



January 12, 2011

Ruppa Minhas
Alberta Electric System Operator
2550, 330 – 5th Avenue SW
Calgary, AB T2P 0L4

Dear Ruppa:

RE: SUPPLY SURPLUS RECCOMENDATION PAPER

The MSA is writing to provide comments on the AESO's December 2, 2010 paper, *Supply Surplus: Recommendation Paper*.

The MSA believes the AESO should focus on providing a market that avoids situations where the market price fails to balance supply and demand and thereby avoid situations of supply surplus and supply shortfall. The recommendation paper focuses on administrative procedures that occur after supply surplus occurs. The MSA does not view these as a substitute for measures aimed at avoidance of surplus conditions. Overall, the MSA believes the AESO has not placed sufficient importance on measures to avoid surplus and, in particular, has been too quick to dismiss negative pricing. We consider each of these points in more detail.

Administrative Procedures v. Avoidance of Surplus

The recommendation paper contains six main recommendations:

- 1) Wind generators are not exempt from supply surplus procedures (Section 4.2.1.3)
- 2) Cogeneration facilities are not exempt from supply surplus procedures (Section 4.2.2.3)
- 3) Voluntary generator curtailments request in a situation of supply surplus (Section 4.2.3.3)
- 4) Exports within T-2 in a situation of supply surplus (Section 4.2.4.3)

- 5) In the long term, possible consideration of voluntary generator curtailment program (payments to generators offering to curtail in supply shortfall) (Section 4.3.1.3)
- 6) Forecasting of potential supply surplus conditions (Section 7.3)

The first five all concern the administrative procedures that the AESO will use to manage supply surplus once it has occurred. The MSA accepts that such procedures are needed if there are any instances where supply could exceed demand. The MSA has relatively few comments on the administrative procedures proposed in the recommendation paper, other than that they should not interfere with market prices or increase the probability surplus conditions will be experienced.

Exports within T-2: The AESO proposes to activate this step following the curtailment of imports i.e. after normal market operations have ceased. Consequently, the MSA considers this an administrative step rather than one that avoids surplus situations from developing. The MSA would object to any proposal that resulted in a level of exports scheduled within T-2 that resulted in a return to market pricing (i.e. an end to supply surplus situations). This would be a case of an administrative procedure interfering with market prices.

Voluntary Generator Curtailment Program: Payments to generators to curtail may create a perverse incentive that some generators prefer situations of supply surplus to situations of low pool price. The MSA would object to any mechanism that encouraged administrative procedures to be activated in preference to normal market operations. The AESO also characterizes this as a market solution. The MSA notes that the proposed design does not contemplate interaction between buyers and sellers instead it merely represents an alternate administrative mechanism to replace, or supplement pro-rata allocation. The AESO notes that VGCP may require significant resources to create and maintain. If so, the MSA would consider it to be a poor option.

Only the sixth recommendation focuses on the avoidance of supply surplus by providing information to market participants in advance of making offers. The MSA believes the AESO should consider additional options aimed at avoiding supply surplus, including negative pricing.

Negative Pricing

The MSA believes negative pricing is worthy of further consideration since it a mechanism common to other electricity markets and would likely reduce the incidence of supply surplus events – encouraging consumption and discouraging generation.

In the discussion paper the AESO notes “the frequency of negative prices in Ontario has been aggravated by generators incented by their contract design to produce in all hours, regardless of market conditions”. The MSA does not view this as a concern with negative pricing but of contract design. Given the absence of similar contracts in Alberta the MSA fails to appreciate the relevance of this quote.

The AESO also appears to be concerned about negative pricing potentially affecting the long term investment signal. The MSA believes that concern is misplaced. If balancing supply and demand within the market requires a negative price then setting price at \$0 would result in a distortion of the long term signal not an enhancement. Negative market prices in a given hour, to the extent they were to occur, would appropriately signal over-supply in a given hour. Investment decisions are made over longer time horizons. The realization of negative prices in a number of hours combined with high prices in other hours is entirely consistent with attracting long term investment. The level and distribution of prices is important in determining the appropriate choice of generating technology – a prevalence of low (or negative) prices and high price hours would attract flexible technologies (those most able to avoid the ‘lows’ and gain from the ‘highs’). Denying hours in which negative prices should occur distorts not enhances long term investment signals.

AESO's response to market participant comments also indicates a negative pricing is a complex solution.¹ Unless impeded by the AESO's current systems the solution appears simple. The AESO also states fairness requires consideration of both price cap and floor simultaneously. Again the MSA disagrees. Introduction of negative pricing does not imply over the long run that overall returns to generators would fall. The MSA is not adverse to discussion on changing the price cap but such discussion should be driven by a concern that supply shortfall events were or were likely to result in the market not clearing.

Conclusions

The MSA will monitor and report on instances of supply surplus and seek to determine the underlying cause. Should instances of supply surplus become more frequent the MSA would be concerned that market is failing to clear and that market rules are not consistent with fair, efficient and open competition. The MSA would be concerned that administrative procedures were resulting in a distorted signal for new investment and that as a result dynamic efficiency would suffer.

It is not yet clear that changes in the generation supply mix will result in more instances of surplus or whether offer behavior of other generators has changed in response. Nevertheless the MSA believes the AESO should seek to facilitate competition, avoid administrative procedures where possible and be mindful of the efficiency impacts of the rules it creates. The MSA believes negative pricing is an option that should be considered. The recommendation paper notes limited support for negative pricing among stakeholders. The MSA does not consider this to be a good reason to dismiss an option unless accompanied by persuasive argument that it would not promote fair, efficient and open competition.

Regards,

Matt Ayres
Chief Economist
(sent via email)

¹ P.44 Comment Matrix – AESO Response to Stakeholder Comments: Supply Surplus Discussion Paper, December 2, 2010