

NOTICE TO PARTICIPANTS AND STAKEHOLDERS

August 23, 2018

Re: MSA Response to the AESO's Final CMD Proposal

On June 29, 2018, the Alberta Electric System Operator (AESO) issued its final Comprehensive Market Design (CMD-Final) proposal.¹

The Market Surveillance Administrator (MSA) is issuing this notice in furtherance of its mandate in relation to Alberta's transition to a capacity market, as issued by the Government of Alberta on March 17, 2017.

The Alberta electricity market is highly concentrated, with the top two firms controlling almost 50 per cent of the unforced capacity and the top five firms controlling almost 80 per cent of the unforced capacity. The MSA is similarly concerned about concentration levels in the energy and ancillary service markets. The MSA believes such levels of concentration require a robust approach to market power mitigation.

In CMD-Final, the AESO is proposing to implement ex-ante market power mitigation measures in both the capacity market and the energy market.

In the MSA's view, effective ex-ante mitigation can improve efficiency by reducing the ability of market participants to exercise market power in the capacity, energy and ancillary services markets. Unlike ex-post market surveillance and enforcement, ex-ante mitigation can impact the results of capacity auctions and the clearing prices in the energy and ancillary services markets.

The MSA considers that the AESO is in the best position to implement ex-ante mitigation measures, since the AESO will conduct the capacity auctions and since the AESO operates the real time energy and ancillary services markets. The MSA intends to monitor the effectiveness and consistency of ex-ante market power mitigation undertaken by the AESO.

With respect to ex-ante mitigation in the capacity market, the MSA has shared the following views with the AESO:²

1. In CMD-Final, the AESO proposes a default offer cap of 80 per cent of net-CONE because a lower threshold could result in asset-specific mitigation applications for a large number of assets. While the MSA appreciates the considerable work involved in determining asset-specific mitigation for a large number of assets, the

¹ CMD Final available at <<https://www.aeso.ca/market/capacity-market-transition/comprehensive-market-design/>> (CMD Final)>

² CMD-Final S. 7.1.6.

MSA considers that such a process would assist in revealing a competitive supply curve and would reduce the potential for the default offer cap to influence capacity prices.

2. In CMD-Final, the AESO proposes that no market power screen be applied in the rebalancing auctions due to the small volumes expected to be procured. The MSA believes that the rebalancing auctions, just like the main auctions, may be susceptible to economic withholding and should be mitigated.
3. In CMD-Final, the AESO proposes that the market power screen for capacity auctions be set at 10 per cent of the price impact level. The MSA considers that a more standardized screen, like a pivotal supplier test that is used in many markets, would increase transparency while making the rules more easily understood by market participants.

With respect to ex-ante mitigation in the energy market, the MSA has shared the following views with the AESO:³

1. In CMD-Final, the AESO is proposing to mitigate pivotal market participant offers of thermal assets to three times marginal cost, in order to allow for the recovery of start-up and cycling costs. The MSA is concerned that offers at three times marginal cost could exceed marginal cost plus bona fide start-up and cycling costs for many assets. In the MSA's view a practical alternative in the short term would be to establish a different offer cap for each type of asset. In the longer term, the MSA recommends the AESO move away from reliance on economic withholding to recover start-up and cycling costs.
2. In CMD-Final, the AESO is proposing to relax the mitigation of energy market offers when the supply cushion falls below 1000 MW, and to eliminate all mitigation of energy market offers when the supply cushion falls below 250 MW. The MSA does not support the relaxation of mitigation when the exercise of market power becomes easier.

In the MSA's view, less reliance on the exercise of market power in the energy market would make energy prices more predictable, which should result in lower risk margins being incorporated in capacity market offers.

With respect to the ancillary services market, the MSA considers that the operating reserves market may be subject to the exercise of market power and that there may be seams between the ancillary services and energy markets that could be exploited by market participants. Therefore, the MSA is of the view that ex-ante mitigation of offers in the ancillary services markets is appropriate. However, the MSA recognizes that practical options may be limited in the short term.

³ CMD-Final S. 10.7

Regardless of the ex-ante market power mitigation measures ultimately included in the forthcoming ISO Rules, implementation of ex-ante mitigation measures by the AESO can never be sufficient to ensure that all market participants satisfy their legislated obligation to conduct themselves in a manner that supports the fair, efficient and openly competitive operation of the market. There will always be gaps between the ex-ante mitigation measures that can practically be implemented by the AESO and market participant offer behaviour that is consistent with fair, efficient and open competition (FEOC).

Accordingly, the MSA will monitor offer behaviour in the capacity, energy and ancillary services markets and, if appropriate, the MSA will initiate formal investigations and/or recommend changes to the ex-ante mitigation measures in the ISO Rules.

The MSA is also concerned that the current energy-only market may be subject to offer behaviour that is not consistent with FEOC during the transition to a capacity market in 2021.

To assist market participants in meeting their FEOC obligations both during the transition period and once the capacity market is implemented, the MSA will publish new Offer Behaviour Enforcement Guidelines. In addition to guidance related to capacity and energy market offers, there may be a need to also include guidance on offer behaviour related to demand-side participation, ancillary services and non-mitigated hydro resources.

The MSA plans to have the new guidelines in place by the end of 2018, before the AESO files its application with the AUC for approval of the provisional ISO Rules. To achieve this objective, the MSA plans on initiating consultation with stakeholders on new guidelines in October of 2018.

Finally, the MSA will continue with its current monitoring of the energy and ancillary services markets. In addition, the MSA will publish a report after each capacity auction. The MSA currently anticipates each capacity auction report will include a review of:

1. Market power screens;
2. The default offer price cap;
3. Each agreement for an asset-specific offer price cap;
4. Demand curve parameters, including the determination of net-CONE;
5. Dispute resolutions;
6. Compliance of capacity offers with the legislated requirement for market participants to conduct themselves in a manner than supports the fair, efficient and openly competitive operation of the market; and

7. The effectiveness of the AESO's ex-ante mitigation measures for capacity auctions.

As well, after each year of operation of the capacity market, the MSA will publish further reporting that is currently anticipated to include:

1. The amount of capacity acquired by the AESO, including a comparison of the actual load to the load forecast for that year;
2. The effectiveness of the rebalancing auctions;
3. The efficacy of the scarcity test;
4. Each asset-specific reference price;
5. Efficiency losses in the energy market;
6. Compliance of energy and ancillary services offers with the legislated requirement for market participants to conduct themselves in a manner that supports the fair, efficient and openly competitive operation of the market; and
7. The effectiveness of the AESO's ex-ante mitigation measures for the energy and ancillary services markets.

While the MSA is not conducting a formal consultation on the scope of these reports, the MSA is open to feedback from market participants and other stakeholders on what reporting would enhance transparency and confidence in Alberta's electricity markets.

/s/ Wayne Taylor