

March 30, 2007

Dr. Neil Campbell
Chair, Market Surveillance Panel
Ontario Energy Board
P.O. Box 2319, 2300 Yonge Street
Toronto, Ontario, M4P 1E4

Re: Proposed Framework for Monitoring the Exercise of Market Power

Dear Dr. Campbell,

OPG is pleased to provide its submission on the proposed framework ("Framework") for monitoring the exercise of market power in the IESO-administered markets as captured in the discussion paper of November 2006 ("Discussion Paper"). First, however, I want to thank you and your staff for your efforts to meet with stakeholders, answer questions and ensure that parties understand what is being proposed.

We appreciate your comments in the consultation that the Market Surveillance Panel ("MSP") is prepared to consider submissions on whether there is a need for a framework along with ideas for how to enhance market monitoring within the province's regulatory and policy landscape. Our submission is, as you will see below, focused on these questions.

To assist with its review of the Discussion Paper, OPG sought the advice of two noted experts in competition law and economics, Professor Michael Trebilcock and Professor Adonis Yatchew ("Trebilcock and Yatchew"). In their analysis, which is attached for your consideration, Trebilcock and Yatchew identify a number of problems with the proposed framework. They contend that it appears unnecessarily burdensome and elaborate, that it discourages investment in the industry, and that it appears to be inconsistent with current regulatory and public policy initiatives. They suggest that the MSP replace its proposed detailed focus on hourly spot market fluctuations with a consideration of the relationship between prices and long-run marginal costs.



OPG agrees with the conclusions of Trebilcock and Yatchew. In this submission, we build on their analysis and provide additional comments. Our concerns with the proposed Framework lie in three areas: it does not appear to have a clear and compelling supporting rationale; it will have unintended and undesirable consequences for the market and electricity consumers; and finally, it ignores more appropriate alternatives for enhancing the market monitor's understanding of key issues. Our submission is organized to explain these three areas of concern.

I. Unclear Rationale

In OPG's submission, the MSP has yet to provide a clear and convincing rationale for the proposed Framework in the Discussion Paper.

The move to a hybrid market in Ontario does not in any way suggest there is a need for greater regulatory effort to scrutinize hourly spot market prices. Spot market prices in Ontario affect only about 20% of electricity production in the province. And in the future, the spot market may well become even less important in terms of pricing for consumers. Many parties are advocating for a model that would see most electricity purchased via long term contracts between suppliers and load-serving entities, with the spot market relegated to a balancing pool role. In the meantime, the MSP states not only that there has been no evidence to date of the abuse of market power, but also that Ontario's HOEP recently produced the lowest average prices among the five interconnected markets.¹ In fact, given all the contractual arrangements and other regulatory constraints that already exist in Ontario, OPG submits that the MSP should consider carefully the conclusion of Trebilcock and Yatchew, that "elaborate analysis of pricing behavior in the spot market, as is being proposed in the Discussion Paper, is misplaced."²

In the stakeholder sessions to date, market participants have repeatedly pressed for clarification of the concerns motivating the proposed Framework. By way of response, the MSP has offered two explanations. On the one hand, it claims that the Framework is meant to do nothing more than assist it in its understanding of the market. Yet to what extent is the MSP's current understanding of the market imperfect – after four years of careful monitoring? In addition, the incremental benefit of "ever more detailed and refined" spot market scrutiny by the MSP is

¹ *Market Surveillance Panel Monitoring Report on the IESO-Administered Electricity Markets for the Period from May 2006 to October 2006*, p. 33.

² Michael Trebilcock and Adonis Yatchew, *Report on the "Discussion Paper Prepared by the Market Surveillance Panel of the Ontario Energy Board: Market Power Framework for the IESO-Administered Electricity Market, November 2006,"* [Trebilcock and Yatchew], paragraph 52.

unclear.³ On the other hand, the MSP also claims the Framework has the potential to assist it in identifying and fixing problems in the market rules. Yet it acknowledges that its current approach has worked “reasonably well to date”⁴ and that where it has recommended market rule changes, these recommendations have mostly been implemented.⁵ From where, therefore, does the need for codification and greater scrutiny arise?

Another concern, not addressed in the Discussion Paper, is the potential for the Framework to alter market participant behavior in certain ways. While the paper argues that the proposed framework will only serve to codify existing practices, in OPG’s view this explanation understates its significance. For the first time, participants are being told that their behavior will be assessed against an explicit set of detailed tests and screens, and that a pattern of exercising market behavior as defined by these tests and screens could be deemed an abuse of market power (a point I will return to shortly). The use of these detailed screens and tests has the potential to influence bidding behavior, supplier investment and entry decisions, and market operations. As such, OPG submits that the monitoring framework will itself serve to regulate activity to some degree. To the extent that the monitoring framework will be both descriptive and prescriptive, the MSP should consider the changes it will likely effect and satisfy itself that these probable changes are in the public interest.

Finally, perhaps the most important question arising from the scope of the Framework was touched on briefly above – the ambiguity surrounding the exercise of market power as distinct from the abuse of market power. Fred Gorbet, former Chair of the MSP, said in 2002 that the “mandate of the MSP is to investigate the *abuse* of market power, not simply the exercise of market power. This is an important distinction.”⁶ In the Discussion Paper, however, and as Trebilcock and Yatchew point, the distinction between the exercise and abuse of market power is “far from apparent,” even “highly opaque.”⁷

On this vital issue, the Discussion Paper and recent consultations provide inconsistent messages . On the one hand, we have heard that the exercise of market power is not a sanctionable activity and that no stigma is attached to it. On the other hand, the Discussion Paper explains in a revealing phrase that the “exercise of

³ Trebilcock and Yatchew, paragraph 73.

⁴ *Discussion Paper*, p. 12.

⁵ *Discussion Paper*, p. 1.

⁶ Fred Gorbet, “The Market Surveillance Panel in Ontario’s Electricity Market: Monitoring, Investigating and Reporting,” April 2002.

⁷ Trebilcock and Yatchew, paragraph 28.

market power is not necessarily abusive;” implying that it could be deemed as such under some circumstances.⁸ Indeed, the Discussion Paper is explicit that if monitoring (according to the screens in the proposed Framework) “revealed a persistent, sustained and substantial exercise of market power, this might well be considered abusive and be the basis for an investigation under the [*Electricity Act*].”⁹ Similar views have been expressed in stakeholder consultation sessions by MAU senior staff.

Yet the Framework does not clearly identify the circumstances by which the exercise of market power could come to be seen as the abuse of market power – clearly an issue of significance to all market participants. This omission raises a fundamental concern regarding the potential application of the proposed monitoring Framework. The possibility that the framework could shift unpredictably from monitoring to enforcement under uncertain circumstances raises questions of transparency and fairness.¹⁰ The MSP should make explicit any linkages it foresees between monitoring for the exercise of market power and potential investigations of abuse. Participants should then have the opportunity to comment on the details of the proposed Framework, along with its stated rationale, with such linkages in mind.

II. Unintended Consequences

OPG is also concerned that the proposed Framework could give rise to a number of unintended consequences and undesirable distortions.

First, the Framework has a high potential for false positives, and not only because the very low price threshold of \$50 is likely to be exceeded routinely in a competitive market. All substantial deratings will apparently trigger the conduct threshold, even though substantial outages and deratings will occur in all electricity markets. The proposed ex post test for energy-limited generation (ELG) is also likely to lead to an excessive number of false positives. For one thing, the MSP itself acknowledges that the opportunity cost for ELG will be difficult to infer with

⁸ *Discussion Paper*, p. 12.

⁹ *Ibid.*

¹⁰ As Jones and de Villars argue of Canadian administrative law, “it is possible to view the ‘duty to be fair’ as being either an extension of the principles of natural justice, or as another way of stating those principles;” or again, “[w]e now refer to the ‘duty to be fair’ or procedural fairness’ as overarching principles which incorporate all of the rules of natural justice and which apply to all quasi-judicial and administrative decisions;” David Phillip Jones and Anne S. de Villars, *Principles of Administrative Law* (Scarborough, Ontario: Thomson Carswell, 2004), pp. 204 and 248 respectively.

no established approaches for determining the extent to which hydroelectric generation has been intentionally withheld from higher-priced periods. Given the complexity of operating hydroelectric facilities, the proposed Framework would require an extraordinary amount of detailed daily shadowing and ‘second-guessing’ on the part of the MAU.

Another undesirable consequence of the proposed framework is that it could entail a considerable administrative burden on participants in response to false positives and expanded data catalogue requirements. There may also be a need for participants to replicate the MSP’s testing models to deal with the challenge of answering various types of MSP inquiries that could arise under the Framework. OPG accepts that the MSP could find ways to manage the issues of false positives and the administrative burden by narrowing the scope or frequency of its monitoring, revising its tests and screens, or limiting the degree to which it will make inquiries of participants, even in cases where all three tests are triggered. Nevertheless, if the MSP accepts the paper’s recommended focus of comparing short-run marginal costs and hourly spot market prices, other distortions and unintended consequences will continue to arise.

OPG submits that there are five interconnected ways in which the MSP’s focus on short-run marginal costs and hourly prices to identify exercises of market power could prove inadvertently harmful to the market. First, it could significantly limit the extent of scarcity pricing – despite the fact that it is an “essential signaling device” in the words of the Discussion Paper.¹¹ The paper expresses concern that too much scarcity pricing can allow for the exercise of market power, but the point makes more sense from the opposite perspective. As Trebilcock and Yatchew caution, since the proposal entails a focus on the price-cost relationship in “isolated hours” with “acute” supply-demand imbalances, scarcity pricing ... is almost always likely to prove problematic.”¹²

Second, the proposed Framework’s implicit regulation of offers against short-run marginal costs could prove uneconomic for some existing generators and damaging to the market in the long run. As Trebilcock and Yatchew explain, “pricing at short-run marginal cost is not a sustainable pricing policy, for the simple reason that it does not cover long-run marginal costs (in effect, fixed costs).”¹³ Third, the Framework could serve as a disincentive for new investment. Already there is evidence, including from the MSP’s own reports, that net revenues from the

¹¹ *Discussion Paper*, p. 6.

¹² Trebilcock and Yatchew, paragraph 44.

¹³ Trebilcock and Yatchew, paragraph 43.

Ontario market are not high enough to attract investment,¹⁴ and the proposed Framework would likely reduce prices even further. As Trebilcock and Yatchew comment, “there are arguments to suggest that excessive restrictions and scrutiny (for example, of spot market prices) discourage rather than promote investment in the industry.”¹⁵ The Framework would also discourage investment by adding another layer of rules to an electricity market already characterized by a very high degree of complexity and bureaucracy. Potential new investors will also have to factor in the additional regulatory burden and risk that will come from operating under the proposed Framework.

Fourth, the Framework could “even have an adverse impact on market reliability.”¹⁶ In the short run, it could discourage market imports and energy limited generation precisely when they are most needed, during shortage conditions. In the long run, it could detract from reliability by discouraging new supply. Fifth, the Framework could limit the development of conservation and demand response in Ontario even as others, including the OPA and the IESO, are trying to promote it.

III. Unexplored Alternatives

If the MSP wishes to improve its understanding of key market issues, including the extent of key problems in market rules and the extent of market power reflected in prices, we believe there are better alternatives on both counts – more promising because they will achieve monitoring outcomes, at lower cost and burden, and with less distortion to important regulatory and public policy objectives.

With respect to improving market rules, the MSP acknowledges that the process to date has worked reasonably well. If it wishes to do more, OPG suggests that a more efficient and cost-effective alternative would be direct discussions with market participants and the IESO, who are in the market daily and who therefore have a good understanding of the priority problems that require resolution. A simple quarterly survey of priority concerns among market participants would allow the MSP to execute its mandate of improving market rules effectively.

¹⁴ See e.g. the MSP’s comments on the first page of the Executive Summary of its May-October 2006 semi-annual report, *supra* note 1, p. vii .Or as Bruce Campbell of the IESO comments, “[i]nvestors have indicated, through their behaviour, that market conditions to date have not been sufficient to support investment;” from his presentation “An Outlook for Ontario,” ‘Grid Reliability & Competition in Power Industry’ Insight conference, Toronto, Ontario, December 12, 2006.

¹⁵ Trebilcock and Yatchew, paragraph 5.

¹⁶ Trebilcock and Yatchew, paragraph 21 D.

With respect to market power, we have provided reasons why we believe an inordinate focus on short run marginal prices can inadvertently do more harm to the market than good. Or as Trebilcock and Yatchew aptly sum up expert commentary on the issue, excessive emphasis on the unilateral exercise of market power in the spot market “can introduce market inefficiencies that cause more economic harm than the market power they are attempting to prevent.”¹⁷ The solution to this problem is not, of course, to eliminate analysis of market power altogether. Rather the solution is to examine market power over a time horizon that will yield more meaningful findings and in a manner that will not alter market behaviour in undesirable ways. Put differently, OPG would encourage the MSP to develop a monitoring framework that better aligns with the broader regulatory and policy objectives of the province.

The alternative proposal of Trebilcock and Yatchew provides such an opportunity for alignment. Instead of implementing the Framework in the Discussion Paper, the MSP could focus instead on “longer term relationships between prices and long-run marginal costs,” an issue “of much more enduring concern to both the demand side and the supply side of the Ontario market.”¹⁸ Long-run marginal costs would provide a more meaningful indicator of the overall economics of the market, including potential exercises of market power, than “isolated price spikes” and the “ephemeral” fluctuations of hourly prices.¹⁹ Such an approach also has the ancillary benefit that it preserves the signaling device of scarcity, with its positive implications for demand response, supply adequacy, and market reliability.

If Ontario is moving more towards regulation of generators, the spot market will be less important; if it is moving more towards competition, participants will expect and need light-handed regulation even more than now. In either case, the paper’s emphasis on short-run costs in the spot market appears to be misplaced.

Conclusion

OPG appreciates the extent of MSP consultation with stakeholders and the opportunity to comment on the proposed Framework. However, as set out above, we believe the Framework as presented is not needed, has an unclear rationale and would have significant undesirable consequences for the Ontario marketplace. At the same time, we understand the MSP’s effort to improve market rules and monitor for market power. We believe the alternative approaches we have articulated – regular consultation with stakeholders on market rules and monitoring prices over

¹⁷ Trebilcock and Yatchew, paragraph 21 A.

¹⁸ Trebilcock and Yatchew, paragraph 45.

¹⁹ Trebilcock and Yatchew, paragraph 45.

the longer term in comparison with long-run marginal costs– would be more efficient, cost-effective and meaningful approaches to achieving these goals. Just as importantly, these approaches would not alter market behaviour in undesirable ways.

If you would like to discuss our submission further, we would be happy to meet with you.

Yours truly,

A handwritten signature in black ink, appearing to read 'A. Barrett', written in a cursive style.

Andrew Barrett

Cc: B. Boland
J. Burpee
J. Haffner