Alberta to Cap Electricity Rates and Bring in a Capacity Market

Alberta continued to rapidly overhaul its electricity market policies with the announcement yesterday that it would cap power rates and introduce a new capacity market in Alberta.

Cap on Power Rates

The Province announced that by June 2017, it will put in place a cap or rate ceiling to ensure that Albertans opting for the Regulated Rate Option ("RRO") will not pay more than 6.8 cents per kWh for electricity. The RRO is available to small customers (residential and small commercial) in Alberta who consume less than 250,000 kWh per annum and who do not choose to sign a contract with a competitive retailer. The RRO price is set periodically by the Alberta Utilities Commission. It is presently 3.8114 cents per kWh in Calgary during this period of historic low electricity prices in Alberta — other areas like Edmonton are within a cent of the Calgary RRO. It has been as high as 15 cents since RRO was first implemented in 2002. The 6.8 cent ceiling price proposed by the Province will apply until June 2021.

It is important to note that it is the retail price charged to consumers, and not the wholesale or Power Pool Price that is paid to generators, that is being capped — yes, think government subsidy for consumers.

The role of providing long-term fixed prices for consumers has generally been performed in Alberta by competitive retailers. Though the Province stated that consumers are still free to contract with these competitive retailers, those opting for RRO will have the price protection afforded by the Province's cap. Not surprisingly, many competitive retailers are wondering whether their business model has been undercut by the actions of the Province in now mitigating power price risk for residential and small commercial customers.

The announcement is light on detail, including the mechanics of how the cap will work and how it will be funded by the Province. The Minister of Energy for Alberta will lead a consultation with distributors, RRO providers, retailers and consumers beginning next month.

New Capacity Market

A key question that stakeholders in the Alberta electricity market have been asking for the past year is whether or not Alberta's energy-only merchant power market is sufficient for the Province to achieve its stated policy of phasing out approximately 6,300 MW of coal-fired power by 2030, and replacing it with renewable generation (2/3) and gas-fired generation (1/3). Until this week, the Province has been saying "yes it is," and has been firmly committed to maintaining the Alberta market in its current form as an "energy only" market. This week the Province changed its mind, and announced that by 2021 the "energy only" market will now be changed to a "capacity market." The new "capacity market" will provide generators with a market in which to compete to sell their electricity, like they have in Alberta today, plus a market in which to compete for payments to keep generation capacity available to produce electricity when needed.

Energy Only Versus Capacity Market?

Currently, Alberta operates Canada's only merchant market through which all electricity, whether generated in Alberta or imported, is exchanged in a fair, efficient and openly competitive manner using an economic merit order system — the Power Pool.

Generation in Alberta is competitive, with generators determining the form of energy they will convert into the electricity they will offer into the Power Pool. If dispatched, the generators are paid the competitively determined Power Pool Price for the hour in which they are delivering their electricity into the grid. The Power Pool is now "energy only" in that the generators are paid based on the electricity they produce based solely on the Power Pool Price. That Power Pool Price fluctuates over time based on the cost of generation and the economic principles of supply and demand. Since 2014, Power Pool Prices have plummeted in Alberta to record lows of under $20 per MWh. For a more detailed description of the Alberta Electricity Market and its Power Pool see *New Opportunities in the Alberta Electricity Market — A BLG Overview*.

Unlike an "energy only" market, in a "capacity market" generators are also compensated throughout the term of a power contract for having the capacity to generate electricity, even if they may not be actually generating electricity. Investors in generation projects like a capacity market because a long term contract for capacity will ensure that they should recover their fixed capital costs even in times of low Power Pool Prices or if their power is not being dispatched in Alberta because it is too expensive.

Why the Change in Alberta Policy?

To ensure that there is new renewable generation in place to replace the phased out coal generation, the Province has committed to provide financial support for 5,000 MW of new renewable power generation in Alberta before 2030. By that date, the Province has promised that renewable power will account for 30% of Alberta's power generation. This commitment to provide financial support for renewables is an acknowledgement by the Province that project developers are not able to economically develop renewable power projects in Alberta based on current and projected Power Pool Prices. Earlier this month, the Province announced that the financial support would come in the form of 20 year Renewable Electricity Support Agreements with the Alberta Electric System Operator ("AESO") to be awarded in the competitive Renewable Electricity Program ("REP"). For more information, see *Alberta's First Competitive Power Procurement Begins*.

Of course, renewable energy is variable and needs to be firmed, often by gas-fired generation. In addition, the Alberta coal phase-out plan contemplated that gas-fired generation would replace 1/3 of the coal being phased out. The Province and the AESO have always maintained that these new gas-fired projects would be built by developers who would be prepared to take or manage their Power Pool Price risk in the energy-only Alberta market — the way that new gas-fired projects have been built since 1996 in Alberta. Simply put, the Province believed that the gas-fired power would show up as coal got phased out without the Province providing long term contracts or capacity payments to incent developers to build these projects. Accordingly, the "sanctity" of the energy-only market alone was something the Province was married to — at least until this week.

A close reading of the Province's announcement helps one to understand why there has been a change in Alberta policy. The Province reached a conclusion that equity investors and project financiers required electricity price stability and the revenue certainty provided by a capacity market for new projects to be built. Without revenue sufficiency, certainty and stability power projects would not get built in Alberta. The Province was not prepared to count on the energy-only market to send the necessary price signal in time for the gas-fired plants to be built for coal's planned phase out. Those price signals would only come if power supply became tight in Alberta such that there was a reliability risk and more price volatility and price spikes during peak hours, something the Province did not think Alberta consumers would accept. This change to a "capacity market" was also recommended by the AESO, who concluded that the current energy-only market would not ensure that Alberta has a reliable electricity system in the future due to a reluctance for developers to invest in energy only markets. For more information, see Alberta's Wholesale Electricity Market Transition Recommendation on AESO website.

The New Capacity Market

Alberta will now transition to an Alberta electricity market that has two separate markets. A market in which generators compete to sell electricity, and a market in which generators compete for payments to keep generation capacity available to generate electricity when it is required. Generators will have a stream of revenue for capacity and another stream of revenue for the electricity that they sell in the market. Like the PJM Market, Alberta will have both an energy and a capacity market.

This announcement should not impact the first procurement of renewable power under the REP because the capacity market will not be in place until after 2019, when the successful renewable projects from the first procurement must already be in-service. Future procurements may require changes to the extent that a renewable project may be eligible for capacity payments. However, renewable project developers in the first procurement should get the revenue sufficiency, certainty and stability they need from the REP terms announced earlier this month and not from any capacity payment.

The AESO will plan, determine, approve and administer the capacity contracts to procure the capacity required to meet Alberta's electricity demands according to the following timetable:

2017 — Stakeholder engagement to determine design;

2018 — Incorporation of design into ISO rules, contracts and/or legislation as required;

2019 — First procurement begins; and

2020/21 — First contracts awarded.

BLG expects that new gas-fired power project developers will welcome the revenue certainty that the new capacity market will bring for them in Alberta. There are a number of gas-fired projects permitted in Alberta, though we expect that other projects will be initiated and expedited by developers so that they can be ready in time to participate in a 2019 procurement. Though we have focused on gas-fired projects, it should be noted that renewable projects, like large hydro or renewable projects paired with energy storage, may also have capacity value.

Finally, BLG thinks that the move to the "capacity market" could provide a mechanism for the Province to deal with the coal plant owners who are seeking compensation for the phase out of their facilities. The CEOs of both Capital Power and TransAlta, the main coal plant owners in the Province, issued press releases yesterday supporting the Province's actions in moving to a capacity market, as did Terry Boston, the individual the Province retained to negotiate with the coal plant owners. No mention was made about the Province-coal plant owner negotiations, but the CEO of TransAlta was quoted as saying the move to a capacity market "enables us to convert some of our coal plants to gas, keep our workers working, keep our communities strong." Could the "capacity market" be a bridge to a settlement with the coal plant owners? Stay tuned.

AUTHOR

Kent D. Howie
T 403.232.9535
KHowie@blg.com

BLG OFFICES

Calgary

Centennial Place, East Tower
1900, 520 - 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3

T +1.403.232.9500
F +1.403.266.1395

Montréal

1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4

T +1.514.954.2555
F +1.514.879.9015

Ottawa

World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9

T +1.613.237.5160
F +1.613.230.8842

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749

Vancouver

1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2

T 604.687.5744
F 604.687.1415