

RELIABLE

Alberta Electric System Operator

2004 ANNUAL REPORT

RELIABLE POWER. RELIABLE MARKETS. RELIABLE PEOPLE.

2004 AESO ANNUAL REPORT

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THE YEAR 2005 REPRESENTS A NEW FOCUS FOR THE AESO.

THE YEAR 2005 REPRESENTS a new focus for the AESO.

Two of our current senior executives, both of whom are well known to the AESO and the industry, have assumed leadership of the day-to-day operations of the company. In February, the AESO Board appointed

Dale McMaster Chief Operations Officer (COO), while David Erickson, Chief Financial Officer (CFO), assumed additional executive accountabilities.



Maury Parsons
AESO Board Chair

THE AESO BOARD PROVIDES EFFECTIVE GOVERNANCE LEADERSHIP WITH RESPECT TO THE AESO'S PUBLIC INTEREST MANDATE. THE AESO FULFILLS A POWERFUL, UNIFYING ROLE, WHICH IS CRITICAL TO LEADING THE PRUDENT AND PRACTICAL IMPLEMENTATION OF GOVERNMENT ELECTRICITY POLICY.

These extremely capable leaders have re-aligned the structure of the company to ensure focus on our core business. Dale and David will harness the talents and skills of our employees, in collaboration with our stakeholders, to deliver on key corporate objectives that affect the success of the entire industry.

The AESO will continue to focus on improving power system reliability, enhancing transmission access, strengthening the provincial grid and implementation and operation of fair, open and competitive electricity markets. We will effectively manage risk and cost, enhance stakeholder

relationships and improve teamwork within our organization.

I invite you to read the messages in the following pages for details about the AESO's core business priorities for the coming year.

I would like to elaborate on two of these areas from a corporate governance point of view. With respect to cost management, our objective is to provide effective and prudent stewardship of industry costs as we fulfill our mandate. The AESO will be implementing additional cost and risk management as required to ensure we have the appropriate controls in place.

We are also aware of the magnitude of challenging work ahead as we continue to provide improved system reliability, develop and execute critical transmission plans and implement any changes reflected in the government's upcoming wholesale market policy.

The AESO will ensure that we have the talents and expertise to be successful in these key areas.

We look forward to collaborating with our industry stakeholders in developing solutions that respect and balance diverse business needs.

DEVELOPING MORE EFFECTIVE WORKING RELATIONSHIPS.

IN CLOSE COLLABORATION WITH STAKEHOLDERS, THE AESO IS WORKING HARD TO IMPROVE THE OPERATIONS OF ALBERTA'S FAIR, OPEN, EFFICIENT AND RELIABLE TRANSMISSION SYSTEM AND COMPETITIVE MARKETPLACE FOR ELECTRICITY.

Our focus will include developing more effective working relationships with our colleagues at the Alberta Energy and Utilities Board, the Market Surveillance Administrator and the Balancing Pool. We believe that by working together more collaboratively, while respecting each other's unique mandates, we can deliver greater efficiencies for the industry overall.

The AESO Board has built a solid governance approach that ensures the AESO's corporate goals and objectives are designed to contribute to advancing the principles of a competitive electricity marketplace. To this end, the AESO is proactively planning and reinforcing Alberta's power grid, which is a key element in facilitating a competitive marketplace. The AESO will also take a critical role in implementing any recommendations from the government's wholesale market policy. The end result of these core business activities will be an attractive market for investors—those looking to build more supply, and those looking to expand or bring their business to the province.

In carrying out its mandate of leading the safe, reliable and economic planning and operation of Alberta's electricity system, and facilitating a fair, open and efficient competitive wholesale market, the AESO has a unique role with a vast impact.

We understand and respect the fact that our plans and activities have a broad reach, often affecting every part of our industry. We understand that our public interest role is critical as we work hard to achieve balance and openness in all our dealings with stakeholders. It is clear that the AESO can take a leadership role in unifying diverse points of view, and that we must achieve this in a way that is realistic, cost effective, prudent and in the best interests of the overall marketplace.



[STANDING L to R] Dr. Ron George | Bob McKenzie | Dr. John Feick | Bill Burch | Murray Nelson [SEATED L to R] Maury Parsons | Nancy Laird | Harry Hobbs

AESO Board members work to maintain a close connection with stakeholders and their interests. For instance, the AESO Board has conducted meetings in different areas of the province to meet industry stakeholders, visit their operations and gain a better understanding of their business needs and concerns.

During 2004, we further strengthened the AESO's Board with two new members: Harry Hobbs who joined in August, and Murray Nelson who joined the Board in October. Our new members add to the Board's depth of expertise in the energy and electricity industries, and complement the diverse business

and entrepreneurial experience of existing Board members. The AESO's Board members are independent of the industry with expertise in a broad range of backgrounds, including finance, auditing, technology, electricity and oil and gas businesses, energy management and regulatory affairs.

In closing, I wish to acknowledge the outstanding contribution of our employees, who are steadfast in their commitment to work in collaboration with stakeholders to develop a balanced, prudent and realistic approach to implementing policy and plans to continue to improve Alberta's competitive electricity marketplace. I would

also like to acknowledge our colleagues throughout industry, government and other agencies for their cooperation and contribution to our initiatives, plans and projects during 2004. We look forward to working together in the coming year.

Maury Parsons

Maury Parsons
AESO Board Chair

March 2005

**RELIABLE POWER. RELIABLE MARKETS. RELIABLE PEOPLE.
THAT'S WHAT THE AESO IS ALL ABOUT.**

IT'S OUR CORE BUSINESS.

THE AESO IS FOCUSED on achieving key objectives in the following areas: reliable system operations, planning the future development of the transmission system, providing customers with access to the transmission system, operating fair, open and efficient markets for electricity and administration and regulation of the load settlement function.



David Erickson
Chief Financial Officer



Dale McMaster
Chief Operations Officer

“WE ARE FOCUSED ON CREATING SUCCESSFUL CONSULTATION BASED ON MUTUAL TRUST AND RESPECT THAT ENSURES DECISIONS BALANCE DIVERSE INTERESTS IN A FAIR MANNER.”

reliable operation fair market cost effective stakeholder consultation risk management

Our corporate priorities are of great interest to our stakeholders and industry partners. What’s just as important in our business is the approach we use to go about achieving our objectives.

Our overarching corporate approach is to create efficient, cost-effective and quality stakeholder consultation, which is based on mutual trust and respect to help ensure our decisions balance diverse and often competing interests in a fair manner.

While we acknowledge that effective consultation may be a time-consuming process, we believe it will get us all to the right place faster. We don’t have a monopoly on good ideas.

We will do a better job of gathering input earlier in the process and achieving early agreement on identifying the problems we are trying to solve. We are committed to creating more effective collaboration with our industry partners, as well as the Balancing Pool, Market Surveillance Administrator and Alberta Energy and Utilities Board.

As our Chair, Maury Parsons, has pointed out in his message, we understand that the work we do affects every part of the industry. It’s a reality and a responsibility that we take very seriously. In fact, we think it’s critical to our public interest mandate that we take a leadership role, a unifying role if you will, to find the balance within the often complex and diverse viewpoints of industry.

It’s not surprising that we have a rich mix of opinions in our industry. Alberta has been one of the leaders in the development and operation of competitive markets for electricity and has some of the most experienced and knowledgeable people in the business.

We think that’s a plus, and we plan to leverage this advantage as we explore the best ways to implement any new market policy and regulations, operate and plan the development of the transmission system, and address load settlement issues.

We invite you to review the following sections, which include additional detail on our priorities for the coming years.

“WHILE WE ACKNOWLEDGE THAT EFFECTIVE CONSULTATION MAY BE A TIME-CONSUMING PROCESS, WE BELIEVE IT WILL GET US ALL TO THE RIGHT PLACE FASTER. WE DON’T HAVE A MONOPOLY ON GOOD IDEAS.”

MARKET DEVELOPMENT AND OPERATIONS

■ Ensure that as Alberta’s competitive electricity markets evolve, they are operated in the best way possible, demonstrating that reliability is not compromised and that the structure is sustainable, predictable and adds long-term value. ■ Provide assistance to the Department of Energy in development of wholesale market policy and associated regulations, if any. ■ Implement any wholesale electricity market policy changes or refinements to the market structure fairly and in a timely and coordinated manner that provides certainty to existing and new market participants. ■ Ensure Alberta’s openly competitive market is tightly aligned with evolving reliability standards. ■ Achieve progress toward reducing seams issues between Alberta and British Columbia markets to facilitate the competitive inter-jurisdictional exchange of energy.

SYSTEM OPERATIONS

■ Lead activities that demonstrate the utmost competence and confidence in the business continuity and operating reliability of the Alberta system. ■ Operate the transmission system in compliance with reliability and security standards in place throughout North America, including the Western Electricity Coordination Council’s Reliability Management System. ■ Ensure system reliability and the facilitation of competitive electricity markets by establishing appropriate system operating limits, which will be documented in the AESO’s Operating Policies and Procedures.

TRANSMISSION PLANNING AND ENGINEERING

■ Demonstrate leadership to achieve a coordinated approach to streamline the existing transmission facility application process, and implement effective stakeholder consultation that results in new transmission facilities in place on a timely basis. ■ Proactively identify, plan and achieve approvals for, and initiate implementation of, needed transmission system reinforcements and upgrades so that transmission facilities are in place to ensure reliable and economic operation of the grid and facilitation of the competitive electricity marketplace. ■ Achieve timely and effective implementation of the Transmission Regulation in a coordinated manner with industry stakeholders. This work includes completion of the 10-year system plan and the 20-year transmission outlook, as well as implementation of required rule and tariff changes. ■ Make progress toward restoring Alberta’s transmission system interconnections with British Columbia and Saskatchewan to their original design capacity. Under normal system operating conditions, this would allow for imports and exports to flow on a continuous basis at or near the transmission path rating. The AESO’s transmission development need applications currently filed or in progress will strengthen the grid, which is required to restore capability on the interconnections. ■ Successful implementation and operation of the transmission interconnection process, which was redesigned with stakeholders in 2004. This process is designed to meet customer requirements on a timely basis, thereby improving customer satisfaction. ■ Support timely and coordinated development of merchant transmission lines, while ensuring system reliability is maintained or enhanced.

LOAD SETTLEMENT

■ Complete the Electronic Load Settlement (e-LSI) initiative to enable the AESO to better fulfill its mandate to administer, monitor and ensure compliance with provincial load settlement rules. ■ Successful ongoing stakeholder consultation to develop and determine additional activities required to complete subsequent phases of the e-LSI initiative.



[L to R] David Erickson, *CFO* | Dennis Kalma, *CIO* | Neil Millar, *VP Transmission* | Dale McMaster, *COO*

In addition to prudently managing risk and costs, we will build the kind of workplace where people enjoy coming to work every day and take pride in the work they do for the AESO and our industry partners.

We hope our message has provided you with some insight into what we're focused on and how we're planning to achieve some of our core business objectives. We have every confidence in the talent and skills of all our employees who will be working with you and for you to address concerns, solve problems, provide quality service and continue to invent better ways to take care of business.

Dale McMaster
Chief Operations Officer

March 2005

David Erickson
Chief Financial Officer

Electric System Operations

TO ENSURE THAT THE ALBERTA INTERCONNECTED ELECTRIC SYSTEM IS OPERATED IN A SAFE, RELIABLE AND ECONOMIC MANNER.

ENSURING RELIABILITY

The system coordination centre (SCC) is the hub of Alberta's Interconnected Electric System. The SCC and our Operations and IT teams encompass the people, the policies and the technology that keep the lights on in Alberta.

During 2004, we implemented a third desk in the SCC to meet increasing workload and to ensure ongoing reliable system operations. We developed training tools and advanced applications to assist in system and market operations and conducted thorough training programs. All of our system controllers are now certified by the North American Electric Reliability Council (NERC), and the AESO has been certified as a continuing education provider by the NERC.

In addition, we have implemented an ongoing training program to make sure that our controllers have the latest information and tools to effectively manage system reliability and market operations, as their job becomes increasingly complex.

To ensure system reliability and the facilitation of competitive markets for electricity, appropriate system operating limits were established and documented in the AESO's Operating Policies and Procedures. While these policies and procedures are critical, we also acknowledge that the cooperation we receive from other operators in facilities throughout Alberta and beyond is absolutely vital in maintaining reliability.

PREPARING FOR A NERC/WECC AUDIT

Our cross-functional teams are preparing for a NERC/Western Electricity Coordination Council (WECC) compliance audit in May of 2005. In addition to our ongoing program to test our readiness and operating expertise, we welcome this external review of our policies and procedures to ensure that we meet the reliability standards and continue to learn from the experience of others. This audit will be based on the NERC's Version 0 standards, which were effective April 1, 2005.

The AESO endorses the creation of mandatory reliability standards. We supported the efforts of NERC in converting its policies into standards. While these standards remain voluntary, they are an important first step toward mandatory standards. The AESO published its own reliability criteria in 2004, and we operate in compliance with the WECC Reliability Management System.

KEY OPERATIONS ACTIVITIES

During 2004, the AESO was involved in development of the NERC functional model, which is an organizational matrix of the responsibilities that used to be carried out by the traditional control area operator and are now disaggregated among various operating entities.

The AESO has registered for four entities related to the functional model: Balancing Authority, Transmission Operator, Transmission Planner and Planning Authority. The Interchange Authority is not yet available for registration.

Another important area of work for the AESO last year was taking the lead in establishing the Alberta Electricity Sector Security Group, which is addressing security issues for the industry.

This group includes the transmission facility owners, the Alberta Department of Energy, the Alberta Energy and Utilities Board (EUB) and Emergency Management Alberta. This group will focus on the creation, testing and continuous improvement of an industry-wide electricity crisis management plan, including elements to address counter-terrorism. This work will leverage crisis management plans that are already in place within each organization.

In late 2004, the AESO also successfully completed an industry-wide drill of its system restoration plan for the provincial grid. Thirty-eight industry partners participated in the drill, which has resulted in suggestions to improve the plan and ongoing preparedness. Work on this initiative is continuing in

2005, with another industry-wide drill likely to occur to test the enhancements to the plan.

The AESO would also like to acknowledge the cooperation of industry during the commissioning of a significant new generating unit—Genesee 3—during the latter part of 2004 and the first quarter of 2005.

Bringing a new 450-megawatt generator onto the system smoothly is no small feat. This work requires some critical coordination between our planning, operations and IT personnel, our customers and our operating partners.

Transmission Planning and Engineering

STRENGTHENING ALBERTA'S TRANSMISSION SYSTEM

We are continuously assessing the needs of the transmission system to continue to meet reliability standards and requirements. In compliance with the Transmission Regulation, we are planning the development of the grid to ensure transmission is in place ahead of generation development and load growth to facilitate a competitive marketplace for electricity in Alberta. Our activities in this area are guided by the government's Transmission Development Policy, released in late 2003 and the Transmission Regulation, which was completed in August 2004.

Last year, the AESO filed more than 50 need applications with the Alberta Energy and Utilities Board (EUB) to reinforce and expand the provincial grid. More than 45 of our pending need applications were approved by the EUB in 2004. While many of these applications addressed smaller local and regional transmission enhancements, we also filed two applications for significant development of the system. One of these developments will reinforce the Edmonton to Calgary corridor—the backbone of the provincial transmission grid—and the other will develop transmission infrastructure to improve reliability and provide system access to wind generators in the southwest region of Alberta.

Developing need applications requires complicated technical analysis of the existing system, extensive system modeling under various operating conditions, and detailed economic analysis.

In other words, it takes the time and talents of many of our employees to compile, dissect and analyze the information required to put together a comprehensive application to effectively describe the need for transmission facilities.

We recognize the value of this work, which reflects our own public interest mandate, and that of the EUB in ensuring that the needs of the system, the overall marketplace and the citizens of Alberta are balanced.

The EUB held a hearing in Lethbridge in July for the southwest Alberta application, and a second hearing in Calgary in December and January for the Edmonton to Calgary reinforcement.

These types of major regulatory activities require a significant amount of time and commitment from employees across the AESO in terms of preparing information for our witness panel and responding to information requests from industry.

At the time of writing this report, the first quarter of 2005, we are awaiting decisions from the EUB on these two important applications. If the EUB approves these

applications, the next stage is for the AESO to assign the work to the incumbent transmission facility owner as per the Transmission Development Policy and Transmission Regulation.

With respect to the Edmonton to Calgary reinforcement application, after receiving the EUB's decision, the AESO will ensure there is a transparent and timely process in place to provide stakeholders with ongoing reports during the construction and energization phase. We will work with the EUB and stakeholders to develop that process.

In 2005, we expect to be implementing the EUB decisions on both of these major applications as well as another application to enhance Calgary reactive power supply, and moving forward on our initiative to relocate our system coordination centre (SCC) to enhance security requirements, and hence the operating reliability of the system.

During the coming year, we will file need applications for critical transmission reinforcements for the city of Edmonton, and for the northwest and the southeast regions of Alberta.

LONG-TERM PLANNING

In late 2004, we filed our first 10-year transmission system plan 2005-2014, which provides information on current and forecasted market needs and the infrastructure developments required to address them. The AESO will also publish its first 20-year outlook in mid-2005.

The transmission outlook will provide a high-level overview of how the transmission system might develop for alternative generation development and load growth scenarios. The 20-year outlook is intended to provide context for development of the 10-year system plan and transmission need applications. The outlook is not a plan, in that it is not used to make decisions on which facilities will be built; those decisions will continue to be driven by transmission need applications.

The AESO's newly-formed Transmission Advisory Committee, comprised of knowledgeable industry representatives, is providing input into the 20-year outlook and our ongoing plans and activities. The AESO is also planning to consult with other stakeholders in developing the 20-year outlook.

IMPROVING CUSTOMER INTERCONNECTIONS

The transmission interconnection process is used when a customer makes a request to interconnect facilities to the transmission grid. During 2004, the AESO led a team of key industry partners who committed time, energy and people to help redesign a process that was seen as slow, complicated and inefficient.

There are several players who have unique roles and accountabilities within this process and the AESO saw it as an opportunity to explore a new way to develop a solution. The team worked together throughout the year to examine all the elements in the process and create something different, something that works better.

The proof of our success will be in the delivery: will it work better and will customers agree that the process is easier, more efficient and will result in the timely delivery of the required interconnection?

Our employees are completing the implementation phase of the project in 2005, which involves aligning our internal functions and those of other industry partners. However, we believe that we can already claim some success due to the way in which industry players came together to create a solution to issues that were affecting us all.

Rather than sit back and continue to be frustrated working with something that wasn't effective,

everyone had the foresight and commitment to take some action to make it better.

We believe this is a model for how we can continue to work with our colleagues in industry to tackle the diverse issues facing our business. The AESO looks forward to working with industry partners, stakeholders, and other implementing agencies in the coming year.

In addition, we would like to acknowledge the many organizations and their staff who share in the success to date on the interconnection redesign: the Energy and Utilities Board, AltaLink, ATCO Electric, EPCOR, ENMAX, PetroCanada,

FortisAlberta, Encana and VisionQuest.

In 2004, we implemented a new customer scorecard to measure how well we were meeting timelines for customers. At year end we met time delivery commitments for major milestones for all interconnection projects 89 per cent of the time, and achieved a 70 per cent customer satisfaction measure.

We would like to acknowledge our customers for their patience and support as we continue to make improvements to how we deliver service.

Market Development and Operations

During 2004, the AESO held a key role as co-chair, with the Department of Energy, of a stakeholder consultation process for a holistic review of Alberta's wholesale electricity market. The review, which began in March of 2004, included a task force group and several sub-committees who explored some of the key issues identified by industry. This work culminated in a draft wholesale market policy released by government for stakeholder input early in March of 2005. The timeline for a final policy is expected to be in early summer with regulations to follow.

As a key implementing agency, the AESO has supported the development of the discussion paper and looks forward to providing its comments during the consultation period. We will be carefully reviewing stakeholder comments with an eye to implementation. We will be working in collaboration with stakeholders and other agencies to develop our implementation plan and our own stakeholder consultation process to create solutions and resolve issues. We also expect that the policy paper will provide some direction on specific enhancements that can be done quickly to improve market performance.

In fact, one of the market issues raised last year, short-term adequacy, was identified as something that could be addressed on an interim basis in the near term, and as such the AESO began to develop potential rules for industry review and comment.

This proposal evolved into a collaborative process where stakeholders became involved in clarifying and identifying the issue upfront and developing an effective interim solution.

The short-term adequacy interim solution and rule changes that were implemented in December 2004 require that physically available energy must be offered

and/or declared as available to the AESO system controller a day ahead through the energy trading system.

This change provides the system controllers with day-ahead information about the maximum available energy for each hour of the delivery day, including unoffered supply. This results in enhanced visibility of available market resources, which can be used by the system controllers to effectively manage reliability.

In 2004, the AESO created a new function to manage compliance with market rules, a much needed addition to help ensure a fair, open and competitive market for electricity.

A compliance monitoring plan and subsequent rules are being developed with stakeholder involvement and input during the first part of 2005. We expect this role will add clarity with the end result delivering enhanced confidence and sustainability within the Alberta marketplace.

Load Settlement

IMPROVING LOAD SETTLEMENT

In 2004, the AESO conducted extensive consultation with stakeholders about how to develop and implement the electronic load settlement (e-LSI) compliance monitoring tool. During this consultation many issues were raised and debated. We under-estimated some of the issues and strong opinions of industry, and we took a break in our implementation schedule and stepped up our consultation so we could gain a better understanding, and move forward with greater cooperation and collaboration.

Load settlement is another example of where the impact of the AESO is abundantly clear. We see this initiative as an opportunity to provide a unifying role. On the one hand we have been given the mandate to administer, monitor and ensure compliance with load settlement rules in the province. To do that work well, we need to develop systems, tools and processes.

On the other hand, this work has significant impact on the operations of our industry partners. In order to proceed at a pace that is balanced and respectful of all participants, we have revised the project scope to implement the first phase of e-LSI in the fall of 2005. We will continue to consult with stakeholders on subsequent phases and have established advisory committees to provide direct input on an ongoing basis.

RELIABLE POWER. RELIABLE MARKETS. RELIABLE PEOPLE.

IT'S OUR CORE BUSINESS.

MANAGEMENT'S DISCUSSION AND ANALYSIS

This discussion and analysis should be read in conjunction with the financial statements and auditors' report included in this annual report. In accordance with its terms of reference, the Audit Committee of the Alberta Electric System Operator (AESO) Board has reviewed and approved the contents of this Management's Discussion and Analysis.

The AESO is responsible for the operation of the competitive power pool; determining the order of dispatch of electric energy and ancillary services; providing system access service on the electric transmission grid; directing the safe, reliable and economic operation of the interconnected electric system; planning the capability of the transmission system to meet future needs; and regulating and administering load settlement.

1 AESO GOVERNANCE

The AESO is governed by the AESO Board, whose members are appointed by the Alberta Minister of Energy (Minister) and are independent of any person or entity having a material interest in the Alberta electric industry. In accordance with the AESO bylaws, the AESO Board must recommend to the Minister individuals to be appointed as members and may recommend to the Minister an individual to be designated as chair. The AESO Board is to have no more than nine members.

The AESO Board is responsible for overseeing the business and affairs of the AESO. The AESO Board is actively involved in the strategic planning process. The AESO Board discusses and reviews all materials relating to the strategic plan with management. At least one Board meeting per year is devoted to discussing and considering the strategic plan, which takes into account the risks and opportunities of the AESO.

The AESO Board has two standing committees:

- The **Audit Committee** reviews and monitors the financial reporting process, the system of internal controls, the systems for managing risk, the audit process and the AESO's process for monitoring compliance with laws and regulations, with a view to ensuring best practices are followed.
- The **Human Resources Committee** provides advice and recommendations to the AESO Board on executive compensation levels, CEO performance, officer selection, and human resources programs (including salary planning and incentive design), and shares information on current human resources practices.

Each committee operates in accordance with a charter that has been approved by the full AESO Board.

2 2003 REPORTING BASIS

On June 1, 2003, the AESO was established under the *Electric Utilities Act* (EUA-2003). Upon formation, the AESO assumed the duties of the Power Pool Council (Council), excluding the Balancing Pool Administration (BPA) and the Market Surveillance Administration (MSA) functions, which were transferred to separate and distinct statutory corporations.

The audited financial statements for the year ended December 31, 2003 reflect the operations of the Power Pool of Alberta (excluding the BPA and including the MSA) and the Transmission Administrator of Alberta Ltd. (TA) for the five months ended May 31, 2003, together with the operations of the AESO for the seven months ended December 31, 2003. The revenue and costs of the AESO for the period June 1 to December 31, 2003 do not include amounts collected on behalf of the MSA or the costs associated with operations of the MSA during this period.

The December 31, 2003 audited financial statements were prepared using continuity of interest accounting in accordance with Canadian generally accepted accounting principles. For further discussion on continuity of interest accounting, see Note 1 – Basis of Presentation of the audited financial statements.

3 OPERATING RESULTS

The AESO, a not-for-profit statutory corporation, recovers its operating and capital costs through three separate revenue sources, each of which is designed to recover the costs directly related to the provision of a specific service, as well as a portion of the shared corporate service costs. The overall revenues and costs of the AESO are as follows:

(\$ MILLIONS)	2004	2003	VARIANCE	% VARIANCE
Transmission revenue	\$ 662.3	\$ 704.7	\$ (42.4)	(6)
Energy market charge	12.2	12.6	(0.4)	(3)
Load settlement recovery	1.9	2.4	(0.5)	(21)
Interest and other income	0.6	5.3	(4.7)	(89)
Wire costs	\$ 398.1	\$ 327.8	\$ 70.3	21
Ancillary services costs	123.0	155.8	(32.8)	(21)
Line losses	109.1	186.2	(77.1)	(41)
General and administrative	35.9	34.1	1.8	5
Amortization and depreciation	5.6	10.4	(4.8)	(46)
Other industry costs	5.0	9.2	(4.2)	(46)
Interest expense	0.7	1.0	(0.3)	(30)

4 REVENUE

EUA-2003 requires that the AESO be operated so that no profit or loss results on an annual basis from its operations. To achieve this, revenue is recognized to the extent of annual operating costs, including the amortization of capital assets. When the annual sum of collections differs from the annual operating costs, the difference is recorded as deferred revenue.

4.1. Transmission

(\$ MILLIONS)	2004	2003	VARIANCE	% VARIANCE
Transmission revenue	\$ 662.3	\$ 704.7	\$ (42.4)	(6)
Interest and other revenue	0.0	4.1	(4.1)	(100)
Total transmission revenue	\$ 662.3	\$ 708.8	\$ (46.5)	(7)

The AESO is responsible for paying all the costs of managing the transmission system and recovering those costs through a tariff approved by the Alberta Energy and Utilities Board (EUB). The tariff is designed to allocate the costs to all users of the transmission system based upon their level of usage.

On a monthly basis, the AESO invoices its customers for system access services based upon approved tariff rates. The AESO also pays for costs associated with providing system access services. The monthly differences in the revenues collected and the costs paid are accumulated in the AESO's transmission deferral account. The accumulated variance between the revenues and costs can be attributed to several factors:

- The timing of revenue and costs (monthly fluctuations);
- Unanticipated forecast changes (pool price volatility and meter volumes); and,
- Any misalignment of approved rates and the current year revenue requirement (delays in having the current year rates approved by the start of a year).

As part of the transmission tariff, Rate Rider C is intended to restore the deferral account balances to zero over the following calendar quarter. It is a dollar per megawatt hour (MWh) collection or payment by rate class and rate component.

In circumstances where annual collections are in excess of the transmission costs, the excess amount is recorded in the deferral accounts and refunded in subsequent years. In circumstances where annual collections are less than the transmission costs, the shortfall is recovered in subsequent years.

(\$ MILLIONS)	2004	2003
Collections	\$ 733.0	\$ 646.4
Costs	662.3	708.8
Transmission deferred revenue	\$ 70.7	\$ (62.4)

On an annual basis, transmission collections are dependent upon approved transmission tariff rates, pool price and volumes of energy transmitted. Transmission costs are discussed in the following section.

As a result of the 2004 surplus in collections, the transmission deferral amount at December 31, 2004 is \$30.1 million payable to transmission customers, compared to \$40.2 million receivable at the end of 2003. Through the Rate Rider C mechanism, the December 2003 deferral balance was collected in early 2004. In the latter part of 2004, and subsequent to determining the fourth quarter Rate Rider C rates, a one-time adjustment of \$32.7 million to transmission line loss costs and transmission revenues was made for a correction of customer meter data for 2004 and prior years. This adjustment reduces transmission line losses and transmission revenues, resulting in a collection surplus in 2004. As a result, the December 2004 deferral balance is a \$30.1 million surplus.

The interest revenue in 2003 related to non-recurring interest payments received by the AESO related to EUB decisions for the settlement of prior year deferral accounts and the negotiated settlement of transmission must-run compensation for 2001 and 2002.

4.2. Energy Market

(\$ MILLIONS)	2004	2003	VARIANCE	% VARIANCE
Energy market charge	\$ 12.2	\$ 12.6	\$ (0.4)	(3)
Interest and other revenue	0.6	1.2	(0.6)	(50)
Total energy market revenue	\$ 12.8	\$ 13.8	\$ (1.0)	(7)

The AESO recovers the costs of operating the real-time energy market through an energy market charge on all MWhs traded. The energy market trading charge for a period is set to recover the operating costs and the amortization of capital assets during that period.

In circumstances where annual collections are in excess of energy market costs, the excess amount is recorded as deferred revenue and incorporated into a reduction in the following year's required energy market trading charge. In circumstances where annual collections are less than the energy market costs, the shortfall is recorded as deferred revenue and collected in the following year.

The energy market deferral amount is comprised of two components:

- The accumulated difference between revenues collected and costs paid that is receivable from or payable to pool participants; and,
- The unamortized portion of system controller capital assets that were recovered from transmission customers in prior years by the TA. The revenue associated with the system controller capital assets is recognized by the AESO over the useful life of the assets. These assets will be fully depreciated in 2008.

For 2004, the energy market trading charge was 11.1 cents per MWh compared to 10.0 cents per MWh in 2003, an increase of 1.1 cents.

(\$ MILLIONS)	2004	2003
Collections	\$ 13.3	\$ 12.3
Costs	12.8	13.8
Energy market deferred revenue	\$ 0.5	\$ (1.5)

Energy market collections are dependent upon the annual energy market trading charge and the volume of energy traded through the power pool. The increased energy market trading charge in 2004, offset marginally by a reduction in other income, resulted in the higher energy market collections. Energy market costs decreased in 2004 due to reductions in general and administrative, depreciation and interest costs.

The energy market deferral amount at December 31, 2004 is \$5.8 million payable compared to \$4.3 million payable at the end of 2003. The change of \$1.5 million during 2004 was a result of the following:

- Surplus collections in energy market trading charges;
- Depreciation of system controller capital assets; and,
- A reclassification of the 2003 MSA deferral balance to a separate deferral category.

Of the December 31, 2004 deferral surplus of \$5.8 million, \$3.9 million is payable to energy market participants and is incorporated into the trading charge requirements in 2005. The remaining deferral balance of \$1.9 million relates to the system controller capital assets.

With the creation of a separate statutory corporation for the MSA on June 1, 2003, the AESO facilitates the cash collection process for the funding of the MSA through a per MWh addition to the AESO's energy market trading charge. The MSA's revenues and costs are separate and independent of the AESO's financial records. The AESO records the difference between the payments made to the MSA and the collection on behalf of the MSA as a separate MSA deferral. At December 31, 2004 there was a \$0.2 million surplus in MSA collections, compared to a \$0.6 million shortfall at December 31, 2003.

4.3. Load Settlement

(\$ MILLIONS)	2004	2003	VARIANCE	% VARIANCE
Load settlement recovery	\$ 1.9	\$ 2.4	\$ (0.5)	(21)

The expenses that are incurred by the AESO to provide services related to administering and regulating provincial load settlement are charged to the owners of electric distribution systems and wire service providers conducting load settlement under the Independent System Operator (ISO)

rules. The costs associated with load settlement include direct function costs, an allocation of the AESO corporate shared services, and an allocation of amortization and depreciation for the recovery of capital acquisitions.

The difference in the annual collections and costs associated with load settlement is recorded as deferred revenue. On an annual basis, the load settlement deferral amount is charged or refunded to the owners of electric distribution systems and wire service providers.

(\$ MILLIONS)	2004	2003
Collections	\$ 2.7	\$ 2.2
Costs	1.9	2.4
Load settlement deferred revenue	\$ 0.8	\$ (0.2)

Load settlement collections are dependent upon the AESO's annual forecast of load settlement costs. Anticipated load settlement cost increases in 2004 did not occur.

5 OPERATING COSTS

5.1. Transmission System Costs

The costs of managing the transmission system are as follows:

(\$ MILLIONS)	2004	2003	VARIANCE	% VARIANCE
Wire costs	\$ 398.1	\$ 327.8	\$ 70.3	21
Ancillary services costs	123.0	155.8	(32.8)	(21)
Line losses	109.1	186.2	(77.1)	(41)
Other industry costs	5.0	9.2	(4.2)	(46)

5.1.1. Wires Costs

Wires costs represent the amount paid to the owners of the transmission facilities in accordance with their EUB-approved tariffs and are not controllable costs of the AESO. These costs increased \$70.3 million or 21 per cent compared to 2003 due to changes in the regulated rates charged by the transmission facility owners.

5.1.2. Ancillary Services

Ancillary services are procured by the AESO to ensure ongoing reliability of the transmission system. The AESO has entered into various contracts for ancillary services that include operating reserves, transmission must-run, system restoration, remedial action schemes and other support services.

The cost of ancillary services decreased from \$155.8 million in 2003 to \$123.0 million in 2004, a decrease of \$32.8 million or 21 per cent in 2004.

The ancillary services costs reflected in the 2003 audited financial statements have been adjusted for the impact of EUB Decision 2003-033, ordering a supplier of transmission must-run services to refund amounts to the AESO for the provision of services billed in 2002, together with interest charges. The impact of this decision has been reflected as a reduction in ancillary services costs of \$21.5 million in 2003 and as interest income of \$1.9 million in 2003.

Absent the impact of EUB Decision 2003-33, ancillary services costs in 2003 would have been \$177.3 million, which is \$54.3 million higher than the costs in 2004 and represents a decrease of 31 per cent. The primary cause of the reduction in ancillary services costs was a reduction in the average unit cost of operating reserves due to increased competition among reserve providers, as well as higher than expected unit availability allowing the AESO to rely less heavily on higher priced standby reserves. Operating reserve volumes for the year remained constant at approximately eight million MWh hours.

Transmission must-run costs were \$43.1 million in 2004 compared to \$47.1 million in 2003, a decrease of \$4 million or eight per cent. This decrease is a result of a reduction in the amount of transmission must-run required.

5.1.3. Line Losses

Transmission line losses represent the amount of energy that is lost as a result of resistance on the transmission lines. The volumes associated with line losses are determined through the energy market settlement as the difference between the generation and import volumes less consumption and export volumes. The line loss volumes are then valued at the hourly pool price. General operations and events on the Alberta Interconnected Electric System (AIES) will impact the hourly volumes of line losses.

The cost of line losses in 2004 is \$109.1 million compared to \$186.2 million in 2003, a decrease of \$77.1 million or 41 per cent. A one-time adjustment of \$27.5 million in 2004 to reflect an adjustment to energy market settlement data for periods prior to 2004 has been reflected as a reduction in the current year line loss cost. The remainder of the decrease in current year costs is a result of a reduction in the average pool price from \$63 per MWh in 2003 to \$44 per MWh in 2004, a 30 per cent reduction.

5.1.4. Other Industry Costs

Other industry costs represent certain costs the AESO funds on behalf of industry participants, including the costs of stakeholder participation in the AESO's regulatory proceedings, the cost of membership in the Western Electricity Coordination Council, and an allocation for EUB-related costs.

The decrease in other industry costs to \$5.0 million or a decrease of \$4.2 million in 2004 from the previous year's costs of \$9.2 million is due primarily to regulatory hearing costs. The regulatory hearing costs were higher in 2003 due to intervenor costs associated with the following EUB hearings that were approved in 2003: congestion management and Energy Provision of Ancillary Services (Article 24) of the transmission tariff.

5.2. General and Administrative Costs

In preparing the discussion on the AESO's costs, the aggregate of AESO costs across all functions are presented. The following table presents these costs:

(\$ MILLIONS)	2004	2003	VARIANCE	% VARIANCE
Salaries and benefits	\$ 22.8	\$ 18.5	\$ 4.3	23
Professional fees and consulting	5.2	7.0	(1.8)	(26)
Office and administrative	7.9	6.1	1.8	30
AESO transition	–	2.5	(2.5)	(100)
Total general and administrative	35.9	34.1	1.8	5
Amortization and depreciation	5.6	10.4	(4.8)	(46)
Interest expense	0.7	1.0	(0.3)	(30)
Total	\$ 42.2	\$ 45.5	\$ (3.3)	(7)

5.2.1. General and Administrative

- **Salary and benefits** > This increase is due to a full year's salary and benefits for staff hired during 2003 and additional staff hired in 2004.
- **Professional fees and consulting** > In 2004, there was a reduction in external legal costs in addition to a reduction in consulting costs for transmission planning, corporate regulatory and load settlement.
- **Office and administrative** > The increase in office and administrative costs is primarily due to the lease of the new office space. Generally accepted accounting principles dictate that the 10 month rent-free period received by the AESO in 2004 be recognized over the term of the lease; thus, a portion of the increase will be recovered in future years. A portion of the increase also corresponds with the increase in staff levels.
- **AESO transition** > These were non-recurring costs resulting from the merger of the Power Pool of Alberta and the Transmission Administrator.

5.2.2. Amortization and Depreciation

Included in the 2003 amortization and depreciation amount of \$10.4 million is the amortization of the acquisition costs of \$4.9 million that occurred in 2003 to recover the purchase price of the ESBI Alberta Ltd. shares and related acquisition costs from transmission customers. This was a non-recurring event. The depreciation of the AESO's capital assets in 2004 and 2003 is comparable at \$5.6 million and \$5.5 million respectively.

5.2.3. Interest

Interest expense is incurred as a result of bank debt held throughout the year. Interest costs are incurred to fund working capital due to timing differences in the collection of revenues and the payment of expenses, and for capital purchases.

5.2.4. Functional Cost Detail

The AESO has been organized to integrate the functions of transmission, energy market and load settlement to maximize the benefits from the merger under the EUA-2003. This integration results in cost allocations in many parts of the organization for the purpose of cost recovery. Management views the operations as one fully integrated operation. In determining the revenue requirement on a function-by-function basis, all AESO costs are assigned or allocated to one of the three functions.

The following table provides the 2004 and 2003 general and administrative, amortization and depreciation and interest cost detail by AESO function.

(\$ MILLIONS)	GENERAL AND ADMINISTRATIVE		AMORTIZATION/ DEPRECIATION		INTEREST		TOTAL	
	2004	2003	2004	2003	2004	2003	2004	2003
Transmission	\$ 25.7	22.8	\$ 1.6	6.2	\$ 0.2	0.4	\$ 27.5	29.4
Energy market	8.5	8.9	3.9	4.2	0.4	0.6	12.8	13.7
Load settlement	1.7	2.4	0.1	0.0	0.1	0.0	1.9	2.4
Total	\$ 35.9	34.1	\$ 5.6	10.4	\$ 0.7	1.0	\$ 42.2	45.5

5.3. Financial Position and Liquidity

(\$ MILLIONS)	2004
Cash and cash equivalents, beginning of period	\$ 120.6
Operating activities	\$ (136.7)
Investing activities	(11.5)
Financing activities	42.3
	(105.9)
Cash and cash equivalents, end of period	\$ 14.7

The cash balance as at December 31, 2004 was \$14.7 million compared to \$120.6 million at December 31, 2003. The decrease is primarily the result of the following:

- Operating activities used cash of \$136.7 million in 2004. The decrease is mainly attributed to a change in non-cash working capital of \$(142.3) million.
 - > Accounts receivable balance at December 31, 2004 was \$101.7 million compared to \$79.1 million at December 31, 2003, an increase of \$22.6 million. At the end of 2004, a receivable of \$32.7 million was accrued for a one-time adjustment for the correction of customer meter data for 2004 and prior years.
 - > Accounts payable balance at December 31, 2004 was \$85.2 million compared to \$201.6 million at December 31, 2003, a decrease of \$116.4 million. The most significant factor contributing to this decrease was the financial settlement of the 2000 to 2002 transmission deferral amounts and EUB Decision 2003-099 that occurred on January 30, 2004.
 - > Participants' security deposits balance at December 31, 2004 was \$4.3 million compared to \$7.2 million at December 31, 2003, a decrease of \$2.9 million. The balance of the security deposits held by the AESO is solely dependent on how participants elect to meet the AESO's security requirements.
- Investing activities used cash of \$11.5 million for the purchase of capital assets.
- Financing activities provided cash of \$42.3 million. Surplus cash of \$72.0 million was provided by the transmission and energy market functions through the deferral accounts with collections exceeding costs. This surplus was offset by the repayment of bank debt in 2004 of \$31.7 million.

As at December 31, 2004, the AESO had the following credit lines available to fund general operating and capital activities:

(\$ MILLIONS)	TOTAL	AVAILABLE	USED
Demand operating facility	\$ 10.0	\$ 0.0	\$ 10.0
Revolving credit facility	50.0	36.8	13.2

The revolving credit facility includes a \$10 million letter of credit option, which was fully utilized at December 31, 2004.

FINANCIAL STATEMENTS

For the year ended December 31, 2004

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The financial statements included in the annual report are the responsibility of management and have been approved by the Alberta Electric System Operator Board. These financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles, and include the use of estimates and assumptions that have been made using management's best judgement. Financial information contained elsewhere in this annual report is consistent with that in the financial statements.

To discharge its responsibility for financial reporting, management maintains a system of internal controls designed to provide reasonable assurance that the Alberta Electric System Operator's assets are safeguarded, that transactions are properly authorized and that financial information is relevant, accurate and available on a timely basis.

The financial statements have been examined by Deloitte & Touche LLP, the Alberta Electric System Operator's external independent auditors. The responsibility of these external auditors is to examine the financial statements and to express their opinion on the fairness of the financial statements in accordance with Canadian generally accepted accounting principles. The auditors' report outlines the scope of their examination and states their opinion.



M. Dale McMaster, PEng
Chief Operations Officer



David Erickson, CA
Chief Financial Officer

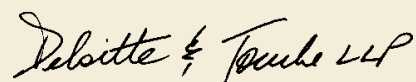
**TO THE MEMBERS OF
THE ALBERTA ELECTRIC SYSTEM OPERATOR BOARD**

We have audited the balance sheets of the Alberta Electric System Operator as at December 31, 2004 and 2003 and the statement of operations and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2004 and 2003 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Calgary, Alberta
January 28, 2005

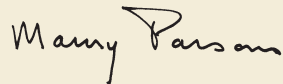


Chartered Accountants

AS AT DECEMBER 31, (IN THOUSANDS OF DOLLARS)	2004 <i>(notes 1 & 13)</i>	2003
Assets		
Current assets		
Cash and cash equivalents	\$ 14,670	\$ 120,647
Accounts receivable	101,711	79,089
AESO deferral accounts receivable <i>(note 4)</i>	–	37,160
MSA deferral accounts receivable	–	565
Prepaid expenses and deposits	1,963	1,591
	118,344	239,052
Capital assets <i>(note 5)</i>	22,465	16,492
	\$ 140,809	\$ 255,544
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities <i>(note 6)</i>	\$ 85,189	\$ 201,561
AESO deferral accounts payable <i>(note 4)</i>	35,745	–
MSA deferral accounts payable	181	–
Participants' security deposits <i>(note 11)</i>	4,329	7,232
Bank debt <i>(note 7)</i>	13,200	44,900
	138,644	253,693
Deferred rent	1,226	–
Long-term AESO deferral accounts payable <i>(note 4)</i>	939	1,851
Equity <i>(note 2)</i>	–	–
	\$ 140,809	\$ 255,544

Contingencies and commitments *(note 10)*

On behalf of the AESO Board:



Maury Parsons
AESO Board Chair



Robert McKenzie, CA
AESO Board Member

FOR THE YEAR ENDED DECEMBER 31, (IN THOUSANDS OF DOLLARS)	2004 <i>(notes 1 & 13)</i>	2003
Revenue		
Transmission revenue	\$ 662,261	\$ 704,692
Energy market charge	12,225	12,607
Load settlement recovery	1,881	2,410
Interest and other	594	5,324
	676,961	725,033
Operating costs and expenses		
Wire costs	398,089	327,794
Ancillary services costs <i>(note 8)</i>	123,020	155,845
Line losses <i>(note 9)</i>	109,149	186,202
General and administrative	35,908	34,141
Amortization and depreciation <i>(note 5)</i>	5,569	10,357
Other industry costs	4,961	9,172
Interest expense <i>(note 7)</i>	677	1,003
	677,373	724,514
Income before taxes	(412)	519
Current income tax recovery <i>(expense) (note 3)</i>	412	(519)
Net income	\$ -	\$ -

FOR THE YEAR ENDED DECEMBER 31, (IN THOUSANDS OF DOLLARS)	2004	2003
	<i>(notes 1 & 13)</i>	
Operating activities		
Net income	\$ –	\$ –
Amortization and depreciation	5,569	10,357
Decrease in future income taxes	–	(2,172)
Cash flows from operations	5,569	8,185
Changes in non-cash working capital*	(142,269)	171,805
Net cash (used in) provided by operating activities	(136,700)	179,990
Investing activities		
Purchase of capital assets	(11,542)	(3,731)
Net cash used in investing activities	(11,542)	(3,731)
Financing activities		
(Decrease) increase in bank debt	(31,700)	30,699
Increase in deferred rent	1,226	–
Increase (decrease) in AESO deferral accounts	71,993	(153,142)
Increase (decrease) in MSA deferral accounts	746	(565)
Net cash provided by (used in) financing activities	42,265	(123,008)
(Decrease) increase in cash and cash equivalents	(105,977)	53,251
Cash and cash equivalents, beginning of year	120,647	67,396
Cash and cash equivalents, end of year	\$ 14,670	\$120,647

*Consists of changes in accounts receivable, prepaid expenses and deposits, accounts payable and accrued liabilities, participants' security deposits and recoverable acquisition and transition costs.

1 BASIS OF PRESENTATION

The Independent System Operator (ISO), operating as the Alberta Electric System Operator (AESO), is a statutory corporation established on June 1, 2003 under the *Electric Utilities Act* (EUA-2003) of the Province of Alberta.

Upon formation, the AESO assumed the duties of the Power Pool Council (the Council), excluding the Balancing Pool Administration (BPA) and Market Surveillance Administration (MSA) functions, which were transferred to separate and distinct statutory corporations. All rights and obligations, including contracts, tariffs, assets, and liabilities of the Council were transferred to the three statutory corporations as appropriate on June 1, 2003 in accordance with transitional provisions included in the EUA-2003.

The Council was a statutory corporation established on May 17, 1995 under the *Electric Utilities Act*. It commenced operations on January 1, 1996 under the name Power Pool of Alberta.

In 1998, the duties of the Council were expanded to include the operations of the Balancing Pool. The Balancing Pool was established to receive and disburse funds arising from the transition to a competitive electricity market in Alberta on behalf of consumers. In October 2002, the functions of the Council were expanded to include the oversight responsibility for load settlement within the province.

The Council acquired all of the issued and outstanding shares of ESBI Alberta Ltd. (EAL), the former Transmission Administrator, on October 25, 2002. Immediately following the share purchase, the Council assigned the Purchase and Sale Agreement, together with all rights and obligations to its newly formed wholly-owned subsidiary, the Transmission Administrator of Alberta Ltd. (TA). Subsequently, the TA and EAL were amalgamated.

The TA was a for-profit, regulated corporation under the provisions of the previous *Electric Utilities Act*. The Alberta Energy and Utilities Board (EUB) approved the TA's transmission rates, charges and terms and conditions of service and related regulatory accounting treatment.

The financial statements of the AESO for the year ended December 31, 2003 include the operations of the Power Pool of Alberta (excluding the BPA and including the MSA) and the TA for the five-month period ended May 31, 2003, together with the operations of the AESO for the seven-month period ended December 31, 2003, in accordance with the recommendations of the Emerging Issues Committee of the Canadian Institute of Chartered Accountants Abstract, which addresses the use of continuity of interest accounting. The results of the operations of the AESO for the seven-month period ended December 31, 2003 do not include amounts related to the BPA or the MSA.

Management views the operations as one fully-integrated operation; therefore, segmented information is not applicable.

2 OPERATIONS

Effective June 1, 2003, the AESO assumed responsibility for the operation of the competitive power pool; determining the order of dispatch of electric energy and ancillary services; providing system access service on the electric transmission grid; directing the safe, reliable and economic operation of the interconnected electric system; planning the capability of the transmission system to meet future needs; and regulating and administering load settlement.

The AESO is governed by the AESO Board, whose members are appointed by the Alberta Minister of Energy and are independent of any person or entity having a material interest in the Alberta electric industry. The AESO Board has an Audit Committee and a Human Resources Committee.

EUA-2003 requires that charges to industry, including the energy market charge, load settlement charge and transmission tariff, be set to recover the costs required to operate the AESO, and that the AESO be operated so no profit or loss results on an annual basis from its operations. The AESO's transmission-related activities continue to be regulated by the EUB. The AESO has no equity.

3 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

These financial statements have been prepared by management on the historical cost basis in accordance with Canadian generally accepted accounting principles. Preparation of these financial statements requires estimates and assumptions that affect the amounts reported and disclosed in the financial statements and related notes. These estimates and assumptions include information, regulatory decisions and other matters that are periodically influenced by third parties that may impact the timing of revenue and/or expense recognition. Any changes from current estimates or assumptions are accounted for in the period that they are determined. Actual results could differ from those estimates.

Cash and Cash Equivalents > Cash and cash equivalents comprise cash, term deposits and other short-term investments with original maturity dates of less than 90 days.

Deferrals > The AESO utilizes deferral accounts to facilitate a matching of revenues and costs on a function-by-function basis. On an individual basis for the transmission, energy market and load settlement operations, in circumstances where annual collections are in excess of the costs, the excess amount is recorded as deferred revenue and refunded in the subsequent year. In circumstances where annual collections are less than the costs, the shortfall is recorded as deferred revenue and collected in the subsequent year. The long-term AESO deferral balance relates to the energy market deferral for the unamortized portion of system controller capital assets that were recovered from transmission customers in prior years by the TA.

Upon the creation of a separate statutory corporation for the MSA on June 1, 2003 with the proclamation of EUA-2003, a portion of the energy market charge collected by the AESO is remitted to the MSA according to its revenue requirement. The difference between the revenue collected on behalf of the MSA through the energy market charge collection process and the funding payments made to the MSA is recorded as MSA deferred revenue. Where the annual collections are in excess of the payments, the excess is recorded as deferred revenue and is incorporated into the estimated per MWh charge for the following year. In circumstances where annual collections are less than the MSA payments, the shortfall is recorded as deferred revenue and is incorporated into the estimated per MWh charge for the following year.

Capital Assets > Capital assets are stated at cost. These assets are amortized on a straight-line basis over their estimated useful life as follows:

Energy trading system	8 years
System coordination centre	8 years
Software development	5 years
Furniture, office equipment and computer hardware	3 years
Leasehold improvements	Over the lease period

Income Taxes > Although the AESO is a not-for-profit organization as set out in EUA-2003, the TA was a for-profit entity prior to June 1, 2003 and thus was subject to income tax.

For the five-month period ended May 31, 2003, the TA used the liability method of accounting for the tax effect of temporary differences between the carrying amount and the tax basis of the TA's assets and liabilities. Temporary differences arose when the realization of an asset or the settlement of a liability would give rise to either an increase or decrease in the TA's income tax payable for the year or a later period.

Revenue Recognition > The AESO's revenue is primarily derived through three separate charges: (1) the transmission revenue; (2) the energy market charge; and (3) the load settlement recovery. Each of these charges is set to recover those costs directly attributable to one of the AESO's main functions as well as a portion of shared corporate costs. Consistent with the requirements of EUA-2003, which requires the AESO to operate with no annual profit or loss, revenue is recognized equivalent to the aggregate of annual operating costs on a function-by-function basis.

EUA-2003 requires the AESO to provide funding for the MSA with the amount to be recovered through the energy market charge. The energy market charge included in the AESO's statement of operations does not include amounts recovered related to the MSA's funding requirements and the AESO's costs do not include amounts related to the operations of the MSA. The revenue collections and the monthly payments associated with the MSA are recorded as offsetting revenue items, with deferred revenue subsequently recognized to have no profit or loss.

Forward Contracts, Operating Reserves > The AESO uses ancillary services forward contracts solely to ensure an adequate supply of operating reserves is available as required by the Alberta Interconnected Electric System (AIES). It does not enter into contracts on a speculative basis. Any gain or loss on these transactions is applied to the cost of the products purchased when the physical operating reserves are provided.

4 AESO DEFERRAL ACCOUNTS RECEIVABLE (PAYABLE)

IN THOUSANDS OF DOLLARS					
	CURRENT PORTION				LONG-TERM PORTION ENERGY MARKET
	TRANSMISSION	ENERGY MARKET	LOAD SETTLEMENT	TOTAL	
Opening balance, January 1, 2004	\$ 40,153	\$ (2,993) ¹	\$ –	\$ 37,160	\$ (1,851) ¹
Current year	(70,689)	(1,380)	(836)	(72,905)	912
Re-allocation adjustment	461	(461)	–	–	–
Closing balance, December 31, 2004	\$ (30,075)	\$ (4,834)	\$ (836)	\$ (35,745)	\$ (939)

¹ A debit balance of \$565 related to the MSA deferral at December 31, 2003 has been reclassified to the MSA deferral account. This balance was included in the energy market deferral account at December 31, 2003.

5 CAPITAL ASSETS

IN THOUSANDS OF DOLLARS				
	COST	ACCUMULATED AMORTIZATION	2004 NET BOOK VALUE	2003 NET BOOK VALUE
Energy trading system	\$ 11,410	\$ (6,618)	\$ 4,792	\$ 6,373
System coordination centre	11,265	(7,509)	3,756	5,168
Software development	7,561	(3,181)	4,380	2,184
Furniture, office equipment and computer hardware	6,821	(4,667)	2,154	1,341
Leasehold improvements	2,707	(362)	2,345	1,085
Work in progress	5,038	–	5,038	341
	\$ 44,802	\$ (22,337)	\$ 22,465	\$ 16,492

At December 31, 2004, work in progress relates to capital acquisitions associated with the relocation of the system coordination centre (occupancy date in 2006) and the load settlement project (commissioning date in 2005).

Included in the statement of operations for the year ended December 31, 2003 is the amortization of the purchase price of the EAL shares and related acquisition costs in the amount of \$4.9 million.

6 ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

IN THOUSANDS OF DOLLARS		
	2004	2003
Accounts payable, other ¹	\$ 66,329	\$ 157,670
Accounts payable, trade	14,335	34,477
Accrued liabilities	4,525	9,414
	\$ 85,189	\$ 201,561

¹ In 2004, the balance includes the December 2004 transmission settlement. In 2003, the balance includes the December 2003 transmission settlement, the financial settlement of 2000 to 2002 transmission deferrals and amounts arising from EUB Decision 2003-099.

7 CREDIT FACILITIES

The AESO has two credit facilities. Under the terms and conditions of these facilities, up to \$10 million can be borrowed under a demand operating loan facility and \$50 million under a revolving loan facility. Included in the \$50 million revolving loan facility is the AESO's option to request \$10 million in letters of credit. The revolving loan facility is renewable every two years. If the revolving loan facility is not extended, repayment is required immediately in full. Both credit facilities are based on prime rates of interest with the option for the loans to be issued in bankers' acceptances.

At December 31, 2004, \$3.2 million was drawn on the revolving loan facility, a \$10 million letter of credit was outstanding, and \$10 million was drawn on the demand operating loan facility.

The amount of interest paid during the year was \$0.7 million (2003 - \$1.0 million).

8 ANCILLARY SERVICES COSTS

In April 2004, a contract between the AESO and a supplier of transmission must-run services expired prior to successful negotiations of a new contract. As a result, payments made by the AESO for services provided have been made in accordance with the AESO's interpretation of the Energy Provision of Ancillary Services (Article 24) of the transmission tariff. The service provider does not agree with the AESO's interpretation of Article 24. The AESO and the service provider are working toward a resolution until a contract can be reached.

At year end, this issue remains unresolved and any settlement amounts related to the difference between the payments that have been made to the supplier pursuant to Article 24 and the final decision for a settlement amount for the period from May 1 to December 31, 2004 have not been incorporated into the 2004 transmission costs, as any difference is not determinable at this time.

In an unrelated transmission must-run matter, on May 1, 2003, the EUB in Decision 2003-033, approved the Article 24 Settlement Agreement that required a supplier of transmission must-run services to refund \$21.5 million to the TA for the provision of transmission must-run services billed in 2002, together with \$1.9 million in interest. The total refund to the TA was \$22.8 million. These adjustments have been reflected in ancillary service costs and interest revenue in 2003.

9 LINE LOSSES

The transmission losses costs in 2004 reflect a one-time adjustment of \$27.5 million to energy market settlement data related to a correction of customer meter data for years prior to 2004. For those periods prior to 2004, transmission line losses were overstated. The underlying metering issue was identified and resolved in 2004. The AESO's 2004 financial statements reflect the adjustment. This adjustment is considered a change in estimate for the affected period as management prepared the prior year's financial statements using the best estimates available for the meter volumes as provided to the AESO by third parties.

10 CONTINGENCIES AND COMMITMENTS

- (i) The AESO leases office space and data processing equipment under various operating leases. The minimum payments associated with these leases are as follows:

Year	Amount (\$ million)
2005	2.2
2006	2.2
2007	1.6
2008	1.7
2009	1.7
Thereafter	8.9

- (ii) To fulfill the duties of the AESO in accordance with EUA-2003, the AESO manages the procurement of ancillary services through contracts with third-party suppliers. These ancillary services include operating reserves, transmission must-run and system restoration. The contracts are for generation capacity and load reduction capabilities ranging in contract duration from one day to 17 years. The amount to be paid under each contract is dependent upon fixed and variable terms. The variable terms are based upon commodity prices, dispatch volumes and frequency.
- (iii) EUA-2003 requires the AESO to provide funding for the MSA with the amount to be recovered through the energy market charge. In 2004, \$2.1 million was paid to the MSA and \$1.3 million in the period from June 1, 2003 to December 31, 2003.

11 PARTICIPANT SECURITY

All market participants and transmission customers who have financial obligations to the AESO must adhere to the AESO's rules and transmission tariff terms and conditions regarding security requirements. Unsecured credit limits are provided for those organizations with acceptable investment-grade unsecured bond ratings, either directly or indirectly through a guarantee, and for organizations that are exempt as determined through government regulation. Security requirements for financial obligations in excess of unsecured credit limits are met with cash deposits and letters of credit.

12 FINANCIAL INSTRUMENTS

The AESO's financial instruments consist of cash and cash equivalents, accounts receivable, AESO deferral accounts receivable/payable, MSA deferral accounts receivable/payable, accounts payable and accrued liabilities, participants' security deposits and bank debt. Due to their short-term nature, the fair market value of the financial instruments approximates the carrying value.

13 COMPARATIVE FIGURES

Certain of the prior year's comparative figures have been reclassified to conform to the current year's presentation.



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printed in **CANADA**

design | **HUMDINGER COMMUNICATIONS** photography | **HORIZON PHOTOWORKS** printing | **APACHE SUPERIOR PRINTING LTD.**

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