March 17, 2003

Mr. James C. Baillie
Chair of the Board of Directors
Independent Electricity Market Operator
655 Bay Street
Suite 410, PO Box 1
Toronto, ON
M5G 2K4

Dear Jim:

I am writing on behalf of the Market Surveillance Panel to respond to your letter of January 17, 2003 in which you asked the Panel to advise the Board of Directors of the IMO on the potential market impacts if any, of certain changes to the confidentiality classifications, and release of information pertaining to generator output and intertie transactions. Specifically:

- you informed us that the Board had decided to release certain information relating to intertie flows in near real-time and IOG price settlement information on a system-wide basis and you asked whether the Panel wished to offer any comments on this decision; and
- you asked for our assessment of the impact of releasing unit specific output in near real-time and planned and historic outages and maintenance of generators, aggregated by fuel type.

This response is organized as follows. Part 1 sets out the process followed by the Panel and the information gathered and reviewed in coming to the views we submit in this letter. Part 2 sets out some general observations that have informed and guided our assessment. Part 3 presents our conclusions on the specific questions you have asked us to assess.

Part 1: The process followed by the Panel

Greater transparency, including in particular, the disclosure of generator-specific information is not a new issue in the Ontario electricity market. At the request of the IMO Board, Allan Kupcis and Michael Trebilcock examined this issue in October, 2000. It was also addressed in the context of encouraging investment (although not in the context of improving price discovery) by John Grant in his letter to you of

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March 1, 2001. This most recent assessment is in response to initiatives taken by IPPSO, which led to an IMO-sponsored consultation process through October and November of 2002.

Panel members reviewed the relevant background material, including the Kupcis/Trebilcock report, the Grant letter, the submissions made to the IMO by market participants in response to the October 24, 2000 announcement of consultations on the IPPSO proposal, the presentations made to the MOSC and minutes of the related discussions, and the IPPSO letter from Jake Brooks to Francis Monize of January 22, 2003.

In addition, the Market Assessment Unit, at the Panel's request, held eight meetings with market participants and with market monitoring personnel from other jurisdictions. At five of these meetings at least one Panel member was in attendance. The Panel also reviewed the minutes of these meetings.

Part 2: General observations

The key argument of those who propose greater disclosure is that such disclosure will improve market participants' understanding of factors that are influencing market outcomes, and in particular improve their ability to forecast prices. They argue that greater transparency is necessary at this stage in the evolution of the Ontario wholesale market because of the dominance of OPG and the resulting asymmetry of information. They submit that the observed price outcomes in real-time compared with pre-dispatch, and the observed volatility in real-time price, seem to result from factors unique to the Ontario market design or structure. Some have conveyed to us their impression that the real-time price may be driven by political interests rather than OPG's commercial considerations. But all have indicated that price outcomes are difficult to understand and explain without greater transparency, and they submit that this lack of understanding makes the market less efficient in the short-run and also makes it more difficult to sustain a case for increased investment in Ontario compared with opportunities for investment in other markets where pricing outcomes are more easily understood.

The benefits that are alleged to flow from a greater ability to understand the drivers of price outcomes include i) improved timing of start-up of fossil generation; ii) more efficient short-term decisions about fuel deployment, and in particular whether contracted natural gas should be used for electricity generation or sold in the spot market; iii) improved timing of planned outages; iv) greater liquidity in the forward markets, and particularly the near-term market; and v) a greater willingness to favourably consider investment in new generation in Ontario. It is also alleged that greater transparency will focus the attention of market participants and others on potentially inappropriate behaviour making it easier to detect, and possibly even deterring such behaviour.

OPG opposes the release of generator output in near real-time, as well as outage information aggregated by fuel type, and has advanced two major arguments. The first is that such information is proprietary, commercially confidential and not required in any of the control areas adjacent to Ontario. The second is that the release of such information in near real-time will allow other market participants to 'price up' or to withhold offers, with the result that prices will be higher than they would otherwise be and market efficiency would be reduced. Neither 'pricing up' nor withholding is contrary to the market rules and they are not necessarily actions that the Panel would regard as abusive of market power. Nevertheless, it is desirable to minimize the likelihood of their occurrence. OPG also submits that requiring the disclosure of detailed information in Ontario will act as a disincentive to new investment by generators who have the option of investing in neighbouring control areas that are less intrusive of their privacy.

Our remit from the Board is to assess, as best we can, the benefits and costs to the efficiency of the marketplace of releasing unit-specific output in near real-time and outages aggregated by fuel type. We were not asked to make a recommendation about disclosure and we do not do so.

Our assessment is based upon the criterion of whether disclosure will increase or decrease the effectiveness of competition. We therefore gave little consideration to the issue of commercial confidentiality and any damage that may result to OPG's competitive position as a result of disclosure, unless there are grounds to believe that this would adversely affect the operation of the market. This is not to minimize the legitimacy of OPG's concerns in this area but rather to acknowledge explicitly that these concerns are beyond the scope of our assessment. We can say, however, that we are not convinced that any negative commercial consequences that OPG may incur as a result of enhanced disclosure would have an adverse affect on the competitive efficiency of the market in its current state of development.

As a general observation, we do not believe a market that is effectively competitive requires the degree of disclosure that is being proposed for the Ontario market. In an effectively competitive market, changes to the fundamentals of the market (key supply and demand drivers) are quickly reflected in prices (either forward market prices or real-time prices) and all competitors can interpret and efficiently respond to the opportunities as signaled through the prices. Our conversations with those responsible for market monitoring in neighbouring jurisdictions confirms that there are varying degrees of disclosure in these markets and that the merits of the level of disclosure depends on the structure of each market. As an example, we understand that the detailed disclosure in the Alberta market, referred to by proponents of greater disclosure in Ontario, was introduced primarily to deal with information asymmetries in that market as a result of the dominance of the three incumbent operators.

As we observed in our October report, the Ontario market is not effectively competitive and is unlikely to become so as long as OPG maintains its dominant ownership position with regard to generation. Our assessment of the issue is therefore couched in terms of whether enhanced disclosure can assist in moving the market toward more effective competition.

We asked the Market Assessment Unit to attempt to evaluate, assess and weight the various arguments relating to market efficiency that are noted above. It quickly became apparent that we continue to face the same basic problem that was noted in the Kupcis/Trebilcock report. That is, the arguments for the potential benefits and the potential costs are all plausible to some degree, but without some actual experience it is not possible to provide quantitative assessments that lend themselves to a rigorous cost-benefit analysis.

The assessment of the alleged benefits, in particular, requires a host of assumptions about how market participants might use the additional information. It is fair to report that there is some skepticism on the part of the MAU and the Panel that the output information being requested will be adequate to provide the understanding of the offer curve and of the price determination process that the proponents anticipate. At the end of the day, however, our view is that rather than second-guessing the proponents on the benefits they claim will arise, we should focus on the likelihood and magnitude of increased costs to load in the form of higher prices than would otherwise obtain.

With regard to the price effects of greater disclosure, we believe that there is some merit in the concern that OPG expresses regarding ‘pricing up’ or withholding by other market participants. This concern is allayed, however, by the current structure of the Ontario market. ‘Pricing up’ occurs when a generator is reasonably confident that it will be the marginal unit and raises its offer to fill any gap that may exist between its average incremental cost and the offer price of the next highest offering unit, thus raising the market clearing price. Withholding (either physical or economic) is profitable if the profit foregone on the generating units withheld from the market is less than the increase in profit derived from the units remaining in production. Withholding leads to both higher prices and less efficient production. There are two key criteria that are relevant to assessing the practical implications of ‘pricing up’ and withholding in the current Ontario market. The first is the extent of market participants’ understanding regarding the shape of the offer curve. The second is the size and composition of the respective generation portfolios of market participants.

At present, no competitor to OPG has a very good understanding of the offer curve and no competitor to OPG has a very extensive portfolio and, in particular, a portfolio that includes both baseload generation and price-setting capacity.

We believe that the enhanced disclosure of generator output and outages will assist market participants in developing a better sense of the offer curve, but we do not believe that this will materially enhance their ability or incentive either to ‘price up’ or withhold capacity. There remains a substantial probability that by attempting to price up they will price themselves out of the money. Moreover, generators with limited portfolios have little to gain and much to lose from a strategy of withholding. A generator with an extensive portfolio which included considerable baseload might be inclined to take the opportunity afforded by improved knowledge of the offer curve to price up or withhold but the facts of the Ontario market are that OPG’s competitors do not presently have such portfolios. This leads us to conclude that given the current state of the Ontario market, the risks of higher prices through enhanced disclosure are not substantial.

There are two caveats to this conclusion.

First, it is possible for a competitor without an extensive portfolio to lessen the risk of pricing up by increasing the offer price for only a portion of its output. It is not clear how widespread or significant such a practice might be, but it would be a practice that could be relatively easily observed and monitored, although we stress again that such a practice would not be offensive under the market rules. This consideration suggests to us that it would not be prudent to release unit output information too close to real time. We have considered what delay might be most appropriate and while there is no hard science that can help in this decision, our judgment is that we would be more comfortable with a delay of at least one hour.

Second, as the market structure changes so that more competitors develop portfolios that effectively allow them to eliminate the risk of pricing up, or profit from withholding, we would become increasingly concerned that the negative aspects of the enhanced disclosure would outweigh the positive aspects. We therefore conclude that if the Board decides to proceed with enhanced disclosure it specifically ask the Panel to monitor the implications and consider periodically whether the disclosure is still warranted. The Board may also wish to consider whether it builds some type of sunset provision into its decision.

With respect to the question of whether greater transparency is likely to enhance or diminish additional investment in Ontario, IPPSO and OPG have diametrically opposing views. Our view continues to be that improved understanding of the Ontario market is essential to new investment and the likelihood of generators establishing themselves in neighbouring control areas to supply Ontario as a means of avoiding disclosure obligations is remote.

Part 3: Specific Conclusions

The Board has decided to release certain intertie flow information and line-specific transmission and intertie outage and maintenance information. It has asked the Panel if it wishes to make any comments on the effect that the publication of this information may have on the market.

> *The Panel has no concerns about the release of such information and no special comments to make to the Board.*

The Board has asked the Panel to assess the implications on the market of releasing unit-level generation output, five to ten minutes after the dispatch interval, and generation outage and maintenance information on both a planned and historic basis, aggregated by fuel type.

> *The Panel has no concerns about the proposal to release outage information disaggregated by fuel type, as proposed in your letter.*
>
> *The Panel has some concerns about releasing unit-specific output information, but we do not think these concerns are significant enough to warrant withholding the information given the stage of development of the Ontario electricity market. We do feel that the information should be released with a longer delay and suggest a minimum of one-hour after dispatch.*
>
> *We also conclude that should the Board decide to release this information (both output and outage), the impacts should be monitored and there should be periodic reviews of the desirability of continuing to release this data in light of the evolution of the structure of the market to one that is more effectively competitive.*

In closing, let me thank the Board for involving the Panel in this decision. We very much appreciate the opportunity to express our view and we hope that it is helpful to the Board's deliberations. I would also like to express our appreciation to those market participants who have assisted us in understanding the issues and arriving at our conclusions.

If you desire any further elaboration of this letter I would be pleased to provide it.

Sincerely,

Fred Gorbet
Chair
Market Surveillance Panel

Attach

Appendix: List of meetings convened by the Market Assessment Unit

January 31, 2003, Conference Call with Rob Cary, Independent Consultant representing Sithe Energies.

February 14, 2003, Conference Call with Joe Bowring, Manager, Market Monitoring Unit, PJM.

February 14, 2003, Conference Call with Wayne Silk, Director, Market Surveillance, and Mike Nozdryn-Plotnicki, Senior Market Analyst, Power Pool of Alberta.

February 14, 2003, Conference Call with Jim Savitt, Principal Economist and Market Monitor, NYISO.

February 17, 2003,* Conference Call with David Hurlbut, Market Oversight Division, ERCOT.

February 26, 2003,* Meeting with Richard Way, Vice President, Regulatory Affairs, TransAlta.

February 28, 2003, Meeting with Randy Heaton, Manager, Emerging Markets, Rules & Compliance, and Andrew Barrett, Vice President, Regulatory Affairs, Ontario Power Generation.

March 3, 2003,* Conference Call with Garrett Tripp, Trader, UBS Warburg Energy Canada.

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* At least one Market Surveillance Panel member attended all meetings, except those marked with an asterisk.