Mitigating Price Spikes in Wholesale Markets through Market-Based Pricing in Retail Markets

Introducing a modest number of spot-based products into the retail portfolio would provide significant price relief and stability by connecting the retail and wholesale markets in a cost-effective and market-based manner.

Douglas Caves, Kelly Eakin, and Ahmad Faruqui

In late June 1998, wholesale electricity prices in the midwestern United States reached unprecedented levels in the neighborhood of $7,500 per MWh for a few transactions. A staff report by the Federal Energy Regulatory Commission concluded that this “price spike” was caused by an unlikely coincidence of supply-restricting events [unit outages and transmission congestion] with demand-enhancing events [hot weather].

An additional factor was the inexperience of market participants with electricity trading. The report suggested that these events were sufficiently unique that they were unlikely to recur. However, an even greater price spike of around $10,000 per MWh was observed in late July 1999. The highest prices again occurred in the Midwest, but this time unexpected supply constraints, buyers’ panic, and trader default were conspicuously absent.

Clearly, something else is causing the spikes in wholesale prices. In our analysis of the June 1998 price spike, we emphasized that the price spike was caused by the disconnectedness of the wholesale and retail markets. We believed then, and still believe, that the more relevant question is “why did prices stop rising?”

Douglas Caves, Vice Chairman of Christensen Associates, Madison, Wisconsin, has directed the consulting firm’s electric utility work since 1976, and is an expert on issues facing industries undergoing deregulation. He has been active in the design and evaluation of a wide range of innovative pricing and service programs, having played a pioneering role in the development of real-time pricing. He holds a Ph.D. in economics from the University of Wisconsin at Madison.

Kelly Eakin, Vice President at Christensen Associates, is a specialist in price theory, industrial organization, and the regulation of industry. He has worked on several projects involving innovative service design, customer price responsiveness, and market assessment with major U.S. utilities. Currently, he is managing consultant for the Product Mix Model, a pricing tool for the energy merchant developed by EPRI (formerly the Electric Power Research Institute). He holds a Ph.D. in economics from the University of North Carolina at Chapel Hill.

Ahmad Faruqui is an economist with EPRI, a provider of global energy solutions based in Stanford, California. He has held consulting positions with several well-known consulting firms, and now has responsibility for managing professionals specializing in risk management, strategic assessments, energy pricing, and forecasting. He holds a Ph.D. in economics from the University of California at Davis.

Dr. Faruqui and Dr. Eakin are co-editors of the forthcoming Pricing in Competitive Electricity Markets, due from Kluwer Academic Publishing.
I. The Economics of Price Spikes

Figure 1 shows the highest hourly trade prices on June 24 and 25, 1998, in the Mid-America Interconnected Network (MAIN) reliability region. A similar pattern of price spikes occurred on July 29 and 30, 1999.

Interestingly, both of the price spikes have been most severe in the Midwest. Perhaps this is because the heat waves that do occur raise the temperature well above the summertime average for this region. Other regions of the country are either not as prone to heat waves or are already responding to hot weather. That is, heat waves may create a larger demand shock in the Midwest than elsewhere. Nevertheless, the same price volatility problem may recur in other regions because the underlying cause is not the extreme weather conditions, but the inadequate market design that impedes the ability of prices to convey information about demand–supply imbalances to market participants.

Table 1 summarizes the six principal factors that contributed to the June 1998 price spike. Only two of these factors were present in July 1999.

In July 1999, hot weather shifted the demand curve to the right, and created a market shock. This shock was magnified several times because retail and wholesale mar-
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