

# Discussion of FTR Liquidation Options Upon Default

Prepared For:  
FTR Credit Working Group  
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# Portfolio Liquidation Overview: Key Questions

- **Motivation: Liquidation allows the ISO to monetize positions thus limiting default risk to the pool; without liquidation rights, once a participant defaults, there is no formally defined method by which the ISO can prevent accrual of further losses from open positions**
- **Core questions needing to be addressed if ISO is given the right to liquidate portfolios:**
  - Timeframe: What time will be available to address margin defaults? Will there be an incremental cure period?
    - More available time allows defaulting participants opportunity to find ways to cover obligations
    - Also allows for defaults to grow worse
  - Flexibility: What flexibility should be allocated to market participants prior to portfolio liquidation?
    - Permissibility of partial portfolio liquidation to cure default
    - Preventing gaming in partial liquidation
  - Liquidation Forum: What forum needs to exist for liquidation of portfolios?
    - Frequency of opportunities for portfolio liquidation are an important consideration
    - Liquidity of market for liquidation also important
  - Liquidation Mechanics: To what end should portfolio liquidation be performed, and should the ISO have discretion in the liquidation process?
    - Partial liquidation may be adequate to meet some defaults
    - Total liquidation in a single auction may not maximize recoverable value for pool

- **Timeframe**

- **Participant Flexibility in Default Cure**

- **Liquidation Forum**

- **Liquidation Mechanics**

# Timeframe for FTR Portfolio Liquidation

- **Goal: Outline appropriate windows for addressing margin defaults prior to portfolio liquidation actions by ISO**
- **Possible Options:**
  - Notification of default with no extended cure period
    - More immediate liquidation would allow ISO to lock in losses at a limited level
    - Longer timeframes would potentially allow defaults to worsen
  - Notification of default with extended cure period
    - Extended window would allow more flexibility for participant to try to recoup value or cover default on its own, potentially through selective liquidation of positions
- **Recommendation:**
  - Optimal choice depends on frequency of opportunities for liquidation
    - If liquidation is easily/frequently accomplishable, best choice would likely be a narrow (few day) window
    - If liquidation opportunities arise only sporadically (i.e., current FTR market design), there is little harm to an extended cure period
  - Window contingent on time lapse until next liquidation opportunity

- **Timeframe**
- **Participant Flexibility in Default Cure**
- **Liquidation Forum**
- **Liquidation Mechanics**

# Pre-Liquidation Participant Transaction Flexibility

- **Goal: Outline transaction flexibility for participants seeking to cure default**
- **Issue Overview:**
  - Potential for gaming in affiliate transactions - discounted sales of profitable positions to an affiliate used to cure default
    - Ultimate outcome is corporate parent capturing upside and socializing losses on portfolio downside
    - Difficulty in establishing that affiliate sales are unreasonably discounted
      - Depending on volumes moved, discounts may actually be required for any counterparty transaction
    - Avoid potential for gaming by requiring that liquidation sales to affiliates transacted outside of auction process only be permitted if transferring entire portfolio
- **Recommendation:**
  - Transparency to ISO, market, and Market-Monitor would be required prior to transaction to minimize gaming of pre-liquidation transactions
  - Must not only be concerned with monitoring “affiliate” transactions as gaming opportunities may extend beyond corporate affiliations
  - For partial pre-liquidation sales, socialize transaction details and allow counter-offers from other market participants
    - Not necessary if transferring entire portfolio

- **Timeframe**
- **Participant Flexibility in Default Cure**
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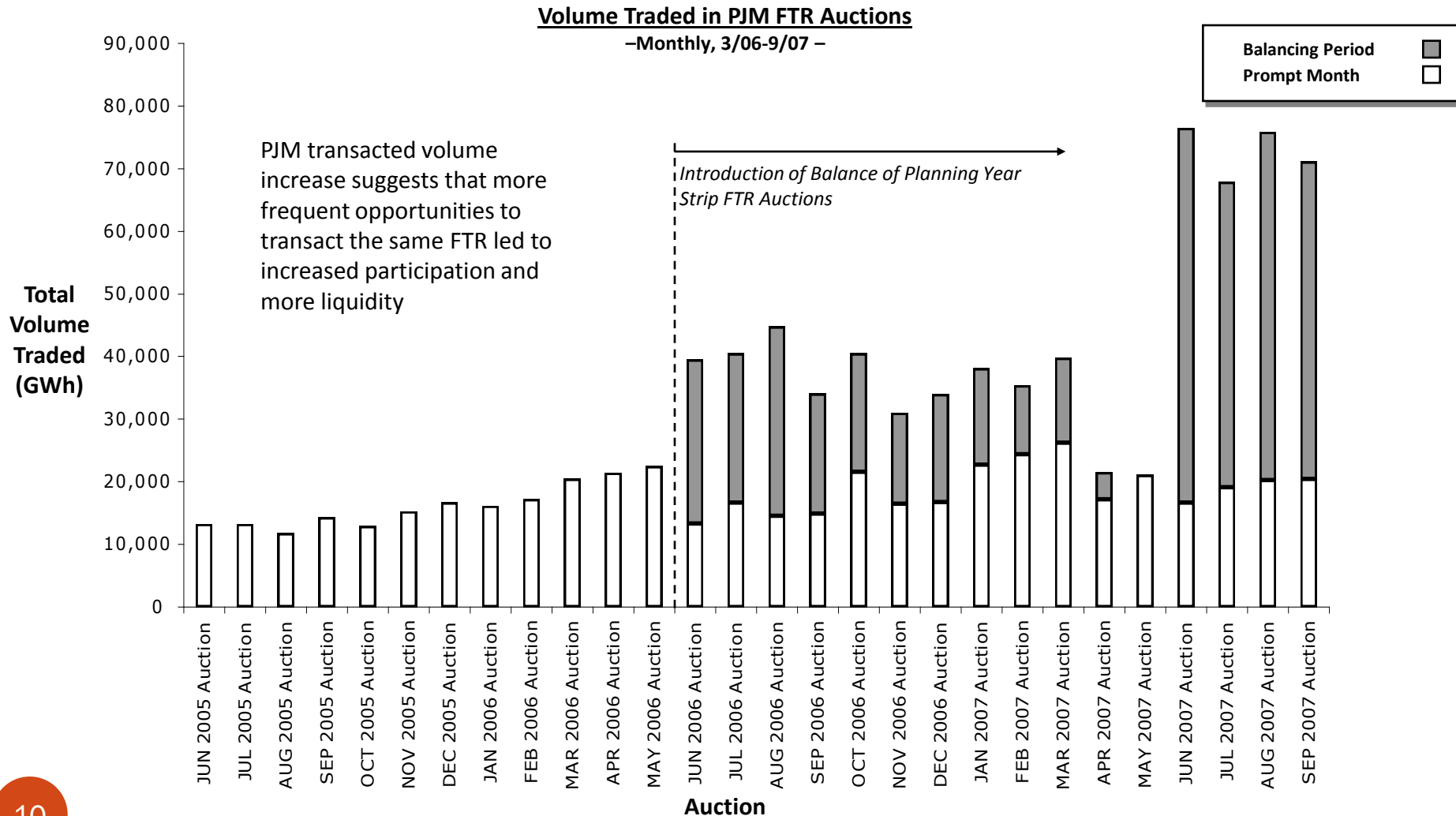
# Avenues for Liquidation

- **Goal: Determine what forum would best allow ISO to liquidate defaulted portfolio and halt pool exposure to open positions**
- **Options Overview:**
  - **Current Set-Up: Monthly FTR Auctions**
    - Core Issue: ISO would only be able to liquidate long term positions one month at a time
    - To the extent positions liquidated each month become less attractive as out months become prompt months, terms for later liquidation may become increasingly unfavorable
  - **Currently Available, Seldom Used: Secondary Market**
    - Core Issue: Lack of market liquidity
    - Would require direct counterparty transactions instead of auction liquidation
    - Potential for unfavorable pricing, opacity
    - System enhancements permitting sale of forward months may improve liquidity
  - **Other Market Option:**
    - PJM Style “Balance of Planning Period Auction”
      - Provides a forum to manage LT contracts on a monthly basis from initial purchase to final settlement month, giving a number of occasions to transact each FTR month
      - Core Issue: Would require development of a new auction forum, not leverage of existing platforms
    - Conduct special “liquidation auction” to sell defaulted portfolio to market

# Avenues for Liquidation (Cont'd)

- **Recommendation:**
  - PJM Style Forward Auction meets goal most directly
    - Immediate forum for liquidation of entire forward portfolio
  - Incrementally, a number of other positives related to credit issues at hand:
    - Forward Auction would likely be a liquid forum for portfolio liquidation (based on PJM results)
    - Auction would provide “marks” for variance margin calculation on all portfolios; critical for mark-to-market handling of positions

# Change in Transaction Volume Resulting from Increased Auction Frequency: PJM Example

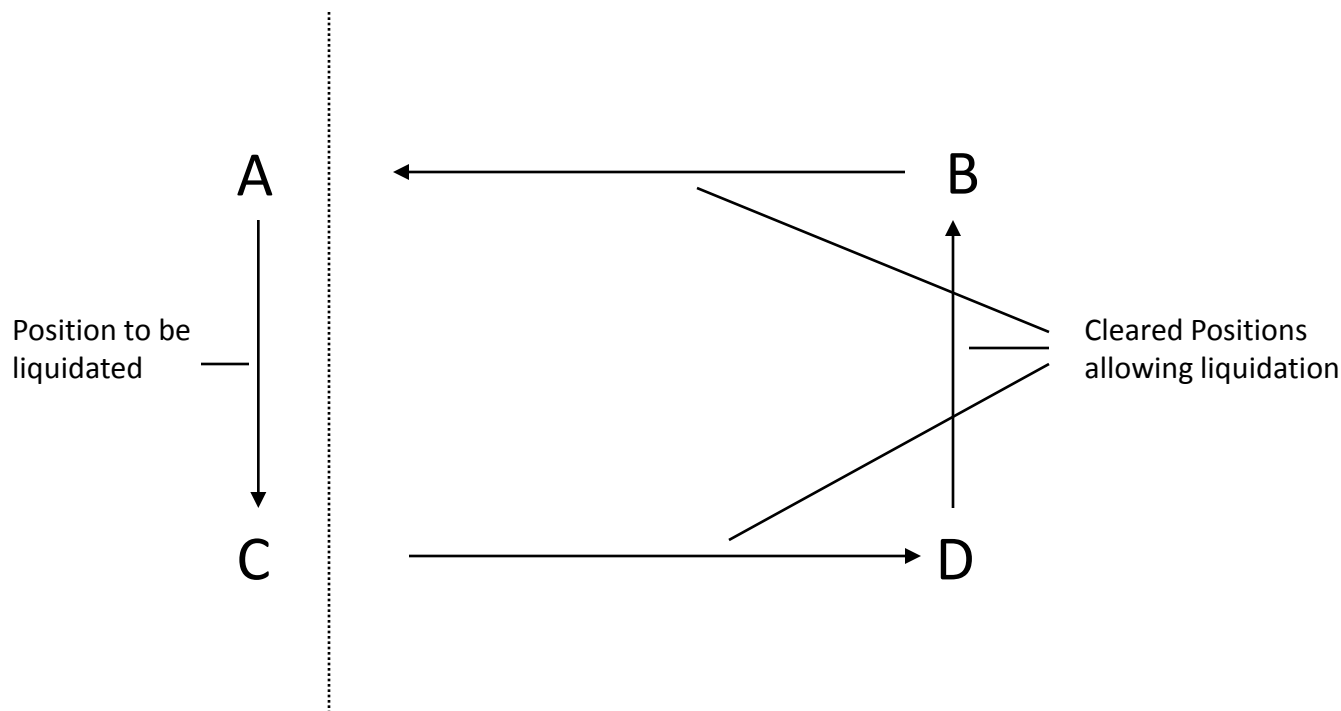


# Credit Policy Implications of Frequency of Auctions

- **Frequency of auctions sets number of opportunities for liquidation**
  - Current “Monthly” approach puts four weeks between opportunities for liquidation
- **More frequent auctions allow for more market-based “marks” for open portfolios**
  - To the extent significant time lapses between transaction intervals, initial margin of positions will need to be higher
  - With fewer auction based marks, other methods of marking portfolios become more important
- **Largest exposure in credit policy perceived to be longer-than-monthly products**
  - Likely don’t need more frequent transaction opportunities for current month
  - Changing conditions likely most relevant to current balance-of-year FTRs - suggests these should be transactable with high frequency
  - With LFTRs, relevant information horizon unlikely to support high frequency auctions
- **Solution may be to increase frequency of balancing auctions as horizon to product settlement decreases**
  - Allow transaction/liquidation of current annual positions 1-2x/month
  - Allow transaction/liquidation of next-year, year-after 3-6x/year
  - Allow transaction/liquidation of years 4 & 5 1-2x/year

# Auction Liquidation: Trade Properties

- Because FTR purchases effectively lead to flow across the grid, a single position can be liquidated by a number of tangentially related other positions - no direct counterparty is required
- Example shows some offsetting MWs clearing at the same nodes as liquidated position; in principle, nodes don't need to be the same, but just proximal to liquidated position



- **Timeframe**
- **Participant Flexibility in Default Cure**
- **Liquidation Forum**
- **Liquidation Mechanics**

# Liquidation Mechanics: Key Questions

- **Key Question: Once the ISO resolves to liquidate a portfolio, how should that be carried out?**
- **There are a number of options in liquidating a defaulted participant's portfolio:**
  - Full Position Close-out
    - Requires least effort on part of the ISO - no nuances or subtleties, just submittal of portfolio back into auction
  - Cure of Default Close-out
    - ISO liquidates partial portfolio until cure default
    - Requires some subtlety on the part of the ISO
    - Requires a determination of how much margin must be built back into participants collateral base beyond default cure
  - Full Close-out of specific defaulting positions, maximization of pool recovery on above-water positions
    - ISO liquidates specific positions that have led to participant default, attempts to maximize recovery of value from any other positions still above water
    - Requires technical savvy on part of ISO
    - Requires pool to continue to bear potential negative exposure to any positions not closed out
- **Recommendation:**
  - Full portfolio liquidation is easiest and requires least amount of subjectivity on behalf of ISO

# Liquidation Mechanics: Key Questions (cont'd)

- **Key Question: At what price should liquidation be carried out?**
- **Possibilities:**
  - Attempt to recover initial pricing or set fraction thereof
    - No guarantee positions will be closed if ISO requires minimum payment amounts
  - Price taker close out
    - No guarantee ISO will recover any value from the liquidation of portfolios
- **Recommendation:**
  - Liquidation driven by desire to end market exposure to defaulted position downturns; prime objective suggests that price-taker is the right way to close out exposure
  - Only way to guarantee close-out of positions

# Liquidation Mechanics: Related Issues

- **Position limits may compromise pricing ISO is able to command in liquidation by limiting prospective buyers**
- **Ditto for portfolio size limitations**
- **Participant default spurred by an auction clearing - need that be handled differently?**
  - Consumption of collateral by initial margin may push participant to default
  - Potentially long forward window before products transact again (2-4 weeks, potentially more)
  - Unclear how to best handle this:
    - Re-running auction without participant's bids?
    - Immediate declaration of default?