



Market Participant Minimum Capital Requirements

Dan Sarti
Director of Credit Risk and
Surveillance
FRMSTF
June 24, 2020

Current PJM minimum capital requirements include a net tangible asset or tangible net worth hurdle:

- FTR participants must demonstrate a tangible net worth in excess of \$1 million **OR** tangible assets in excess of \$10 million
- Other market participants must demonstrate a tangible net worth in excess of \$500,000 **OR** tangible assets in excess of \$5 million

Meeting the minimum capital requirements per the PJM tariff allows participants to potentially post lower levels of collateral

- Collateral in the FTR markets is mandatory but the required posting could be decreased if participant meets minimum capital requirements and scores high enough using the PJM credit model
 - FTR minimum collateral must cover “current risk plus any future risk”
 - “Future risk” is a calculation based on participant credit risk profile combined with a forward market stress on participant market positions
 - For other markets some level of unsecured credit could be granted to those meeting minimum capital requirements
- In either case credit exposure may exceed posted collateral in times of market stress

Higher capitalization provides higher likelihood of capital access which would otherwise require large amounts of collateral to cover outer-tail market events

- Companies with greater assets and lower debt more likely to have access to lender capital
 - Debt to capital ratio is a common lender covenant
- Higher incentive for equity holders who have more “skin in the game” to provide additional capital to meet collateral calls
 - Equity contributions are frequently made to smaller companies through an investment pool but those funds are typically not committed capital

Current minimum capital standards definition does not necessarily promote a high creditworthiness standard

- The “OR” condition in the capital threshold definition leaves the potential for overleveraged companies to pass the minimum net asset test
 - Based on this definition an insolvent entity would pass the minimum capital requirements
 - $\text{Assets} - \text{Liabilities} = \text{Equity}$
 - Insolvent company not likely to have easy access to capital

Minimum capitalization standards tend to be uniform throughout ISOs/RTOs

- Of 7 ISOs/RTOs surveyed the minimum capitalization thresholds were similar though SPP is close to increasing their threshold
 - A participant presenting a balance sheet with \$10 million in total assets and \$1 million in tangible net worth would pass the threshold to participate in all markets
 - The potentially limited amount of additional capital available to that participant would have to be divided amongst all ISOs/RTOs during a market event affecting all markets

PJM desires to maintain an open and liquid market while minimizing costly credit defaults

- Higher capital requirements could be structured in various ways
 - Higher minimum thresholds across the board applied to all participants
 - Assign tenor and/or volumetric limits to participants depending on level of capitalization
 - Allows for some limited level of market activity for smaller companies while limiting overall risk to PJM members
 - Helps maintain high level of market liquidity