



August 31, 2004

**Message from the President and CEO**

We are pleased to provide the Balancing Pool's first mid-year report to our stakeholders. As part of consultations held with various stakeholders earlier this year, it was apparent that more frequent communication of our activities and financial results was valued. This mid-year report is one of the initiatives we undertook to respond to this input received from stakeholders.

As reported in our 2003 annual report, the final phase of the Market Achievement Plan II (MAP II) was completed with the sale of the last Clover Bar unit contract in late 2003. We also closed the sale of the H.R. Milner generating station effective January 1, 2004 (upon which a gain of almost \$5 million was recognized). Pursuant to MAP II most of the power dispatch rights held by the Balancing Pool are pre-sold at fixed prices, and as a result the associated components of our revenue and expense streams are not materially impacted by power pool prices during 2004.

As per the attached financial statements, an operating deficit of \$26 million was incurred during the first six months of this year. As outlined during our presentation to stakeholders at our annual meeting in April 2004, this deficit was expected to occur during 2004 as a result of the carrying costs of our Power Purchase Arrangements ("PPAs") being higher than revenues received from the MAP II contracts. One of the main contributors to this deficit is the Clover Bar PPA and given the negative value of this PPA, the Balancing Pool is in the process of conducting a review of the long-term economics of this PPA .

As a result of the operating deficit incurred, our cash and investment position has been reduced from \$138.4 million at December 31, 2003 to \$98 million as at June 30, 2004 and we project the operating deficit to continue during the 2<sup>nd</sup> half of this year and through the 1<sup>st</sup> half of 2005. As our cash position will continue to decline, we will ultimately need to offset the deficit either through financing or the assessment of a charge to consumers. Our conclusion between these alternatives will be based upon the long-term financial forecast for our operations, which is updated periodically. A decision on the method of covering the shortfall for 2005, either through a consumer charge or financing, or a combination of both, will be communicated to stakeholders in early October 2004.

We are pleased to report that Dominion Bond Rating Service Limited conducted a credit review in July 2004, and renewed our corporate credit rating of AA (low). This strong credit rating is beneficial in sourcing competitive financing terms and providing strong credit support to our business counterparties.

As outlined in the attached Management's Discussion and Analysis, some of our major activities during the first six months of 2004 include participation in the arbitration of the Battle River force majeure claim and preparation for the EUB hearing on TransAlta's application for the decommissioning Wabamun Units 1, 2 and 3. The Wabamun EUB hearing has recently been postponed to allow the parties to discuss a negotiated settlement, in which the Balancing Pool will play a lead role.

Subsequent to June 30th, we have successfully concluded a re-negotiation with TransAlta of certain terms related to the Hydro PPA, which we believe will have a positive impact on the ancillary services market in Alberta. These revised terms took effect on August 1, 2004.

I hope that the information in this mid-year report is of value to our stakeholders and would be happy to respond to any questions or comments that may evolve.

A handwritten signature in black ink that reads "Gary Reynolds". The signature is written in a cursive, flowing style.

**Gary Reynolds**  
*President and Chief Executive Officer*

**Management's Discussion and Analysis**

This Management's Discussion and Analysis ("MD&A"), dated August 31, 2004, should be read in conjunction with the unaudited interim financial statements of Balancing Pool for the six months ended June 30, 2004 and in conjunction with the audited financial statements and MD&A for the year ended December 31, 2003.

The Balancing Pool's obligations and responsibilities are governed by the *Electric Utilities Act* (the "Act"). Our two primary roles are to manage the financial accounts arising from transition to a competitive generation market on behalf of electricity consumers, and to meet any obligations and responsibilities associated with both sold and unsold Power Purchase Arrangements ("PPAs").

**Results at a Glance**  
(thousands of dollars)

	Six months ending, June 30, 2004 (unaudited)	Twelve months ending, December 31, 2003
Revenues	<b>288,933</b>	592,457
Operating income (loss)	<b>(26,119)</b>	3,628
Net surplus (deficit) attributed to the deferral account	<b>(21,288)</b>	8,146
Ending deferral account balance	<b>189,891</b>	168,603
Total assets/liabilities	<b>1,985,543</b>	2,058,784
Cash and short term investments	<b>98,627</b>	138,383
<i>Other Information</i>		
Average pool price per MWh	<b>\$54.48</b>	\$62.99

**Revenues**

In the six months ending June 30, 2004, the Balancing Pool's revenues were derived mainly from the sale of generating capacity related to the Market Achievement Plan II ("MAP II") contracts. Through the MAP II sales process, generating capacity contracts related to the Sheerness and Genesee plants (eight strip contracts), and Clover Bar plant (four unit contracts) were sold. The final phase of MAP II was completed in January 2004 with the sale of the last

Clover Bar unit contract. The MAP II contracts are comprised of fixed and variable amounts that are paid monthly to the Balancing Pool. The fixed component of the monthly payment was established through the MAP II competitive bid process, and the variable component is structured to cover other costs payable by the Balancing Pool under the PPAs. In the six months ended June 30, 2004, revenue from the sale of generating capacity was \$244.5 million.

Prior to MAP II, revenue from the Sheerness, Genesee, and Clover Bar PPAs was received in the form of payments for the sale of electricity. Revenue from the sale of electricity of the H.R. Milner plant is shown in discontinued operations, as the plant was sold with an effective date of January 1, 2004.

In the six months ended June 30, 2004, revenue from payments in lieu of tax ("PILOT") was \$15.5 million. PILOT payments are installments on 2004 deemed taxes calculated for non-taxable entities net of adjustments for prior years. PILOT filings are subject to audit by Alberta Revenue, and any adjustments arising from audits will be recorded in future years.

The Hydro PPA is recorded as a financial instrument, with its value calculated at the discounted value of estimated future payments to be received by the Balancing Pool over the remaining term of the arrangement to 2020. The payments are calculated as the amount by which notional energy and reserve quantities priced at market price exceed PPA obligations. The recorded value of the Hydro PPA is evaluated annually, and will be adjusted as required. In the six months ended June 30, 2004, income of \$26.6 million represents annual accretion of the value of the PPA, and the difference between the actual market price and the price used to value the PPA at the beginning of the year.

## **Expenses**

In the six months ended June 30, 2004 cost of sales of \$278.1 million is comprised of fixed and variable operating costs payable under the Genesee, Sheerness, and Clover Bar PPAs, and transmission charges. In the six months ended June 30, 2004, there were no operating costs for the H.R. Milner plant due to the plant being sold effective January 1, 2004. Operating costs of the H.R. Milner plant for 2003 are shown in discontinued operations.

In the six months ended June 30, 2004, other PPA costs include \$2.1 million for a negative bid payable under the Rainbow PPA.

The Balancing Pool is obligated to make certain payments ordered by the Minister of Energy and the Alberta Energy and Utilities Board ("EUB"). These costs are included in Other Expenses and Office of the Utilities Consumer Advocate.

Under the Act the Balancing Pool is required to make monthly payments to TransAlta, the utility that administers the small power producer contract payments, for the amount by which market revenues on small power producer contracts fall below contracted amounts. The discounted value of estimated payments to 2014 is recorded as a payable on the balance sheet. In the six months ended June 30, 2004, the total expense of \$0.3 million represents the net annual accretion of the value of the liability.

### **Operating Loss**

In the six months ended June 30, 2004 an operating loss of \$26.1 million was incurred. This loss was in line with current projections and is the result of the carrying cost of the PPAs being higher than the revenues received from the MAP II contracts.

### **Other Revenue**

The H.R. Milner plant was sold with an effective date of January 1, 2004. In the six months ended June 30, 2004, net cash proceeds in the amount of \$5.2 million was received, and a gain on the sale was recorded in the amount of \$4.8 million.

### **Cash and Short Term Investments**

Cash and short term investments balances have declined from \$138.4 million at December 31, 2003 to \$98.6 million at June 30, 2004. The Statement of Cash Flows summarizes the inflows and outflows that resulted in this \$39.8 million decrease.

In 2002, the Balancing Pool assisted in the securitization of Pool Price Deferral Accounts of various utility companies by providing Letters of Credit equal to 25% of the remaining Deferral Accounts, in accordance with indemnification agreements. The required credit support was reduced as retailers collected deferred amounts through rate riders. As at June 30, 2004, all deferred amounts have been collected and all associated Letters of Credit cancelled.

## **Subsequent Event**

Alberta Power (2000) Ltd. claimed force majeure relief from its obligations under the Battle River PPA for the months of February, March and May of 2003 due to lower water levels in the Battle River generating station cooling reservoir. As required under the PPA, the Balancing Pool paid \$3.0 million of capacity payments to Alberta Power (2000) Ltd. for the force majeure claims; however, the Balancing Pool reviewed the claims, as required under the Act, and subsequently rejected the claims. The payment of \$3.0 million was subject to the dispute resolution process under the PPA. In August 2004, the dispute resolution process was concluded and Alberta Power (2000) Ltd. was awarded \$2.7 million. As a result, the Balancing Pool will receive a refund of \$0.3 million. When the refund is received, the net amount of \$2.7 million will be expensed. As at June 30, 2004, the \$3.0 million previously paid was recorded as a deferred charge.

## **Outlook**

Under the MAP II contracts, the Balancing Pool is not materially affected by fluctuations in power prices and plant output. However, power price fluctuations will still affect Hydro energy and ancillary services revenue.

As per the Act, the Balancing Pool may be ordered by the EUB to pay for the decommissioning costs, above those already collected, of any PPA unit provided an application to the EUB for such cost reimbursement is made within one year of the termination of the PPA and the PPA unit has ceased generating. An application for an additional \$35.4 million beyond what has already been collected by TransAlta Utilities Corporation has been requested for the decommissioning of Wabamun units 1, 2 and 3. The Balancing Pool is participating in an EUB review process to ensure the appropriateness of the costs.

Alberta Power (2000) Ltd. has claimed force majeure relief from its obligations under the Battle River PPA for June and July 2004 due to lower water levels. As required under the PPA, the Balancing Pool paid \$1.0 million for the June 2004 capacity payment to Alberta Power (2000) Ltd. for the force majeure claim. The estimated capacity payment for July 2004 is \$2.6 million. As required under the Act, the Balancing Pool is required to subsequently review this claim. The total cost of this force majeure claim is not yet known. Until this claim is resolved, these amounts will be recorded as deferred charges.

The Balancing Pool is conducting a review of the economics of the Clover Bar PPA.

## **Forward-Looking Information**

Certain information in this MD&A is forward-looking information and related to, among other things, anticipated financial performance, operational prospects and strategies. Forward-looking information typically contains statements with words such as “anticipate”, “believe”, “expect”, “target” or similar words suggesting future outcomes. By their nature, such statements are subject to various risks and uncertainties that could cause the Balancing Pool’s actual results and experience to differ materially from the anticipated results. Such risks and uncertainties include, but are not limited to: availability and price of energy commodities; regulatory decisions; the ability of the Balancing Pool to successfully implement the initiatives referred to in this MD&A; and electricity market factors (such as cost of transmission).

## Balancing Pool

### Balance Sheets

(in thousands of dollars)

	As at June 30, 2004 (unaudited)	As at December 31, 2003
<b>Assets</b>		
<b>Current assets</b>		
Cash and short term investments	98,627	138,383
Accounts receivable and prepaid expenses	58,112	77,252
Current Portion of hydro power purchase arrangement	51,184	53,000
	<hr/> 207,923	<hr/> 268,635
<b>Property, plant and equipment</b>	948,927	977,689
<b>Deferred charges</b>	6,456	7,857
<b>Hydro power purchase arrangement</b>	632,346	636,000
<b>Balancing Pool deferral account</b>	189,891	168,603
	<hr/> 1,985,543	<hr/> 2,058,784
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	69,922	81,112
Deposits	1,050	1,050
Current portion of power purchase arrangement lease obligations	110,410	107,655
Regulatory deferral payable	45	5,824
Current portion of reclamation and abandonment provision	12,339	12,339
Current portion of small power producer contracts	11,489	8,000
	<hr/> 205,255	<hr/> 215,980
<b>Power purchase arrangement lease obligations</b>	1,732,708	1,789,290
<b>Reclamation and abandonment provision</b>	22,514	22,514
<b>Small power producer contracts</b>	25,066	31,000
	<hr/> 1,985,543	<hr/> 2,058,784
<b>Equity</b>	<hr/> -	<hr/> -
<b>Contingencies and commitments</b>	<hr/> 1,985,543	<hr/> 2,058,784

## Balancing Pool

### Statements of Operations and Balancing Pool Deferral Account

(in thousands of dollars)

	Six months ending, June 30 2004 (unaudited)	Twelve months ending, December 31 2003
<b>Revenues</b>		
Sale of generating capacity	244,546	418,247
Sale of electricity	655	114,233
Payments in lieu of tax	15,535	39,193
Increase in value of the Hydro power purchase arrangement	26,625	15,159
Investment income	1,572	5,625
	<hr/> 288,933	<hr/> 592,457
<b>Expenses</b>		
Cost of sales	278,138	546,612
Other power purchase arrangement charges	2,530	4,200
Amortization and depreciation	29,472	59,194
General and administrative	1,872	3,092
Other Expenses	500	3,061
Office of the Utilities Consumer Advocate	2,200	2,118
Increase (decrease) in liability for small power producer contracts	340	(29,448)
	<hr/> 315,052	<hr/> 588,829
<b>Operating income (loss)</b>	(26,119)	3,628
<b>Discontinued Operations (H.R. Milner)</b>	-	(1,771)
<b>Other revenues (expenses)</b>		
Revaluation of electricity rebates payable	-	4,739
Revaluation of reclamation, abandonment and regulatory deferral payable	-	1,550
Gain on sale of H.R. Milner	4,831	-
	<hr/> 4,831	<hr/> 6,289
<b>Net surplus (deficit) attributed to the deferral account</b>	(21,288)	8,146
<b>Balancing Pool deferral account, beginning of year</b>	<hr/> 168,603	<hr/> 176,749
<b>Balancing Pool deferral account, end of year</b>	<hr/> <hr/> 189,891	<hr/> <hr/> 168,603

## Balancing Pool

### Statements of Cash Flows

(in thousands of dollars)

	Six months ending, June 30 2004 (unaudited)	Twelve months ending, December 31 2003
<b>Operating activities</b>		
Net surplus (deficit) attributed to the deferral account	(21,288)	8,146
Items not affecting cash		
Amortization and depreciation	29,472	59,194
Discontinued Operations Amortization	-	20,878
Discontinued Operations Reclamation and Abandonment	-	1,200
Increase in value of Hydro power purchase arrangement	(26,625)	(15,159)
Increase (decrease) in liability for small power producer contracts	340	(29,448)
Gain on sale of assets	(4,831)	-
Revaluation of assets and liabilities	-	(6,289)
Net cash flow from operations	(22,932)	38,522
Net change in non-cash working capital	7,950	(4,806)
	<u>(14,982)</u>	<u>33,716</u>
<b>Investing activities</b>		
Reclamation and abandonment	-	(5,398)
Deferred charges	342	(5,270)
Regulatory deferral	(5,779)	(1,557)
Proceeds on sale of property, plant and equipment	5,182	-
Additions to property, plant and equipment	(3)	(158)
	<u>(258)</u>	<u>(12,383)</u>
<b>Financing activities</b>		
Power purchase arrangement lease obligations	(53,827)	(102,418)
Hydro power purchase arrangement receipts	32,096	61,371
Refund of electricity rebates	-	4,739
Small power producer contracts payments	(2,785)	(714)
	<u>(24,516)</u>	<u>(37,022)</u>
<b>Decrease in cash and cash equivalents</b>	(39,756)	(15,689)
<b>Cash and cash equivalents, beginning of year</b>	<u>138,383</u>	<u>154,072</u>
<b>Cash and cash equivalents, end of year <sup>(1)</sup></b>	<u>98,627</u>	<u>138,383</u>

<sup>(1)</sup> Cash and cash equivalents includes cash and short-term investments