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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: December 6, 2017

Re: Ontario Fair Hydro Plan - IESO Security over Receivables

At the November 22, 2017 special IESO Board meeting, there was a discussion about the potential impact to market participants resulting from IESO granting the financing entity security over LDC market receivables.

Summary

We consider it unlikely that the granting of this security will have a material impact on market participants due to a number of factors. First, the secured obligation is small in relation to the total amount settled by the IESO on a monthly basis (e.g. approximately $50 million secured compared to $1.4 billion settled monthly). Second, the risk of the security being triggered is small (i.e. IESO not paying monthly carrying cost) and this risk will be mitigated by an implicit, and potentially explicit, funding commitment by the Province to fund the IESO (for example Moodys rating general references to this implicit funding reference; and DM Imbrogno letter assuring the IESO the government will obtain approvals to provide an explicit commitment to fund). Third, the market rules and IESO electricity supply agreements do not guarantee market participants or contract counterparties rights to not be subordinated; therefore market participants should not have an expectation that the IESO would not provide such security. Fourth, market participants and contract counterparties will continue to be settled by the IESO in the normal course without priority amongst them.

Nature and Quantum of Security

Pursuant to regulation the IESO's funding obligation is to pay financing charges to the financing trust monthly over the first four years (the deferral period). The financing charges will be comprised of interest (and not principal), other costs and taxes, collectively referred to as "carrying costs".

Any amount paid by IESO to fund the financing entity's carrying costs will be added to the IESO's Fair Hydro variance account and will give rise to a regulatory asset, which, in the ordinary course would be transferred to the financing trust in due course. The purchase price payable to the IESO would retire the related IESO financing incurred to fund the carrying costs.

In relation to its regulatory funding obligation, the IESO is being asked by OPG (due to a dealer/rating agency requirement to try to obtain a AAA rating) to provide security. The requested security would provide the financing entity first priority over IESO receivables due from LDCs and other electricity vendors. The security secures only the IESO's current monthly obligation to pay the carrying costs.

OPG's estimate of the maximum interest only carrying costs over the four year period is as follows:

Year	**2018**	**2019**	**2020**	**2021**
annual amount (millions)	$133	$257	$394	$536

Costs for the OPG financial services manager fee, costs for vendors (lawyers, accountants) and taxes would be in addition to the above but would not be expected to be material.

We would expect therefore that the greatest one month exposure will occur in the first half of 2021 and will be roughly $45 to $50 million. The IESO's security to the financing trust ends by July 2021when Clean Energy Amount recovery begins; thereafter the IESO will have no further obligation to pay monthly carrying costs.

Comparatively, the IESO clears approximately $1.4 billion a month for the total market. The obligation secured by this security is therefore a relatively low percentage of the total amount settled by the IESO in a typical month, which should alleviate concern from market participants.

<u>Market Rules and Contract Provisions</u>

All counterparties to IESO electricity supply agreements are unsecured creditors of the IESO. IESO's electricity supply agreements do not restrict the IESO from providing security to any other person in priority to the payment right of the generator. In the largest of these contracts, the Amended and Restated Bruce Power Refurbishment Agreement, which was heavily negotiated with a highly sophisticated counterparty, the issue of the IESO granting priority to another creditor was not raised as a point of concern. We are confident that if it had been a concern, particularly with respect to the cost of raising debt for Bruce Power, this issue would have been raised.

The market rules also do not restrict the ability of the IESO to provide this requested security.

The source of funds for the IESO to pay the financing entity's carrying costs will be the OFA Fair Hydro credit facility, not market participants. The most likely reason the IESO would default on its payment obligation would therefore either be that the OFA credit facility has reached its limit and no further funding will be extended, or through some form of material administrative error on the part of the IESO. In either of these unlikely scenarios, the failure to fund would not be as a result of a default by one or more market participants and therefore the provisions of the market rules relating to payment defaults by market participants would not be applicable (see Section 6.14 of Chapter 9 and Section 1.5.2 of Market Manual 5.9).

Mitigants

As referred to in the November 22, 2017 memorandum to the Board, the IESO has in place two credit facilities with the OFA. Namely a Fair Hydro dedicated $2 billion credit facility and a $475 million general facility. The IESO also has other sources of liquidity through a TD credit facility and an OEFC credit facility.

In addition, the Province signed an indemnity agreement with the IESO to indemnify the IESO and its directors, officers and employees for all losses, costs, damages, charges, expenses, demands, liabilities, fines, penalties, judgement and/or settlement amounts arising directly or indirectly as a result of activities, acts and/or omissions in the implementation of, or otherwise relating to, the Fair Hydro Plan.

The IESO also received assurances from Deputy Minister Imbrogno in a letter dated May 15, 2017, assuring the IESO that the Ministry of Energy will take the necessary steps to ensure that an insolvency situation would not be created for the IESO and intends to request the necessary funding and approvals in order to provide the IESO the formal commitment the IESO requested in this regard. We are currently negotiating the form of this formal commitment with the Ministry. We are advised such a commitment will require Ministry of Finance approval, and possibly Treasury Board approval.

Encls

Cc: IESO Records