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REVIEW OF THE COLLAPSE OF THE SEPTEMBER 2007 CONTRACT

On August 22, 2007 we published a notice of a review to be undertaken of the circumstances surrounding the steep decline of the September electricity contract over August. There are many reasons why a participant's forward view of prices would change, although the rapid change of the September contract price is unusual. The MSA takes an interest any time that market prices or price changes are unusual. Further to that, some concerns were expressed by participants about the steep decline in price and possible infractions against the MSA's Trading Practices Guideline (TPG).

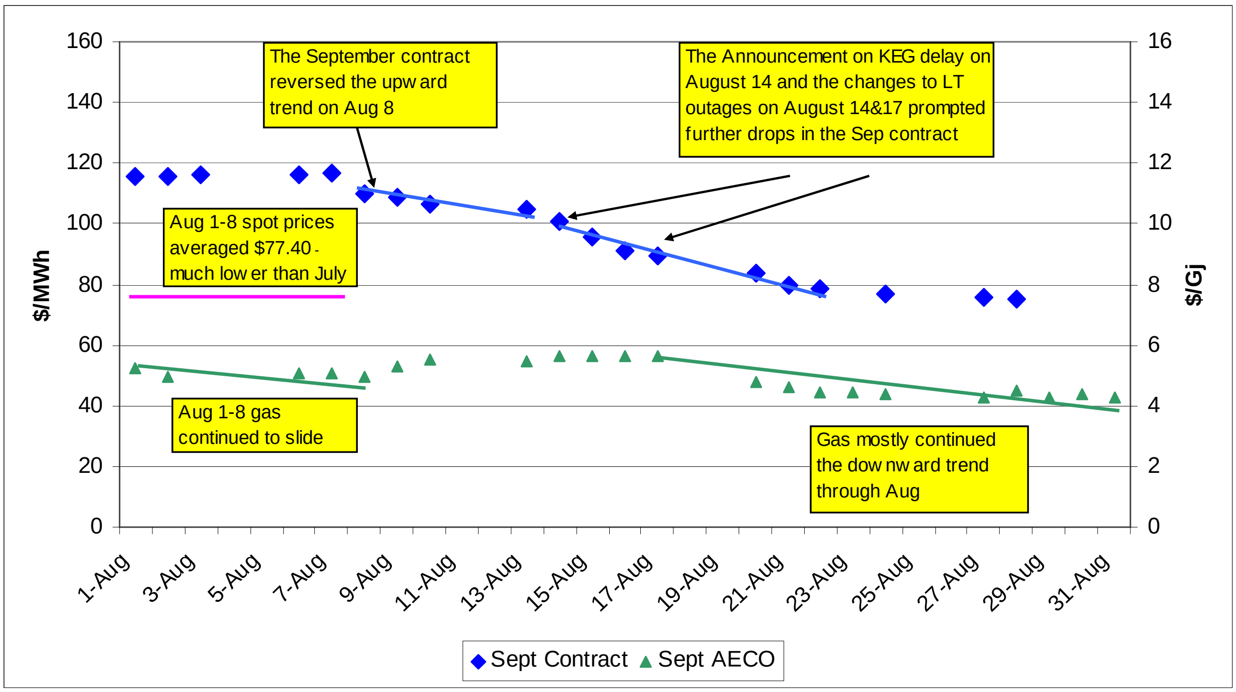
The MSA monitoring team has undertaken its review of the circumstances surrounding the rapid changes in the September contract price and has assured itself that they were in all likelihood driven by market fundamentals. We have found no evidence of any untoward behaviour in terms of breaching the TPG.

The September contract first began trading in significant volumes in June and July, 2007. At that time prices were quite bullish despite the forward price of natural gas being in decline. The main driver of this high-price outlook appeared to be the S-KEG Conversion Project and its effects on supply. The project was slated for the September-October period and its execution would require several unit outages and derates, above and beyond any other maintenance in this time period. The project execution would also negatively impact the capacity of the intertie thus further tightening the supply situation in the September-October period. Coming into August, the September contract was trading near $120/MWh, a market Heat Rate of over 20GJ/MWh. Prior analysis of tight market conditions, such as the high prices over October and July, 2006 had indicated that at low capacity cushion values the **daily** market heat rate tends to increase dramatically – the break out value of market heat rate being about 20GJ/MWh. For the forward market to price the **month** of September at >20GJ/MWh is an indication of the level of implied scarcity. Also, any news that would have a bearing upon the supply-demand situation for September could be expected to move the price quite significantly – either up or down.

Figure 1 shows the development of the price of the September contract over the month of August and it is apparent how significantly the price moved – a reduction of close to $40/MWh. On a standard 25MW contract the implied loss in value is more than $700,000. The price of natural gas (AECO) is normally an important factor in the pricing mechanism and is shown on Figure 1 along with daily average spot market prices as they too can stimulate the forward view of a trader. In August, the September contract is the prompt month that usually trades the heaviest and the price can be quite responsive to market 'news'. Also shown on Figure 1 is the date (August 14) when AESO announced the deferment of the S-KEG Conversion Project. The largest declines in the September contract occurred after this announcement. However, price had already come off prior to August 14. The declines after August 14 are logical given the delay of the S-KEG project and the changes to planned outages that occurred shortly thereafter (and are discernable by market participants from the outage graphs).

Focusing on the period ahead of the public announcement on August 14, there are a number of market features that might explain some of the drop in price. Pool prices in early August were settling much lower than July that had managed to settle at more than $150/MWh. The price of natural gas was sliding but given the high market Heat Rate this wouldn't be a significant factor. A planned unit outage was removed from the September period which traders could see in a change to the outage graph on the AESO's web site and would be a bearish signal. Stop loss orders by some traders might have further exacerbated the slide. Whether the foregoing is sufficient to explain the drop in price is an open question.

Figure 1 – Evolution of the Price of the September Electricity Contract



We have excellent visibility into trading activity on NGX including who sold what to whom and at what price. Our visibility into trades through the brokers and straight bi-laterals is not as good. We had discussions with both traders and brokers on this matter. The AESO provided information on the critical time lines of the S-KEG Conversion project and background on the various attempts to rescue the project schedule following the July 19 equipment testing failure. Some information we gleaned from these combined sources is relevant. About a week before the AESO notice on the S-KEG delay someone was shopping a 'put' through a broker – a definite bearish sign, but one that still indicates some uncertainty on the part of the would-be buyer. On August 8, when the September contract first began to slide, several participants were selling and buying. This is not a sign of the activity being driven by one or two parties in the 'know'. In the same week, one participant called the AESO several times asking about the status of the S-KEG project – a sign that perhaps participants were becoming aware of the risks faced by the project.

The first sign of a major problem for the S-KEG project was on July 19 when a transformer failed factory testing. Subsequently, the project team investigated numerous ways to try to overcome the problem before ultimately announcing the decision to delay the project on August 14. Throughout the July 19 to August 14 period the S-KEG Conversion Project was likely at increasing risk of delay as the team sought to overcome the problem. Similarly, it must be said that there was a corresponding increasing risk that market participants would somehow become aware of this project risk and adjust their forward view of the market prices for September. We have no clear evidence of someone obtaining such information and then using it to take undue advantage of the knowledge.

There were several changes to planned unit outages originally scheduled for September and either cancelled or rescheduled. The data did not indicate any untoward trading activity by the relevant parties and we have not had any indications by market participants of being 'run over' by a counter party. Hence we have no evidence of insider trading and breaching of the TPG.

The TPG applies to transmission outages as well as generation outages. There are some differences between the two. In the case of a generating unit it is usually the unit owner who controls the outage and thus has the responsibility to make the information public ahead of managing his position. Making the information public is achieved by informing the AESO who in turn update the outage graphs on their web site. AESO generally controls the transmission system in Alberta and outages are under its control, and executed by the applicable transmission companies. Once an outage is scheduled it is normally made public by posting the information on the AESO's web site under Long-Term Critical Outages. Most transmission outages have little effect on the market (except for those on the interties) since the system is robust and has built-in redundancy. The S-KEG Conversion Project is unusual in its significant market effects. The lack of updates meant that the market was missing a significant piece of information to manage its risks for the September contract.

If one could be sure that the information on the project was sealed tight then there is no possible preferential leakage of information to any parties. The chances of that persevering for a period of nearly four weeks seems low. From an efficiency perspective it would have been better for the AESO to have posted regular status updates providing a general description of what had transpired and the next steps in the project. This would have ensured that all market participants were equally informed on the matter. We have had discussions with the AESO and they are reviewing the procedures in place to manage and control public and confidential information.

If you have questions please feel free to contact Jenny Chen (705-3193) or the undersigned.

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