

September 22, 2021

Ms. Susanna Zagar
Chief Executive Officer
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, 27th Floor
Toronto, ON M4P 1E4

RE: Market Surveillance Panel Monitoring Report 35

Dear Ms. Zagar,

I am writing in reply to your letter of August 24, 2021 and the Market Surveillance Panel's ("MSP" or "Panel") Monitoring Report on the IESO-Administered Electricity Markets for the period from May 1, 2020 to October 31, 2020 (MSP 35).

The MSP's report included eight recommendations to the IESO on three topics. The IESO's responses to each of these recommendations are included below and set out the following:

- a. The steps that the IESO plans to take in response to the recommendations made in MSP 35 and the timelines for completion of those steps; and
- b. In the IESO's view, whether any actions or market rule amendments should be taken or initiated in addition to those reflected in the MSP recommendations.

Demand Response Performance

Recommendation 3-1

The IESO should develop structural solutions for Capacity Auction resource performance failures, with an emphasis on stronger penalties. In general terms, penalties should work together with a Qualified Capacity process to ensure that capacity payments net of penalties reflect each resource's ability to deliver capacity when dispatched.

IESO Response

The IESO agrees with the MSP's recommendation and is in the process of stakeholdering a capacity qualification process for all Capacity Auction resources (including Hourly Demand Response) where past performance will directly impact future qualified capacity and participant revenues.

The capacity qualification process will provide a financial incentive for resources to improve performance and much stronger financial consequences for poor performance. The capacity qualification process will work with performance penalties to ensure capacity payments net of penalties reflect a resource's ability to deliver capacity when dispatched.

The IESO is targeting implementation of the capacity qualification process for the 2022 Capacity Auction. Further information on the capacity qualification process is available on the IESO's resource adequacy stakeholder engagement webpage.¹

Recommendation 3-2

For all Capacity Auction resources, the IESO should adjust penalties and payments such that there are no financial incentives to submit Capacity Auction offers that exceed expected capabilities.

IESO Response

The IESO agrees with the MSP's recommendation and is in the process of stakeholdering a suite of enhancements to the Capacity Auction performance assessment framework. Through this process, the IESO is reviewing the performance assessment framework holistically including testing criteria, performance deadbands, as well as penalties for non-performance. The changes to the performance assessment framework will work together with the capacity qualification process (referenced above with regard to recommendation 3-1) to ensure resources only offer their expected capability into the Capacity Auction.

The IESO is targeting implementation of the resulting performance assessment framework changes for the 2022 Capacity Auction. Further information on the changes to the performance assessment framework are available on the IESO's resource adequacy stakeholder engagement webpage.²

Real-Time Generation Cost Guarantee Program and Carbon Pricing

Recommendation 3-3

The IESO should immediately cease reimbursements to gas generators of carbon cost payments.

¹ IESO Resource Adequacy Stakeholder Engagement Webpage, <https://www.ieso.ca/en/Sector-Participants/Engagement-Initiatives/Engagements/Resource-Adequacy-Engagement>. Please see the May 28, 2021 and August 26, 2021 presentations.

² IESO Resource Adequacy Stakeholder Engagement Webpage, <https://www.ieso.ca/en/Sector-Participants/Engagement-Initiatives/Engagements/Resource-Adequacy-Engagement>. Please see the August 26, 2021 presentation.

IESO Response

The Real-Time Generator Cost Guarantee (RT-GCG) program ensures that non-quick start generators are available to meet reliability in real-time. The RT-GCG Program is not a full cost-recovery program. The objective of the program is to provide eligible generators recovery of certain incremental fuel, operating, and maintenance costs incurred as a result of starting up and ramping to minimum loading point, to the extent those costs are not recovered through market revenues. Carbon costs are an additional operating cost incurred by generators during the start-up period and the IESO considers recovery of these costs to be consistent with the program's methodology³, and appropriately reimbursed.

In the short term, the RT-GCG program will continue to reimburse carbon costs to ensure reliability consistent with the current program design as set out in 2017. In the future, the Market Renewal Program (MRP) will introduce the enhanced real-time unit commitment process which will facilitate enhanced competition between generators based on their all-in costs, including carbon costs. MRP is expected to be in service by November 2023.

Recommendation 3-4

If the IESO insists on reimbursement of carbon cost payments, they should develop a methodology that preserves the incentives of the carbon price. Any reimbursement should amount to a small percentage of the carbon cost payments imposed by the carbon pricing system. Only facilities that have paid an annual carbon cost charge should qualify for the carbon cost reimbursement.

IESO Response

The RT-GCG's current carbon cost recovery methodology is designed to accurately reflect the eligible carbon costs incurred by generators. This methodology takes into account the heat rate of thermal generators by assessing the fuel consumed and energy produced specific to startup operations. With further carbon costs potentially incurred during the full run of a facility, an incentive to reduce emissions intensity and resulting carbon costs remains. The IESO also notes that based on the current emissions intensity benchmark and the dispatch patterns and efficiency of Ontario's gas fleet, all eligible RT-GCG participants are expected to incur an annual carbon charge.

As noted in response to recommendation 3-3 above, in the short term, the RT-GCG program will continue to reimburse carbon costs to ensure reliability consistent with the current program design as set out in 2017. In the future, the Market Renewal Program (MRP) will introduce the enhanced real-time unit commitment process which will facilitate enhanced competition

³ Please see Section 5 of Market Manual 4, Part 4.6, <https://www.ieso.ca/-/media/Files/IESO/Document-Library/Market-Rules-and-Manuals-Library/market-manuals/market-operations/mo-rtgcgprogram.ashx>

between generators based on their all-in costs, including carbon costs. MRP is expected to be in service by November 2023.

Recommendation 3-5

If the IESO does reimburse gas generators for carbon cost payments, the total annual reimbursement from the IESO should be made public to improve transparency, beginning with the total reimbursement to gas generators for 2019 that was made in 2021.

IESO Response

The IESO agrees with the MSP's recommendation. The IESO will provide an update to the MSP with regards to the approach for publishing the total annual reimbursement for carbon costs under the RT-GCG by the end of 2021.

Non-Competitive Procurements

Recommendation 3-6

The IESO should issue a Request for Proposals in all possible cases where it intends to secure a resource to meet an identified system need that cannot be addressed by existing competitive mechanisms (e.g. Capacity Auction).

IESO Response

The IESO agrees with the MSP's recommendation. Competitive mechanisms are preferred, in cases where it is possible to design and execute a competitive mechanism with a reasonable likelihood for a successful outcome. In accordance with the IESO's Resource Adequacy Framework, the IESO intends to use competitive mechanisms to meet identified system needs whenever possible. A competitive process may not be possible where addressing an urgent need to maintain reliability and:

- a. Only one capable supplier exists;
- b. There is insufficient time or benefit to administer an effective competitive mechanism; and/or
- c. Ratepayers would incur additional costs with no benefit, and potentially incur higher costs, compared to a non-competitive mechanism.

There may be instances where a competitive process is not possible, as the IESO has outlined in the 2021 Annual Acquisition Report, and the IESO would expect to secure a better outcome for ratepayers in these cases by entering into bilateral negotiations.

The IESO expects to share additional information with stakeholders on the use of competitive procurement mechanisms designed to meet identified system needs in the 2022 Annual Acquisition Report.

Recommendation 3-7

In advance of full implementation of the IESO's Resource Adequacy Framework, when non-competitive procurements may be required, information should be published that clearly states why a non-competitive procurement was necessary, what effort was made to encourage competition, specific details for both the need and the proposed solution (e.g. amount of annual Unforced Capacity and location), and whether additional actions are necessary if the proposed solution provides more, or less, than what is required.

IESO Response

The IESO agrees with the MSP's recommendation. For planned non-competitive procurements designed to meet system needs, the 2021 Annual Acquisition Report sets out the need being addressed and the proposed solution, the negotiating party, and the justification for a non-competitive procurement.

With regard to efforts made to encourage competition, the IESO is taking a holistic approach across a series of reports and activities. By publishing reliability needs in the Annual Planning Outlook, bulk and regional plans, and Annual Acquisition Report, the IESO aims to transparently identify what system needs exist now and in the future and the steps being taken to address them. This information should inform existing and potential market participants who are interested in opportunities to compete to address system needs. Further, the IESO is also aligning the contract terms of non-competitive procurements with the timing of future competitive mechanisms in order to allow for greater competition going forward.

The IESO publishes details on system needs and whether additional actions are necessary if proposed solutions provide more or less than what is required within the applicable bulk and regional plans, and in the Annual Planning Outlook. For example, details on the system needs met by the Lennox GS were captured in the Annual Planning Outlook⁴, and details on the system need to be met by Brighton Beach GS will be included in the forthcoming Need for Bulk System Reinforcements West of London planning report.

The IESO expects to share additional information with stakeholders on the use of non-competitive procurement mechanisms designed to meet system needs in the 2022 Annual Acquisition Report.

Recommendation 3-8

To facilitate the inclusion of projects with broader public benefits in competitive procurement processes, the IESO should separate non-electricity system costs and benefits from the electricity system cost-benefit analysis and publish the results.

⁴ IESO Annual Planning Outlook, <https://www.ieso.ca/en/Sector-Participants/Planning-and-Forecasting/Annual-Planning-Outlook>.

IESO Response

The IESO is aware that some facilities or projects may provide public benefits beyond those related to the electricity system. Through the operationalization of the Resource Adequacy Framework via the Annual Acquisition Report and subsequent procurement activities, the IESO is shifting the procurement focus from a resource-centric to a system-centric approach, where eligible facilities compete to provide the electricity services needed to maintain a reliable electricity system. The identified needs, ensuing procurements, and ultimately procurement outcomes will help to transparently identify the benefits and costs to provide these electricity services.

However, accounting for any other non-electricity benefits that may materialize from a procurement, outside of the IESO's objects, is not part of the IESO's mandate. Other public benefits are best assessed and published by the appropriate branch of Government, who can assign a value to the public benefit, and determine how much of the cost of that benefit should be attributed to electricity ratepayers. In these instances, the Government is best positioned to provide policy direction to the IESO in cases where these non-electricity benefits are to be factored into electricity system decisions.

With regard to bilateral arrangements, including those that are part of the Ministry of Energy's Unsolicited Proposal assessment process⁵ specifically, the IESO would be unable to publish the results of its assessments as these contain third-party confidential information. Furthermore, as part of the Unsolicited Proposal process, this information is provided as confidential advice to government. Information on the project valuation framework used by the IESO to assess a broad range of projects, including Unsolicited Proposals, is available on the IESO's website.⁶

Should you have any additional questions on these matters, please do not hesitate to contact me at (416) 904-1620 or by email at Lesley.gallinger@ieso.ca.

Yours truly,



Lesley Gallinger, President & CEO, IESO

CC: Glenn Leslie, Chair, Market Surveillance Panel

⁵ IESO presentation on the Unsolicited Proposal assessment process (Feb 2021): <https://www.ieso.ca/-/media/Files/IESO/Document-Library/sac/2021/sac-20210217-unsolicited-proposals.ashx>

⁶ IESO presentation on Project Valuation Framework (March 2021), <https://www.ieso.ca/-/media/Files/IESO/Document-Library/sac/2021/sac-20210217-ieso-project-valuation-framework.ashx>