Independent Electricity Market Operator

Market Rule Amendment Proposal

PART 1 – *MARKET RULE* INFORMATION

Identification No.: MR-00215-R00
Subject: Reductions in Prudential Support Obligations – Credit Ratings
Title: Proposed Suspension of Deemed Credit Downgrade Resulting from Credit Watch Warning
Nature of proposal (please indicate with X): **_X__Alteration___Deletion ___Addition**
Chapter: 2 **Appendix:** **Sections: 5.8.2A (new)**
Sub-sections proposed for amending:

PART 2 – PROPOSAL HISTORY

Version	Reason for Issuing	Version Date
1.0	Consideration by URAC	November 15, 2002
2.0	Approved by URAC	November 19, 2002

Approved Amendment *Publication* Date: **November 19, 2002**

Approved Amendment Effective Date: **November 19, 2002**

PART 3 – EXPLANATION FOR PROPOSED AMENDMENT

Provide a brief description of the following:

- The reason for the proposed amendment and the impact on the *IMO-administered markets* if the amendment is not made
- Alternative solutions considered
- The proposed amendment, how the amendment addresses the above reason and impact of the proposed amendment on the *IMO-administered markets*.

The IMO is seeking an urgent rule amendment suspending the operation of section 5.8.2 of Chapter 2. Section 5.8.2 of Chapter 2 states:

5.8.2 Any recommendation to move a *market participant* to "credit watch status" by any of the major bond rating agencies identified in the list referred to in section 5.8.7 shall be deemed to automatically result in a one-rating-category reduction in terms of the credit rating of that *market participant* for the purpose of determining the *market participant's prudential support obligation*.

The criteria set out for urgent rule amendments under section 34(1) of the *Electricity Act, 1998,* are as follows:

a) To avoid, reduce the risk of or mitigate the effects of conditions that affect the ability of the integrated power system to function normally.

b) To avoid, reduce the risk of or mitigate the effects of the abuse of market power.

c) To implement standards or criteria of a standards authority.

d) To avoid, reduce the risk or mitigate the effects of an unintended adverse effect of a market rule.

The credit rating agencies upon whom the IMO relies for an assessment of the credit worthiness of market participants have placed a number of LDCs on "credit watch status" as a direct result of uncertainty associated with the recent Ontario government announcements on the provincial electricity market. The IMO anticipates that additional LDCs may be placed on credit watch status. Credit rating agencies are, in addition to being generally concerned about the uncertainty relating to the market, concerned that the government's announced freeze on the third tranche of distribution rate increases, previously approved by the OEB, will jeopardize LDCs cash flows and result in possible write-offs of assets.

Until the legislation is passed and the impact of changes are better known, the credit rating industry is not in a position to accurately determine the impact of the proposed changes on the financial position of LDCs who rely upon the use of credit ratings to reduce their prudential support obligation (PSO). Even after the legislation is enacted it will take the credit rating industry some time to determine the various impacts of the legislation on the market and market participants.

Currently section 5.8.2 of Chapter 2 of the market rules provides that the moving of a market participant to credit watch status results in an automatic one-rating-category reduction in its credit rating. This, in turn, results in an increase in the market participant's prudential support obligation (section 5.2.6, Ch.2).

The IMO believes there is an unintended adverse consequence of section 5.8.2 of Chapter 2. The rule

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was intended to mitigate the credit risk to the wholesale market posed by the potential credit downgrading of a market participant. It was not anticipated, and the rule was not designed, to protect the market against a potentially large number of participants being subjected to credit watch status because of uncertainties surrounding significant changes in government policy. Moreover, it is the IMO's view that if the recent government pronouncements are enacted, rather than increasing risk, the credit risk to the wholesale market – and, in particular, that posed by LDCs – will be reduced.

The IMO, therefore recommends that section 5.8.2 be temporarily suspended for distributors until the impact upon the changes in the electricity marketplace are clearer, at which point actual changes to the credit ratings of market participants may be made. Section 5.2.6 of Chapter 2 and section 5.8.1 of Chapter 2 will retain the requirement to post additional prudential support in the event of an actual credit downgrade of a market participant.

PART 4 – PROPOSED AMENDMENT

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5.8.2A The operation of section 5.8.2 shall be suspended for *distributors* as of November 19, 2002, until February 14, 2003 or until such other date as may be determined by a resolution of the *IMO Board*. The management of the *IMO* shall monitor and report to the *IMO Board* on the credit situation of *distributors* and other *market participants* and the *IMO Board* shall modify the suspension of section 5.8.2 (or, if appropriate, shall expand the scope of the suspension) if the credit situation changes in a way that makes such modification desirable.

PART 5 – IMO BOARD COMMENTS