settlement, Inc. will become a counterparty in each EFTR transaction

2. Exchange of FTRs for futures



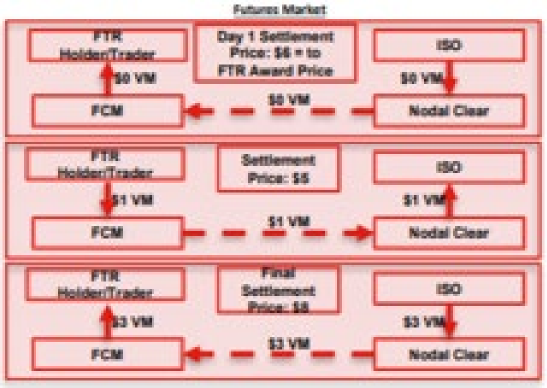
Under current proposals, FTR holders will be required to exchange their FTR position for an EFTR with Nodal.

PJM Settlement, Inc. will be responsible for daily variation margin due to/from Nodal

- Variation margin payments will be funded via a revolving line of credit taken out by PJM Settlement, Inc.

EFTR holders will be responsible for variation margin with Nodal and will be responsible for the costs of clearing FTRs, specifically settlement fees

3. Cash flows alter as futures trade and settle at Nodal Exchange



In the event that PJM Settlement, Inc. exhausts line of credit capacity, the FTR awards will be put back to the ISO through a reverse EFTR transaction.

Nodal proposal and PJM Analysis

Nodal's proposal provides a mechanism to reduce default risk to PJM Members

PJM believes Nodal's proposal merits further review

- PJM has identified work streams to evaluate questions regarding cost, collateral facility sizing, residual risk, etc.

PJM Analysis: Work Streams

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1. Treasury
2. Market Settlement
3. Accounting and Income Tax
4. Regulatory
5. Risk Management

Treasury

Line of credit necessary to support PJM Settlement variation margin requirements

- Modeling of line of credit sizing
- Garner interest and indicative pricing
  - Likely syndication to multiple parties
  - Pricing fee analysis: closing costs, arrangement fees, unused commitment fees, interest rate and spread

Market Settlement

Analysis of market settlement billing implications

- FTR auction charges and credits
- Congestion revenues
- Schedule 9–2 auction charge
- Development of underfunding procedures

Accounting and Income Tax

- How should PJM Settlement account for the arrangement with Nodal for the EFTR positions?
- How should PJM Settlement account for the variation margin transactions on the company’s statement of financial position and balance sheet?
- Analysis of income tax impacts resulting from proposed accounting

Regulatory

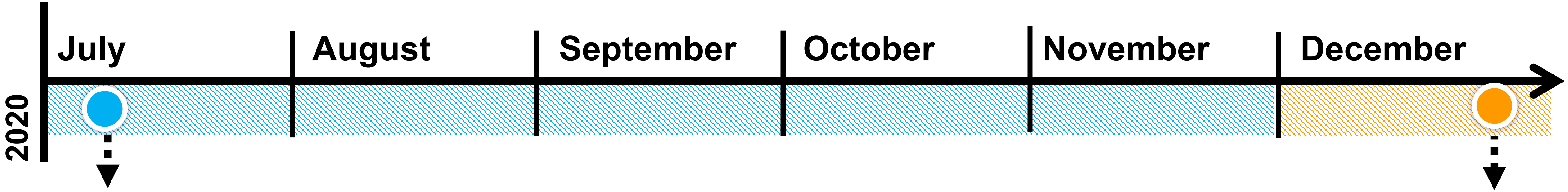
- Exemption from Commodity Futures Trading Commission (CFTC) regulations
- Tariff revisions
  - Attachment Q, PJM Credit Policy
- Ratemaking
- Section 204 filing to support line of credit

Risk Management

- FRMSTF
  - Default management / liquidation process
  - Margining methodology
  - Full variation margining
  - Minimum capital requirements
- Default protection beyond initial margining
  - Default insurance / waterfall protections

PJM Analysis: Timeline

Milestone Reporting July–November



July–November
PJM staff analysis of external clearing proposal

December
Presentation of PJM staff analysis results to the FRMSTF