Categorization of Market Issues

UC Market Simulation Group
What Could Go Wrong?

• Market Power
• Market Manipulation
• Non-strategic Market Frictions
Confusion Between Market Manipulation and Market Power

• “Market Manipulation” is standard term used when behavior in commodity markets is not competitive

• That’s because commodity markets *usually* trade goods produced by sellers with little market power
  – Gold, silver, wheat, corn, oats, natural gas
  – BUT then there’s oil or electricity?

• Regulators have at times responded to market power problems with actions meant to control market manipulation

• A poor policy if the real problem is market power
Distinguishing Strategic Market Behaviors

• Market Power - maintaining price above (or below) competitive levels, usually by changing supply
  – Or, with cap and trade, by changing demand
• Market Manipulation - creating profitable short-run price deviations, usually with (mis)information
• Some differentiating characteristics
  – Physical participant vs trader strategy
  – Supply/demand-based vs information-based strategy
  – Equilibrium vs dis-equilibrium strategy
• Related issue: manipulation vs. arbitrage
Market Power and Manipulation in California’s Electricity Crisis

• Generator withholding/bidding strategies
• El Paso withholding of gas
• Enron memo strategies
• “Round-trip” gas trades and misreporting of transaction prices to bias indices
• Interaction of market power and manipulation

• **Bottom line:** Separate problems that call for different policies
Mitigating Market Power

—Structural Policies

• concentration controls: e.g., divestitures or merger reviews
• accommodating entry: e.g., reducing barriers to import supply or transmission capacity

—Operational Policies:

• price-caps
• bid controls
• must-offer requirements
Mitigating Market Manipulation

Two Schools of Thought in Electricity

• Option 1: crack down on “financial” trading by enforcing more strict and rigid verification of “physical” capabilities and intent

• Option 2: limit ability to manipulate by making markets more deep, liquid, and better informed. Accommodate entry of financial traders. Limit position sizes.
Non-strategic Barriers to Market Efficiency

• Cost/ability of participants to find counterparties in trades
• Cost/ability of participants to be well-informed about price and other market factors
• Bureaucratic barriers to efficient trade
  — Including unclear rules or property rights