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Market watchdog provides “no guidance” on controversial offer behaviour amid power market changes

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For electricity market participants, the practice of intentionally pricing power generation out of the market to drive price spikes is one of particular interest. This practice – commonly referred to as “economic withholding” – is regarded as illegal in some jurisdictions, but has been accepted as permissible behaviour in Alberta, at least since 2011. However, on May 26, 2017, the Market Surveillance Administrator (MSA) revoked the Offer Behaviour Enforcement Guidelines (OBEG) [PDF], which had once clarified that generators engaging in economic withholding would not be subject to enforcement actions. In its decision to revoke the OBEG (available here [PDF]), the MSA stated its view that the negative effects from economic withholding would no longer be offset by the benefit of incenting new investment in generation due to the impending transition to a capacity market. While the MSA hasn’t gone so far as to impose a “prohibition” on economic withholding, this move signals the need for market participants to proceed with caution when engaging in offer behaviour strategies that aim to impact market prices.

This update examines the process leading up to the OBEG’s revocation, the reasons for the revocation, and what this means for market participants going forward.
I. BACKGROUND

Effective September 2009, the *Fair, Efficient and Open Competition Regulation* (FEOC Regulation) introduced a number of prohibitions that were applicable to the behaviour of market participants in Alberta’s electricity market. In January 2011, the MSA introduced the OBEG, which was intended to explain the MSA’s analytical framework and enforcement of the FEOC Regulation as it applied to offer behaviour. The purpose of the OBEG was to provide transparency and predictability regarding the MSA’s assessment of market participant offer behaviour so that market participants could govern themselves accordingly.

The OBEG addressed unilateral effects arising from individual market participants responding to incentives and acting alone. The MSA noted that single participant conduct aimed at capturing surplus profits that a market participant has created independent of the conduct’s effect on rivals is considered competitive and would not result in an enforcement action from the MSA. One example of this offer behaviour is known as economic withholding. The MSA, consistent with the United States Federal Energy Regulatory Commission (FERC), defined economic withholding as:

“offering available supply at a sufficiently high price in excess of the supplier’s marginal costs and opportunity costs so that it is not called on to run and where, as a result, the pool price is raised. Such strategy is only profitable for a firm that benefits from the higher price in the market.”

The OBEG posited that, in the absence of a capacity market, economic withholding was permissible because, in the long term, it spurred dynamic efficiency that outweighed any static efficiency losses. The dangers from the opposite approach of giving too much emphasis to static efficiency losses was that it could chill the incentive to innovate or invest. Ultimately, so long as the benefit derived from dynamic efficiency outweighed the static efficiency loss, resulting in a net efficiency gain, competition and innovation would flourish.

In December 2015, following a number of high-profile decisions from the Alberta Utilities Commission (AUC) interpreting the FEOC Regulation and the OBEG, the MSA held a preliminary stakeholder meeting respecting a possible “refresh” of the OBEG. In June 2016, the MSA issued a notice indicating that the comments received from stakeholders indicated that other matters, including those related to the Climate Leadership Plan (CLP) (discussed here), demanded a significant amount of the stakeholders’ time and that the consultations respecting the OBEG would resume once other demands had subsided.

On October 3, 2016, the Alberta Electric System Operator (AESO) issued a report and recommendation that Alberta transition from an energy-only market (EOM) to adopting a capacity market structure. On November 23, 2016, the Government of Alberta endorsed the AESO’s recommendation to transition from an EOM to a new framework that would include a capacity market (available here). On January 10, 2017, the Government of Alberta issued a mandate letter to the AESO, AUC, and the MSA in relation to Alberta’s transition to a lower carbon system and a new capacity market framework (available here [PDF]). The Government of Alberta asked the AESO to lead the technical design of the new capacity market and ancillary services products to enable an efficient and reliable electricity system. The AESO was to work in conjunction with the AUC and MSA in leveraging their collective expertise.

II. REVOKE THE OBEG

On March 17, 2017, in light of the impending changes to the electricity market in Alberta, the MSA...
announced a stakeholder consultation process respecting the possible revocation of the OBEG. The MSA noted that a revocation of the OBEG would not result in a change of market rules or the legislative framework, but would signal a change in the MSA’s enforcement stance in relation to economic withholding. The MSA cited an AESO statement to support the contention that no investments in new supply were expected until the details of the capacity market were determined.

The stakeholder engagement process involved two rounds of written comments, an in-person stakeholder meeting and a draft and final version of the MSA’s position. At all times, Matt Ayres (the person designated as the MSA) signalled his view that economic withholding should no longer be permitted and that the OBEG should be revoked. In contrast, all stakeholder participants took the view that the OBEG should not be revoked. In summary, their views were:

- Market participants made investment decisions in reliance on the OBEG and none of the applicable market rules or regulations have changed since the OBEG was issued.
- There is no current problem with economic withholding/market power due to (i) the current supply/demand balance, (ii) the Balancing Pool’s control of a large portion of the market following the recent termination of power purchase arrangements (PPA) (discussed here) paired with the Balancing Pool’s ongoing practice of offering electricity at short run marginal cost, (iii) forthcoming generation from the Renewable Electricity Program (REP), and (iv) high levels of forecast reserve margins.
- By revoking the OBEG, the MSA will create uncertainty that damages investor confidence and/or delays investment decisions and will send a signal to investors that the current low-price environment is likely to continue.
- The MSA has failed to consider that new investment might occur or is occurring and results in dynamic gains and the MSA does not give proper weight to whether static efficiency losses will result in corresponding dynamic efficiency gains from innovation and investment.
- The MSA must present evidence or has an onus to provide evidence to support a change, and it has not provided any evidence in this case.
- Guidelines are necessary and are part of the “price setting regime.”
- The REP structure is unfair and generators need sufficient offer flexibility.

Consumer organizations were also not supportive of revoking the OBEG at this time. The representative association for large industrial power consumers provided the following comments:

- The electricity market does not provide a guaranteed return nor should it, but market participants were not anticipating the centralized market power that developed following the transfer of the PPA assets to the Balancing Pool and, given the current price environment, it is unclear that the market can sustain itself through the transition.
- It may be more prudent for the MSA to better articulate needed outcomes during the transition than to revoke the OBEG outright.
- As a new capacity market design has yet to be finalized, it may be premature to discuss changes to the OBEG until a clearer capacity market design emerges.

On May 26, 2017, the MSA revoked the OBEG. The MSA’s views expressed in person and in writing were that:

- In light of the impending capacity market, a net benefit from economic withholding would not be realized by the loss of static efficiency for the gain of dynamic efficiency. The MSA acknowledged it had not recently observed significant instances of economic withholding.
- The OBEG was not in place to ensure fair returns to investors. Further, the OBEG was expressly not
The MSA's attention is not limited to the revocation of the OBEG during the transition to a capacity market.

III. CONCLUSIONS AND IMPLICATIONS

Despite the various provisos cited by the MSA through the consultation process, economic withholding was commonly regarded as “safe” conduct in Alberta prior to the revocation of the OBEG. The FEOC Regulation is silent on that issue, and thus the only firm pronouncement on the practice was found in the OBEG, which participants relied on. Recently, in the context of an MSA-initiated proceeding regarding the AESO’s historical trading report, the AUC confirmed that “the OBEG clarifies that market participants can exercise unilateral market power through economic withholding” (the decision is here [PDF]). Therefore, our view is that the OBEG did indeed provide useful clarification.

By revoking the OBEG for the reasons stated in its decision letter, the MSA has signalled to the market that economic withholding is no longer consistent with the fair, efficient and openly competitive operation of the electricity market. It follows that the MSA may be inclined to take enforcement action if it observes a generator engaging in this type of behaviour. This is consistent with the MSA’s earlier statement that a revocation of the OBEG would “signal a change in the MSA’s enforcement stance in relation to economic withholding.” In that regard, we note that the AUC typically acts consistently with the recommendations from the MSA when it comes to interpreting the FEOC Regulation and questions of competitive vs. anti-competitive behaviour.

As a result, we recommend that market participants refrain from engaging in economic withholding or other unilateral conduct with the intent of causing significant market price movements without first seeking guidance from the MSA. The MSA has indicated that it remains willing to meet with market participants and to discuss possible offer strategies – including fact patterns – and to offer guidance on a one-on-one basis. Some market participants – especially small players – have expressed concern over this behind-closed-doors approach to market guidance, which lacks the transparency and reliability of published guidelines. However, it is currently the only tangible means of receiving guidance on the MSA’s enforcement stance in the absence of a published guideline on offer behaviour.

Through the consultation process, stakeholders complained that revocation of the OBEG would send a signal of a continued low price environment in Alberta and that it would impact decisions made by investors. This could include decisions by generators to expand or maintain operations and by lenders that support those businesses. At the same time, electricity prices are currently depressed and the opportunities to engage in economic withholding or similar behaviour are few and far between. It therefore remains to be seen whether there will be any tangible impacts experienced as a result of the
OBEG revocation.

We note that the MSA is currently investigating the conduct of the Balancing Pool through a confidential investigation process (the announcement is here [PDF]). If the outcome of that investigation causes the Balancing Pool to change its offer practices or if intervening events cause a shift in the current supply/demand balance, the permissibility of economic withholding and similar behaviours could once again become a live issue.

Finally, we note that the MSA is not the only entity that can make relevant determinations regarding economic withholding. The AUC or the government could address this conduct through regulation or – more likely – the AESO could provide important clarity through market rules. However, this is unlikely to occur outside of the capacity market implementation process. The development of that market – including the associated rules – is still in the early stages. The new framework is not expected to be in place until late 2018, at the earliest, followed by first capacity procurement in 2019 and first delivery as early as 2021. Market participants will have to take a cautious approach to developing and implementing offer behaviour strategies in the meantime.


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