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Memorandum

To: THE BOARD OF DIRECTORS
of the Independent Electricity System Operator

From: Anthony Martinello, Director, Treasury & Pension Operations
Jeannette Briggs, Director, Settlements – Corporate Services
Michael Boll, Associate General Counsel

Date: November 22, 2017

Re: Ontario Fair Hydro Plan

Purpose of Item

The purpose of this item is to request the approval of the Board of Directors for the Independent Electricity System Operator ("**IESO**") to execute key agreements required to implement the Government of Ontario's Fair Hydro Plan. The agreements are:

(1) the Master Transfer and Servicing Agreement between the IESO and the Fair Hydro Trust (the "**financing entity**");
(2) a Security Agreement in favour of the financing entity; and
(3) an Acknowledgement and Indemnity Agreement in favour of BNY Trust Company of Canada, in its capacity as Indenture Trustee of Fair Hydro Trust (the "**Indenture Trustee**").

Drafts of these agreements are attached.

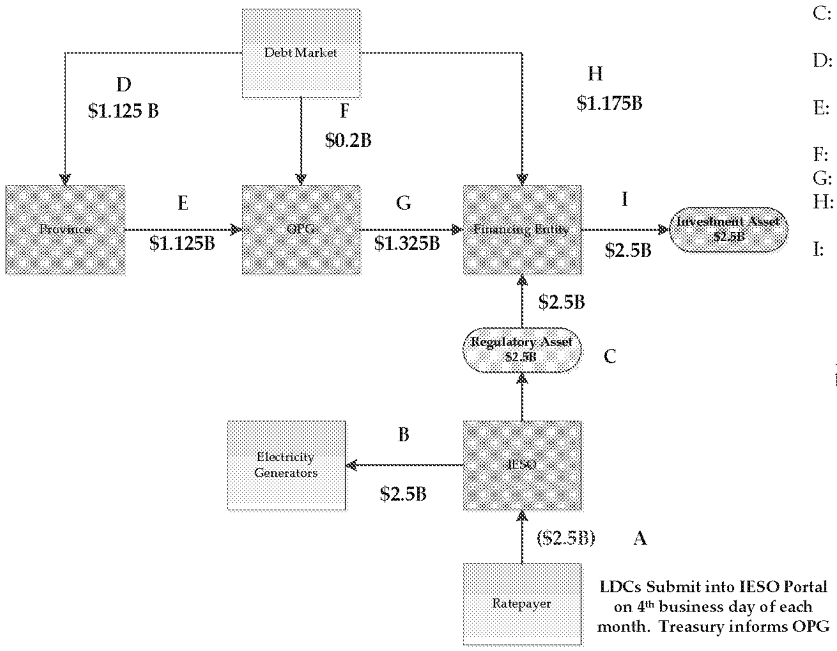
The terms of these agreements are substantially settled but may be subject to comment by the rating agencies as the rating agencies complete their ratings process of the Fair Hydro securitization transaction. We are bringing these agreements to the Board for approval prior to the completion of the rating agencies review because of the short timelines to complete the rating agencies' rating process, execute the various agreements required to implement the securitization transaction and for Ontario Power Generation Inc. ("**OPG**") to complete the debt offering to the market to achieve a first transfer of the regulatory asset in December.

As a result of the potential for issues to arise through the ratings process, management recommends the following approvals:

- Board approval prior to completion of rating agencies' rating process, given the timelines for completion of the ratings process and execution of the various agreements required to implement and effect a first transfer of the regulatory asset in December;
- delegation of authority to CEO to finalize and execute the agreements in substantially the form provided with non-material changes, and to execute such non-material changes to the executed agreements;
- delegation to Board Chair, Chair of Audit Committee and CEO to finalize and execute the agreements if significant, unanticipated revisions are requested during the rating agencies' rating process resulting in material changes, and to execute such material changes to the executed agreements; and any such material amendments will be reported to the Board promptly and no later than the Board's next regularly scheduled meeting;
- delegation to one officer of the Corporation to execute and deliver additional ancillary agreements and all material instruments, certificates and documents necessary to implement the agreements; and
- delegation to any one of the Director, Treasury, or Director, Settlements, or Corporate Controller to execute non-material instruments, certificates and documents necessary to implement the agreements.

Fair Hydro Plan Update

As reported previously, on June 1, 2017, the government of Ontario passed legislation - the *Ontario Fair Hydro Plan Act, 2017* (“**Fair Hydro Act**”), - that lowers electricity bills by 25 per cent on average for all residential customers and other specified consumers. The Fair Hydro Act provides for the deferred global adjustment costs to be a regulatory asset of the IESO, recoverable from future consumers. The legislation further provides that this regulatory asset may be transferred to the financing entity. When transferred to the financing entity, the asset becomes an investment asset, the costs of which will in part be financed by way of a securitization transaction and in part by equity or debt from OPG and the Province. See a representative diagram of the transactions creating the regulatory asset and investment asset below.



A: IESO collects $2.5 billion less from ratepayers on invoice day (12th business day)
B: IESO pays $2.5 billion to generators on payment day (14th business day)
C: IESO records a regulatory asset of $2.5 billion and transfers $2.5 billion to Financing Entity
D: Province borrows $1.125 billion (45% of shortfall) from debt markets
E: Province invests $1.125 billion into OPG as equity
F: OPG borrows $0.2 billion from debt markets
G: OPG loans $1.325 billion to Financing Entity
H: Financing Entity borrows $1.175 billion from debt markets
I: Financing Entity has financed $2.5 billion investment asset

Actual monthly amounts are anticipated to be in the $200 to $300 million range.

During the period of December 1, 2017 and July 31, 2021, the IESO will pay the financing entity’s carrying costs which include borrowing expenses and tax, as required by regulation. In later years, the financing entity’s cost of financing related to the investment asset will be recovered directly through adjustments to consumer electricity bills called a clean energy adjustment. The IESO, as an agent of the financing entity, will receive the clean energy adjustment from LDCs and licensed retailers (“**electricity vendors**”) (and any specified consumers invoiced directly by the IESO) and remit amounts received to the financing entity.

The rate reduction implemented by the Fair Hydro Act took effect on July 1, 2017. The total amount of IESO deferral to date as a result of the Fair Hydro Act is approximately $1 billion (Treasury can provide the exact amount at the meeting). The IESO has borrowed this amount from the Ontario Financing Entity ("**OFA**") on a credit facility solely utilized for Fair Hydro draws. On November 7, 2017, the IESO and OFA entered into two new credit facilities (a $2 billion Fair Hydro only facility and a $475 million general facility) to replace the previous OFA $975 million credit facility.

The Master Transfer and Servicing Agreement, the Security Agreement and the Acknowledgement and Indemnity Agreement are necessary in order to enable the first and subsequent transfers of the IESO's regulatory asset to the financing entity, which will in turn enable the IESO to receive the funds necessary to repay the amounts borrowed on the Fair Hydro credit facility and thereby adjust the IESO's Fair Hydro variance account accordingly.

As you know, in June of this year the Province signed an Indemnity Agreement with the IESO agreeing to indemnify the IESO and its directors, officers and employees from all liability arising as a result of activities, acts and/or omissions in the implementation of, or otherwise relating to, the Fair Hydro Plan. A copy of this indemnity agreement is attached for your reference.

In addition, the IESO is working with the Ministry of Energy to implement a funding commitment from the Province to support the IESO's liquidity in the event the financing entity does not acquire the regulatory asset from the IESO, the Fair Hydro credit facility is near its capacity and the Fair Hydro rate reduction remains in place. Deputy Serge Imbrogno provided an assurance to the IESO in a May 15, 2017 letter (attached for your reference) that the Ministry of Energy would take the necessary steps to ensure that an insolvency situation would not be created for the IESO and that it intended to request the necessary funding and approvals in order to provide the IESO the formal commitment the IESO had requested.

As a companion to this memorandum, a Fair Hydro risk update has been provided to the Board.

OPG has indicated it is targeting December 12 for initial bond issuance pricing date with a closing of the financing on December 19. As a result, the IESO would anticipate issuing its first transfer notice under the MTSA on or about December 11, with a first transfer of the regulatory asset to the financing entity on or about December 19.

[accounting discussion / KPMG view of accounting on the agreements may be included in this memo, or in a separate document]

Approvals Requested

1. Master Transfer and Servicing Agreement ("MTSA")

Management recommends that the Board approve the IESO's execution and delivery of the MTSA.

The MTSA is between the IESO and the financing entity. The MTSA addresses two main topics, being (1) the transfer of the IESO's regulatory asset to the financing entity; and (2) the IESO's role as servicer to the financing entity. It also provides for the provision of security by the IESO to the financing entity for failure of non-credit rated electricity vendors to remit clean energy adjustments, and provides processes related to payment of the financing entity's carrying costs during the first four years.

The MTSA follows a form typically used in securitization transactions, but modified to reflect the unique nature of the Fair Hydro plan. The negotiation of the MTSA was challenging since it involved negotiations with both OPG and the banks/dealers, and reflects the unique nature of the Fair Hydro transaction. The banks/dealers have described the MTSA as a bare bones form of securitization servicing agreement. Typically banks and rating agencies would expect to see more robust servicing obligations and transfer of risk to the servicing party. However, the full scope of servicing functions for the Fair Hydro securitization transaction will be provided through a combination of services provided by the IESO and OPG. OPG will provide the services not being provided by the IESO, such as enforcement and auditing.

<u>Transfers of Regulatory Asset</u>

The MTSA provides the processes to be followed to effect a transfer of a regulatory asset by the IESO to the financing entity. In line with the Fair Hydro Act, the financing entity may, but is not required to, accept a transfer of a regulatory asset.

The process generally will be for the IESO to provide a transfer notice to the financing entity setting out the specified portion of the regulatory asset to be transferred (i.e. the dollar amount) and the closing date to effect the transfer. The financing entity will then have two business days to accept the transfer notice. Upon receipt of the purchase price from the financing entity, the IESO will reduce the balance in its Fair Hydro Variance Account by an amount equal to the purchase price received. Upon payment of the purchase price, by operation of the Fair Hydro Act, the financing entity will have acquired a corresponding investment interest.

<u>Services</u>

The IESO will provide services to the financing entity relating to its investment interest. These services include providing the OEB and the financing entity the forecast information the IESO is required to provide the OEB by regulation to enable the OEB to set the rate for recovering the clean energy adjustment. The IESO will also provide services relating to clean energy adjustments including working with electricity vendors regarding the implementation of their obligations under the Fair Hydro Act and regulations relating to clean energy adjustments. The IESO's services may result in further IESO resources being dedicated to manage the fair hydro program including following up with electricity vendors on program implementation/reporting matters. The IESO will be responsible for receiving amounts remitted to it by electricity vendors and for paying these amounts to the financing entity. The IESO will also obtain and report on information received from electricity vendors, review information for material manifest discrepancies, and follow up with electricity vendors on discrepancies and non-performance of their obligations under the Fair Hydro Act and regulations.

The MTSA is clear on the limits of the IESO's obligations. Consistent with the Fair Hydro Act, the IESO is not responsible for any amounts not collected by electricity vendors from specified consumers, or amounts that are not remitted by electricity vendors to the IESO. The IESO is also not responsible for enforcing the obligations of specified consumers to pay clean energy adjustments or for enforcing the performance of electricity vendors of their obligations under the Fair Hydro Act and regulations.

The MTSA contemplates reimbursement by the financing entity of direct costs IESO incurs for providing its services that it is unable to recover elsewhere.

The term of the IESO's servicer obligations continues until the financing entity has fully recovered amounts it requires from specified consumers, which should be no later than 2047.

<u>Financing Entity Carrying Costs during first four years</u>

During the clean energy adjustment moratorium period (i.e. the time the legislation prohibits the recovery of clean energy adjustments from specified consumers – December 1, 2017 until July 31, 2021), the Fair Hydro general regulation (O. Reg. 206/17) requires the IESO to pay the financing entity its carrying costs. Carrying costs is defined in the regulation to be interest costs, financing entity expenses and taxes. The MTSA provides the process steps related to these payments.

<u>IESO security for electricity vendor defaults</u>

Included in the MTSA is an IESO commitment to provide a letter of credit or other form of security, as security for the failure of electricity vendors who are not credit rated or are rated less than investment grade to remit clean energy adjustments. This security would be required to be provided in four years' time when clean energy adjustments begin to be collected from specified consumers. The Ministry is currently working on a regulation to permit the IESO to recover its costs relating to this security from specified consumers. Please note that the rating agencies, following their due diligence of the Fair Hydro securitization transaction, may indicate a need for this security to relate to defaults by any electricity vendors, not just non-credit rated electricity vendors, to provide additional credit enhancement.

Protocol Agreement with the financing entity

Collateral to the MTSA, the IESO and the financing entity will enter into an agreement establishing greater specificity regarding servicer obligations. For example, it will provide greater detail regarding the IESO's review for material manifest discrepancies in LDC information, and reporting details. We are recommending the Board authorize management to finalize and execute this agreement as ancillary to the MTSA.

2. **Security Agreement**

Under the Fair Hydro general regulation (O. Reg. 206/17), the IESO is required to pay the financing entity its carrying costs during the first four years (i.e. between December 1, 2017 and July 31, 2021). In order to provide credit enhancement to assist the financing entity in obtaining the highest credit rating possible (OPG is targeting AAA), OPG and the banks requested that the IESO provide security to secure the IESO's obligation to pay the carrying costs. Because the IESO's credit rating is less than AAA, OPG and the banks believe this credit enhancement is necessary to avoid a lower rating for the entire structure.[1]

The security requested is first priority over the IESO's receivables which means market participants/contract counterparties will have second priority. The IESO has proposed that this be limited to IESO's receivables owing from electricity vendors.

Management recommends granting the requested security. It supports the implementation of the government's Fair Hydro Plan in a way that may help reduce the cost of borrowing and therefore benefit ratepayers. Despite being an unprecedented request and not without business and reputational risk, there are no material impediments to agreeing to the request.

Due diligence relating to grant of security

Due to the unprecedented nature of this request (the IESO has not previously granted security over receivables to any contract counterparty), the IESO conducted extensive due diligence to determine if there were impediments to providing the requested security. Together with our external legal counsel (Stikeman Elliott LLP) we performed the due diligence. We have concluded that the IESO has the legal authority to provide the security, and it would not breach legislation or the market rules. Based on our due diligence, we do not believe providing security over receivables owing from electricity vendors would breach any IESO energy supply agreements or related agreements. [redacted]

[1] Attached to this memorandum for your reference is DBRS' methodology for Rating Canadian Structured Finance Transactions, which includes a new appendix on Legislated Utility Collections.

[redacted]

3. **Acknowledgement and Indemnity Agreement**

The financing entity is issuing debt by way of a Trust Indenture and is retaining an Indenture Trustee (BNY Trust Company of Canada) to act as agent for the security holders (i.e. the investors). This Acknowledgement and Indemnity Agreement in favour of the Indenture Trustee permits the Indenture Trustee to enforce the rights of the financing entity under the MTSA directly against the IESO and provides an indemnity by the IESO to the Indenture Trustee for liability caused by IESO's breach of its obligations under the MTSA.

We are advised that this is standard in securitization transactions where the servicer (i.e. IESO) and financing entity are ostensibly considered related parties (even though not technically the case) and is necessary to achieve the best credit rating possible. The IESO and financing entity (an OPG established trust) are both under the umbrella of the government of Ontario and the banks and rating agencies expect the Indenture Trustee to be able to enforce obligations directly rather than relying on the financing entity to do so. Executing this agreement does not increase the IESO's liability risk, as it would have existed indirectly through the MTSA.

Management recommends the execution and delivery of this Acknowledgement and Indemnity Agreement.

Encls

Cc: IESO Records