Electric Power Supply Association
Advocating the **power** of competition

MARKET MONITORING:
Guiding Principles

BACKGROUND

- Anti-competitive behavior hurts competitors as well as consumers. EPSA has consistently argued that such behavior must be identified and remedied. However, high prices, in and of themselves, are not proof of anti-competitive behavior and may be due to market fundamentals such as supply scarcity, high demand growth in a short period, or high variable costs. Market monitors should not attempt to artificially adjust prices (high or low) that are sending accurate price signals to the market.

- Standards to identify and remedy anti-competitive behavior must be clearly stated and consistently applied. While there are unique features of the California market that must be taken into account, the standards for market monitoring in California should not be fundamentally different from those applied elsewhere. In addition, California should not replicate the disruptive experiences with market intervention experienced in some of the eastern ISO markets.

- We see three progressive levels of market power assessment that the Commission might apply.

FIRST-LEVEL ASSESSMENT

- In assessing market power, the Commission first should apply traditional antitrust standards, focusing on generation and transmission market concentration levels and barriers to entry. These standards are the core of the Commission's market power review with respect to mergers and market-based rate authority.

- In addition, a first-level assessment of market power must take into account the effect of specific market rules such as mandatory use of spot markets by regulated load-serving entities and prohibitions on use of risk management tools such as forward contracting. This first-level assessment should also examine the ability of end-use customers (or their agents) to respond quickly to changes in commodity prices. **By identifying anomalous market rules and recommending changes early on, a market monitor may be able to prevent troublesome outcomes by making the market work more efficiently.** If this can be achieved, the need for further market monitoring would be reduced significantly.

SECOND-LEVEL ASSESSMENT

- If a second-level assessment involves a review of market prices, it is essential to recognize that market prices which result from bids above marginal energy cost are not evidence of market power. Numerous factors can lead bidders to bid above or below their marginal energy costs in a given hour.
- **Chief among the factors omitted by a marginal energy cost analysis are capacity value, opportunity costs, scarcity value, and risk.** Until there is a generally accepted methodology for measuring these four factors, applications of price-based tests for market power are challenging and would require significant consensus among the parties on appropriate methods and data sources. (Some marginal cost analyses omit even more fundamental factors such as transmission constraints and emission offsets.)
- With respect to capacity value, it is essential that such value be reflected so that new investment (new entry) is sufficient to assure system reliability. If a marginal cost analysis is used, marginal capacity value, which varies as generating capacity and load get out of balance, must be included.
- Opportunity cost, in its many forms, can often explain why a bidder would bid above its marginal costs. A bid might reflect the fact that the bidder has the opportunity to sell electricity at a higher price in another geographic market (in the Desert Southwest rather than in California, for example) where prevailing market conditions have created higher prices in the short-term. Similarly, a bid could reflect the opportunity to sell in another product market (ancillary services rather than energy, for example).
- Other situations in which opportunity costs matter include (a) times when it would be more profitable to resell natural gas supply rather than use it to generate electricity and (b) times when it would be more profitable to resell emission credits. In these times, any price analysis must be sure to reflect current market prices for gas and offsets. Opportunity cost should also be taken into account at times when a generator facing limitations on operating hours would find it better to wait to produce at another, more profitable or critical market period.
- Scarcity value must be reflected when available generating capacity falls short of customer needs. At that point, market prices must rise to the level necessary to curtail load. In a shortage, prices reflect customer value, not supplier cost.
- Risk management comes into play because physical or financial commitments have been made in the face of uncertainty. The decision on whether to run and what price to offer could reflect, for example, a commitment to assure physical reliability.

THIRD-LEVEL ASSESSMENT

- If a situation has passed through the first two levels of assessment, and there is evidence that market power has been exercised, a third level would be applied. A third-level assessment would delve into specific indicators of potential market power abuse such as those listed by the Commission (outage rates of seller's resources, failure to bid unsold MWs in the real time market, and variations in bidding patterns for the same or similar resources).
- Failure to bid all of a generating unit's capacity into the energy market is not evidence of market power abuse. Numerous factors can lead a generator to fail to bid in a particular hour, including limits on total operating hours, limits on fuel or hydroelectric resources, a need to hedge against possible outages in real time by other units, or maintenance requirements.
- Accurate status reports on unit availability must be provided by resource schedulers. Routine audits should assure suppliers are accurately stating unit availability.
- If and when the Commission goes beyond such audits, it is essential that some safe harbor standards be set to document "valid" reasons for outages, failing to bid, and varied bidding patterns.

THE MARKET MONITORING PROCESS

- **The process of market monitoring is as important as the technical approach of any assessment.** Although the market monitor must rely on ISO/RTO systems and data, the market monitor should be independent from the ISO and transparency of any analysis should be assured. Any party or parties alleged to have acted in an anti-competitive manner should have an opportunity to address the allegations. The market monitor should provide the diagnostic analysis and recommend remedies for anti-competitive behavior. Enforcement of any relevant laws, however, should be left to FERC and the DOJ. The market monitor should identify market rules that impede an efficient market and recommend rule changes.
- Going forward, the scope of the market monitoring function in commodity energy markets should diminish because single-price auctions should be used to set the market clearing price only for a small residual market. Freed of regulatory and political constraints, most buying and selling is likely to occur through voluntary, negotiated bilateral contracts. For the remaining short-term markets, the market monitor must consider that accurate price signals are needed to encourage investment in new generation and demand-side management, as well as encourage use of appropriate hedging mechanisms.