

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

The New Power Company,)	
)	
Complainant,)	
)	
v.)	Docket No. EL01-105-000
)	
PJM Interconnection, L.L.C.,)	
)	
Respondent.)	
)	

SUPPLEMENTAL COMMENTS OF
THE ELECTRICITY CONSUMERS RESOURCE COUNCIL AND
THE AMERICAN IRON AND STEEL INSTITUTE

The Electricity Consumers Resource Council (“ELCON”) and the American Iron and Steel Institute (“AISI”), Industrial Consumers who filed a motion for late intervention on August 20, 2001, submit the following supplemental comments in this docket and discuss the implications of the decision issued by FERC on August 28, 2001, with respect to ISO-New England’s ICAP requirements.

SUMMARY

- Generators should not be allowed to “double dip” or “triple dip” by (i) increasing prices during a time of power shortage; (ii) recovering installed capacity (“ICAP”) payments; and (iii) recovering stranded costs associated with uneconomic generation assets. In a

competitive market, generators are able to increase prices during shortage and customers are able to curtail demand in real time in response to price increases.

- With the advent of restructuring, the original purposes of capacity requirements need to be reexamined and reevaluated. A capacity market is a vestige of the old regulated industry where all retail loads were captive and served on a coincident basis under average rates. Capacity reserve margins were maintained to hedge against a combination of demand uncertainty and price inelasticity. In the restructured environment, ICAP can be applied with discriminatory impact, because vertically integrated load-serving entities (“LSEs”) do not have to incur these costs while new LSEs must incur substantial ICAP charges.

- The capacity requirements that have been adopted in wholesale-only markets like PJM in fact represent a disguised form of reregulation. ICAP requirements are an ill-designed mechanism to force adequate capacity. Rather than encouraging new entry and demand response, ICAP masks price signals that would encourage new entry into the market. Industrial Consumers note that as recently as August 28, 2001, FERC recognized that curtailable loads represent an alternative to ICAP and invited ISO-NE to file by December 3, 2001, a compliance report regarding the feasibility of use of demand response to meet ISO-NE’s reserve capacity needs in lieu of ICAP. ISO New England, Inc., Order on Proposed ICAP Deficiency Charge, 96 FERC ¶ 61,234, slip op. at 1 (Aug. 28, 2001).

I. NEWPOWER’S COMPLAINT

NewPower’s complaint argues that the contained imposition of ICAP requirements on LSEs in the PJM market enables capacity owners to set capacity prices at inflated, noncompetitive levels that effectively preclude competition in the electricity markets for

residential customers. With the advent of restructuring, new LSEs, like NewPower, must purchase capacity in auction markets to satisfy their capacity reserve obligations. New entrant LSEs, which do not have their own capacity resources, or which were unable to enter into favorable long-term bilateral contracts as a result of being divested from formerly vertically integrated utilities in PJM, must acquire in the auction and bilateral capacity markets sufficient capacity or face imposition of these significant financial penalties.

LSEs purchasing capacity in both the auction and bilateral markets are not able to reduce their demand, i.e., capacity reserve obligations, in response to price increases. On the supply side, there is no corresponding requirement that capacity owners in PJM sell capacity to entities that serve load in PJM. Under current PJM rules, individual capacity owners may “delist” capacity and declare it is no longer a Capacity Resource in PJM.

NewPower alleges that the prices that new LSEs must pay for capacity places them at a significant disadvantage. NewPower states that participation in retail access programs is declining in Pennsylvania, New Jersey and Maryland in large part due to ICAP.

NewPower contends that FERC has a statutory mandate to act on its complaint for the following reasons:

- Prices in the PJM capacity markets are unjust and unreasonable. Where there is a competitive market, the courts allow FERC to rely on market-based rates in lieu of cost-of-service regulation. In PJM, there is no competitive capacity market. “While prices in competitive markets approximate the marginal cost of the marginal source of supply, prices in the PJM capacity markets are many times in excess of the marginal cost of supplying capacity.”

NewPower Complaint at 30.

- Rates are unduly discriminatory. New LSEs must compete with incumbent LSEs that do not have to incur these costs because they are vertically integrated or had the opportunity to enter into long-term bilateral contracts in connection with sale of generation facilities.

- The level of the penalty is unjust and unreasonable because it is many times greater than any amount that might be necessary to ensure construction of new capacity resources.¹

PJM, on August 3, 2001, filed an answer to NewPower’s complaint. PJM states that high prices are insufficient evidentiary support that market power is exercised in the capacity market. NewPower’s argument, that a “price above zero reflects the exercise of market power, is fallacious.” PJM Answer at 7. Since capacity owners have alternate uses for their capacity, these alternate uses have a value that has a legitimate impact on the PJM capacity markets when capacity owners forego those opportunities in order to sell capacity in the PJM capacity market. While daily prices “were \$177 per MW January through March...[d]uring April 2001 and thereafter, the daily price has been near zero at least one-half of the time and has exceeded \$100 none of the time. Since June 11 the price has not exceeded \$50.” PJM Answer at 9. PJM asserts that NewPower’s complaint would sidestep the PJM stakeholder process. Moreover, ongoing mediation among the Northeast ISOs may moot NewPower’s complaint.

¹ NewPower requests that FERC order PJM to eliminate immediately the recently imposed seasonal deficiency penalty and set the Capacity Deficiency Rate on a daily basis at the higher of the marginal cost of the least efficient capacity resource required to make up the deficiency on that day or the “Alternate Value,” *i.e.*, the difference between the energy prices on that day at the Cinergy Hub and PJM’s Western Hub. NewPower requests that the Commission set a refund effective date of 60 days from the date of filing of its complaint. See NewPower Complaint at 48, 51.

II. COMMENTS OF INDUSTRIAL CONSUMERS

A. ICAP Is Tantamount To Double Dipping Or Triple Dipping

In the absence of price-responsive load in the wholesale spot markets, the effect of the PJM ICAP requirement is to create a market for capacity that often allows generators to be paid twice for the same product. Owners of assets can recover costs more than once (i) by raising prices in times of shortage; (ii) through ICAP which represents a payment for generation capacity; and (iii) through recovery of stranded costs of generation assets. In California, this feature was easily gamed in the CAISO's market for replacement reserves after a suppliers market emerged. Industrial Consumers oppose a cost recovery system that allows owners of generation assets to recover their fixed costs more than once. Such cost recovery cannot meet the Federal Power Act mandate of "just and reasonable" rates.

FERC must satisfy itself that there is no double recovery of generation capacity. It has a duty under the Federal Power Act to protect consumers against excessive rates. See Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 610-612 (1944); Pennsylvania Water & Power Co. v. Federal Power Comm'n, 343 U.S. 414, 418 (1952).

B. The Need For ICAP Requirements Should Be Rethought Post Restructuring

ICAP requirements were created in an era in which vertically integrated utilities built and owned generation, transmission and distribution facilities. These utilities were obligated to provide retail services in exclusive franchise territories. As originally conceived, capacity requirements were designed to assure availability of sufficient generating capacity in a tight power pool and to prevent free riding by one or more of the pool participants. In a

regulated environment, the capacity requirement and deficiency charge made sense and avoided the scenario that a utility would decline to build sufficient capacity and then routinely rely on other pool members to make up the shortfall. ICAP did not cause competitive injury in the regulated environment since the members of PJM did not compete in each other's exclusive franchise territories.

Post restructuring, capacity owners are no longer required to serve exclusive franchise territories or build new resources to achieve reliability or even commit their resources to PJM. New LSEs are not in the business of supplying capacity, and it was never intended that they build new resources to ensure reliability.

It is especially appropriate to revisit the continued need for ICAP in light of FERC's June 28, 2000 order permitting the elimination of the ICAP auction market in ISO-New England effective August 1, 2000, based upon a finding "that the existing auction is not useful and that it can produce inflated prices unrelated to the actual harm created by ICAP deficiencies." ISO New England, Inc., Order Conditionally Accepting Congestion Management and Multi-Settlement Systems, 91 FERC ¶ 61,311 at 62,081 (2000). The Commission required the ISO to revert to administratively determined sanctions and to propose an appropriate ICAP deficiency charge.²

The decision that FERC issued reflected ISO-New England's own conclusion that ICAP no longer fulfills its reliability purpose. See ISO-NE July 28, 2000 Compliance Filing,

² FERC's order was reviewed by the U.S. Court of Appeals for the First Circuit. The Commission has extended a \$.017 deficiency charge pending further order of the court. See ISO New England, Inc., Order on Rehearing, 95 FERC ¶ 61,174 at 61,562 (May 4, 2001).

Aff. of William Hogan at 2 (expressing Professor Hogan’s view that the current ICAP market design “is structurally flawed and does not serve to preserve reliability”).

C. PJM’s ICAP Requirement Does Not Promote New Generation Or Encourage Demand-Response

As the California crisis illustrates, price caps have as obvious defects stifling the development of new generation and concealing price signals necessary for effective demand response. Capacity markets also tend to neuter price volatility, defeating an important attribute of competitive markets. Generators should recover their costs by raising prices in times of shortage. Where markets are allowed to operate, new generation will enter and demand will respond to price. Older inefficient units should not be subsidized by ICAP.

The alleged need for a separate market for capacity reflects an imperfect market and the failure to adequately develop price-responsive load resources in real time, an original intent of industry restructuring. FERC’s November 1, 2000 Staff Report, “Investigation of Bulk Power Markets – Northeast Region,” warned that “bid and price caps are, at best, transition controls that can limit the extent and speed of development of competitive markets.” *Id.* at 1-41.

Industrial Consumers welcome FERC’s recognition in its August 28, 2001 Order in the ISO New England Docket, EL00-62-026, that curtailable load response is an alternative to ICAP:

Our goal is to promote the development of the most efficient mechanism to ensure the availability of sufficient reserve capacity in New England. Among the possible mechanisms, one such mechanism would be the acquisition of reserves on a forward basis. Under this mechanism, an LSE's reserve obligation for a given period would be announced in advance, and the obligation would need to be met in advance. This mechanism could more directly incent the construction of new generation for reserve purposes, and

also potentially reduce the exercise of market power because LSEs will be able to meet their obligation by contracting with new entrants as well as current generators. Another (or possibly complementary) option would be the use of demand side mechanisms, i.e., allowing LSEs to meet part of their capacity requirement by identifying load that would curtail usage, when directed by the grid operator. Curtailable loads could be identified by permitting price-sensitive users to submit demand bids that would indicate the price at which they would curtail usage for economic reasons.

We are therefore directing ISO-NE to file, on or before December 3, 2001, a compliance report in this proceeding regarding its efforts to develop an alternative to the ICAP requirement, in particular the feasibility of a program of acquiring forward reserves and using demand side mechanisms to meet ISO-NE's reserve capacity needs, in lieu of the current ICAP requirement. If ISO-NE states in its compliance report that it believes that such a program would be feasible, ISO-NE should either make a filing under section 205 implementing that program simultaneously with filing its compliance report, or provide in its compliance report in this proceeding a time frame within which ISO-NE could make such a filing.³

Beyond the impediment that price caps play in enticing the development of new generation, the current crazy quilt of conflicting ICAP scenarios in the Northeast fragments balkanized markets. As FERC Staff stated in its November 1, 2000 Report on the Northeast Market: "Differences" in ICAP requirements "act to fragment the Northeastern region, rather than bring it together, and may also drive resources from one control area to the next, potentially exacerbating market power in situations of limited ICAP." Id. at 1-87.

CONCLUSION

We appreciate that PJM and other parties counsel patience, that deficiencies in the Northeast Power market may gradually be resolved through stakeholder processes or the pending Northeast RTO mediation. Unfortunately, the experience of efforts to coalesce the three

³ ISO New England, Inc., Order on Proposed ICAP Deficiency Charge, 96 FERC ¶ 61,234, slip op. at 12-13 (Aug. 28, 2001).

Northeast ISOs has not been encouraging. FERC should act promptly to reexamine the utility of ICAP and its anticompetitive impact rather than wait months or years for all aspects of the Northeast RTO to be resolved. PJM should also be required to make a filing with FERC to address demand response as an alternative to ICAP.

Respectfully submitted,

/s/ Sara D. Schotland

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing Comments of the Electricity Consumers Resource Council and American Iron and Steel Institute were today mailed to parties on the service list of this proceeding by U.S. mail, postage prepaid.

Dated at Washington, D.C., this 5th day of September, 2001.

/s/ Kari Vander Stoep

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