MARKET SURVEILLANCE ADMINISTRATOR

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July 28, 2005

NOTICE TO: MARKET PARTICIPANTS

RE: INTERTIE CONDUCT

Background

Pursuant to its overall mandate under the *Electric Utilities Act* (Act), the Market Surveillance Administrator (MSA) undertakes surveillance and investigation of electricity exchanges on the tie lines connecting the interconnected electric system in Alberta with electric systems outside Alberta.

In January, 2005 the MSA published a Report on the MSA website titled *A Review of Imports, Exports, and Economic Use of the BC Interconnection*. This Notice follows upon matters discussed in that Report, to provide further advice and guidance about MSA expectations concerning import and export activity.

Conduct on the tie lines can have negative consequences for the fidelity of the price signal in the short and longer term, and can otherwise undermine the *fair, efficient and openly competitive* operation of the market. In particular, importing or exporting designed or foreseen to manipulate the Alberta pool price beyond natural market levels is not seen as a legitimate business practice, is considered harmful to the market, and is inconsistent with the requirements of the Act. The MSA continues to monitor the tie lines closely, against such conduct.

Standard of Conduct

Section 6 of the Act sets a conduct standard for market participants that should, among other things, guide decisions relating to use of the tie line: *market participants are to conduct themselves in a manner that supports the fair, efficient and openly competitive operation of the market.*

Import and export activity are generally seen as positive for the market. The present market design in Alberta requires that imports come in at a price of zero; exports are treated in the converse fashion. Each can therefore materially impact pool price. Changes to the market design may change the manner in which imports and exports are treated. In all cases, the ability to materially affect pool price places upon market participants an obligation.

In the view of the MSA, Section 6 of the Act requires market participants to take into account any reasonably foreseeable effect of their import or export upon the market, as well as on their portfolio. Managing one's portfolio to suit pool price is a reasonable and normal commercial practice. However, the reverse is not so. A market participant whose conduct has as its primary or material intent the management of pool price to suit their portfolio will, by that conduct, be breaching Section 6 of the Act.

Meeting the Standard of Conduct

In the course of its mandate, the MSA has had the opportunity to consider and test with market participants various principles which should help to guide market participants in their import and export decisions. These are described below. The list is illustrative but not exhaustive; other principles might also be relevant. The MSA is prepared to speak to additional circumstances as they arise.

These principles are generally intended to apply symmetrically to import and export conduct, to allow for consistent treatment of both.

- *A portfolio strategy which relies upon manipulation of pool price to be successful is not legitimate, and undermines the fairness and efficiency of the market.*

  Example of undesirable conduct: A market participant arranges their portfolio to be systematically short/long and then boosts the value of that portfolio by using uneconomic imports/exports to manipulate pool price down/up - the volumes of import/export settle at a loss while the value of the participant's overall portfolio is enhanced. Manipulation of pool price is not considered a legitimate strategy for addressing a portfolio issue, howsoever created.

- *Import and export activity should normally be economic versus the next best market alternative (by opportunity cost), accordant with market efficiency. Given that current ISO rules require that imports and exports are price takers, some degree of economic uncertainty and inadvertence can be expected, and allowed for.*

  Example of undesirable conduct: Energy is imported into Alberta with a landed (or opportunity) cost of $CDN75/MWh. The Pool price is settling at $CDN50 and the OTC market has been offered by credit worthy counterparties at $CDN52/MWh. The import continues for several hours with no bona fide attempt to moderate import volumes or purchase less expensive energy OTC.

- *As a matter of economic efficiency, absent transmission constraints, import and export activity should normally close arbitrage opportunities.*

  Example of undesirable conduct: An import or export widens (rather than narrows) the price spread between interconnected markets (eg. Alberta vs. Mid-C) beyond the range or duration that might be explained by uncertainty or inadvertence.

In assessing import or export strategy against these principles, a market participant will have an opportunity to assess their conduct (or someone else's conduct) against the standard set in Section 6, as the MSA will do. It is conceivable that a market participant may be able to document a plausible explanation for conduct inconsistent with any one of the above principles. However, the likelihood of a failing grade overall (as against that standard) significantly increases as the number of inconsistencies increases.

The reader is encouraged to review the January, 2005 Report referenced above, as well as the recent MSA Report titled *Undesirable Conduct and Market Power*; both are published on the MSA website. Given that the current Act, including Section 6, has been in force since June, 2003, the expectation is that market participants have been given ample notice of their obligations.

Please do not hesitate to contact the MSA with any questions or comments about these or other matters.

Yours truly,

"Original signed"

W.W. (Wayne) Silk
Vice-President, Chief Operating Officer
Market Surveillance Administrator.