



## Market Rule Amendment Proposal

### PART 1 – MARKET RULE INFORMATION

Identification No.:	MR-00280-R00		
Subject:	Prudential Requirements		
Title:	Limit of Use of Cash to Meet Prudential Support Obligation		
Nature of Proposal:	<input checked="" type="checkbox"/> Alteration	<input type="checkbox"/> Deletion	<input type="checkbox"/> Addition
Chapter:	2	Appendix:	
Sections:	5.7		
Sub-sections proposed for amending:	5.7.2.; 5.7.5		

### PART 2 – PROPOSAL HISTORY

Version	Reason for Issuing	Version Date
1.0	Submitted for Technical Panel Review	August 19, 2004
2.0	Incorporated Technical Panel Comments and Posted for Review and Written Comments	August 25, 2004
3.0	Submitted for Technical Panel Review and Recommendation	September 16, 2004
4.0	Submitted for Technical Panel Review and Recommendation	September 21, 2004
5.0	Recommended by Technical Panel and Submitted for IMO Board Approval	September 21, 2004
Approved Amendment Publication Date:		
Approved Amendment Effective Date:		

### 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*.

#### Summary

It is proposed to limit the use of cash as means for a market participant to meet its prudential support obligation (PSO). This limitation is necessary to reduce the risk to the rest of market of the imposition of a default levy as a result of the default of a market participant that has provided cash and the IMO being ordered to return the cash to the defaulting market participant.

The market rules propose to only permit those market participants currently providing cash to meet their PSO to continue to do so, provided their PSO is and remains less than or equal to \$200,000. No other market participant would be allowed to use cash as a means to meet its PSO.

Allowing some small market participants to continue to use cash is an appropriate balance between the burden that would be imposed on these participants to make alternate arrangements to meet their PSO and the residual risk to the rest of the market.

#### Background and Discussion

Currently, the IMO holds approximately \$1.1 billion in prudential support on behalf of 191 participants. Of these 191 participants, 28 post \$13.2 million of cash to satisfy a total PSO to the market of \$25.2 million (the difference is satisfied through other forms of acceptable collateral).

The Technical Panel has identified that accepting cash to satisfy a prudential support obligation (“PSO”) is not a secure form of collateral and thus poses a financial risk to the electricity marketplace and its participants. Specifically, in the event of a bankruptcy of a market participant that provided cash to satisfy its PSO, the IMO could be forced to return the cash collateral to the bankrupt participant or its creditors. This could result in a default levy to the marketplace for the equivalent amount. Furthermore, such other costs as legal and staff time would be incurred in the attempt to recover the cash. These costs would also be borne by all participants.

The IMO has spoken with each of the 28 participants that provide cash, asking specifically if they would be able to use an alternative means to satisfy their obligation. For the majority, a letter of credit or treasury bills would not be particularly difficult. However, approximately half the group cited that they would either not be able to post anything other than cash or that it would cause undue burden to them. Many of these participants are quite small (PSO under \$200,000) and they are not normally involved with sophisticated financial arrangements. For example, one participant’s PSO is \$418, and another’s is \$2,140. All of these factors were taken into consideration when developing solutions to mitigate the risk.

The IMO considered not accepting cash from any participant but eliminated this solution on the basis that it could be costly for the smaller MP’s and that some would simply not be able to comply. The IMO also considered continuing to accept cash from all participants but would mitigate the risk by “perfecting” its security interest in the cash. This solution was investigated but was also eliminated due to the very significant administrative cost and burden for participants and the IMO. Two additional full

### PART 3 – EXPLANATION FOR PROPOSED AMENDMENT

time staff would be necessary to support this new function within the IMO. Participant staffing burden would likely be less but there would be additional market rule requirements to be met. The final recommended solution blends some aspects of the two aforementioned alternatives arriving at a compromise that balances risk mitigation and the needs of certain participants.

The IMO recommends that the Market Rules be amended so as to grandfather the existing rule that allows cash to be posted as collateral to those participants who are currently using cash as a means to satisfy their obligation **provided that** their PSO is and remains at \$200,000 or less. The \$200,000 level was chosen for three important reasons. The first being that it captures those participants that we believe would suffer undue burden and/or would not be able to comply with market rules that would not allow the use of cash. Secondly, the probability is very small that all participants within this group would become insolvent at the same time therefore should a default occur and the monies not be available the default levy would be limited to \$200,000 to be shared by all remaining participants. And finally, the aggregate exposure would be significantly **reduced and capped** at approximately \$1.3 million. Grandfathering to current cash users only also results in the obvious benefit to participants of not increasing the risk in future years.

### PART 4 – PROPOSED AMENDMENT

## 5.7 Obligation to Provide Prudential Support

- 5.7.1 Each *market participant* must meet its obligation under this section 5 to provide and maintain *prudential support* by providing to the *IMO* and maintaining *prudential support*, the value of which is equal to the *market participant's prudential support obligation*.
- 5.7.2 A *market participant's prudential support obligation* must be met through the provision to the *IMO* and the maintenance of *prudential support* in one or more of the following forms:
- 5.7.2.1 a guarantee or irrevocable commercial letter of credit provided by a bank named in a Schedule to the *Bank Act*, S.C. 1991, c.46;
  - 5.7.2.2 a guarantee in a form acceptable to the *IMO* provided by a person, other than an *affiliate* of the *market participant*, having a credit rating from a major bond rating agency identified on the list referred to in section 5.8.7;
  - 5.7.2.3 ~~cash deposits made with the *IMO* by or on behalf of the *market participant* which may include near-cash~~ marketable securities in the form of Canadian Government treasury bills. Such treasury bills shall be valued as cash at their current market value less 2 percent to take

into account the potential eroding effects of interest rate increases;  
and/or

5.7.2.4 subject to section 5.7.4, a guarantee in a form acceptable to the *IMO* provided by a person that is an *affiliate* of the *market participant* and that has a credit rating from a major bond rating agency identified on the list referred to in section 5.8.7; and/or-

5.7.2.5 cash deposits made with the *IMO* by or on behalf of the *market participant* provided that that *market participant* meets the following criteria:

(a) the *market participant* was already meeting its *prudential support obligation* in whole or in part through a cash deposit on [effective date]; and

(b) the *market participant's prudential support obligation* was less than or equal to \$200,000 on [effective date] and remains less than or equal to \$200,000 thereafter.

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5.7.5 The minimum terms and conditions that shall be included in the *prudential support* shall be as follows:

5.7.5.1 *prudential support* provided in accordance with sections 5.7.2.1, 5.7.2.2 and 5.7.2.4 shall be obligations in writing;

5.7.5.2 *prudential support* provided in accordance with sections 5.7.2.3 and 5.7.2.5 shall be ~~an~~ obligations reflected in a written instrument in a form acceptable to the *IMO*;

5.7.5.3 *prudential support* provided in accordance with sections 5.7.2.1, ~~and~~ 5.7.2.3 and 5.7.2.5 shall constitute valid and binding unsubordinated obligations to pay to the *IMO* amounts in accordance with its terms which relate to the obligations of the relevant *market participant* under the *market rules*; and

5.7.5.4 *prudential support* provided in accordance with sections 5.7.2.1 to 5.7.2.4 ~~5~~ shall permit drawings or claims by the *IMO* on demand to a stated certain amount.

**PART 5 – IMO BOARD COMMENTS**

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