

Republic of the Philippines
ENERGY REGULATORY COMMISSION
San Miguel Avenue, Pasig City

INVESTIGATORY UNIT

IU CASE NO. 06-01

INVESTIGATION REPORT

1 Introduction

- 1.1 Referring to the electric power industry, Section 45 of Republic Act No. 9136 (EPIRA) prohibits anti-competitive behavior including, but not limited to, cross-subsidization, price or market manipulation, or other unfair trade practices detrimental to the encouragement and protection of contestable markets.
- 1.2 The Energy Regulatory Commission (ERC) is the administrative body empowered in Section 43 of the EPIRA to penalize abuse of market power as proscribed in Section 45.
- 1.3 Pursuant to this mandate, the ERC has created this Investigatory Unit (IU) to investigate allegations, in particular by the Philippine Electricity Market Corporation (PEMC), of anti-competitive behavior and market power abuse in the commercial operation of the Wholesale Electricity Spot Market (WESM), committed by the Power Sector Asset and Liabilities Management (PSALM).

2 Background

- 2.1 PEMC, through its Enforcement and Compliance Office (ECO) and Market Surveillance Committee (MSC), conducted an investigation of PSALM's conduct in the commercial of the WESM for the third billing month.
- 2.2 The ERC decided to await the outcome of the PEMC investigation before conducting its own investigation, if still necessary in the exercise of its authority to penalize market power abuse.
- 2.3 After concluding its investigation, PEMC transmitted to the ERC on 24 November 2006 a copy of the MSC Memorandum Report dated 20 November 2006.

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- 2.4 As stated in its Memorandum Report, the MSC found that PSALM behaved anti-competitively and abused its market power. It said:

PSALM, acting as one through its three trading teams, exercised market power. They were able to set the market price to a level that they wanted during peak hours. Since the production costs were well below the P10,000/MW and above offered during the 3^d billing month, they abused market power during the peak hours which market power would not have been there had the three trading teams acted competitively and independently with each other. (MSC Memorandum Report, p. 3)

- 2.5 Given this finding, and in accordance with its Competition Rules and Complaint Procedures (CRCP), the ERC constituted on 29 November 2006 this IU to conduct an inquiry into the alleged anti-competitive behavior and market power abuse.

3 ***Antecedent Proceedings***

- 3.1 In a letter dated 22 September 2006 addressed to PEMC, the Manila Electric Company (MERALCO) expressed concern about the increasing WESM clearing prices and requested PEMC, through the MSC, to investigate the matter to determine whether or not there was breach of the WESM rules or any anti-competitive behavior that occurred and to determine the person or persons responsible for the violation.
- 3.2 On 25 September 2006, the MSC requested the PEMC Board (or PEM Board) to authorize the ECO to conduct an investigation in view of the following observations:
- *The Load Weighted Average Price (LWAP) was relatively high during the third month of WESM commercial operation where the LWAP was most of the time above P10,000/MWh during peak hours;*
 - *The most frequent price setters, KEPCO Ilijan, Pagbilao CFTPP and Sual are being traded by the different trading teams, but all under PSALM;*
 - *The said three generating plants significantly increased its offer prices during the third month compared to the first two months.*
- 3.3 Through a Certification by its Corporate Secretary dated 29 September 2006, the PEM Board directed the ECO to conduct an investigation of the following:

Possible abuse of market power and / or anti-competitive behavior by the Power Sector Assets and Liabilities Management (PSALM) for power plants: Kepco Ilijan, Pagbilao Coal Fired Thermal Power Plant and Sual.

- 3.4 The ECO conducted its investigation and came out with an ECO Investigation Report (or ECO Report).
- 3.5 The MSC reviewed the ECO Report and came out with the MSC Report on the ECO Report (MSC Memorandum Report), which it transmitted to the PEM Board.
- 3.6 PEMC informed the ERC of the result of the investigation by furnishing it with a copy of the MSC Memorandum Report.
- 3.7 PEMC agreed with the ECO and MSC finding that PSALM behaved anti-competitively and abused its market power. It then publicized such finding and, on this basis, adjusted the settlement prices for the third and fourth billing period of the WESM commercial operations.
- 3.8 There being an allegation of anti-competitive behavior and market power abuse, on 29 November 2006, the ERC constituted the IU to conduct an investigation of the matter and to initiate appropriate action and/or make such recommendations, as may be warranted by the results of its investigation conducted in accordance with the CRCP and such other procedural guidelines that it may issue in the course of its investigation.
- 3.9 On 4 December 2006, the IU issued its Notice of Investigation and directed PEMC and PSALM to appear before it on 11 December 2006 for a pre-investigation conference to discuss, among others, the procedures to be observed in the conduct of the investigation.
- 3.10 On 8 December 2006, the IU approved its "Procedure to Govern the Conduct of Investigation by the Investigatory Unit (IU)".
- 3.11 The IU conducted the pre-investigation conference on 11 December 2006 with representatives from PEMC and PSALM. During the pre-investigation conference, the IU discussed with PEMC and PSALM the nature and purpose of the investigation and furnished them with the "Procedure to Govern the Conduct of Investigation by the Investigatory Unit" and the IU Order dated 11 December 2006, directing PEMC and/or the MSC to clarify certain statements in the MSC Memorandum Report; to provide additional information/explanation in support thereof; and to submit certain documents to the IU.
- 3.12 On 9 January 2007, PEMC submitted its Manifestation/Compliance.

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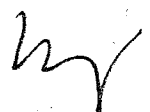
3.13 In the said Manifestation/Compliance, PEMC did not address point by point the issues and questions raised in the IU Order dated 11 December 2006. Without stating its reasons, it also did not submit all the required documents and information, especially the ECO Report, the transcript of the proceedings before the ECO, and all the submissions of PSALM to the ECO or MSC, which the IU deemed to be relevant to the investigation of the alleged anti-competitive behavior and market power abuse of PSALM.

3.14 PEMC's compliance consisted of the following:

- Reiteration of the significant increase in the market clearing price with no significant change in the supply and demand situation on the third billing month and that the most frequent price setters are being traded by separate trading teams but all under PSALM;
- The bidding strategies of the three trading teams which submitted offers for the KEPCO Ilijan, Pagbilao CFTPP and Sual, the most frequent price setters, as indicated in the affidavits of each of the three (3) trading managers attached therewith;
- The trading behavior of the three concerned trading teams and the continuation of the trading behavior into the fourth month of WESM operations;
- The fixed and marginal costs of the most frequent price setters as verbally given to the PEMC investigating group;
- Submission of the following documents:
 - The Market Surveillance, Compliance and Enforcement Market Manual;
 - The Trader's Code of Ethics.

3.15 The deficient compliance of PEMC constrained the IU to secure whatever available information it needed from PSALM. Consequently, it issued an Order dated 15 January 2007, directing PSALM to submit within ten (10) days certain documents, information, and explanations in response to certain issues arising from the MSC Memorandum Report.

3.16 On 12 February 2007, PSALM filed its Manifestation dated 9 February 2007, stating that:



- *PEMC's failure to: (a) answer the queries contained in the IU Order dated 11 December 2006, (b) subscribe, swear or verify that the allegations are true based on their personal knowledge or authentic records and (c) attach documents, which are readily available, demonstrates that the finding that "PSALM behaved anti-competitively and abused its market power" does not have sufficient legal and evidentiary basis.*
- *By requiring PSALM to answer queries contained in the IU Order dated 15 January 2007, PSALM is placed in an absurd situation where it has to prove its innocence instead of PEMC proving and sustaining its position that PSALM committed market power abuse and anti-competitive behavior.*
- *Instead, the investigation should proceed against PEMC to determine whether or not it usurped the authority of the ERC which has sole jurisdiction to hear and penalize market power abuse and anti-competitive behavior pursuant to Section 45 of the EPIRA.*
- *Since the investigation was initiated by the ERC motu proprio, if there would be a resolution for the filing of a complaint against it, PSALM would face a situation where the initiator, investigator, complainant, prosecutor and the quasi-judicial body that would hear and determine the case, are all rolled into one, a violation of its constitutional right to procedural due process.*

3.17 In response to PSALM's Manifestation dated 9 February 2007, the IU issued an Order dated 26 February 2007, denying PSALM's prayer in its Manifestation dated 9 February 2007 for the termination of the investigation. In denying PSALM's prayer, the IU stated:

PSALM's argument in support of its prayer for the termination of the investigation is baseless. Regardless of the actions of the Philippine Electricity Market Corporation (PEMC) or its inaction, this investigation can proceed. PEMC's failure to submit the documents and information as directed in the Order of the Investigatory Unit (IU) dated 11 December 2006 does not take away from ERC and, as delegated to the IU, from the IU, the authority to investigate "anti-competitive practices, abuse of market positions and similar or related acts". To say otherwise is absurd. Moreover, that this investigation is one initiated motu proprio does not amount to violation of due process considering that, aside from being expressly provided for and allowed in the law, the ERC remains to be impartial under such circumstances, with the IU being separately tasked to investigate the matter and prosecute the appropriate case/s with the ERC,

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if warranted by the results of the investigation. (IU Order dated 26 February 2007)

- 3.18 In the IU Order dated 26 February 2007, the IU also required PSALM to comply with the IU Order dated 15 January 2007 on or before 1 March 2007.
- 3.19 On 1 March 2007, PSALM submitted its Compliance dated 28 February 2007, together with its Answers (with Annexes).
- 3.20 Upon evaluation of PEMC's and PSALM's submissions and the other information and documents at hand, the IU resolved that it could not dispense with the ECO Report, surmising that the bases for the allegation of anti-competitive behavior and market power abuse were cited and explained more thoroughly in that document than in any of the submissions of PEMC or PSALM. To compel the presentation of the ECO Report, the IU issued an Order dated 26 March 2007, which reads in part:

... the IU hereby reiterates its directive for the submission of the required documents and information as contained in the Order dated 11 December 2006, particularly, the ECO Report. PEMC is further directed to include all the annexes to the said report, if any, and such other documents submitted to the ECO in the conduct of its investigation. Compliance to these directives shall be made within five (5) days from receipt of this Order. (IU Order dated 26 March 2007)

- 3.21 Finally, on 29 March 2007, PEMC furnished the IU with a copy of the ECO Report.

4 ***Material Facts and Admissions***

- 4.1 Going direct to the allegation that PSALM behaved anti-competitively and abused its market power, the IU deemed it necessary to conduct an assessment of the facts, assumptions, and observations that led PEMC to this conclusion.

Sual G01, Pagbilao G01 and G02 and Ilijan G01 and G02's offers of PhP10,000 and higher

- 4.2 Perusing over the ECO Report, it appeared that PEMC's allegation was drawn from the following:

There were significant increases in the offer prices (bids) for Ilijan, Pagbilao and Sual during the third month of operation especially during peak periods.

Bid offers submitted for Ilijan, Pagbilao and Sual were increased to P10,000/MW and higher starting August 30 for peak hours starting at trading interval 11 (from trading intervals 11 to 21). The P10,000/MW bids started from the first block for these three (3) plants. The investigating team expressed concern that the simultaneous and almost similar bids of P10,000 and higher were made for 3 plants by 3 different trading teams of PSALM. From 30 August 2006 onwards, the clearing price significantly increased, which most of the time was at P10,000/MW during peak hours.

The day before (August 29), the bids for the peak trading intervals were dissimilar...xxx

For these three plants, the bids offered were as follows on August 30. It is observed that all three plants' bids started at P10,000. For Sual G01, Pagbilao G01, and Ilijan G01 and G02, the bids are observed to cluster around P10,000...xxx. (Excerpts from the ECO Report)

- 4.3 The IU validated the factual statements contained in the above excerpts from the ECO Report against the available data of the Spot Market Division (SMD) of the Market Operations Service (MOS), which is tasked to monitor the movement of demand and price, bidding behavior of trading participants, occurrences of price spikes or irregularities and forecast errors.
- 4.4 The IU confirmed that indeed PSALM's three electricity trading teams (Trading Teams or ETT) that traded the capacity of Sual G01, Pagbilao G01 and G02 and Ilijan G01 and G02 submitted offers of PhP 10,000 and higher starting on 30 August 2006 during the peak hours from trading intervals 1100H to 2100H.
- 4.5 Looking at the actual offers, the IU determined that the exact similarities on the price offers of Sual G01, Pagbilao G01 and G02 and Ilijan G01 and G02 occurred on 30 and 31 August 2006, for the time period 1100H to 2100H, with price offers of PhP 10,000 on the first two blocks. The offers of the three plants, however, differed in the other blocks on these trading intervals. The number of times of the exact similarities was fewer than the instances when the offers differed.

Sual G01, Pagbilao G01 and G02 and Ilijan G01 and G02's offers for the first two billing months

- 4.6 Based on available data on the offers of the three PSALM Trading Teams, prior to 30 August 2006, Ilijan G01 and G02 submitted offers of PhP 10,000 and PhP 15,000 on 05 to 08 August 2006 for the first two offer blocks and on 20 to 25,

28, 29 August 2006 for the last blocks. Pagbilao GO1 and GO2 submitted offers of PhP 20,000 on 21-22 August 2006 for the first blocks and PhP 10,000 on 26-30 August 2006 for the last blocks.

- 4.7 During the ECO investigation, the PSALM Team Managers disclosed their respective bidding strategies for the first two billing months, as follows:
- 4.7.1 Team Manager of ETT1, Mr. Pablo B. Anido (Anido), disclosed in his 18 October 2006 Affidavit that on the first month, the offers were aimed at recovering at least the variable costs. On the second month, the offers were guided by the objective of recovering variable costs as well as recovering losses incurred during off-peak hours wherein the prices for energy were zero.
- 4.7.2 Team Manager of ETT2, Ms. Maria P. Garcia (Garcia), disclosed in her 18 October 2006 Affidavit that on the first month, the offers were based on variable cost of the plant with some adjustments to lower prices to get a share in the dispatch order. On the second month, the bid prices were still based on variable cost but adjusted a little higher.
- 4.7.3 Team Manager of ETT3, Mr. Nestor F. Aliman (Aliman), disclosed in his 18 October 2006 Affidavit that with zero clearing prices during off-peak periods, his offer prices during peak hours were at a level sufficient to achieve an average price that can recover the production cost for the entire day and to contribute to the reduction of losses incurred during the first two months of operations. He also stated that the average market prices during the first two months of WESM operations were not sufficient to recover the production cost of Pagbilao, which was around PhP 4,500/MWh.

Supply and demand situation

- 4.8 There had not been any significant increase in the demand during the first two billing months and the demand during the third billing month. In its letter dated 22 September 2006 to PEMC, MERALCO mentioned that the increase in demand was only by an average of four percent (4%).
- 4.9 The supply for the third billing period was enough to meet the increase in demand. As MERALCO pointed out in its letter, "there is a significant capacity in the current month due to the lower level of plant on outage compared to the previous two months, where the capacity is more than enough to satisfy the increase in demand."
- 4.10 In its Memorandum dated 13 November 2006 submitted to the ECO, PSALM admitted the foregoing factual assertions on the demand and supply conditions prevailing during the first three billing months.

PSALM's market share

- 4.11 As of 31 October 2006, the total registered maximum capacity in the WESM was at 11,986.2 MW. Each PSALM Trading Team's share of the market ranged from 12% to 20% share of the market. However, if taken as one, PSALM controlled 57% percent of the total market share.

Percentage Share of Each Plant in the Total Registered Capacity in the WESM

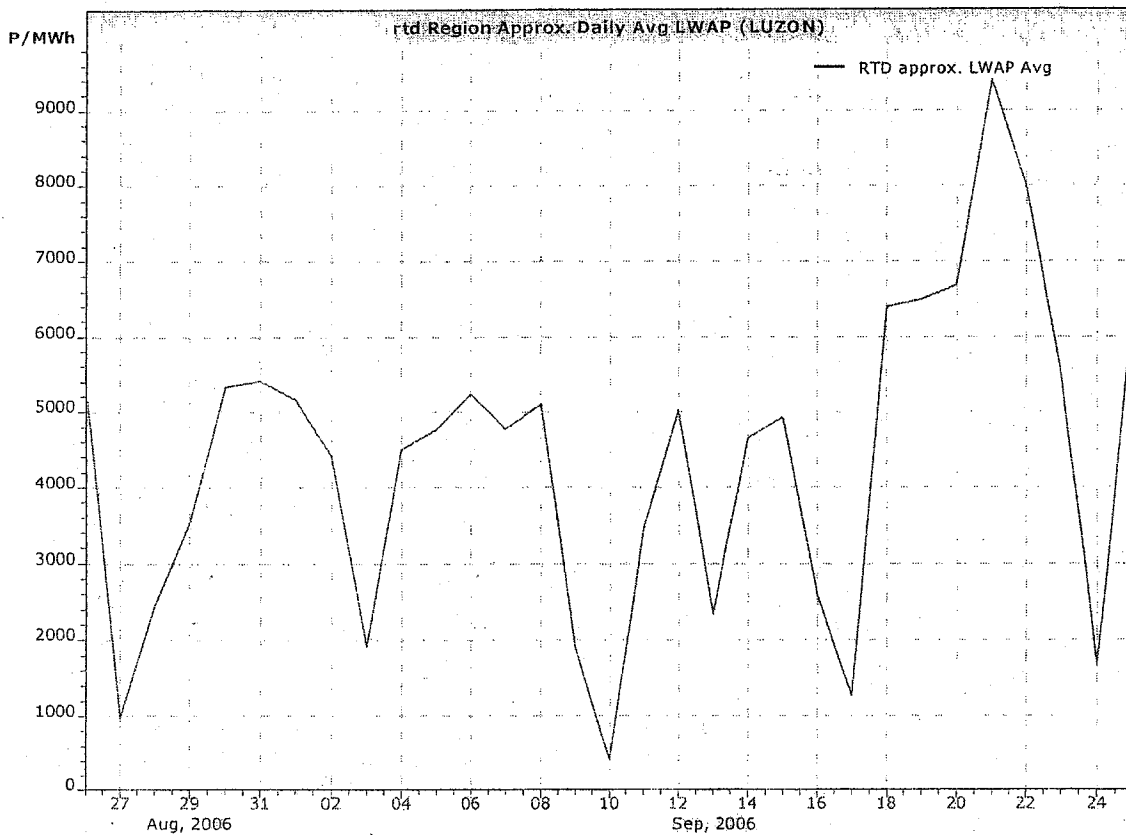
Generator Unit	Percentage Share
PSALM	57%
NPC	24%
FGP Sta. Rita	8%
FGP San Lorenzo	4%
QPPL	4%
DURACOM	2%
	100%

(Source: ECO Report)

WESM clearing prices

- 4.12 Based on MOS data, in the first billing month, the WESM clearing price averaged at PhP 2,398/MWh (ex-ante). In the second billing month, the average clearing price stood at PhP 2,984/MWh (ex-ante), which translated to a twenty-four percent (24%) increase from the previous month. In the third billing month, the average clearing price reached PhP 4,903/MWh (ex-ante) or a percentage increase from the previous billing month of sixty-four percent (64%). The fourth billing month showed a further increase in the WESM average clearing price at PhP 7,218/MWh.
- 4.13 The chart below shows the average daily LWAP during the third billing month (26 August to 25 September 2006). From PhP 980/MWh on 27 August 2006, the LWAP rose to PhP 5,422/MWh on 31 August 2006. Thereafter, the daily LWAP ranged from PhP 422/MWh to PhP 9,407/MWh.

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(Source: MOS)

The National Power Corporation's (NPC) letters to PSALM

4.14 On two occasions prior to 30 August 2006, NPC President Cyril C. del Callar wrote PSALM about the staggering losses incurred by NPC and PSALM during the first two billing months. In his letter dated 23 August 2006, the NPC President summarized his assessment of how the losses were incurred:

- **XXX including the displacement of cheaper NPC plants by NPC IPPs (Independent Power Producers) due to lower bid offers from the PSALM trading teams. XXX**
- **On the other hand, the average clearing price of electricity for NPC IPPs traded by PSALM is 56.23% lower than their average production costs and 55.29% lower than ERC-approved average TOU rates. This is due to zero clearing prices in the market during off-peak period and Sundays and lower clearing prices during peak period which is the direct result of lower or even negative bid offers from the PSALM trading teams.**

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- *x x x NPC IPPS have an estimated total revenue of **P3.819B** as compared to a total production cost of **P5.672B** or a net loss of **P1.853B**. This excludes the consumption of Kalayaan during pumping which accounts to P91.0M. **The resulting loss is attributable to the maximized generation objective of the PSALM trading teams even if such objective results in lower clearing prices in the market and losses to NPC. The PSALM trading teams are bidding at below the ERC approved TOU rates, below the production costs of the IPP's they are bidding or even at zero if only to maximize the generation and dispatch of the IPP's even if such results in losses to the government.***

4.15 In his letter, NPC President del Callar also proposed to PSALM the adoption of certain policies some of them affecting how offers should be made by the PSALM Trading Teams:

- *WESM bidding policies should be based on the true pricing of electricity. NPC and PSALM trading teams should be made responsible for delivering, at the end of the month, the minimum revenue required to cover for the production costs of their respective plants. In this regard, NPC and PSALM should enter into an agreement on the revenue requirement for each trading team.*
- *PSALM trading teams should bid based on the established merit order of both NPC owned plants and NPC IPPs. At the very least, the PSALM trading teams should bid prices that are based on the ERC-approved TOU rates. x x x"*

4.16 PSALM, in its reply to NPC dated 15 September 2006, expressed its disagreement to NPC's suggestions above. It said:

The adjustments we all have to make will not be easy. We are now operating in a different policy regime far from the highly regulated milieu that prevailed for decades. With the policy reforms that have been put in place, we are institutionalizing, through WESM, a market-oriented pricing and supply mechanism for the country's electricity industry.

In light of these policy reforms, we find it difficult to agree to your suggestion that National Power and PSALM should "enter into an agreement on the revenue requirement for each trading team" and that the PSALM trading teams should bid based on the established merit order of both National Power-owned plants and National Power IPPs." By taking that track, we would be subverting the goals and objectives of EPIRA, which we, NPC and PSALM, are supposed to champion as the lead

agencies responsible for its successful implementation. We must ensure the success of the industry reforms we are currently implementing and counter accusations that government is using its market power.

4.17 Notwithstanding its disagreement to the suggestions and recommendations of NPC, as admitted by the PSALM Trading Managers in their affidavits, PSALM Management relayed to them these concerns and proposals of NPC.

4.18. As admitted also by the PSALM Trading Managers, NPC's letters affected their bidding strategy starting on the third billing month.

- *Prior to 30 August 2006, I had been informed of complaints from NPC on the recurring zero prices during off-peak hours. There were also allegations that it was the PSALM Trading Teams that are causing the zero prices during off peak hours. Also because of NPC's letter which alleged that PSALM was bidding low in order to clear the market, a meeting was called by the Office of PSALM President on 25 August 2006 in order to respond to NPC's letter which alleged that PSALM has offered low and dispatched the oil-based plants in the WESM. (Anido Affidavit)*

- *On August 30, 2006, PSALM received a letter from NPC dated August 23, 2006. The letter alleged that the heavy losses that NPC incurred were due to PSALM's trading of the IPPs. Again, this allegation from NPC somehow affected the bidding strategy of ETT2. (Garcia Affidavit)*

- *A letter from NPC President dated August 23, 2006 which was received by PSALM on August 30, 2006, stating that NPC had incurred losses during the first and second months of operations, served to reinforce our team's resolve that starting August 30, 2006, pricing for Pagbilao would be based on total production cost recovery, with the rationale that to do otherwise would be to contribute to the ballooning debts of NPC and PSALM, and ultimately, of the National Government. (Aliman Affidavit)*

5. ***PSALM's Explanation***

5.1 PSALM stated in its 18 October 2006 letter addressed to the ECO that the "rise in LWAP level is but a natural phase in the process of market stabilization and adjustment of the three-month old market".

- *The records show that during the first month of WESM operations, the MERALCO IPPs caused prices to dip to zero levels during off-peak hours by offering zero bids. In response, the PSALM traders then started with price*

offers near their respective plants' marginal costs. Consequently, the market yielded depressed prices, which came to about P 2.81/kWh on the average for the first billing period. This caused huge under-recoveries for most plants, not to mention the under-compensation for those plants which were being run at their minimum operating levels (Pmin) and the "must offer" policy considering that the market at the time (and even to date) had not been clear on the policy for Pmin and must-run plants.

While the second month of operations showed a higher LWAP of P3.07/kwh, the same was still insufficient to enable the traders of the contracted energy of Keilco Ilijan, Pagbilao and Sual to recover the energy production costs.

The WESM is a new market in the start-up stage. While initial glitches and mistakes should be expected, we believe that it is but just for the individual trading teams of PSALM to make adjustments in their trading strategies for their plants in their portfolio. MERALCO, as a monopsony, should not be the only participant entitled to recover its costs; as the government too has to maximize the use of its assets and minimize losses. (PSALM's 18 October 2006 letter)

- 5.2 PSALM also stated in its 18 October 2006 letter that the alleged significant increase in the offer prices during the third month arose out of the efforts of the Trading Managers "to recover production cost and avert, if not minimize, further losses." According to it, the rise in prices in the third month was "part of price adjustment and discovery process resulting from unrealistic, artificial levels during the first and second month of operations which benefited only the biggest consumer." Moreover, the increase in the offers during the third month could not be considered excessive "because the resulting load weighted average of Php 4.853/kWh is still less than the ERC approved grid rate with the DAA (GRAM and ICERA) of Php 4.91/kWh. Also, "at no time did the offers of Kepco Ilijan, Pagbilao and Sual plants exceed the bid cap of PhP 62,000/MWh, as set by the WESM Tripartite Committee."
- 5.3 PSALM categorically declared that it "has not committed any breach, nor violated any rule as would serve as basis for the allegation of anti-competitive behavior/market power abuse" and that its "traders have conducted their business in good faith and in accordance with all applicable laws, regulations, and rules and with commitment to honest dealing, having due regard to the contractual and financial obligations relating to the energy output of the NPC-IPP's."
- 5.4 PSALM also mentioned that it had intended to be registered as four (4) independent market participants, as supported by the acknowledgement letter

from PEMC dated 24 January 2005. However, PEMC inexplicably registered PSALM as one market participant only for the trading of the energy output of the NPC-IPPs comprising the power plants in the portfolio of the four PSALM Trading Teams. This "resulted to PSALM, as the registered market participant, having an aggregate rated capacity of 6,559 MW, which comprises approximately 54% of the capacity in the WESM." It then argued that this "imperfection in the market structure should not be attributed to (it) as to warrant the imputation of market power abuse/anti-competitive behavior."

- 5.5 On the part of the PSALM traders, in his 18 October 2006 Affidavit, Anido of ETT1 explained his team's bidding strategies. According to him, during the first month of WESM commercial operations, the prices offered for energy were based on the economic principle for short run costs which aimed at recovering at least the variable costs. During the second month, the offers were guided by the objective of recovering variable costs as well as recovering losses incurred during off-peak hours when the prices for energy were zero. In the third month, the objective was to recover variable and fixed costs or total production costs, as well as losses incurred during off-peak hours.
- 5.6 In her 18 October 2006 Affidavit, Garcia stated that her team's (ETT 2) offers for the third month were already based on production cost in order to minimize the losses incurred during the first and second trading periods, when her team's offers were based on the variable costs of the plant with some adjustments.
- 5.7 In his 18 October 2006 Affidavit, Aliman stated that with zero clearing prices during off-peak periods, his trading team's (ETT 3) strategy for the third billing month was to offer prices at a level sufficient to achieve an average price that can recover the production cost for the entire day and to contribute to the reduction of losses during the first two months of operation. He further stated that the average market prices during the first two months were not sufficient to recover Pagbilao's production cost, which was at around PhP 4,500/MWh.
- 5.8 All three Trading Managers categorically asserted that their offers were the result of "independent assessment" and were "not influenced by or in any way directed at setting the price high."
- 5.9 Anido, Garcia, and Aliman executed supplemental affidavits on 3 November 2006 to further explain their offers of PhP 10,000/MWh starting on 30 August 2006.
- 5.9.1 Anido stated in his 3 November 2006 Affidavit that based on the estimated losses and his desired level of price of PhP 4.50/kWh to allow the recovery of the fuel and the Electricity Conversion Agreement (ECA) costs of Ilijan (at

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capacity factor of around 50%), it will take a price offer of PhP 10,000/MWh to recover that hour's costs as well as those for the zero prices during off-peak hours. He said that the strategy will cover the production cost of Ilijan but not Casecanan which is part of ETT 1's portfolio. He pointed out that even prior to 30 August 2006, ETT 1 had been offering PhP 10,000, PhP 12,000 and PhP 15,000/MWh at the higher price bands, which offers were clearing at these levels.

5.9.2 Garcia explained in her 3 November 2006 Affidavit that the low clearing prices during the first and second billing period caused her team to change the bases of offers in accordance with the market forces and social impact prevailing at that time. The offers during the third period were based on production cost to minimize the previous billing periods' losses. She mentioned that the letter from NPC dated 23 August 2006 affected the bidding strategy of ETT 2. The fixed costs were included in the bid offers resulting in a positive contribution margin for third period. ETT 2 prepared simulations of bid offers of PhP 8,000 and PhP 10,000. The offer of PhP 10,000/MWh during peak hours was adopted and sustained with the view of minimizing losses. In her affidavit, she mentioned that she hoped "that the sustained PhP 10,000/MW bid strategy would ease the pressure on the PSALM traders for allegedly causing the government losses because of the previous low bids, as expressed in the letter from NPC dated August 23, 2006."

5.9.3 Aliman explained in his 3 November 2006 Affidavit that his team arrived at PhP 10,000 using PhP 4,884/MWh or PhP 4.88/kWh as target average for the day. Prices were raised during peak hours to compensate for the losses during the off-peak period. He added that NPC's letter dated 23 August 2006 reinforced ETT 3's unanimous resolve that starting 30 August 2006, pricing for Pagbilao would be based on total production cost recovery, with the rationale that to do otherwise would be to contribute to the ballooning debts of NPC and PSALM, and ultimately, of the National Government.

6 ***ECO's Findings and Conclusions***

6.1 As concluded in the ECO Report, Sual G01, Pagbilao G01 and G02 and Ilijan G01 and G02's offers of PhP 10,000 and higher, although possible, were not coincidental.

Based on the events that had occurred prior to and on August 30, the investigating team concludes that the submission of increased bids to at least P10,000 during the peak hours by the 3 different PSALM trading teams occurring at the same time and at the same date, while in the realm of possibility, is not coincidental. The investigation team therefore looks at it with guarded caution, especially if the meetings with PSALM

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management and the NPC letters are taken into account. There was uniformity in bidding levels from a previously dissimilar level.” (Excerpts from the ECO Report)

- 6.2 This conclusion assumed that the PSALM Trading Teams agreed or were directed to raise their offers to at least PhP 10,000 during peak hours, realizing that with the combined capacities of the Sual, Pagbilao, and Ilijan plants, and the demand during the peak hours, these plants would be dispatched notwithstanding the increased offers. This also assumed that the PSALM Trading Teams uniformly increased their offers in response to NPC's letters and instructions from PSALM Management.

While the traders said they were acting independently of the other teams, it is very unnatural for a trader to suddenly bid based on its production cost which would create a swift substantial increase in its bid offer because of the possible consequence of not being dispatched. Moreover this offer price increase happened just after the 25 August 2006 meeting where the first NPC letter (Annex K) alleging losses, was discussed. Even assuming that PSALM Management met with the traders individually, and therefore no strategy was planned or shared by each trading team as a group, the uniformity of their acts undoubtedly reveal that an authority higher and outside the trading teams has made and caused the individual traders to act and trade as one.

These factors clearly establish that the PSALM through its three trading teams acting in unity has exercised market power during the third billing month, notably starting on 30 August 2006. (Excerpts from the ECO Report)

7 **Issue**

- 7.1 In this investigation, the IU was guided by the following:

Were the evidences gathered during the investigation sufficient to warrant the institution of a formal Complaint against PSALM for anti-competitive behavior and/or market power abuse?

8 **Discussion**

On the quantum of proof

- 8.1 The CRCP sets the standard by which the IU shall decide whether or not to file a formal Complaint against any person it investigated. Section 9, Rule 20 of the CRCP provides that: "(i)f, after conducting the investigation, the

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Investigating Officer finds that there exists a *prima facie* case against the Person investigated for violation of these Rules, he shall prepare the appropriate Complaint for filing with the ERC. Otherwise, he shall transmit his recommendation to the ERC to terminate and close the investigation, together with the entire records of the investigation."

- 8.2 Since no definition of what comprises *prima facie* case is provided in the CRCP, the IU accorded it its usual, natural, plain, ordinary and commonly understood meaning, consistent with the canons of statutory construction.
- 8.3 Consequently, it interpreted Section 9 as giving it the responsibility to determine if there is a case, which if accepted and not contradicted, would be sufficient to find the respondent administratively liable for anti-competitive behavior and/or market power abuse, and to ensure that there is sufficient support to justify the commencement of such administrative case before the ERC.

Conduct alleged to be anti-competitive or to constitute abuse of market power

- 8.4 As alleged, the PSALM Trading Teams did not act competitively "with each other" based on their offers of "at least PhP 10,000 and the events that occurred prior to and on 30 August 2006." However, as later on concluded in the ECO Report, they did not act in bad faith. PSALM, on the other hand, behaved anti-competitively when it had a "meeting" with its traders to apprise them of the "financial status with regard to the IPP contracts" and exercised its market power when it relayed to them NPC's letter dated 23 August 2006. (ECO Report, pp. 27-28)

The ECO's reasoning

- 8.5 While there was no finding of collusion among the PSALM Trading Teams to fix prices in the WESM or the existence of any explicit instruction from PSALM for them to offer prices at a certain level or to adopt any specific bidding strategy, the ECO concluded that PSALM behaved anti-competitively and abused its market power when it "influenced" the Trading Teams to offer higher prices for it to recover its losses for the first two billing months. Such influence manifested itself in the uniform offers of PhP 10,000 made by the three Trading Teams on certain trading hours starting on 30 August 2006 and was also inferred from the conduct of the meeting between PSALM Management and the traders to discuss NPC's letter to PSALM.

While the traders said they were acting independently of the other teams, it is very unnatural for a trader to suddenly bid based on its production cost which would create a swift substantial increase in its bid offer

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because of the possible consequence of not being dispatched. Moreover this offer price increase happened just after the 25 August 2006 meeting where the first NPC letter (Annex K) alleging losses, was discussed. Even assuming that PSALM Management met with the traders individually, and therefore no strategy was planned or shared by each trading team as a group, the uniformity of their acts undoubtedly reveal that an authority higher and outside the trading teams has made and caused the individual traders to act and trade as one.

These factors clearly establish that the PSALM through its three trading teams acting in unity has exercised market power during the third billing month, notably starting on 30 August 2006. (ECO Report)

IU's Analysis

- 8.6 It is important at the outset to lay down the standard against which PSALM's conduct would be compared and from which the resolution of whether or not there was anti-competitive behavior or market abuse committed in this case would be based.
- 8.7 Rule 11, Section 8 of the EPIRA IRR generally treats anti-competitive conduct as something that "unreasonably restricts competition in any market for electricity" and lists certain acts or conduct that constitute abuse of market power or attempted monopolization, to wit:

Section 8. Anti-Competitive Behavior and Other Unfair Trade Practices.

The ERC shall promulgate Competition Rules prohibiting, and specifying appropriate penalties and other remedies for, any contract, combination or conspiracy that unreasonably restricts competition in any market for electricity, or any conduct that constitutes an abuse of market power or an attempted monopolization of any market for electricity, including but not limited to the following:

(a) Fixing prices of products or services: Electric Power Industry Participants that are competitors shall not enter into any agreement or understanding, tacit or explicit, to fix, peg or stabilize the price of any product or service. Price fixing shall be deemed to include agreements on bids, price floors, price ceilings, pricing formulas and resale prices, and agreements on credit or any other terms of a transaction between a buyer and a seller.

(b) Fixing output of products or services: Electric Power Industry Participants that are competitors shall not enter into any agreement or

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understanding, tacit or explicit, to fix, limit or otherwise determine their output of any product or service.

(c) Customer, Product, Service or Territorial Divisions: Electric Power Industry Participants that are competitors shall not enter into any agreement or understanding, tacit or explicit, as to the customers or the geographic territories they will serve, or the products or services they will sell.

(d) Tying: Electric Power Industry Participants shall not use a position of market power to condition the sale of one product or service on the purchase of another product or service. No Distribution Utility shall make access to its Distribution System contingent upon the purchase of generation, metering, billing or other services.

(e) Physical or Economic Withholding: Electric Power Industry Participants shall not use physical operating practices or bidding strategies that limit the market participation of a generation unit under conditions that will result in significant increases in market prices.

(f) Discriminatory provision of regulated distribution or transmission services: Regulated distribution and transmission services shall be provided on a basis that is not unduly discriminatory.

8.8. In the CRCP, the ERC describes anti-competitive agreements partly as agreements or arrangements which would have or would likely to have "the effect of substantially lessening competition in a Market." This evokes that anti-competitive conduct is conduct that has or will have the effect of substantially lessening competition or, in the language of Rule 11, Section 8, conduct that unreasonably restricts competition.

8.9 As for abuse of market power, in addition to the enumeration in Rule 11, Section 8, and the factors provided in the CRCP with reference to "misuse of power", the IU finds the discussion in the ECO Report on market power to be relevant:

There are numerous references and papers readily available on market power abuse and anti-competitive behavior. These are produced by leading authorities in competition and the power industry. There are general themes and common threads grounded on sound economic principles. The following reflects commonly held views and general agreements on market power abuse. Market power is commonly defined as the ability of the seller to set prices above competitive levels and to do so profitably. Profitably means to profit or gain from the act.

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- 8.10 With these in mind, it should then be asked: Did PSALM influence its three Trading Teams and made them act as one, thereby substantially lessening competition or unreasonably restricting competition in the market? Did PSALM through its three Trading Teams profited by setting the prices above competitive levels? The answers to these should resolve whether or not there was anti-competitive behavior or market abuse committed by PSALM.
- 8.11 The bidding behavior of the market participants during the first two billing months resulted to low prices. There were also the zero offers during off-peak hours, which had a significant impact on the level of prices during these months. These contributed to NPC's losses, which it brought to PSALM's attention and which the latter brought to its Trading Teams' attention.
- 8.12 The IU examined NPC's letter, calling PSALM's attention to the estimated losses to the National Government of Php 1.965 Billion resulting from the combined trading operations of NPC and PSALM in the WESM. In the letter, NPC recommended that NPC and PSALM implement certain policies, among them, that "the WESM bidding policies should be based on true pricing of electricity"; that "NPC and PSALM should enter into an agreement on the revenue requirement for each trading team; that "the PSALM trading teams should bid based on the established merit order of both NPC owned and NPC IPP's"; and that "at the very least, the PSALM trading teams should bid based on the ERC-approved TOU rates".
- 8.13 These recommendations plainly suggest that NPC and PSALM agree on policies, which if implemented, would surely affect the prices in the WESM. Without question, had PSALM agreed to such recommendations, there would have been a clear violation of the provisions of the CRCP and abuse of market power as provided in Rule 11, Section 8 (a) of the EPIRA IRR, which provides:
- Fixing prices of produces or services: Electric Power Industry Participants that are competitors shall not enter into any agreement or understanding, tacit or explicit, to fix, peg or stabilize the price of any product or service.*
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- 8.14 From the tenor of PSALM's reply-letter to NPC's letter and from the fact that PEMG did not find any basis to include NPC in its market power abuse allegation, no agreement was reached between NPC and PSALM to implement these recommendations and thus no market power abuse, as described above, was established to have been committed by NPC and PSALM.
- 8.15 Ironically, notwithstanding that it rejected NPC's recommendations, which would have resulted to price-fixing, PSALM, and only PSALM, was found to

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have behaved anti-competitively and abused its market power when it "influenced" the Trading Teams by meeting with them and relaying to them NPC's concerns and recommendations.

- 8.16 The question, therefore, that begs to be answered is this: Do the three Trading Teams' PhP 10,000/MWh offers starting on 30 August 2006 establish that PSALM influenced its Trading Teams for them to act as one in setting the WESM prices and, in the process, abused its market power?
- 8.17 In this regard, the IU differs from the ECO's findings, which the MSC and PEMC adopted.
- 8.18 It is expected that market participants will have a common approach to offer high during peak periods when demand is high. That the offers are the same on the same dates and trading intervals by itself does not prove that those who made these offers were influenced by some higher authority and that without such influence these similar offers would not have been made.
- 8.14 The ECO found it too coincidental that the three PSALM Trading Teams would be submitting offers of PhP 10,000/MWh starting on 30 August 2006. Hence, on its assumption that the offers for the third month should not have differed much from the LWAPs for the previous months, there being no substantial changes in the costs of production and in the supply and demand, it concluded that PSALM must have influenced them to submit such offers, thereby increasing WESM price.
- 8.15 The records showed, however, that Ilijan previously submitted offers of PhP 10,000 and PhP 15,000 on 05 to 08 August 2006 for the first two offer blocks and on 20 to 25, 28, 29 August 2006 for the last blocks of 600 MW. Likewise, Pagbilao also submitted offers of PhP 20,000 on 21-22 August 2006 for the first blocks and PhP 10,000 on 26-30 August 2006 for the last blocks. Hence, it was not only starting on 30 August 2006 that the offers reached the PhP 10,000/MWh level.
- 8.16. As for the underlying assumption that led ECO to conclude that PSALM must have influenced its Trading Teams, it could be said that the LWAPs for the first and second months of WESM commercial operation did not reflect the true prices of generating electricity, with the market participants still learning the intricacies and implications of trading in the electricity spot market. The increases in the LWAP in the third month from the first two months, while appearing to be substantial, did not readily reveal that at PhP 4.86/kWh, the LWAP in the third month during which the market power abuse was allegedly committed by PSALM was still below the ERC-approved NPC effective rate of PhP 4.91/kWh prevailing before WESM operation.

- 8.17 Consequently, even if there had been no substantial increases in costs and in demand, contrary to the ECO's belief, it was probable that the Trading Teams' offers for the third billing month, without any influence or pressure from PSALM Management, would substantially differ from their offers in the first two billing months. As the Trading Team Managers explained, the PhP 10,000/MWh or more offers were not some arbitrary figure that they happened to submit for the same trading intervals. These offers were products of their bidding strategies independently arrived at, which took into account NPC's concerns on the losses sustained by NPC and PSALM during the first two billing months that were partly attributed to the bidding strategies the Trading Teams implemented during these months. Besides, regardless of costs, the offers could vary as there was simply no requirement in the WESM rules that the offers should match the costs.
- 8.18 As for PSALM's referral of NPC's letter to its Trading Teams and also the holding of a meeting to discuss such letter, these were neither anti-competitive nor indicative that PSALM intended to influence its Trading Teams to increase their offers. The members of the Trading Teams remain to be employees of PSALM, which continues to exercise supervision over them. It was not unusual or anti-competitive that PSALM met with its Trading Teams to discuss NPC's concerns. After all, there was no rule in the WESM that prohibited PSALM from discussing with the Trading Teams matters relating to their job performance.
- 8.19 That there was supposedly competition prior to 30 August 2006, which was subverted when PSALM influenced its Trading Teams to offer high, was more of an illusion, far detached from reality. With PSALM's registration into the WESM as one market participant, thereby enabling each PSALM Trading Team "to see the market results of other PSALM teams, during the hour," (ECO Report, p. 15), it was not farfetched that even without any such meeting with PSALM, the three Trading Teams, after reading NPC's letter, would behave the way they did on 30 August 2006 and onwards without fearing that their plants would not be dispatched because of their offers.
- 8.20 Neither was there any evidence of the elements as cited in the ECO Report that determine abuse of market power: (a) that PSALM used its market power to set the prices above competitive levels; and (b) that PSALM profited from such exercise. In the first place, there had been no showing of what the competitive level of prices should have been at that time. Given that the market was at its infancy and taking into account the price levels before the market started, it was simply inappropriate to conclude that because there had been a marked increase in the offers of PSALM's Trading Teams for the third billing month, as compared to the first two billing months, it could already be said that the

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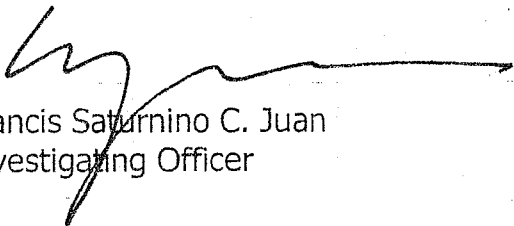
resulting prices based on such offers were already above competitive levels and that PSALM profited from such higher prices.

- 8.21 Absent any other evidence that would, even if indirectly, prove what transpired during the meeting or what other discussions took place between PSALM and its Trading Teams, particularly, that there was such an agreement or understanding, express or implied, on the Trading Teams' offers into the WESM, and that the Trading Teams' offers pushed the prices above competitive levels, thereby making PSALM profit thereby, the IU would only be speculating if it would say that because the three Trading Teams simultaneously offered similar offers of PhP 10,000/MWh starting on 30 August 2006, PSALM already unduly influenced the submission of such offers and abused its market power.
- 8.22 Of course, this could have been what really happened. But then, this "could have been" possibility, to the IU's determination, falls short of the "*prima facie* case" standard to warrant the filing of a formal Complaint against PSALM.

9 ***Conclusion and Recommendation***

- 9.1 The IU finds no *prima facie* case against PSALM for anti-competitive behavior or market power abuse. For this reason, further investigation and proceedings are not warranted. The IU, therefore, recommends that this investigation be terminated.

For the Investigatory Unit:


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Investigating Officer