

## Asset Backed Commercial Paper

### **Background**

Asset-backed commercial paper (ABCP) is a sophisticated form of liquid, primarily short term, investment in which a note is issued by a trust based on pools of assets, or collateralized by the cash flows from a specific pool of underlying assets, which provide security for the repayment of the notes. ABCP was a significant financial instrument in Canadian financial markets, with an established track record, and a broad range of highly rated products. The trusts issuing ABCP would use the proceeds of sale of the ABCP notes to fund the purchase of assets which would generate income to service (pay interest on) the ABCP notes.

Governments, universities, pension funds, agencies, corporations and individual investors regularly purchased ABCP notes as an effective, secure, highly liquid vehicle for short term investments. These notes typically had very short term maturity dates, ranging from a matter of days to less than one year, on which the trust would redeem them; there was also an active secondary market. Rather than liquidate the underlying trust assets to fund the redemption of ABCP notes as they matured, the trusts would largely rely on the sale of new notes to fund the redemption of maturing notes. The new notes in turn were secured by the underlying trust assets. To the extent that there was a general disruption of the market for ABCP notes, such that they could not sell new notes in sufficient quantities to fund their obligations to redeem maturing notes, the trusts had arrangements to draw upon liquidity facilities, a form of line of credit, from major financial institutions.

In August 2007 there was a general disruption of the \$35 billion non-bank Canadian ABCP market as a result of concerns that the trusts which issued the ABCP were exposed through their trust assets to US sub-prime mortgages. In particular, the concern

was that the assets held by the trusts to secure their ABCP notes had lost a significant percentage of their value because of the decline in the value of their investments in US sub-prime mortgages. Though actual exposure to US sub-prime mortgages was quite limited, given that most of the trusts were prevented by confidentiality provisions from disclosing their specific asset holdings to the market at large, the uncertainty over this exposure led to a market disruption.

The markets for these notes which, as noted above, are widely held by governments, universities, pension funds, agencies, corporations, and individual investors lost liquidity – no one would purchase new ABCP notes - as concerns mounted that the value of the trust assets was impaired. At the same time the trusts were unable to draw upon liquidity facilities to allow them to fund their current obligations as liquidity providers claimed that it was not a general disruption in the market for ABCP, a prerequisite to drawing on the liquidity facilities, but was a disruption limited to non-bank ABCP. As a result of the lack of buyers for ABCP notes and the inability to access liquidity facilities, the trusts which had issued ABCP notes were unable to redeem them when they matured, and the market froze.

In response to this, the finance industry backed the adoption of the “Montreal Accord” to implement a standstill agreement to facilitate an organized industry response to the lack of liquidity and avoid triggering a series of defaults. The Montreal Accord led to the establishment of the Pan-Canadian Investors Committee (Committee), chaired by Mr. Purdy Crawford, a pre-eminent member of the Canadian legal and financial communities, and assisted by Ernst & Young, JPMorgan, and external legal advisors. The Committee worked to develop and implement a restructuring of these notes which was fair and equitable for all investors and would provide transparency regarding the

value of the underlying assets to promote liquidity and market value of the restructured notes.

The Committee made an application for approval of a Plan of Compromise and Arrangement (the Plan) under the *Companies Creditors Arrangement Act*. The Plan itself, like the current ABCP financial instruments, is complex and a detailed discussion of its attributes is beyond the scope of this summary. Simply, it will result in a pooling of trust assets, and the issuance of new notes with much longer maturity dates. Noteholders overwhelmingly voted to approve the proposed restructuring and the Plan was ultimately sanctioned by Mr. Justice Campbell of the Ontario Superior Court of Justice on June 5, 2008. A subsequent appeal to the Ontario Court of Appeal by certain noteholders was dismissed with the Court of Appeal concluding that the Plan was fair and reasonable in all the circumstances. Applications for leave to appeal to the Supreme Court of Canada were dismissed on September 19, 2008 and the restructuring of the affected notes may proceed. More detailed information regarding the restructuring plan is available through the Monitor's web site at: <http://documentcentre.eycan.com/pages/Overview.aspx?SID=35>

Following the dismissal of the application for leave to appeal the Committee has continued its work to implement the restructuring Plan. The size and scope of the restructuring is unprecedented in Canadian history. While it is our expectation that the restructuring will be implemented before year end, given the size and scope there is some uncertainty at this time regarding the details of the restructuring including when the restructured notes will be issued. Moreover, there remains considerable uncertainty regarding the market value of the ABCP notes, particularly in the shorter term. It is not anticipated that by the end of 2008 there will be a liquid market for the restructured notes, nor that there will be readily available pricing/valuation information. It is

expected that to the extent market prices are disclosed, they will initially be depressed. The IESO's expectation is that following the restructuring, some ABCP noteholders will quickly move to sell their restructured notes for the following reasons:

- Certain noteholders are restricted from holding investments with durations longer than one year and thus must sell the restructured notes because of the restructured notes' longer term to maturity;
- The restructured notes may no longer meet required credit ratings for certain noteholders; and
- Some of the noteholders have an immediate need for cash in their business.

It should be noted that none of the above conditions apply to the IESO.

Though the value of the underlying assets is not independent of global financial market forces, the underlying assets continue to be highly rated with limited exposure to US sub-prime mortgages.

## **IESO Investments**

### Summary of IESO's ABCP Investments

The IESO has investments of \$59.5 million in ABCP. The investments were made in accordance with approved IESO policy in that the ABCP investments had a credit rating of R1 High, the highest rating available for any short-term investment (e.g. Government of Canada paper is rated R1 High). The ABCP notes were issued by a number of different trusts and they relate to IESO accounts as follows: \$1.4 million for corporate, \$23.1 million for real-time market and \$35.0 million for transmission rights market. Through its ongoing cash flows and/or borrowings on either the corporate \$60 million credit facility or the market \$100 million credit facility, the IESO has sufficient liquidity to clear corporate and market accounts as required.

### IESO Disclosure and Reporting of ABCP Investments

In September 2007, the IESO exchanged information and discussed the details of its holdings with OEB staff in Regulatory Compliance. The IESO provided updates to OEB staff through February 2008, at the time of finalizing the 2007 results and the treatment of ABCP within the IESO accounts.

The IESO brought the matter to the attention of market participants in a notice on September 27, 2007. Since that time, related disclosures have been included in the IESO's publicly issued financial statements and an update was provided to market participants on July 17, 2008. Copies of the foregoing notice and update are attached as Appendix A to this document. The IESO's 2007 financial statements are attached as Appendix B to this document.

### Treatment of IESO's ABCP Investments in 2008 Fees Submission Proceeding

At the time of the initial 2008 rate application, there was considerable uncertainty regarding the value of the ABCP investments. Accordingly, the projected 2007 results, which were included in the 2008 application (EB-2007-0816, Exhibit B, Tab 1, Schedule 1, pages 20, 22, 25), did not reflect any gains/losses associated with the ABCP investments. The matter of the IESO's investment in ABCP and the potential implications for its 2008 revenue requirement was included as an issue on the Board-approved Issues List and was addressed by the IESO at the February 11, 2008 Technical Conference. Specifically, the IESO advised intervenors that:

- No market-related interest (including non-ABCP related investments) income was recognized in 2007 since the real-time market ABCP investments remained illiquid at the end of 2007;
- The IESO took a provision of \$0.7 million, or 50%, of the initial \$1.4 million corporate investment in ABCP; and

- The IESO recorded an overall deficit of \$4.3 million in 2007 resulting in an accumulated surplus balance of \$0.7 million, and consequently no impact on the requested 2008 revenue requirements or proposed fees.

The matter of the IESO's investments in ABCP was also addressed before the Board. In its decision, the Board accepted the IESO's proposed fee reduction on the basis that there was no evidence that the proposed fee reduction, in combination with the financial consequences of the IESO's ABCP investments, would likely result in an accumulated deficit by the end of 2008.

#### **Treatment of Investment Returns within the IESO Accounts**

The IESO 2009-2011 Business Plan is included in the application as Exhibit B, Tab 1, Schedule 1.

#### Corporate Investments

Investment returns (income or losses) on corporate investments flow directly through the IESO's financial results as the income or losses are earned. Investment income serves to reduce the revenue requirements to be recovered by the IESO usage fee, and vice versa for investment losses.

In 2007, based on discounted cash flow modelling, the value of the corporate ABCP holdings was estimated to be 50% of their initial investment. This estimate reflects the fact that a material portion of the underlying assets within these ABCP investments have exposure to sub-prime mortgages in the U.S. As there is insufficient information to support a revision at this time, no change to this provision has been projected for 2008.

The attached 2007 financial statements (Appendix B) reflect the 50% provision (i.e., \$666,260)<sup>1</sup> within the 'interest and investment income' amount of \$97 thousand (page 9 – statement of operations, other comprehensive income/(loss) and accumulated surplus), the 'long-term investments' balance of \$16,718 thousand at the end of 2007 (page 10 – statement of financial position, page 18 - note on long-term investments) and 'provision for other than temporary losses on long-term investment' (page 11 – statement of cash flows).

Within the 2009-2011 Business Plan, investment income on corporate investments is included in the 'net interest' amounts. Therefore, the actual 2007 'net interest' amount of \$4.9 million (page 26 of the Business Plan) includes the \$666,260 provision associated with the corporate investments in ABCP.

#### Real-time Market Investments

Investment returns (income or losses) on real-time market investments flow through the IESO's financial results as market-related interest income. However, only accumulated investment income, and not losses, are recognized in the IESO results on an annual basis. Should there be an accumulated loss at the end of a year, as was the case at the end of 2007, no market-related investment income is recognized in the year. Market-related interest income serves to reduce the revenue requirements to be recovered by the IESO usage fee.

In 2007, because of the illiquid ABCP real-time market investments which had uncertain market value, no market-related investment income was recognized in the year. At this time, there remains considerable uncertainty as to the value of these investments. The 2009 rate application assumes that the real-time ABCP investments will be restructured

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<sup>1</sup> The face value of the corporate investments was \$1.35 million; a 50% discount on the investment adjusted for the then current rate of exchange amounted to \$666,260

prior to the end of 2008 but that there will not be a liquid market established or readily available pricing/valuation information on the ABCP investments by the end of 2008. Given this uncertainty, the IESO has assumed a December 31, 2008 market value of no more than 60% of the initial real-time market ABCP investments. Consistent with the practice of other noteholders, the IESO has developed a pricing model based on discounted cash flows. Though this analysis indicates a market value that is higher than 60%, given the expected depressed nature of the initial market/sales, as discussed above, the IESO has assumed an initial lower market value.

Therefore, for 2008, it is anticipated that the real-time market ABCP investments of \$23.1 million will have a market value on December 31, 2008 of no more than \$13.9 million, or some \$9.2 million lower than the initial investment. The actual and projected investment income on non-ABCP investments for 2007 and 2008 total \$7.2 million; therefore, the net return is projected to be a loss of \$2.0 million. Accordingly, no market-related interest income is projected to be recognized in 2008.

For 2009, the IESO has assumed that the ABCP market recovers somewhat by the end of 2009 and the real-time market ABCP investments pay interest of \$0.6 million and have a market value of 70% of their original purchase price, an amount closer to the IESO's discounted cash flow model results. Therefore, the provision against the initial \$23.1 million investment would be \$6.9 million. The IESO is also budgeting that a further \$2.7 million of interest will be earned in 2009 on other real-time market investments. Therefore, the accumulated interest income not yet recognized will total \$10.5 million, an amount that would exceed the budgeted \$6.9 million ABCP loss by \$3.6 million. Accordingly, the IESO has budgeted market-related interest income of \$3.6 million for 2009.

The 2007 financial results recognize zero revenue for market-related interest income within the 'other revenue' balance of \$2,143 thousand for 2007 (page 9 – statement of operations, other comprehensive income/(loss) and accumulated surplus, page 17 - note on other revenue). Within the 2009-2011 Business Plan, market-related interest income is presented as its own revenue class. Therefore, the actual 'market-related interest income' amount was nil for 2007 (page 23); the projected 'market-related interest income' is nil for 2008 (pages 12, 14, 15); and, the budgeted 'market-related interest income' is \$3.6 million for 2009 (pages 23, 24, 25).

#### Transmission Rights Market Investments

Investment returns (income or losses) on transmission rights market investments remain with the transmission rights accounts and do not impact the IESO corporate financial results. Any surpluses in the transmission rights clearing account may be distributed to market participants, as was the case when the IESO distributed \$57 million in 2007/2008. Conversely, market participants may be responsible for funding deficits.

#### **Treatment of ABCP Investments Going Forward**

While the IESO believes that its projections are reasonable, there remains uncertainty as to the future value of the ABCP investments. Should the value of the real-time market investments in ABCP prove to be worth less than the assumed 70% of the initial investment this would serve to reduce or eliminate market-related interest income in 2009 and possibly in future years. Similar to other variances against approved budget, this variance would be absorbed within the approved accumulated surplus/deficit (the approved regulatory deferral account) and addressed, if required, within the 2010 and possibly subsequent rate applications.

With the support of external expertise, the IESO has developed a confidential ABCP Investment Policy which outlines the IESO's strategy for the prudent management of the restructured notes including the necessary approvals for divestiture of any of the restructured notes. This policy, approved by the IESO Board of Directors on October 6, 2008, will continue to be refined as further and better market information becomes available.