

Annual Assessment Report  
Natural Gas Exchange Inc.

**2010  
Report**

Alberta  
Securities  
Commission

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## Introduction

This report summarizes the Alberta Securities Commission's (ASC) assessment of compliance of the Natural Gas Exchange Inc. (NGX) with its obligations under the *Securities Act* (Alberta) (the Act) and other requirements for the 2010 calendar year and for the subsequent quarter ending March 31, 2011.

In the view of the ASC, NGX has demonstrated compliance with its obligations under Alberta securities laws.

## Background

### (a) Regulatory Status

NGX, a wholly-owned subsidiary of TMX Group Inc. (TMX Group), carries on business as an exchange in Alberta under an ASC recognition order (Exchange Recognition Order) dated October 9, 2008 made under section 62 of the Act. As such, under section 63(2) of the Act, NGX is required to regulate the operations, standards of practice and business conduct of its participants in accordance with its rules and practices. NGX is subject to regulatory oversight based on compliance with the operating principles (Operating Principles) and reporting requirements specified by the ASC under the Exchange Recognition Order. Under the Memorandum of Understanding (MOU) respecting the Oversight of Exchanges and Quotation and Trade Reporting Systems, the ASC is the lead regulator of NGX and is primarily responsible for its oversight.<sup>1</sup>

NGX also provides clearing and settlement services to contracting parties under a separate ASC recognition order (Clearing Agency Recognition Order) dated October 9, 2008 made under section 67 of the Act. NGX is subject to regulatory oversight based on compliance with the clearing principles (Clearing Principles) and reporting requirements (together with the reporting requirements specified by the ASC under the Exchange Recognition Order) specified by the ASC under the Clearing Agency Recognition Order.

For the remainder of this report, the Exchange Recognition Order, together with the Clearing Agency Recognition Order, are herein referred to as the "Recognition Orders". The operating principles under the Exchange Recognition Order, together with the clearing principles under the Clearing Agency Recognition Order, are herein referred to as the "Core Principles".

NGX has been granted exemptions from the requirements to be recognized as an exchange, subject to certain terms and conditions, by the OSC, AMF, BCSC and MSC. These exemptions are based, in part, on the ASC's recognition of NGX as an exchange under the MOU.

NGX is registered to operate in the United States (U.S.) with the Commodity Futures Trading Commission (CFTC) as a derivatives clearing organization. NGX also operates a marketplace in the U.S.

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<sup>1</sup> Under the lead regulator model in Canada, the jurisdiction in which the head office is located recognizes the exchange and is primarily responsible for the oversight of the exchange, while other jurisdictions in which the exchange carries on business exempt the exchange, subject to appropriate terms and conditions, and rely on the oversight of the lead regulator. In the case of certain exchanges in Canada, including NGX, the lead regulator model has been partially effected under the terms of a MOU about the Oversight of Exchanges and Quotation and Trade Reporting Systems effective January 1, 2010 among the ASC, British Columbia Securities Commission (BCSC), Autorité des marchés financiers (AMF), Ontario Securities Commission (OSC) and Manitoba Securities Commission (MSC).

under an exemption granted by the CFTC as an exempt commercial market. An MOU concerning cooperation and the exchange of information related to the supervision of cross-border clearing organizations was established between the ASC and the CFTC in June 2010 to allow for effective regulation of NGX by Canada and the U.S.

**(b) Current Business Operations and History**

In 2004, the TMX Group acquired 100 per cent of NGX shares. NGX currently operates an electronic trading and clearing system based in Calgary for the trading, clearing and settlement of natural gas, power, and crude oil physical and financial contracts.

Prior to October 2008, when the ASC recognized NGX as an exchange and as a clearing agency under the Recognition Orders, NGX had been operating an electronic trading system in Alberta, for the trading of natural gas, electricity and related contracts under a series of exemptive relief orders granted by the ASC since 1993.

In 2007, NGX entered into an agreement with IntercontinentalExchange, Inc. (ICE), to form a technology and clearing alliance for the North American natural gas and Canadian power markets. Under the arrangement, the cleared and bilateral markets for North American physical natural gas and Canadian electricity operated by NGX were listed on ICE's electronic trading platform in February 2008.

Under the Recognition Orders, NGX was permitted to trade and clear natural gas, electricity and related contracts. Under a variation order dated April 14, 2009, the ASC varied the Recognition Orders to permit NGX to trade and clear crude oil contracts. In 2009, the TMX Group acquired NetThruPut Inc. (NTP), an electronic crude oil trading and clearing platform, and integrated the operations of NTP into NGX as part of a consolidation of TMX Group's energy trading and clearing operations.

**Market Regulation's Oversight Program**

In order for NGX to maintain its recognition as an exchange and as a clearing agency under the Act, NGX must continue to comply with the requirements of Alberta securities laws and the Recognition Orders. The ASC's oversight program primarily includes:

- determining the adequacy of NGX's policies and procedures for ensuring ongoing compliance with its obligations under Alberta securities laws and the Recognition Orders; and
- identifying issues in NGX's operating and compliance procedures that may need to be addressed to ensure ongoing compliance with its obligations under Alberta securities laws and the Recognition Orders.

The ASC received the filings required under the Recognition Orders for the 2010 calendar year. ASC staff conducted an analysis of all filed materials and followed up with NGX staff to ensure that ASC staff have an appropriate understanding of NGX's business operations. The ASC does not have any outstanding concerns with regards to materials filed during this time frame.

In addition to the reporting requirements specified in the Recognition Orders, NGX is required to fulfill the undertakings specified in the Recognition Orders. More specifically, in paragraph 5(h) of the

Exchange Recognition Order, NGX undertakes to notify the ASC in advance of any significant change in the operation of the Trading System (as defined in the Exchange Recognition Order). In paragraph 6(g) of the Clearing Agency Recognition Order, NGX undertakes to notify the ASC 10 business days in advance of any significant change in the operation of the Clearing System (as defined in the Clearing Agency Recognition Order). NGX reported the following significant changes during the 2010 calendar year and during the first quarter ending March 31, 2011:

- i. Alliance with ICE*  
NGX reported an expansion of its agreement with ICE (further described below).
- ii. Enhancement to Market Surveillance Program*  
NGX reported its intention to enhance its market surveillance program and make corresponding amendments to its Contracting Party's Agreement (CPA).
- iii. Changes to Margining and Settlement Models*  
NGX reported four significant changes to its margining and settlement models.

NGX complied with the requirements to report significant operational changes by providing the ASC with presentation materials and written proposals, and followed up on outstanding requests as required. ASC staff carefully examined all proposals and found no significant outstanding issues with respect to the creation or implementation of those initiatives.

In conjunction with receiving the reports required by the Recognition Orders, ASC staff engaged in regular communication with NGX executive team members and operational staff members. ASC staff coordinated quarterly meetings with the NGX president to review NGX's operational results, challenges and future business plans. ASC staff also conducted periodic on-site reviews with NGX operational staff to address ongoing changes to NGX's trading and clearing models, and to review NGX's business practices against stated policies and procedures. During the 2010 calendar year and the first quarter of 2011, ASC staff specifically organized on-site examinations with NGX to review its enhanced market surveillance regime and the proposed expanded alliance with ICE.

## **NGX Business and Regulatory Activities**

### **(a) Summary of NGX's Business Activities**

NGX achieved a trading volume record in 2010 at 16,720,050TJ of total energy volume, up 13 per cent from 2009.<sup>2</sup> NGX added 62 new products during 2010: six products for the U.S. crude oil market, 40 products for the U.S. natural gas market, one product for the Canadian natural gas market and 15 products for the Canadian financial electricity market.

Throughout the 2010 calendar year and into early 2011, NGX completed modifications to its margining model for certain natural gas and electricity products, and for certain crude oil contracting parties. In May 2010, NGX implemented "Pairwise", an initial margin offset system that allows for highly correlated positions to be offset, thereby reducing the amount of initial margin collected by NGX. In March 2011, NGX implemented a crude oil margin netting initiative for qualified contracting parties, which requires

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<sup>2</sup> TMX Group Press Release January 6, 2010. [http://www.tmx.com/en/pdf/month\\_stats/TradingStats\\_Dec10.pdf](http://www.tmx.com/en/pdf/month_stats/TradingStats_Dec10.pdf)

that contracts for the same-month delivery positions be managed on a net basis, regardless of the type or location of crude, to reduce the amount of collateral required by NGX.

NGX also made significant revisions to its settlement model for financial power transactions. In November 2010, NGX implemented "Daily Settlement of Power Contracts". This daily cash margining model for financial power contracts provides participants with the ability to realize mark-to-market (MtM) gains and losses on a daily basis and follows a more traditional clearinghouse model for financial contracts. Prior to the daily settlement of power contracts, a transaction that was executed today for forward delivery would require settlement of the transaction following delivery at the expiry of the contract. Utilizing this new model, NGX would MtM the value of the transaction executed on a daily basis and receive or provide settlement payment within two business days. Daily MtM valuation and settlement would occur on the contract until the expiry of the contract. The business model for power contracts was further refined in March 2011, when NGX initiated a change to its financial power initial margining model. These changes to the financial models were implemented to encourage higher trading and clearing volumes for NGX products.

In February 2011, NGX transitioned its crude oil products onto the ICE trading platform as part of an extension of its alliance with ICE. Under the agreement, trading and trading support services are to be provided by ICE to NGX on an outsourced basis. For clearing and settlement services, NGX is to provide such services for physical transactions in Canadian and U.S. crude oil products and ICE is to provide such services for Canadian financial crude oil products. As a result of this alliance, NGX was able to start decommissioning its crude oil trading system platform previously in operation as a result of the NTP integration referred to above.

**(b) Summary of NGX's Regulatory Initiatives**

NGX seeks to comply with regulatory developments across various jurisdictions where NGX operates. As the ASC is the lead regulator for NGX, the ASC has requested that NGX provide periodic updates regarding its ongoing regulatory status with other jurisdictions.

The ASC, in conjunction with the Canadian Securities Administrators (CSA), are preparing regulatory proposals that may impact NGX's business.

In November 2010, the CSA published Consultation Paper 91-401 *Over-the-Counter Derivatives Regulation in Canada* (Consultation Paper 91-401). Following receipt of industry comments, the CSA Derivatives Committee is working to prepare more specific regulatory proposals for the regulation of OTC derivatives, including proposals relating to derivatives trading systems and clearing agencies. By letter dated January 24, 2011, NGX, through the TMX Group, responded to the request for comments on the high level proposals contained in Consultation Paper 91-401<sup>3</sup>.

In February 2011, ASC Staff Notice 91-703 *Over-the-Counter Derivatives* gave notice of the ASC's intention to restore its statutory powers to regulate OTC derivatives transactions under the Act, through the proposed repeal of Blanket Order 91-503 *Over-the-Counter Derivatives Transactions and Commodity Contracts* and the proposed enactment of Rule 91-505 *Over-the-Counter Derivatives* (Proposed Rule 91-505). Proposed Rule 91-505 will restore the ASC's authority to regulate trading in

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<sup>3</sup>TMX Group Comment Letter January 24, 2011  
[http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com\\_20110124\\_91-401\\_kloett\\_pels.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20110124_91-401_kloett_pels.pdf)

OTC derivatives as futures contracts while exempting all OTC derivatives transactions from the prospectus requirements. By letter dated April 29, 2011, NGX responded to the request for comments on Proposed Rule 91-505, in particular with respect to the scope of the physical commodity contract exclusion<sup>4</sup>.

In the U.S., NGX has monitored and provided comments on the regulatory proposals drafted by the CFTC. The ASC has been notified of the regulatory submissions NGX has made to other regulatory jurisdictions and has reviewed materials accordingly.

## **Conclusion**

In the ASC's view, NGX has demonstrated compliance with its obligations under Alberta securities laws and the Recognition Orders during the 2010 calendar year. ASC staff will continue to conduct oversight activities of NGX in the context of NGX's business and developments in the broader marketplace in the coming years.

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<sup>4</sup> NGX Comment Letter April 29, 2011  
[http://albertasecurities.com/securitiesLaw/Regulatory%20Instruments/9/Proposed%20ASC%20Rule%2091-505/3867787-v1-Comment\\_Letter\\_from\\_Natural\\_Gas\\_Exchange\\_Inc\\_\(Cheryl\\_Graden\).PDF](http://albertasecurities.com/securitiesLaw/Regulatory%20Instruments/9/Proposed%20ASC%20Rule%2091-505/3867787-v1-Comment_Letter_from_Natural_Gas_Exchange_Inc_(Cheryl_Graden).PDF)