

MMP Update to the ICAPWG

- Market Power Mitigation Measures*
- Suggestions for the ICAPWG*

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Market Power Mitigation Measures

- *Adequacy of Current Measures*
- *Demand-side Issues*

Market Power Mitigation Measures

Adequacy of Current Measures:

- *MMP advised that the current (proposed) measures are not adequate for the long-run*
 - The current measures do not fully address long-run market power concerns
 - ▶ *Applied to DGU's (Divested Generation Units) not all generation owned by DGO's/Pivotal Suppliers*
 - ▶ *Withholding of non-DGU capacity by DGO's may increase prices above reference levels in Winter 2007*
 - ▶ *Demand-side market power concerns are not addressed by the measures*
 - The negotiated reference price methodology under the current approach is arbitrary and has no basis in economic theory
 - Additional question: do we still need DGU revenue caps?
- *Based on these concerns, MMP does not consider the current measures to be the final long-run solution to market power concerns.*

Market Power Mitigation Measures

The Demand-Side Issue:

- *The following concerns have been raised:*
 - Concern that uneconomic investments made by large demand-side MP's can depress ICAP prices:
 - ▶ *Such investments may be the result of out-of-market bilateral procurements by the MP (i.e., where the contract prices are higher than expected ICAP market prices);*
 - ▶ *The additional supply from these investments will tend to lower capacity prices, which may reduce the costs of other capacity purchases by the demand-side MP;*
 - Concern that these strategic long-run capacity transactions may not be least-cost and are not subject to open tender; and
 - Concern that by depressing capacity prices, uneconomic investment will tend to preempt merchant investment and undermine the market.
 - These concerns are magnified if regulatory support provides cost recovery for the investments.
- *MMP reviewed a hypothetical case of this nature:*
 - We evaluated a number of hypothetical cases under different capacity conditions and concluded that there are cases where large demand-side MPs may have the incentive to engage in the conduct described above.
 - The conditions under which the concern is the greatest is when capacity levels are close to the minimum requirement.
 - However, our analysis did not consider the incentive effects that long-term bilateral capacity contracts and state regulation may have on the large demand-side MPs.

Market Power Mitigation Measures

The Demand-Side Issue:

- *MMP reviewed a specific case involving allegations against an MP made in previous ICAP WG meetings.*
- *We found that:*
 1. The bilateral prices were within our estimates of a competitive range; that is, within a range of estimates that we have determined for CONE.
 2. It is reasonable for prices specific to this transaction to vary from recent ICAP auction outcomes:
 - ▶ *ICAP auction prices are short-run prices that reflect excess capacity, which would not be expected to persist over the long run;*
 - ▶ *Prices for this type of bilateral transactions reflect expectations over the term of the transactions, i.e., the transaction should be priced based on procurement of long-run capacity.*
 3. A documented 2002 decision-basis for this transaction reflected concerns regarding capacity insufficiency and reliability concerns.
 4. Although the transaction may benefit the MP in question, depending on its contractual position and the way it is regulated, it is not clear that the intent of the transaction was to inefficiently reduce capacity prices.
 5. The conduct had very little impact on the market outcomes due to countervailing supply-side conduct (capacity offers by certain suppliers cause the supply curve to be very inelastic near the equilibrium).

Market Power Mitigation Measures

Potential Mitigation of Demand-Side Market Power:

- *Just because we cannot prove the exercise of demand-side market power when looking at recent auctions, this does not mean there is no issue.*
 - Our market rules must be resilient to all likely scenarios that the market may face;
 - When we assessed this concern at the hypothetical level, we did identify some scenarios where we have a problem.
 - MMP therefore recommends that Market Rules be enhanced to manage this concern as part of the long-run solution for this market.
- *It has been proposed that a potential measure to manage market power concerns of this nature is a bid-floor applied to the supply-side of the transaction.*
 - We have some concern with this measure given that offering capacity at very low prices is consistent with competitive conduct in this market and is a common feature in our markets.
 - However, some variant of this type of measure might be reasonable, as discussed next.

Suggestions for the ICAPWG

Suggestions for future consideration

To address supply-side market power concerns:

1. Extend the conduct and impact market power mitigation mechanism to all generation units of pivotal suppliers;
2. Introduce a new reference price methodology that reflects the marginal cost of selling capacity;
3. Review the continued appropriateness of the DGU revenue caps;
4. Review whether a forward ICAP auction may mitigate some market power by allowing potential entrants to sell in our markets.
5. Identify options to increase demand-response to increase compete with supply-side capacity.

Suggestions for future consideration

To address demand-side market power concerns:

1. Introduce rules that require newly-commissioned plants to be offered into the ICAP auctions for a temporary period (i.e. 2-3 years). This will bring make their conduct more transparent and easier to address within the monitoring and mitigation framework.
2. Consider extending the conduct and impact market power mitigation mechanism to new units when certain criteria are satisfied. Such a measure would require:
 1. Clear criteria can to developed to identify when a) uneconomic investment is made by (or supported by) a large demand-side MP, and b) the investment will inefficiently lower capacity prices.
 2. A reference price methodology (or minimum bid requirement) that reflects long-term capacity prices (prices needed to support entry).
 3. That merchant investments be exempt from the measure unless the merchant has a contract or other financial support from a Demand-Side MP.
3. MMP monitoring activities should include more frequent monitoring of the auction process, of potential collusive conduct and more comprehensive participant portfolio monitoring.