



End-User Purchases of Electricity in Alberta Selected Contracting Issues

By

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with assistance from Cecilia Low

*This paper was prepared for the Canadian Institute Conference:
"Managing High Energy Costs – The End-Users Forum"
November 26 & 27, 2001*

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Introduction

Prior to implementation of deregulation in Alberta, industrial and commercial customers took their energy supply from their local utility at a cost-based price and pursuant to terms and conditions set out in the utility’s tariffs. A buyer had no input into the tariff terms and conditions (except through the EUB hearing process) and there was no ability to negotiate terms and conditions or different prices for different energy products. This has all changed under deregulation so that industrial and commercial customers now have the option of being served by their default retailer under its ‘default retailer rate’ or opting to be supplied by a chosen retailer under a negotiated energy supply agreement or by a direct seller under a bi-lateral ‘direct sales agreement’. With this shift away from tariff-based energy purchases

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toward negotiated, market purchases, it is imperative that buyers understand the contracting issues relevant to their energy supply and be prepared to negotiate the contract terms of that supply.

This paper explores selected contracting issues under energy supply agreements in the context of the Alberta marketplace. For purposes of this paper, the term ‘energy supply agreement’ will be used when referring to either an energy supply agreement between a consumer and a retailer or a direct sales agreement between a buyer and a direct seller. The term “buyer” will be used to refer to an end-use buyer under either kind of agreement and “seller” will be used to refer to either a retailer or a direct seller.

Market Purchases in Alberta

A buyer may choose a retailer and negotiate an energy supply agreement with that retailer for the buyer’s needs at a specific site or for all of the buyers’ sites. The retailer will then be responsible for supplying that buyer’s energy in accordance with the terms of the agreement and for securing distribution/transmission access service for that buyer. If the buyer chooses to self-retail and procure its own energy, it might enter into direct sales agreements for its energy supply requirements and will have to enter into distribution/transmission access agreements with the appropriate wires service provider.

Direct Sales Agreements

In order to enter into a direct sales agreement, the buyer must be a Power Pool participant and will require access to Power Pool software and knowledge of the settlement procedures. The rules for direct sales can be found in the Direct Sales Regulation³ and in the Pool Rules⁴. The buyer will also be required to arrange distribution access service with its local

³ AR 167/2001 replaced the former Direct Sales Regulation, AR 180/99, as amended by AR 239/2000, on August 26, 2001

⁴ Available at <http://www.powerpool.ab.ca/downloads/rules2001.pdf>

distribution utility. As a practical matter, direct sales agreements are probably more appropriate for sophisticated buyers with larger loads.

Pursuant to the Pool Rules⁵, the parties under a direct sales agreement must submit “net settlement instruction” data to the Power Pool, including the hourly quantity of energy, in MW, that is to be sold under the agreement. This information, which must be submitted by one party and acknowledged by the other party, allows price settlement for the transaction to occur outside the Power Pool. If the net settlement instruction is not submitted or acknowledged, any energy transactions by the seller or buyer will be settled at the Pool Price.

As long as supply exceeds demand for the Alberta system as a whole, a buyer under a direct sales agreement will be served, regardless of whether a net settlement instruction is submitted and acknowledged by the parties and regardless of whether the seller actually generates or delivers energy to the Power Pool. Conversely, if demand exceeds supply in Alberta, the buyer under a direct sales agreement has no priority against curtailments, even if the seller’s generation is dispatched. The principal issue for the buyer in this instance will be ensuring it pays the contract price and not the Pool Price (at least if the Pool Price is higher) if the seller fails to submit or acknowledge the net settlement instruction.

Energy Supply Agreements

A buyer that does not wish to enter into a direct sales agreement can opt instead to purchase energy from a retailer under a negotiated energy supply agreement. Unlike the buyer under a direct sales agreement, the buyer under an energy supply agreement with a retailer does not need to be a Power Pool participant or arrange distribution access with the local distribution utility. In this case, it is the retailer itself, not the buyer, that interfaces with the Power Pool, manages its supply portfolio and pays or is paid Pool Price adjustments for taking or not taking contract quantities of energy.

⁵ Pool Rules 4.3 and 4.4

Contract Price

Contract Price Considerations

A buyer that enters into either a direct sales agreement or an energy supply agreement with a retailer can expect its load to be served regardless of the seller's performance, barring a contingency on the transmission or local distribution system. Therefore, any analysis of the agreement will focus on those elements which affect the cost of power to the buyer: quantity, performance excuses (e.g. force majeure), liability for non-performance, credit and performance assurances, and termination provisions. These components of an energy supply agreement are all interrelated -- in theory at least, each of these components should have a value to the buyer and seller and the contract price should be affected by the negotiation of each of them.

The price negotiated between buyer and seller should bear a direct relationship to: (i) what flexibility is afforded to the parties in terms of quantity obligations; (ii) which party bears the cost of a party's non-performance; and, (iii) which party bears the cost of unanticipated future events. For example, if the buyer is willing to assume part of the seller's potential loss in the case of a buyer's force majeure (such as a strike or fire at buyer's facility), the buyer may be able to negotiate a more favourable price. Likewise, a buyer that insists on its seller assuming the risk of regulatory changes should be prepared to pay a premium on the price the seller would otherwise be willing to accept.

Variable Prices

An energy supply agreement will generally be priced in dollars per megawatt-hour. Assuming a buyer has a time-of-use meter, pricing can differ by the hour or other period during a day, for example, a different price for so-called on-peak and off-peak hours. There is no reason why a buyer cannot negotiate different pricing periods that enable it to adjust its production to take the benefit of lower prices.

What is included in the Price?

When considering offerings from different sellers, the buyer must read the contractual fine print to compare the aggregate price under different options available. Does the price

include or exclude municipal access fees, distribution costs or losses, pool transaction fees, pool participant levies, costs of unaccounted-for-energy, uplift charges or other costs? At least in the case of a direct sales agreement, in the absence of specific contractual terms allocating costs to the seller, the buyer will be responsible for some of these costs, in addition to the agreed contract price. What about future federal or provincial taxes on the sale or consumption of energy -- are they included or excluded? With a shorter term agreement, future costs can perhaps be ignored since changes of this sort are likely to come with some warning. Longer term agreements should include a mechanism for allocating changes in costs, including taxes.

An energy supply agreement that is a direct sales agreement should specify if and how losses are to be accounted for. If the buyer is responsible for losses, are they charged at the contract price or the Pool Price? Likewise, a direct sales agreement should provide that the contract price includes the cost of any ancillary services required to deliver energy under the direct sales agreement. While these costs are presently included in the transmission tariffs and so are prorated into the distribution tariff costs, this could change over the course of a longer term agreement.

Price-based Curtailment

If the buyer is a significant power consumer and has the ability to reduce load at its facility on relatively short notice, a demand buy-back or price curtailment provision could be negotiated in the energy supply agreement with the seller. Under this type of provision, if the forecasted Pool Price will be high, the seller and buyer can agree to a reduction in the buyer's load over the expected period of the high prices. Usually the seller and buyer would share the excess of the Pool Price received by seller over the contract price. The agreement would spell out whether the price-based curtailment can be triggered by the buyer, the seller or by agreement of the parties. In addition, if the price excursions do not materialize, allocation of any loss must be addressed in the agreement. A price-based curtailment provision should also tie into the minimum contract quantity. Generally, a buyer would wish a price-based curtailment to apply towards any minimum contract quantity.

Quantity of Energy subject to Contract Price

An element of any energy supply agreement will be the quantity of energy to be delivered and taken at a particular price. This may take the form of a flat baseload agreement (e.g. 5 MW every hour, 7X24), where the baseload is the volume of energy that the buyer expects to take on an ongoing basis. The buyer could agree with the seller to purchase its baseload at one price and quantities in excess of the baseload at a different price.

A buyer under a direct sales agreement may negotiate additional flexibility and purchase amounts in excess of the baseload under another direct sales agreement, by way of forward contracts through the Watt-Ex exchange and/or by spot purchases at the Pool Price.

Maximum Demand and Minimum Contract Quantity

Rather than a baseload agreement, the parties may negotiate a maximum rate at which the buyer takes energy in any hour (the “demand”) and the quantity of energy the buyer is required to purchase over any particular period. The combination of these two factors establishes an agreement’s load factor. If a buyer is entitled to take energy at a rate of 10 MW in any hour, then taking flat-out (or at 100% load factor) for a month would result in a purchase of 7,200 MWh (10 MW x 24 hours x 30 days). If instead the buyer’s minimum monthly obligation is 5,400 MWh (a 75% load factor), the buyer has the flexibility without penalty to operate its facility at a 75% production level for the whole month or could operate flat-out for 3 weeks and shut down for 1 week in that month.

The energy supply agreement will likely establish a maximum demand or threshold amount. If the buyer takes energy in excess of the specified maximum demand or threshold amount, a different price (likely the Pool Price plus an adder) may apply if purchasing from a retailer. A buyer under a direct sales agreement who takes in excess of the agreed amount in any hour will pay the Pool Price for the difference. In either case, since the seller must reserve generation or pay the Pool Price to meet the buyer’s maximum demand, a high maximum demand will generally come at a cost to the buyer, either in the form of a higher contract price or a higher minimum purchase quantity. A buyer with a variable load may be better off

to accept the Pool Price risk for its demand peaks, rather than paying higher overall prices to accommodate peaks under the energy supply agreement.

A seller is likely to require the buyer to purchase a minimum quantity of energy in a specified period -- a take or pay amount -- so that the seller can hedge that minimum quantity either by physical generation or third party purchases. From a buyer's perspective, a lower load factor generally gives more flexibility, but usually comes at a cost to the buyer, since the seller will be exposed to the Pool Price for any generation the buyer chooses to take in excess of the minimum.

If the period over which the minimum contract quantity must be purchased is relatively short, the buyer will have less flexibility to reduce load for maintenance, process reductions and so on. So, for example, if the minimum quantity is determined monthly, a 75% load factor contract would not permit the buyer to shut down for 2 weeks in a month without incurring a take or pay obligation, whereas if the minimum quantity is determined quarterly, the buyer could shut down for up to 3 weeks in the quarter and still meet the minimum quantity by operating flat-out for the other 9 weeks of the quarter. For buyers with more than one facility, it may be possible to negotiate the minimum quantity across all of the buyer's facilities.

If the buyer takes less than the minimum contract quantity, it is not a given that the result should be take or pay. A buyer with a larger load may be able to negotiate a credit against the contract price to reflect the price that seller presumably received for the energy not taken. A buyer should carefully consider how the credit is calculated. It will likely be based on some average of Pool Prices during the period in which the buyer did not take the minimum. From the buyer's perspective, basing the credit on the Pool Price for the days when the buyer's load is actually reduced may give the buyer some control over its power costs. For example, if the buyer is able to shut down for non-critical maintenance during a period of high Pool Prices, the credit may eliminate any take or pay charge to the buyer. Buyers should beware of significant administrative charges or other "adders" which penalize the buyer for not taking the minimum contract quantity. The contract price for the

minimum quantity, less any credit, should keep the seller whole without the need for any significant additional charge.

As an alternative to taking less than the minimum, the buyer under a direct sales agreement may be able to nominate energy from the seller that it knows it cannot actually consume. Under the Pool Rules⁶, the buyer is deemed to have sold to the Power Pool the difference between actual consumption and the net settlement amount. Although the Pool Rules are not clear on the point, it appears the buyer would be entitled to receive the Pool Price for such energy. If this is and continues to be the case, the buyer may also be able to take advantage of high Pool Prices by nominating more than its expected load and receiving a credit from the Power Pool. This alternative would not be available under a retailer's energy supply agreement.

Transmission

Delivery Point

In some regions, the delivery point for an energy transaction is an important contractual term due to transmission costs and availability, constraints, loss factors and the availability of a real time market at different delivery points. A seller is generally responsible for transmission costs and losses up to the delivery point and the buyer is generally responsible for costs and losses from and after the delivery point.

System Access Service

The delivery point for an energy supply agreement other than a direct sale agreement will be the buyer's facility. The retailer is required to secure system access service to its customers. The seller under a direct sales agreement will require system access service (through the Transmission Administrator's tariff) to notionally deliver energy to the Pool. A buyer should ensure that the energy supply agreement allocates responsibility for such system access service and all costs associated with supply transmission service to the seller.

⁶ Pool rules: 7.2.1

Distribution Access Service

As long as the delivery point is the buyer's facility, the seller will be responsible for arranging distribution services from the local distribution utility for the buyer pursuant to the Distribution Access Service tariff. The energy supply agreement should be clear whether distribution charges and losses are included in the contract price or paid for by the buyer as adders to the energy price.

The delivery point negotiated under a direct sales agreement will likely be the Power Pool. In that case, the buyer, as a self-retailer, will be responsible for arranging and paying for system access service transmission or distribution as appropriate from the Power Pool to its facility. A buyer who is a self-retailer should be aware that there may be terms and conditions in the distribution access tariff that do not apply to self-retailers by reason of AEUB decisions.

Finally, some buyers may be eligible to directly connect to the transmission system⁷, in which case the buyer would be responsible for arranging and paying for transmission service from the Transmission Administrator.

Performance Excuses -- Recall, Force Majeure and Regulatory Change

Recall

An energy supply agreement could give the seller a right of recall, allowing seller to redirect energy in certain circumstances or offer energy into the Power Pool for the seller's own account. From the buyer's side, the buyer may wish to reserve the contractual right to reduce its required purchase of energy under the energy supply agreement for specific reasons such as maintenance or annual shutdown. Flexibility on the buyer's or seller's side of the transaction should have some impact on the price.

⁷ An eligible direct buyer who takes power at transmission voltages can take service directly from the Transmission Administrator with approval of the Transmission Administrator and the distribution utility for the particular point of connection.

Force Majeure

Contracts for the purchase and sale of energy most often contain a “force majeure” provision under which the parties are excused from their obligations to perform under the agreement. In case of an energy supply agreement, the parties would be excused from the obligation to deliver or take energy with the result that the other party would be exposed to the differential between the Pool Price and the contract price. Force majeure is usually defined to include extraordinary events beyond the control of the party claiming suspension of its obligations under the agreement.

An argument can be made that there should be few, if any, circumstances where the buyer or seller should be excused from their obligation to deliver or take the contract quantity. In transactions at other trading hubs such as Mid-Columbia in the US Pacific Northwest, the only recognized event of force majeure is often the failure of firm transmission at the delivery point itself (i.e. not upstream or downstream transmission), on the assumption that the seller can buy energy to replace its lost generation -- at the market price. In Alberta, if the seller’s generation is unavailable due to a force majeure event, the buyer still takes energy from the Power Pool -- but at a cost to either the buyer or seller of the Pool Price. Likewise, if the buyer’s facility is shut down due to a force majeure event, the seller can still sell its generation into the Power Pool, but at a price that may be less than the contract price. In both cases, the question becomes: as between two ‘innocent’ parties, which party should be exposed to the difference between the Pool Price and the contract price?

In any event, much litigation over many years proves that a buyer should not consider the force majeure provisions in an energy supply agreement to be just ‘boilerplate’. The buyer should consider whether a broad definition of force majeure or a narrow one is in its interest, recognizing that it is difficult to negotiate a force majeure clause that is narrow for the seller but broad for the buyer.

A seller will generally seek force majeure protection against generation outages. In the case of imports into Alberta, the capacity and availability of the relevant intertie will likely give rise to issues of force majeure. Sellers supplying energy from a PPA may seek to limit their

risk by claiming force majeure under the energy supply agreement when the PPA facility owner declares force majeure. In these cases, the seller will no doubt wish the buyer to pay the Pool Price for its energy rather than the contract price.

In addition to protecting the seller against generation and/or transmission outages, a force majeure clause can protect the buyer from an obligation to take or pay for the minimum contract quantity. The buyer should analyse its processes and markets and consider what could go wrong to disrupt them. Fires, explosions, storms and other Acts of God could disrupt buyer's operations. Does the buyer need protection against strikes? What about a strike at a customer's facility that allows the customer to suspend purchases from the buyer? Force majeure clauses can protect against labour and material shortages or transportation problems affecting sales of the buyer's product. These and other potential disruptions should be considered when negotiating an appropriate force majeure provision for the energy supply agreement. How an event of force majeure should apply to reduce the minimum purchase obligation will also need to be addressed in the agreement. Since a force majeure provision reduces risk to the party that is able to rely on it to suspend its obligations, the contract price should be affected if the force majeure provision is unbalanced in favour of one party over the other.

Regulatory Change

The restructuring of the Alberta electricity market has not gone without its hitches and the rules for market purchases are not necessarily settled. Who takes the risk of changes imposed by government or regulators or market facilitators such as the Power Pool will be a matter for negotiation in the energy supply agreement. It is likely that a seller will wish the buyer to assume additional costs imposed on generation by changes to legislation or regulation. The buyer would likely need to pay a risk premium if the agreement allocates regulatory risk to the seller.

Section 3(3) of the *EU Act* has the effect of amending bilateral agreements (e.g. an energy supply agreement) that are inconsistent with any future amendments to the *Electric Utilities Act*. Such amendment is to eliminate the inconsistency. A buyer may wish to include a

contractual provision that permits termination of the energy supply agreement if there is any material amendment by operation of Section 3(3). Of course, a provision of this sort may also give the seller an option to escape what turns out to be a below market contract price. Other options to deal with a statutory change include renegotiation, with an arbitrator being authorized to impose new contract terms if the parties are unable to agree.

Liability for Non-Performance

Liquidated Damages

In the short term, the buyer's load will continue to be served under a retailer's energy supply agreement, regardless of any failure of the seller's supply arrangements. The issue for the buyer will be whether the contract price or a price based on the Pool Price will prevail under the energy supply agreement. In the longer term, failure of the seller's supply arrangements or the seller's insolvency may affect the ability of the seller to meet its contractual obligations to the buyer. In this event, the comments under "Events of Default and Termination" below will apply. On the other side, if the buyer fails to take required energy in an hour or the minimum contract obligation in any period (unless the buyer's failure is excused by the force majeure provisions of the agreement), the agreement will likely require the buyer to pay "take or pay" charges as discussed under "Quantity of Energy subject to Contract Price" or so-called "liquidated damages" -- usually defined to be the positive difference, if any⁸, between the contract price and the Pool Price.

As noted above, the seller and buyer under a direct sales agreement must submit and acknowledge net settlement instructions in respect of each hour in order for the sale transaction to be settled between the seller and buyer outside the Power Pool. The direct sales agreement should address the nomination process to be used between the seller and the buyer. It should also require the seller to either submit or acknowledge the net settlement instruction based on the buyer's nomination.

⁸ If the Pool Price is in fact lower than the contract price, the seller will have no liability to the buyer and the buyer will get its energy for less than the contract price.

There are two different scenarios where the seller fails to perform its obligations under a direct sales agreement. In the first scenario, the seller and buyer submit and acknowledge the net settlement instruction but the seller fails to make its generation available for dispatch when required. In this case, the buyer continues to be served, unaware that the seller has failed to deliver. The buyer will pay the contract price to the seller for the energy taken. Pursuant to the Pool Rules⁹, the seller will be deemed to have purchased the undelivered energy at the Pool Price.

In the other scenario, the seller does not submit or acknowledge the required net settlement instruction and the net settlement instruction is therefore ineffective. The buyer's load will continue to be served, but as a Power Pool purchase at the Pool Price. Unless the seller's failure is excused by the force majeure provisions of the agreement, the agreement should require the seller to pay the buyer "liquidated damages" -- in this case, the positive difference, if any, between the Pool Price and the contract price.

Instead of the seller's failure, it may be the buyer that fails to submit or acknowledge a net settlement instruction. The result will depend on the nature of the direct sales agreement. If the buyer has only committed to purchase a minimum quantity of energy over a specified period, there may be no cost to the buyer for failing to nominate and take energy for any particular period. As noted above, if the buyer does not consume the quantity of energy specified in the net settlement instruction, the seller should be paid the contract price (subject to force majeure) and the buyer should be entitled to any credit available from the Power Pool.

⁹ Pool Rules: 7.1

Credit and Performance Assurances

General

The contractual issue that has gained the most attention in US power markets over the last few years is credit. Unsinkable utilities have been sunk and counterparties have lost hundreds of millions of dollars as a result of insolvencies in the US west.

A key component in protecting the buyer from credit exposure is knowing who the seller is, not who the seller's affiliates are. Marketing entities, while affiliates of large and financially strong energy companies, may not themselves be particularly creditworthy. A buyer should never assume that the seller's parent company will support the seller and a legally binding and enforceable guarantee is essential in order to rely on the credit of the parent.

Value at Risk

The buyer under an energy supply agreement will want to ensure that it will get the benefit of the contract price for the entire term of the agreement, particularly if future market prices exceed the agreed contract price. On the other hand, the seller will want assurances that the buyer will pay for energy purchased and that the seller will get the benefit of the contract price for the entire term of the agreement, if future market prices are lower than the contract price. In times of volatile market prices, the "mark to market" exposure under an agreement -- the value of the difference between forecasted future market prices and the contract price over the balance of the contract term -- can vastly exceed the actual payment risk for energy delivered.

Collateral Threshold

An energy supply agreement can seek to address the issue of fluctuating mark to market exposure through the concept of a "collateral threshold". In this case, the agreement would define an amount of open credit for each party, usually based on a party's (or its guarantor's) credit rating at the time of entering into the agreement. If the mark to market exposure (netted against amounts currently due) exceeds the collateral threshold amount determined for a party (plus any security previously received), that party must upon demand provide performance assurances, usually in the form of an irrevocable letter of credit. Failure to

provide the performance assurance within a short period of time (often 48 hours) entitles the other party to declare a default and terminate the agreement. The innocent party then is able to claim (perhaps along with other creditors in the case of bankruptcy) the net termination payment based on its mark to market loss.

The energy supply agreement should provide that the collateral threshold determined for a party will be reduced to \$0 if a material adverse change occurs with respect to that party. 'Material adverse change' could be defined to include credit rating changes, events of default, failure to pay debts when due and proceeding under insolvency legislation.

Form of Collateral

By far the preferable performance assurance is an irrevocable letter of credit drawn on a major bank. Many agreements also provide for security to be provided by cash deposit, treasury bills or other securities. While cash or T-bills might sound like good security for the other party's obligations, there are PPSA¹⁰ filing and priority issues which strongly suggest against permitting these forms of security under the energy supply agreement.¹¹

Events of Default and Termination

Right to Terminate and Liquidate for Default

One of the most important legal provisions of an energy supply agreement will be the provision dealing with events of default and termination. As noted above, the value to the buyer of a fixed price agreement is in the hedge it provides against future increasing market prices. If market prices increase, the value of the agreement can be quantified based on the difference between the contract price and the forecasted future market price (however difficult it may be to forecast) until the end of the contract term. In the event the seller defaults under the agreement (including default due to the seller's insolvency), the buyer

¹⁰ Personal Property Security Act

¹¹ Our mailing to clients describing this issue is available on our website: www.lawsonlundell.com under Energy Law Practice Group.

should have the right to terminate the agreement and quantify the value of the agreement (sometimes called liquidating the contract).

Calculating Termination Payment

The agreement should generally provide for the non-defaulting party to calculate its loss (the value of the remaining term to the buyer if it is the non-defaulting party) in a commercially reasonable manner. On termination, the non-defaulting party will be obliged to use a forward market price for determining its expected loss, if any. The buyer should expect that the default and termination provision will be mutual (and certainly not unilateral on the part of the seller) so that if the buyer defaults it would be liable to the seller if the forward market price for the balance of the term is less than the contract price.

It is quite possible that a non-defaulting party would have a net 'gain' on terminating and liquidating the energy supply agreement. Whether the non-defaulting party is obligated to pay the amount of the gain to the defaulting party is a matter that the energy supply agreement should address.

Netting

If the buyer and seller have dealings with each other in addition to the energy sale under the energy supply agreement (or more than one transaction under an umbrella agreement), provisions dealing with cross-default and netting of the contractual obligations should be considered and likely included in the agreement. These provisions help protect against a potential disaster scenario if the seller goes bankrupt i.e. the buyer must pay the seller the full amounts owing under the agreement but the buyer's concurrent claim against the seller for mark to market exposure or for amounts owing by the seller under other agreements is subject to pro-rating under bankruptcy rules.

Conclusion

The foregoing is a necessarily brief overview of some selected contracting issues that buyers will face when considering their power supply choices. Buyers should take the time to fully understand those issues and their inter-relationship. Finally, buyers must ensure that the terms and conditions of any transaction agreed with a seller are properly reflected in the signed agreements.

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