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MSA REPORT

Ancillary Services Investigation

14 November, 2008

MARKET SURVEILLANCE
ADMINISTRATOR

1 INTRODUCTION

In a notice to Market Participants dated May 14, 2007 the Market Surveillance Administrator (MSA) advised that it had commenced a formal investigation regarding certain trading activity in the Ancillary Services (AS) market. The MSA has concluded this investigation and has decided that it will not take direct enforcement action regarding the conduct of the parties which were the subjects of the investigation. Accordingly, on the basis set out below, the MSA is closing the investigation.

1.1 Conduct at Issue

The conduct at issue concerned the manner in which certain trades were negotiated and concluded in the AS market during 2007 and previous periods.

The MSA investigation determined that:

- i. The Alberta Electric System Operator (AESO) and a counterparty would, through direct bilateral communications, negotiate the specifics of a trade for operating reserves required by the AESO and to be supplied by the counterparty, and
- ii. Then post and execute the trade on the Watt-Ex market, rather than completing the transaction as an Over-The-Counter (OTC) trade.

The MSA is of the opinion that this conduct can properly be considered “pre-arranged trading” on the Watt-Ex market.

1.2 Self Reported by AESO

The AESO came forward under its own volition and self-reported the conduct to the MSA. The AESO coincidentally ceased carrying out that conduct, and in that regard posted an explanatory notice on its website on May 10, 2007.¹

1.3 Scope of the Investigation

The MSA investigation began by reviewing the conduct of the AESO, and was subsequently expanded to include an assessment of the conduct of all possible counterparties (market participants who carried out AS trading with the AESO during the relevant period). Ultimately the investigation was narrowed to concentrate on the conduct of the AESO and three counterparties.

Generally, the period under review was 2006 and Q1 – Q2 2007. During its investigation the MSA reviewed all AS trades carried out on Watt-Ex during the period, ultimately identifying 113 trades of concern associated with Active Term and Standby AS products.

¹ http://www.aeso.ca/downloads/AESO_May_10_2007_Announcement.pdf
Market Surveillance Administrator

2 BACKGROUND

2.1 Legislation

Pursuant to the *Alberta Utilities Commission Act* (AUCA), the MSA has the mandate to carry out surveillance, investigation and enforcement in respect of the supply, generation, transmission, distribution, trade, exchange, purchase or sale of electricity, electric energy, electricity services or ancillary services, or any aspect of those activities.

Section 6 of the Alberta *Electric Utilities Act* (EUA) requires that market participants conduct themselves in a manner that supports the *fair, efficient and openly competitive* operation of the market.

The term “market” is defined to mean any type of market through or under which an offer, purchase, sale, trade or exchange of electricity, electric energy, electricity services or ancillary services takes place in relation to the production or consumption of electricity, electric energy, electricity services or ancillary service.

Section 51 of the AUCA provides, among other things, that if the MSA is satisfied that a person has contravened the EUA, regulations made under that Act or the ISO rules, or where a person has engaged in conduct that does not support the *fair, efficient and openly competitive* operation of the market, the MSA may request that a hearing or other proceeding be initiated by the Alberta Utilities Commission (Commission).

2.2 MSA Guidance

The MSA assessed the conduct at issue against several of the high level principles set out in the MSA Report entitled “*Undesirable Conduct and Market Power, July 26, 2005*”; namely, (i) competitive response, (ii) information rich environment, (iii) level playing field, and (iv) opportunity to compete.

That July 26, 2005 Report also set out the MSA’s expectations regarding conduct necessary to support the *fair, efficient and openly competitive* operation of the market. In relation to this investigation, the MSA assessed the conduct of the AESO and its counterparties *vis a vis* matters such as legitimate business purpose, sound trading practices and understanding of applicable rules.

3 DISCUSSION

3.1 Methodology

The investigation process followed by the MSA is generally described in the *MSA Investigation Procedures*, which can be found on the MSA website under *Processes*.

During the course of the investigation the MSA issued information requests, interviewed market participants and conducted computer searches. The MSA also consulted with industry experts and undertook research in the area of pre-arranged trading in order to develop a comprehensive understanding of the conduct. Early in the investigation, the MSA attended a presentation by the AESO and its industry experts and legal counsel wherein the AESO's position was discussed.

The MSA provided its draft facts and findings to the AESO and the relevant counterparties for their review and comment. The MSA also met individually with those parties in order to receive additional comments.

This report reflects certain comments and suggestions made by the AESO and the counterparties in their written and verbal comments.

3.2 Overview of the AS Markets

There is one overall market for AS products (operating reserves) in Alberta, which can in turn be broken down into specific classes of AS products. The list of AS products is categorized as 'Active' and 'Standby', depending on the required operational or delivery status. Within the Active and Standby categories are 'Regulating', 'Spinning' and 'Supplemental' AS products.

Pursuant to its responsibilities as operator of the system, the AESO procures AS products using two competitive procurement platforms: the Watt-Ex market and the OTC market. Each of those procurement platforms has its own separate and distinct rules, terms and conditions.

The Watt-Ex platform is an anonymous exchange market to the extent that the parties are not identified to each other. Given that there is only one buyer (the AESO), the identity of the buyer is obvious and well known to all sellers on Watt-Ex. The converse is not true however. The Watt-Ex market provides price transparency to market participants.

The OTC platform is a bilateral market where the AESO can negotiate individual trades with counterparties. There is no price transparency other than a composite price index which is periodically published on the AESO's website.

3.3 Key Facts and Findings

In April 2007 the AESO reported to the MSA that the AESO had concerns regarding certain trading activity in 2007 in the AS market.

On May 10, 2007 the AESO published an announcement which advised that it had ceased the “pre-arranged trading” (see MSA description above) activity on Watt-Ex.

The MSA accepts the AESO’s May 10, 2007 announcement in the Stakeholder Newsletter that described the pre-arranged trades as “inappropriate”; that the trading at issue was self-reported; and that the AESO immediately stopped the conduct at issue once it had been recognized by senior AESO management.

During the course of its investigation, the MSA identified a total of 113 pre-arranged trades in 2006 and 2007. Of the 113 trades, 108 pre-arranged trades with a contract volume (i.e. the quantity specified for each hour in a Trading Instrument) of 5,841 MWs pertained to Standby Regulating, Spinning and Supplemental AS products. Based on comments from the AESO and counterparties, the MSA eliminated a number of trades which did not have adequate supporting evidence. The MSA notes that the pre-arranged trades led to counterparties providing actual Ancillary Services products to the AESO.

The MSA also identified and confirmed 5 pre-arranged trades concerning the Active Term Regulating and Supplemental AS products. The contract volume for the term trades totaled 148 MWs.

The AESO negotiated the transactions with counterparties by telephone or Instant Messaging (IM) where the terms of the transaction were agreed between the parties, and then the transaction was posted or confirmed to Watt-Ex rather than completed as an OTC transaction.

Three suppliers accounted for the entire volume of Standby and Active Term pre-arranged trades identified and confirmed by the MSA.

After being negotiated, the pre-arranged trades were executed through the Watt-Ex market in the hope that the use of Watt-Ex, rather than the OTC market, would increase transparency to other participants.

The MSA did not find any evidence of intent by the AESO or counterparties to manipulate market prices.

The MSA investigation disclosed that prices in the pre-arranged transactions were generally consistent with market prices before and after the trades. The MSA did not find any evidence of a distortion of market prices. Accordingly, the MSA is of the view that there was no financial harm to the market as a result of the conduct.

The AESO and counterparties cooperated with the MSA's investigation and voluntarily provided access to its employees, documents and trading records to assist in the investigation.

4 RELATED MATTERS

4.1 Watt-Ex Agreement Issues

The pre-arranged trades appear to be contrary to Sections 201 and 205 of the Watt-Ex Ancillary Services Agreement (here described as the Watt-Ex rules), as the trades were not anonymous and they were not truly offered to the market when posted but rather were negotiated and generally posted in manner that prevented others from competing for the deal.

The MSA recognizes that the AS market is unusual in that there is only one buyer and a limited number of potential sellers. The Watt-Ex rules can take this feature into account, and are in any event intended to be followed by market participants. In the view of the MSA, market participants (here including the AESO) should not be in the position of getting to (or having to) decide which rules they will adhere to.

The Watt-Ex rules may be modified from time to time to recognize the nature of the AS market. If pre-arranged trading is to be made available at some time in the future, appropriate rules should first be in place for the conduct and disclosure of such trades.

The MSA is not taking a position on any specific changes to the Watt-Ex rules and, as noted above, is not contemplating its own direct enforcement action in relation to the conduct at issue. That said, the MSA will in accordance with Section 45 of the AUCA forward the information it has obtained in this investigation to Watt-Ex as well as to the Alberta Securities Commission for their review and consideration.

4.2 Future Considerations

Apart from this specific investigation, the MSA remains interested in a number of matters that arose during the course of the investigation. These matters concern the conduct of the various parties, including: (i) the use of unrecorded Instant Messages (IMs) for trade negotiations and confirmations; (ii) the extent and adequacy of internal training; and (iii) the extent and effectiveness of internal governance and oversight. The MSA intends to give these areas further thought and may engage the AESO and other market participants in related discussions in order to obtain their input.

5 CONCLUSION

The MSA is of the view that pre-arranged trading, as described previously, is not *in itself* necessarily either beneficial or harmful. However, if pre-arranged trades are going to occur, the MSA believes there must be (as there are some other markets) rules in place governing the circumstances and manner in which such transactions are permitted, in order to prevent harm to the market.

The MSA has concluded this investigation and has decided not to take direct enforcement action in relation to the conduct at issue, including as to the requesting of a hearing before the Commission.

The MSA believes that the pre-arranged trades appear to be contrary to Sections 201 and 205 of the Watt-Ex Ancillary Services Agreement and have referred the matter to Watt-Ex and the Alberta Securities Commission accordingly.