Neither Flat Forward Nor Over Backwards

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The Market Surveillance Administrator is an independent enforcement agency that protects and promotes the fair, efficient and openly competitive operation of Alberta's wholesale electricity markets and its retail electricity and natural gas markets. The MSA also works to ensure that market participants comply with the Alberta Reliability Standards and the Independent System Operator's rules.

The title in the conference brochure – Competition Issues in the Alberta Electricity Markets – is perhaps a little too grandiose (although I chose it myself some months ago). If I followed that path I fear that any number of you in the audience would leap up with suggestions on important issues that I have overlooked.

So this is a bait and switch: I am going to speak about the MSA's philosophical and methodological approach to competition oversight. And you will see why I call it "Neither Flat Forward Nor Over Backwards" in a moment.

The focus of my remarks then is the broad frame of reference the MSA will take in analyzing competition issues now and for the next four years. This framework is shaped by the Alberta construct, the special nature of electricity markets and (I hesitate to admit) almost 40 years of experience in promoting competitive markets in various capacities.

Alberta is itself special by virtue of the strong entrepreneurial spirit that has developed over the years in the energy sector, particularly oil and gas, and the unwavering commitment by the government to the wholesale electricity market. Other jurisdictions have not been so lucky; I need only mention that great province to the East, Ontario, where the ugly word "market" was effectively expunged from the equivalent of Alberta's *Electric Utilities Act* in 2005 and where there are periodic applications of carbolic soap to those who forget.

The special nature of the Alberta framework is referenced in the MSA's Foundational Elements discussion paper released in April 2010.[1] The statutory language setting out the purposes of the *Electric Utilities Act* that we cited is worth repeating:

> The purposes of this Act are…
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> (b) to provide for a competitive power pool so that an efficient market for electricity based on fair and open competition can develop, where all persons wishing to exchange electric energy through the power pool may do so on non-discriminatory terms and may make financial arrangements to manage financial risk associated with the pool price;

[1] Market Surveillance Administrator (April 2010).

> (c) to provide for rules so that an efficient market for electricity based on fair and open competition can develop in which neither the market nor the structure of the Alberta electric industry is distorted by unfair advantages of government-owned participants or any other participant;
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> (d) to continue a flexible framework so that decisions of the electric industry about the need for and investment in generation of electricity are guided by competitive market forces;
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> …
>
> (h) to provide for a framework so that the Alberta electric industry can, where necessary, be effectively regulated in a manner that minimizes the cost of regulation and provides incentives for efficiency.
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> (Emphasis Added)

From this and other aspects of the existing framework for the Alberta wholesale market we observed:

> ...the legislative framework is constructed to allow competition, not regulation (and particularly not quasi-price regulation), to shape market outcomes. A key role of the MSA is then to monitor whether competition and competitive market outcomes are impeded by market participant conduct, by rules or by other means. If competition is enabled and allowed to deliver an efficient outcome, regulatory intervention is not warranted.[2]

Lurking behind this statement is a piece some years ago by one of my mentors, Lawson Hunter, that I remember fondly because of its original title: "You Might as Well Fall Flat on Your Face as Lean Too Far Over Backwards".[3] The essential message of which is that competition authorities should not be overly zealous to fill the void left by the departed brethren from the regulatory sphere. In Lawson's words:

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[2] Ibid. page 1.

[3] For those of you interested, the parable from which this title was drawn is a James Thurber story about the bear who lived in a tree with his wife and son. The bear drank to excess, came home late, knocked over the chairs and lamps in the living-room, and his wife and son were so afraid. One day the bear saw the error of his ways, stopped drinking and took up physical fitness. He started exercising regularly, brought equipment into the living-room, knocked over the chairs and lamps, and his wife and son were so afraid. The parable of the story, of course, was that you might as well fall flat on your face as lean too far over backwards.
Quoted in Hunter (1997).

> …as more and more formerly regulated sectors of the economy fall under the competition law model, the pressures will be great for competition authorities to act in a quasi-regulatory fashion. Such a result could, at the extreme, merely replace one regulator for another. Not only would it be a perversion of traditional competition law values, but it would run the serious risk of not reaping the benefits of the deregulation policies advanced by governments.
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> The competition authorities must be extremely careful that they do not embark on a course that produces detailed, behaviourial conduct rules for industry, requiring constant monitoring and supervision in the application of the competition policy.[4]

I expressed this sentiment in a slightly different way a year ago when I drew on the sports metaphor that 'the best games are those where the referee is almost invisible and the play unfolds based on the competitive abilities of the teams'.

For the referee to stay in the background requires that the players understand the rules and the MSA has taken several initiatives to make this so. The starting point is an acknowledgement of the founding principle of the Alberta market - section 6 of the *Electric Utilities Act* that states "market participants are to conduct themselves in a manner that supports the fair, efficient and openly competitive operation of the market." It is in everyone's interest to meet this commitment and the MSA does not view it as necessarily an adversarial process. The challenge is communicating how the MSA will apply this flexible standard.

Let's talk about MSA analytics vis-à-vis section 6 of the *Electric Utilities Act*. The Alberta market is still young and the statutory language is new and largely untested. It is expressed in general terms and that is as it should be because the concepts need to apply to a variety of circumstances. While it is not possible to be prescriptive and, in fact, dangerous to be so, there is a well trodden path that provides guidance. This is the law and economics of competition policy (antitrust) that has developed over the past 100 years in North America, Europe and Australasia. The MSA will be applying this logic in the Alberta context and that alone should ensure consistency and provide a compass for stakeholders.

We drew on this learning in assessing the allegations that ENMAX was not acting in a manner that supported the *fair, efficient and openly competitive operation of the market* - a major case that preoccupied the MSA in 2010. At its heart the allegations were that ENMAX had an unfair advantage by virtue of its ownership by the City of Calgary and

[4] Ibid. p. 22. This short, insightful article is well worth reading.

an exclusive long term supply agreement that hobbled other participants' ability to compete.

Our starting point was the development of the 'theory of the case' – a term that you will be hearing on a repeated basis in the future. The theory of the case involves two things: (i) a working hypothesis about how the conduct in question harms competition (an economic analysis), and (ii) whether the hypothesis and supporting facts meet the legal requirements (a legal analysis). It is an analytical process that allows us to assemble and test the evidence against the relevant legal standard drawing on the economics of competition analysis.

In the case of ENMAX it involved testing whether there was a plausible theory of foreclosure based on the allegations and targeted evidence we sought during our investigation. Foreclosure in this context meant a dominant incumbent depriving competitors of a major downstream outlet or customer for their product. In essence, did ENMAX have the market power in either the conventional energy market or Alberta's renewable energy market to undermine competition? We found, based on a relatively exhaustive review of the facts, that the conduct at issue did not create or maintain market power, i.e. harm competition.[5] We also found that the law did not place a special onus on the City of Calgary on how it chose to procure energy.

Not everyone will be happy with these findings but it is grounded in sound, well-established competition analysis. Our report sets out the principles of analysis as clearly as possible so market participants can govern their conduct accordingly in future. I believe it meets Lawson Hunter's dictum.

The MSA's development of an offer behaviour guideline has provided another opportunity to provide guidance and bring the application of competition law and economics into the Alberta context.[6] It provides the analytical basis to distinguish between what are called unilateral effects and coordinated effects. I will elaborate on this in a moment.

I earlier referred to the special nature of the Alberta market and one of those aspects is what is tagged as 'energy-only'. In the words of the *Electric Utilities Act* - "…to continue a flexible framework so that decisions of the electric industry about the need for and investment in generation of electricity are guided by competitive market forces".

[5] This is explained in detail in our public report. MSA (September 2010).
[6] The principal documents are found under the MSA's Consultations tab http://albertamsa.ca/

This sets us apart from almost all organized electricity markets in the world and demands a different approach to addressing the exercise of market power that may lead to market prices higher than (short run marginal) costs for varying periods of time. On this point, Peter Cramton, an expert on auction markets, comments as follows:

> As a matter of economic theory and sound market design for wholesale electricity bid-based auction markets, there is and should be no competitive norm stipulating that suppliers' bids should equal marginal costs. The lack of marginal cost bidding is not evidence of anticompetitive or manipulative behavior by market participants, nor is it evidence even that competition is failing or that markets are broken. In any real-world market in which suppliers are not forced by conditions or rules to be price takers, bidding above marginal cost is consistent with and, indeed, is impelled by independent, non-collusive, profit maximizing behavior. Bidding above marginal cost should be viewed as an inevitable and desirable response of independent, profit maximizing decisions in real-world markets where the ideal conditions of a perfectly competitive market do not prevail.[7]

The MSA has adopted a two-pronged approach: First, a tolerant attitude to single firm offer behaviour not tainted by anticompetitive conduct, meaning behaviour that creates, enhances or maintains market power. Second, identification, assessment and reporting of these price excursions, with a call to action should the market not respond in a way consistent with a *fair, efficient and openly competitive operation of the market*.

Let's discuss these prongs in more detail. The MSA's approach is more tolerant compared to, say, the U.S. markets which all have a capacity market in one form or another and typically have major transmission congestion issues. As a consequence, these markets all have price controls to address the exercise of market power, mainly in the form of the famous AMP (Automatic Mitigation Procedure) – the market equivalent of a Taser where offers are sapped when they breach a pre-determined threshold.[8]

Our discussions with stakeholders on offer behaviour have clarified that unilateral action affecting the Pool price, whether up or down, will not be challenged by us unless it is associated with ancillary restraints that impede competition. The intellectual basis for this comes from the antitrust world. It is what a learned commentator in the field, Dennis Carlton, calls "extension" – "single firm conduct that increases the firm's profit

[7] Cramton (2004).

[8] Offer prices are reduced after they have been submitted to control the perceived exercise of market power.

by weakening or eliminating the competitive constraints provided by products of rivals."[9]

We believe this approach fits within the language of the FEOC Regulation and is appropriate for an energy-only market that has a price cap and other mechanisms to check market power. We have also taken the fundamental view that the Alberta framework is meant to promote dynamic efficiency, not just static efficiency. Dynamic efficiency is about new investment in generating capacity, the retirement of costly production facilities and the introduction of new products and services all of which are the domain of competitive markets.

This is a unique and longer term view of the performance of an electricity market. Once again, I draw on another of Lawson Hunter's tenets. He counseled that:

> "…it must be recognized that the application of competition laws does not have immediate short-run effects. The policy, overall, is a medium- to long-term policy. This means that administrators of competition policy and their political masters should not try to place expectations and demands on competition law regimes to produce immediate results."[10]

While I am saying the MSA will not be pursuing individual market participants for pure pricing behaviour alone without associated anticompetitive behaviour, that does not mean that we will stand by if we do not see the competitive response one would expect in a market regulated by FEOC market forces. However, rather than attempt to police or constrain the individual market participant we would look to the removal of rules or procedures, extending even to structural remedies where necessary. The obvious forum for discussion and decisions on potentially consequential matters of this order is a proceeding before the Alberta Utilities Commission initiated by a section 51(1)(b) *Alberta Utilities Commission Act* application.

Cramton observes that this approach spotlights flaws in market rules:

> A final benefit of profit maximizing behavior is the identification of poor market rules. Restructured energy markets begin with imperfect rules. Profit maximizing bidding exposes these imperfections, leading to corrections that move the market toward an efficient long-run equilibrium. All new electricity markets have had market rules that have led to unanticipated

[9] Carlton and Heyer (2008) p.1. This paper is a brief and exceptionally clear exposition of the difference between problematic (" extension") and acceptable (" extraction") forms of single firm conduct.
[10] Hunter (1997), p.22.

> behavior by some participants. When this behavior has been detrimental to market efficiency, the rules often have been adjusted to eliminate the adverse behavior. Thus, even though the market rules may result in short-term adverse behavior, the behavior itself ultimately leads to overall market improvements by identifying undesirable market rules. Profit maximizing behavior thus provides the signals necessary to reduce these market imperfections.[11]

Some market participants have asked how they will know when this frontier is about to be breached. There is no precise brightline or coloured traffic signal that I can offer but the MSA will continue to regularly report facts and its analysis of events in the market. There should be no surprises. We have also elaborated on the principles and decision points in our hypothetical illustrative examples to be reflected in the forthcoming enforcement guideline.

All of the foregoing relates to what we have called unilateral effects; it is single market participant conduct. Coordinated effects are the second category and it covers arrangements between or among participants that have not been given an express exemption. The issue was summarized in our June 2010 discussion paper where we observed that:

> Alberta's tight oligopoly structure means the MSA must be vigilant to potential adverse competitive effects termed 'coordinated effects', that is, the risk of coordinated, accommodating, or interdependent behaviour among rivals. Simply put, it is easier to organize anticompetitive behaviour when there is a small number of competitors than when there is a large number. (This is not a statement about the ethical behaviour of the market participants in Alberta but simply recognition of the classic oligopoly structure of the Alberta market where a small number of entities supply most of the market.) In addition, through joint ventures and power purchase arrangements market participants are frequently in contact with one another. These arrangements are fundamental to the Alberta market and satisfy legitimate business purposes. Nonetheless, they may also create avenues for collusion or coordination.[12]

I interpret the quiet reaction of stakeholders to our strong take against horizontal arrangements during the guideline discussions as acknowledgement that this is a no-go area. The rub may well be around the boundaries of existing authorized arrangements,

[11] Cramton (2004) p. 12.
[12] MSA (June 2010) p. 4.

such as the Power Purchasing Arrangements. Once again, some of the illustrative examples and the forthcoming Offer Behaviour Guideline will seek to clarify our views.

I would again stress that any suggestion of coordinated behaviour can quickly become a very sticky business for the participants involved, willingly or unwillingly. Early contact with the MSA would be prudent and, I would assume, make your risk officers and lawyers happy. The mechanisms for doing so are discussed in some of the MSA's written materials and will be addressed again in the forthcoming Offer Behaviour Guide.

Procedures and Expectations

Let me now turn to some procedural practices and expectations appropriated from the antitrust world that will move in parallel with the MSA's analytics. Complaints and allegations are just that until the MSA is satisfied of a contravention or that there is 'an issue to be tried'. Until that point the investigations are private and the identity of the party or parties under investigation will not be disclosed. Monitoring reports will be on a no-names basis for the same reason.

MSA investigations are evidence-based and organized in terms of the theory of the case that I described earlier. Once a preliminary picture emerges we will not hesitate to test the strength of our findings with the parties involved. Our view is that it is only responsible to do our best to learn of factual errors or misconceptions before involving parties and the Alberta Utilities Commission in an expensive formal proceeding.

The same view of engagement and openness to debate and discussion extends to matters that do not necessarily involve investigations. We view it as important to be accessible and as transparent as possible (while protecting information that must be held confidential). Clearly the MSA does not have all the answers but an exchange of views helps clarify everyone's thinking around an issue. That has certainly been the case as we moved through the consultative process on the offer behaviour guideline during the course of the year.

A final observation: complainants that allege anticompetitive behaviour by another market participant seem surprised when they are asked to show the competitive harm they are suffering. The only one more surprised is me. In future I would hope that complainants are prepared to demonstrate not only how the conduct harms them, i.e., restricts their ability to compete, but why this restriction on their ability to compete harms <u>competition.</u> There can be no more probative evidence to prove a breach of section 6 than that coming from a participant in the marketplace.

Closing Remarks

As I said a year ago, Alberta is a real gem among organized electricity markets in the world. It is unique in many ways. I have highlighted the forceful commitment to market forces and our recognition of the network and design differences with other jurisdictions.

Wholesale electricity markets are difficult beasts. Harnessing a complicated technology, delivering a staple commodity in real time and transacting billions of dollars annually require precise technical rules.

Operating in parallel, the preservation and promotion of competitive market forces - achieving Alberta's *fair, efficient and openly competitive operation of the market* - requires a deft hand that is not overly interventionist, sees the big picture, is grounded in well-developed concepts and principles but ultimately is moved by facts not theories. This is the challenge the Market Surveillance Administrator accepts going forward. It hopefully involves neither a face plant nor falling over backwards.

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