



Market Rule Amendment Submission

This form is used to request an amendment to, or clarification of, the *Market Rules*. Please complete the first four parts of this form and submit the completed form by email or fax to the following:

Email Address: Rule.Amendments@ieso.ca

Fax No.: (416) 506-2847 Attention: Market Rules Group

Subject: Market Rule Amendment Submission

All information submitted in this process will be used by the *IESO* solely in support of its obligations under the *Electricity Act, 1998*, the *Ontario Energy Board Act, 1998*, the *Market Rules* and associated policies, standards and procedures and its licence. All submitted information will be assigned the *confidentiality classification* of “Public” upon receipt. You should be aware that the *IESO* will *publish this amendment submission* if the *Technical Panel* determines it warrants consideration and may invite public comment.

Terms and acronyms used in this Form that are italicized have the meanings ascribed thereto in Chapter 11 of the *Market Rules*.

PART 1 – SUBMITTER’S INFORMATION

| | |
|---|--|
| Please enter contact information in full. | |
| Name: <u>IESO Staff</u> | |
| (if applicable) <i>Market Participant / Metering Service Provider</i> No. ¹ : <u>N/A</u> | <i>Market Participant Class</i> : <u>N/A</u> |
| Telephone: <u>905-403-6955</u> | Fax: _____ |
| E-mail Address: <u>rule.amendments@IESO.ca</u> | |

PART 2 – MARKET RULE AMENDMENT SUBMISSION INFORMATION

| | |
|--|--|
| Subject: <u>Prudential Support</u> | |
| Title: <u>Revisions to Prudential Support Obligations</u> | |
| Nature of Request (please indicate with x) | |
| <input checked="" type="checkbox"/> Alteration | <input type="checkbox"/> Deletion |
| <input type="checkbox"/> Addition | <input type="checkbox"/> Clarification |
| Chapter: <u>2</u> Appendix: _____ Sections: <u>5.3, 5.7, 5.8</u> | |
| Sub-sections proposed for amending/clarifying: <u>various</u> | |

¹ This number is a maximum of 12 characters and does not include any spaces or underscore.

PART 3 – DESCRIPTION OF THE ISSUE

Provide a brief description of the issue and reason for the proposed amendment. If possible, provide a qualitative and quantitative assessment of the impacts of the issue on you and the *IESO-administered markets*. Include the Chapter and Section number of the relevant *market rules*.

Prudential Support – Overview

As a condition of participating in the real-time markets or conveying electricity through the IESO-controlled grid, market participants who are projected to be net debtors must provide the IESO with prudential support (or collateral) to guard against payment default. Prudential support is required:

- Because of the anonymous nature of transactions in the real-time market;
- To provide assurance to suppliers that the total amount due to them will be paid irrespective of the amounts collected from all participants; and
- Because of the characteristics of electricity itself i.e. electricity is consumed at the moment it is generated it is not possible to recover the physical commodity in the event a payment is not received.

The level of prudential support required from an individual market participant can be reduced by factors such as the participant's credit rating or good payment history.

The Market Rules direct the IESO to pay creditors (net sellers to the market) in full on the payment date with funds received from debtors (net buyers in the market). If a debtor does not pay the amounts owed in full, the IESO then calls upon that participant's prudential support for the amount outstanding. However, as a result of reductions for credit rating or good payment history (i.e., unsecured prudential support); the prudential support held could be less than the outstanding amount. Any difference between the prudential support held and the amount outstanding is collected from all non-defaulting market participants through the default levy process. The prudential framework, from the perspective of its participants, seeks to balance the cost of providing prudential support against the potential cost of a default levy.

Prudential Review - SE-23

In 2006, as part of IESO's continuing efforts to reduce the financial burden to those participating in the IESO administered-markets (IAM), a review (Review) of the physical market prudential framework was initiated. The Review was undertaken to assess whether the current prudential requirements are reasonable and whether there are opportunities to reduce the prudential support requirements while not unduly exposing market participants to additional risk of a default levy. For further information on the review please refer to Prudential Review Stakeholder Engagement (SE) Plan 23 on the IESO web-site at the following location:

http://www.ieso.ca/imoweb/consult/consult_se23.asp

The finding of the Review is that the current prudential system results in market participants posting more collateral than is reasonable to protect against a default levy. The IESO's quantitative analysis supports this statement in that the expected cost of defaults is lower than the total cost market participants bear to carry their prudential requirements. The statement is further supported, at least in part, by the very low rate of actual defaults and total lack of default levies since Market Opening in May 2002. The main conclusion from the Review is that higher levels of unsecured prudential support are appropriate.

PART 3 – DESCRIPTION OF THE ISSUE

The Review examined various options for increasing unsecured prudential support, using quantitative modeling that projected both estimated costs to market participants of carrying the required credit and the estimated costs of defaults uncovered by prudential support. This analysis led to the choice of the recommended option as best balancing these concerns.

The Review includes the following recommendations:

- The level of unsecured credit should be increased for all market participants with a credit rating of BB or better;
- Local Distribution Companies should continue to be treated differently from other market participants in some aspects of the prudential framework;
- The prices utilized to calculate credit requirements should be based on Ontario Energy Board price estimates included in their semi-annual Regulated Price Plan update;
- The IESO should continue to utilize good payment history as the basis for unsecured credit provisions for unrated companies and the IESO should not perform in-house credit worthiness assessments;
- The daily withdraw energy should be adjusted for the value of a physical bilateral contract for market participant with a credit rating of BBB- or higher; and
- Acceptable financial institutions should have a specified credit rating and also be a bank named in a Schedule to the Bank Act, or a credit union licensed by the Financial Services Commission of Ontario.

Overall, the estimated results of implementing the recommendations of the Review will serve to reduce collateral requirements by approximately \$200 million. This reduction in collateral requirements will result in an estimated net reduction in annual costs to the market of \$900,000 resulting from a reduction in credit carrying costs for market participants of approximately \$1.2 million per year, partially offset by an increased risk of a default levy quantified at \$300,000 per year.

The final report of the review can be found on the IESO web-site at the following location:

<http://www.ieso.ca/imoweb/pubs/consult/se23/se23-20070313-Prudential-Review-Report.pdf>

IESO Board Decisions and Direction

At its meeting on April 26, 2007 the IESO Board:

- Approved the recommendations made in the SE-23 Prudential Review Report;
- Directed IESO Management to amend or develop market rules consistent with those recommendations for IESO Board of Director approval at their September 7, 2007 meeting;
- Directed IESO Management to amend market manuals and implement the recommendations in 2007;
- Directed IESO Management to conduct a review of the Real-time Market prudential framework at least once every three years; and
- Directed IESO Management to undertake a review of the Financial Market prudential framework as part of the Day-Ahead Market undertaking or separately as warranted.

PART 4 – PROPOSAL (BY SUBMITTER)

Provide your proposed amendment. If possible, provide suggested wording of proposed amendment.

In order to implement the IESO Board's decision on the provision of prudential support in IESO-administered markets it is proposed that the market rules be modified in the following manner:

Amend Chapter 2, section 5.3 (Calculation of Participant Trading Limit, Default Protection Amount and Maximum Net Exposure) to:

- Obligate the IESO to review the price basis used to calculate maximum net exposure on an annual basis, taking into consideration price information published by the OEB
- Obligate the IESO to modify the price basis only if the underlying reference price changes by 15% or more from the previous value used by the IESO to calculate prudentials.

The related IESO Board approved recommendations for the above changes can be found in Section 5.3 of the SE-23 Prudential Review Report.

- Permit a metered market participant, under specified conditions, to request the IESO modify their minimum trading limit or default protection amount reflecting physical bilateral contracts registered with the IESO
- Obligate the IESO, provided the metered market participant has met specified conditions, to incorporate the impact of physical bilateral contracts which have been registered with the IESO on the calculation of the minimum trading limit and default protection amount for investment grade market participants.

The related IESO Board approved recommendation for the above changes can be found in Section 7.3 of the SE-23 Prudential Review Report.

Amend Chapter 2, section 5.7 (Obligation to Provide Prudential Support) to:

- Give the IESO discretion over the terms of a bank guarantee, and define acceptable institutions as a bank named in a Schedule to the Bank Act, or a credit union licensed by the Financial Services Commission of Ontario (FSCO), in either case having a specified minimum long-term credit rating from an IESO approved credit rating agency.

The related IESO Board approved recommendations for the above changes can be found in Sections 9.3 and 12.3 of the SE-23 Prudential Review Report.

- Increase the maximum amount for affiliate guarantees for both distributors and non-distributors, consistent with the revised unsecured credit limits in section 5.8.

The related IESO Board approved recommendation for the above change can be found in Section 6.3 of the SE-23 Prudential Review Report.

Amend Chapter 2, section 5.8 (Reductions in Prudential Support) to:

- Increase the unsecured credit limits for credit ratings and good payment history for both distributors and non-distributors.

The related IESO Board approved recommendations for the above change can be found in Sections 6.3 of the SE-23 Prudential Review Report.

PART 5 – FOR IESO USE ONLY

Technical Panel Decision on Rule Amendment Submission: _____

MR Number: MR-00212-Q00

Date Submitted to *Technical Panel*: May 16, 2007

Accepted by *Technical Panel* as: (please indicate with x) Date:

General Urgent Minor May 22, 2007

Criteria for Acceptance: The amendment submission identifies ways to simplify the market and/or reduce participant or IESO costs. The proposed rule amendment will result in an estimated net reduction in annual costs to the market of \$900,000 resulting from a reduction in credit carrying costs for market participants of approximately \$1.2 million per year, partially offset by an increased risk of a default levy quantified at \$300,000 per year.

Priority: High

Criteria for Assigning Priority: Pervasiveness of the problem: Prudential support is an obligation of all market participants who are net debtors (approximately 180 participants) to the IESO-administered markets. The existing prudential framework represents significant credit carrying costs for these market participants and thus a reduction in these costs would impact on a significant portion of the participants in IESO-administered markets.

Not Accepted (please indicate with x):

Clarification/Interpretation Required (please indicate with x):

Technical Panel Minutes Reference: IESOTP 202-1

Technical Panel Comments: _____