MARKET SURVEILLANCE ADMINISTRATOR

fair
efficient
& openly
competitive

www.albertamsa.ca IPPSA – March 15, 2004

The Electric Utilities Act passed last spring and two related regulations, the Market Surveillance Regulation and the Code of Conduct Regulation reincarnate the MSA giving it a new mandate, new tools and new independence. My opening slide captures the essence of the mandate and this language appears in several places in the Act… FAIR, EFFICIENT and OPENLY COMPETITIVE.

The Act gives us:

1. funding through a budget vetted by the Chair of the EUB and collected for us by the AESO through a small adder to their trading charge,
2. fairly liberal prerogatives to compel the provision of information…. Prerogatives we have not had to use as cooperation from industry has been excellent
3. and finally a prosecution and sanctioning mechanism via a Tribunal which would be established by the EUB at the request of the MSA.

Since being appointed in July, I've had a little over half a year to reacquaint myself with many of you, to get a feel for the issues, and to get a feel for:

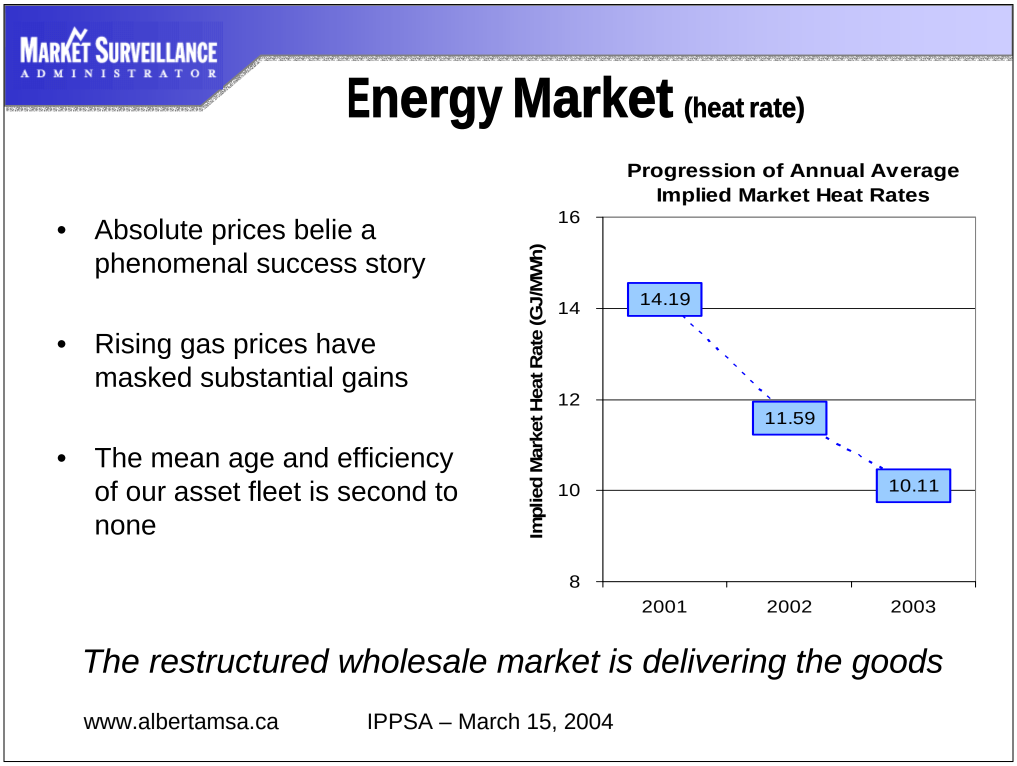
1. How and where the MSA can make a contribution to this market given:
2. The MSA's mandate under the Act and regs
3. The current state of the market
4. The tools we have to work with

So in the next 15 min I'm going to try to touch on each of these.

Fair, efficient and openly competitive are excellent objectives for our market and a very workable mandate for an agency like the MSA.

Before I go to the next slide I want to say that in 25 years years in commodity industries the best regulators I ever had were customers and competitors. I have not forgotten this and it shapes my view that the MSA's best contribution is to be made not by being the regulator but by ensuring the presence and functioning of regulating mechanisms.

I've been fortunate enough to be invited to this conference on a handful of previous occasions and I have never been able to resist commenting on market performance before! … it seems more appropriate than ever that I do so in my current capacity and that what I'd like to do with my next few slides!



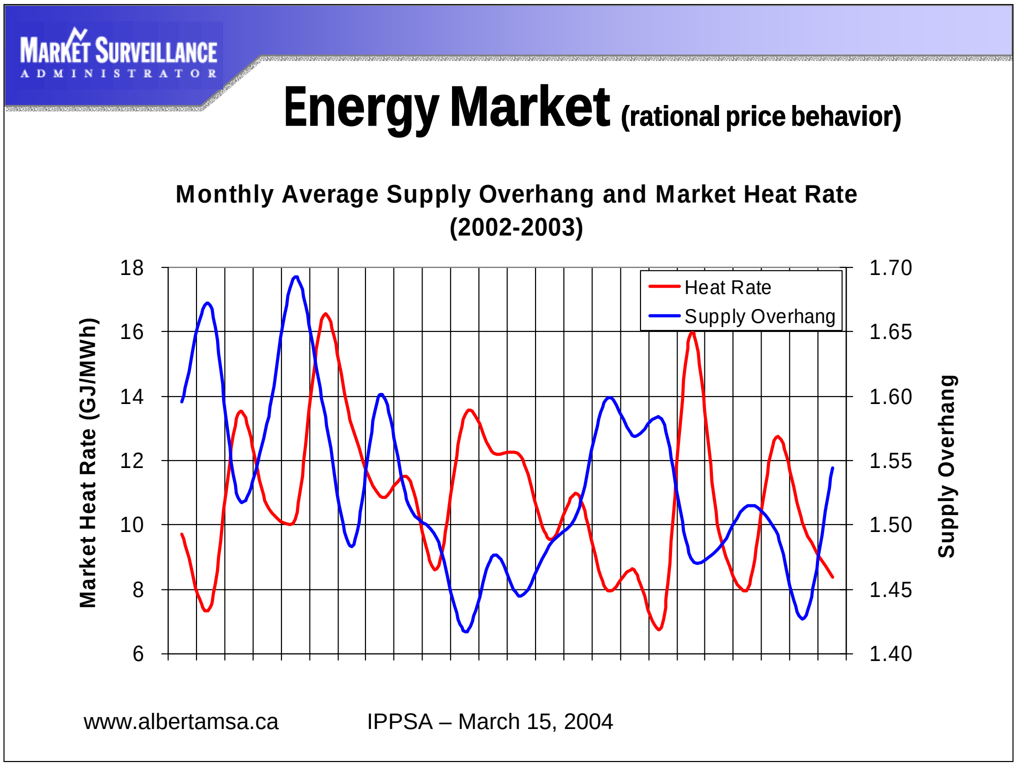
The last year before any restructuring started (1995) the market heat rate was 13, in 2000 (the last year before the PPAs were sold marking the beginning of the new restructured era) the heat rate was 12…..In 2003 the market heat rate was just over 10! And thank god for the drop because we've been burning $6-7 gas. The legacy regulated equipment would have produced power at least $15/MWh more expensively than we produced it last year in our restructured wholesale market.

Now it is possible to believe that this is not so, but you have to make a couple of assumptions:

1. Either that Gas only climbed to such high prices because of electric restructuring (and one also has to presume the corollary, that lower prices would have somehow been better for Albertans) ***OR***
2. That regulators and legislators would have been clairvoyant enough to begin construction of 3000MW of coal fired generation before the wrangling over Genesee's construction had even died down at a time when all across North America no one was building anything but gas fired!

Both feel like a bit of a stretch to me!

Folks there is no doubt that restructuring of the wholesale side of Alberta's electric industry has been delivering the goods for some time, nor is there any doubt that most generators made lower returns in 2003 than they would have under regulation.



The MSA's mandate includes more than monitoring of participant behavior, it includes assessing the structure and rules of the market against the same fair, efficient and openly competitive yardstick.

We are always looking for broad "goodness" indicators for the wholesale energy market, something beyond heat rate, something to indicate at a macro level the rationality (or not) of the market's ebbs and flows. We are still working on this, and like all things statistical you never have enough data but let me offer the following:

In red plotted against left scale we have market heat rate….think of this as a proxy for power price but adjusted for gas prices.

<click>

In blue plotted against the right scale we show average available capacity as a fraction of average load. Available capacity includes adjustment for actual outages determined after the fact.

One would expect a strong inverse relationship between supply excess and price...and here we see it. When one line goes up the other generally goes down. The correlation is about -.6,

All of this may be just a fancy evidence for what most would have intuited…that price really does hinge on supply/demand balance and that the supply/demand balance is strongly influenced by outages.

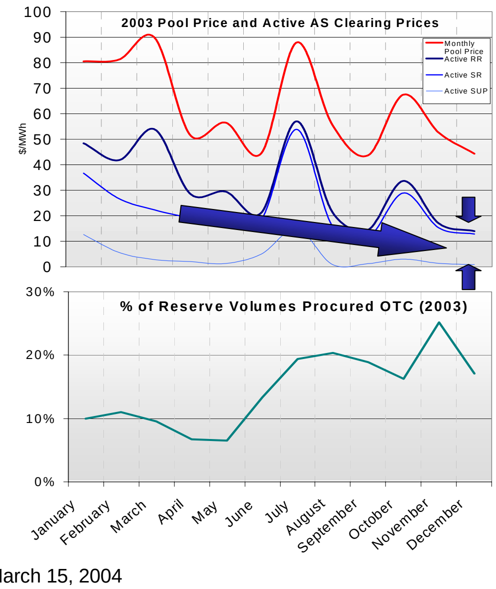
![Market Surveillance Administrator]

Ancillary Service Market (evolution of)

New Participants
- 4 new gas-fired, 3 with AGC capability
- 45 units qualified providers across 19 companies

Prices
- Trend with Pool price
- Converging on each other
- Sustainability?

AESO procurement strategy
- Overall OTC volumes up
- MSA focus on transparency



www.albertamsa.ca IPPSA – March 15, 2004

•The AS market is a challenging one to design, to operate and to participate in. It is small, has a sole purchaser, is frequently dominated by the legacy of the Hydro PPA and yet at least at a macro level it appears to produce logical and competitive results at lower prices than we could have expected from regulated monopolies.

•One of the most powerful regulating forces in a well functioning commodity market is arbitrage… this concept is known colloquially as "voting with your feet" Most generators have the ability to participate in the energy or the ancillary market and within the AS market many have the ability to sell any of the three Active products (regulating, spinning or supplemental reserves). As MSA when I see evidence that arbitrage is working I sleep well. Generators, voting with their feet as they choose between markets and products produce the results you see on the top graph behind me….(pool price in red and the three AS products in blue) Ancillary Prices trending with pool price and AS product prices converging on each other with a small price spread representing their value difference.

•If I have one concern about this picture it is that the prices are all converging on a point well below their full cost which for a pure capacity product would be somewhere in the $20 range. Clearly this is great for consumers as it reduces the AESO costs…it is also clearly not sustainable so we will watch to see if it trends back up as capacity tightens

•The AESO recently advised that their procurement strategy for Ancillary Services would be shifting to use a wider mix of OTC contracts to compliment the volumes traditionally procured through Wattex. This was not without some controversy as change always is but as you can see from the lower chart the increase in OTC volumes does not appear to have upset the apple cart. The MSA has raised the concern that the shift to greater levels of OTC must not lead to a reduction in transparency because transparency underpins confidence and it greases the wheels of arbitrage, an important market regulator. The AESO understand our concern and are working on ways to address it.

MARKET SURVEILLANCE ADMINISTRATOR

Level Playing Field - Retail

- Code of Conduct ***Compliance*** Plans approved
  - Battle River
  - Direct Energy

- Code of Conduct ***Audit Plans*** being approved for
  - Enmax, Epcor and their affiliates

www.albertamsa.ca IPPSA – March 15, 2004

The new Act gives the MSA responsibility for administering the electricity Code of Conduct (the EUB has responsibility for a similar code on the gas side) The Code has two objectives:

1. To protect customer information and
2. To assure a level playing field between those unregulated retailers who are affiliates of a wires owner (ie: Epcor and Enmax) and everybody else.

The code sets out rules for the handling and use of customer information typically held by the regulated utility and prescribes that their affiliated retailer develop and have approved by the MSA a **COMPLIANCE PLAN** that outlines the internal procedures by which the provisions of the Code will be assured.

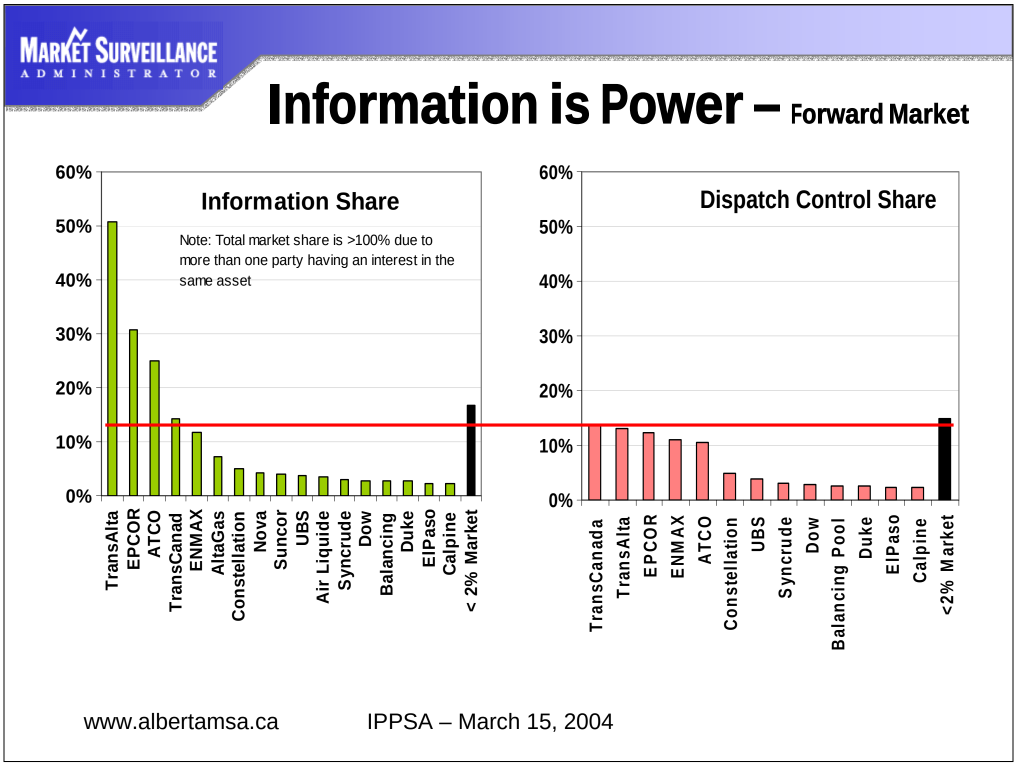
Then, each year those companies are subject to a 3rd party audit, with both the **AUDIT PLAN** and the auditor being approved by the MSA

We are working with every firm who requires a Compliance Plan, most are several drafts along. I am pleased to advise that the first 2 have been approved and they are for Battle River a large and progressive REA and Direct Energy…both new entrants. This is encouraging.

Epcor and Enmax are both subject to audits for the 7 months of 2003 covered by the new Act and Code of Conduct, we are working with each of them now on approval of their auditor and audit plan.

While it is no secret that the retail side of the business has not seen the massive interest and influx of new players that we have seen on the generation side there are many new niche players contesting the mid size and up market we also have Direct Energy's entry pending. Will the niche players look to expand their scope to both larger and smaller customers? I don't know but it would seem logical and in both their and customers interest assuming… of course that playing field is level.

Our prospects for success on the retail side of the market depend on many things most of which are beyond the control of the MSA, one thing that is within our control that we intend to stay on top of is the level playing field. The policy intends it, the Code prescribes it and we have the tools to ensure it.



Over the course of this conference I expect that you will hear chapter and verse about how well the real time wholesale market operated by the AESO is serving Albertans. Real time market runs on assets, on the right hand side you can see the 5 largest players in terms of dispatch control have between 10% and 15% market share each, as any generator in this room will tell you this creates a very competitive market, some evidence of which I showed earlier.

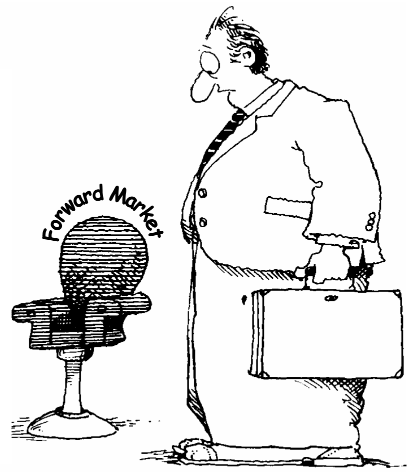
The forward market on the other hand runs on information, forward markets trade on expectations (or knowledge) about the future status of the generation asset base. Forward markets are key to retailers, generators, new investors or anyone who needs to manage risk or secure predictable cost or revenue streams. The information asymmetry in Alberta's forward markets is unacceptably high. The largest player has a birds eye view of over 50% of the generation assets in the province, 3x the size of the asset base he dispatches, almost as much as the next 2 largest generators combined and over 3x that of anybody else. There is simply NO prospect of a fair and liquid forward market emerging in Alberta with the distribution of information existing among the players as shown on the left. This information asymmetry manifests itself in very wide bid/ask spreads in the prompt days, week and month, and consequently relatively low volumes transact to the detriment of the market at large and most players in it.

Not everyone who holds a disproportionate share of the information pie exercises it, some do not as a matter of practice trade the forward market, some have chosen to take the moral high ground by restricting the internal distribution and use of the information as a matter of corporate policy. Unfortunately though, a certain amount of predation has gone on in this market segment. Until recently there was nothing to protect the wildebeasts from the lions except their own survival instinct…which has increasingly been to stay the hell out of the market.

MARKET SURVEILLANCE ADMINISTRATOR

Forward Market (Summary)

- The forward market is artificially small
- It is small because it is neither fair nor competitive
- It is not fair because a few players hold all the cards



The Trading Practices Guideline addresses this issue

www.albertamsa.ca IPPSA – March 15, 2004

The MSA recently announced a **Trading Practices Guideline** in order to lay ground rules to replace the law of the jungle and from which Alberta might grow a fair and liquid forward market for the benefit of all participants.

The TPG is a necessary pre-cursor to **<u>any</u>** forward market, Wattex, NGX, the brokered markets, something that the AESO might develop or that might arise out of a new policy initiative from the government. None of them will function well in the face of the information asymmetry that the TPG is designed to remedy.

Without a forward market in which participants can exchange risk investors will require higher returns and consumers will pay higher prices than they otherwise would.

This initiative is not without controversy but it is the right next issue for us to tackle, we look forward to working with participants to devise an effective implementation.

I encourage you to visit our website to see two papers we have written on this subject, there is substantial scope and time remaining for input on all but the most fundamental issue – which is that this is not the African savannah and lions have to stop eating wildebeasts!

MARKET SURVEILLANCE ADMINISTRATOR

MSA 2004 Issues/Challenges

- **TPG** – the right next step for forward market
- **Retail** –keep playing field level
- **Transparency**

www.albertamsa.ca IPPSA – March 15, 2004

Just to wrap up then with some of the issues that I expect to dominate the MSA's agenda for the balance of 2004….

1. TPG a necessary next step.
2. We shall be staying on top of the Code of Conduct to ensure that the bureaucratic drag created by our own agency is kept to minimum and that new retailers have every opportunity to compete that the Act and the Code contemplates
3. Finally, transparency is a natural and appropriate theme for us because it serves the "openly" competitive part of our mandate, it greases the wheels of arbitrage a powerful efficiency improver and price regulator and it naturally co-opts market participants into the role of market surveillance. Transparency features prominently in a handful of issues on the 2004 radar screen including:
    - Outage information (IDP)
    - OTC procurement
    - Hydro PPA impact on AS market
    - Contractual symmetry for tie line in AS market
    - Interface between the Energy market & Regulating Reserve operation

We take complaints, we make house-calls,

Check out our website

Stay tuned for annual report

And also quarterlies about 30 days after the end of each quarter

Thanks a lot