

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Maryland Public Service Commission, *et al.*

v.

PJM Interconnection LLC

Docket No. EL08-67-000

**MOTION TO INTERVENE AND COMMENTS OF
ELECTRICITY CONSUMERS RESOURCE COUNCIL (“ELCON”)**

Pursuant to Rules 211 and 214 of the Federal Energy Regulatory Commission’s (“FERC’s”) Rules of Practice and Procedure, and the Notice of Complaint dated June 2, 2008, the Electricity Consumers Resource Council (“ELCON”) hereby moves to intervene in the above-captioned proceeding. ELCON supports RPM Buyers’ position¹ that FERC should reject the capacity prices set in PJM Interconnection LLC’s (“PJM”) first four “transitional” base residual auctions under its Reliability Pricing Model (“RPM”). ELCON agrees that serious structural flaws both in the structure of the PJM capacity market and in the design of the RPM mechanism will result in unjust and unreasonable capacity prices for delivery years through May 2011.

This proceeding presents yet another opportunity for FERC to address the dysfunction in the operation of the organized wholesale electricity markets. ELCON and other consumers have

¹ Complaint of the RPM Buyers, Docket No. EL08-67-000, filed May 30, 2008 (“RPM Buyers’ Complaint”).

been taking advantage of every possible opportunity, in multiple fora, to express their dissatisfaction with the status quo. Here, ELCON continues to urge FERC to fulfill its role as a consumer protection agency.

Description and Standing of ELCON

ELCON is a national association of industrial consumers of electricity organized to promote the development of coordinated and rational federal and state policies that will assure an adequate, reliable and efficient electricity supply for all users at competitive rates. ELCON member companies produce a wide range of products from virtually every segment of the manufacturing community. The member companies of ELCON consume approximately five percent of all electricity in the United States. Many ELCON members operate major facilities and are consumers of electricity in the footprint of the PJM region and therefore will be directly affected by the outcome of this proceeding.

Background on PJM's RPM Mechanism

In April 2006, FERC endorsed PJM's new capacity market structure and in December 2006, conditionally approved PJM's RPM mechanism (including a settlement reached among certain stakeholders) to establish new market rules aimed at enabling PJM to obtain sufficient capacity to reliably meet the needs of consumers within PJM at a reasonable cost.² PJM's then existing market rules established a single market for supply, but the structure did not assure that the supply was available to all local areas. Like previous attempts to establish a separate capacity market in parallel with PJM's energy markets, the new rules were expected to provide greater incentives for new generation, transmission, and demand response, while also providing

² PJM Interconnection, L.L.C., 115 FERC ¶61,079(April 20, 2006), 117 FERC ¶61,263 (December 22, 2006).

sufficient revenues to retain existing resources that are needed for reliability. FERC also stated that it expected the overall cost to market participants to be less than what would otherwise be incurred under PJM's existing mechanisms.³

The key premise underlying the RPM mechanism was that capacity prices would be set in each area (to reflect the needs of that area) through an auction market with an administratively-determined demand curve was intended to reflect the reliability value of increased supply. The demand curve was to decrease market volatility thus creating a better market environment for investment in new generation and retention of existing plants. The program called for a three-year forward period between an auction and delivery date to increase the opportunities for competition from new generation, with a series of transitional auctions for shorter delivery periods.

When FERC approved the program, it acknowledged the experimental nature of the program, noting that it was uncertain whether PJM's RPM mechanism would in fact procure the needed capacity.⁴ FERC stated that it would monitor performance of RPM to ensure that it was achieving its objectives and "to ensure that prices remain just and reasonable."⁵ The current evidence, summarized below and in the RPM Buyers' Complaint, is that, to the contrary, PJM's RPM mechanism is leading to unjust and unreasonable rates.

³ Among the key features of the RPM mechanism as approved were forward procurement, locational pricing phase-in in 23 locational delivery areas, and the determination of supply prices through use of a downward-sloping demand curve so that: (1) prices within each local area change gradually based on the balance between the amount of supply offered and the amount required for reliability; (2) investment would be encouraged by increased revenue stability over time; (3) the incremental value of capacity would be better indicated, thus eliminating price spikes driven by small changes in supply or reliability requirements; and (4) the potential for excessive profits through withholding or other market manipulation would be reduced or eliminated.

⁴ 117 FERC ¶61,331 (December 22, 2006) at P. 146; 119 FERC ¶61,318 (June 25, 2007) at P. 191, 194

⁵ 119 FERC ¶61,318 at P. 194.

ELCON's Motion to Intervene and Comments

PJM's RPM transition auctions have utterly failed to achieve any of the stated objectives of the RPM mechanism to send proper signals regarding the value of capacity by location through the introduction of a locational element in the capacity market, encourage the entry of new and additional resources, and reduce price volatility and the potential for market manipulation. Instead, customers in PJM have experienced sudden dramatic price spikes, market mitigation was required in every zone to address the lack of competition, and the new resources that the incentive payments were supposed to attract were unable fully to participate in the auctions.

RPM Buyers' expert identifies numerous specific problems with the transitional auctions, including:

- Little or no new capacity was offered into the transitional auctions and there was very little capacity at prices close to RPM clearing prices.
- Supply curves were steep and inelastic at the clearing point.
- Steep and inelastic administratively-determined variable resource requirement curves were set at the wrong levels using exceptionally conservative parameters.
- Because auctions cleared on nearly vertical segments of the supply curves, withholding of small amounts of capacity resulted in a substantial increase on prices.
- Mitigation provisions, such as must-offer requirements and avoidable cost offer caps for existing generation, included exceptions that created advantageous loopholes for suppliers to justify much higher offer prices than were expected or intended when the program was designed.
- Various PJM procedures and RPM provisions excluded some capacity, further reducing supply and increasing prices.
- Locational "price signals" were highly volatile and moved as a result of regulated transmission enhancements and supplier strategic conduct. Locational Delivery Areas changed from one auction to the next and new investment was not attracted to transmission-dependent areas. Additionally, PJM imposed a stringent non-standard resource adequacy requirement that raised LDA reliability requirements

that, coupled with the steep supply and demand curves, increased prices significantly.⁶

A. Excessive Prices Under the Transitional Auctions Amount to Windfalls to Existing Generation

ELCON, together with other Industrial Customers, had predicted early on that the resulting capacity price increase under RPM would be excessive and that RPM would have a severe and negative economic impact, particularly on energy-intensive businesses.⁷ With respect to the transitional auctions, this prediction has materialized. As RPM Buyers explain in their complaint, in each of the transitional auctions, various factors including lack of new capacity offered into the auctions and misstatements or misunderstandings of capacity supply and demand combined to produce unjust and unreasonable capacity prices in the RTO and in every local delivery area. Prices have greatly exceeded PJM's estimated increases (as presented in pre-auction simulations) and have been as much as forty times higher than what they were pre-RPM.⁸

At the same time, there has been no measurable improvement in reliability, and it is questionable whether the exorbitant prices generators reaped during the transition period will in fact attract significant new investment, given that prices dropped in the first auction that included new resources. Rather than achieving the goals of RPM and providing reasonable incentives to

⁶ See Affidavit of James W. Wilson in Support of Complaint of the RPM Buyers, pps. 3-7, attached to RPM Buyers' Complaint.

⁷ See Industrial Customers' Motions to Intervene and Protest of PJM's Reliability Pricing Model, October 19, 2005, FERC Docket Nos. ER05-1410 and EL05-148 ("Industrial Customers' Comments").

⁸ See, e.g., "Raising the Stakes on Capacity Incentives: PJM's Reliability Pricing Model (RPM)," James F. Wilson, LECG, LLC at 5 (March 14, 2008), attached to RPM Buyers' March 19, 2008 Motion for Technical Conference, FERC Docket Nos. ER05-1410 and EL05-148; see also PJM Interconnection, L.L.C., Reliability Pricing Model Updated Prototype Simulation Using FERC Settlement VRR, December 1, 2006 (updated December 27, 2006), available at <http://www.pjm.com/markets/pjm/downloads/20061201-rpm-ptototype-simulations-ferc-settlement-vrr-curve.pdf>.

new resources, the transition auctions resulted simply in an unwarranted windfall to existing generators in the PJM region.

B. PJM’s Capacity Market Has Proven Highly Vulnerable to Market Power

In its RPM Proposal, PJM acknowledged that the RPM auctions would not necessarily be fully competitive but that new resources would participate in the transition auctions and serve to mitigate market power of existing suppliers. However, PJM has since stated that it was only with the May 2008 RPM auction that new resources were offered a reasonable opportunity to participate equally with existing resources in the PJM capacity auctions, and therefore could not have had the expected mitigating effect in the transition auctions.⁹ PJM’s own MMU has indicated that structural flaws necessitating mitigation have existed in all areas for all transitional auctions.¹⁰ Furthermore, the MMU has stated recently that the problem is unlikely to see resolution any time soon:

Given the basic features of market structure in the PJM Capacity Market, including significant market structure issues, inelastic demand, tight supply-demand conditions, the relatively small number of nonaffiliated LSEs and supplier knowledge of aggregate market demand, the MMU concludes that the potential for the exercise of market power continues to be high. *Market power is and will remain endemic to the existing structure of the PJM Capacity Market. ... The Capacity Market is unlikely*

⁹ Reply Testimony of Michael J. Kormos, Senior Vice-President of Reliability Services, PJM Interconnection L.L.C. on Behalf of the Staff of the Maryland Public Service Commission, *In the Matter of the Commission’s Investigation of Investor-Owned Electric Companies’ Standard Offer Service for Residential and Small Commercial Customers in Maryland*, Case No. 9117 (Oct.30, 2007) at 4:65-5:76, available at <http://webapp.psc.state.md.us/intranet/casenum/CaseForm.cfm>

¹⁰ “All participants in the RPM auction failed the market structure tests with the result that offer caps were applied to all sellers.” See PJM Market Monitoring Unit Analysis of the 2007-2008 RPM Auction (Aug. 16, 2007), available at <http://www.pjm.com/markets/market-monitor/downloads/mmu-reports/20070820-analysis-2007-2008-rpm-auction.pdf>; See also PJM Market Monitoring Unit Analysis of the 2008-2009 RPM Auction (Nov. 30, 2007), available at <http://www.pjm.com/markets/market-monitor/downloads/mmu-reports/20082009-rpm-review-with-att-a.pdf>; PJM Market Monitoring Unit Analysis of the 2009-2010 RPM Auction (Feb 11, 2008), available at <http://www.pjm.com/markets/market-monitor/downloads/mmu-presentations/20092010-rpm-review.pdf>; PJM Market Monitoring Unit Analysis of the 2010/2011 RPM Auction (May 6, 2008), available at <http://www.pjm.com/markets/market-monitor/downloads/20080506-20102011-rpm-review.pdf>.

*ever to approach the economist's view of a competitive market structure in the absence of a substantial and unlikely structural change that results in much more diversity of ownership.*¹¹

PJM also touted the demand curve component of RPM as a tool to mitigate market power. However, given the nearly vertical slopes of the supply curve and the variable resource requirement curve, along with RPM's flexible rules and the concentration of suppliers within PJM, the incentive to withhold capacity is strong.¹² Indeed, as RPM Buyers point out, in spite of high price signals, available capacity in one transmission-constrained Locational Delivery Area fell for the 2007 to 2009 delivery years.¹³ With relatively inelastic supply and demand, even small changes in supply offered in an auction dramatically affected price.

The lack of competition from new or alternative resources, coupled with steep and inelastic supply and variable resource requirement demand curves, significant structural market flaws and strong incentives to cheat left the RPM process wide open to supplier manipulation.

C. RPM's Locational Incentive Has Driven Up Prices Without Attracting Investment

The creation of local deliverability areas during the transition period and the application of stringent reliability tests to constrained regions were central to RPM's plan to incent retention and construction of capacity in constrained regions where it is most needed. ELCON and other industrial groups questioned how PJM expected the locational capacity requirement to function

¹¹ PJM Market Monitoring Unit, 2007 PJM State of the Market Report (Mar. 11, 2008) Vol. 2 at 232-233, *available at* <http://www2pjm.com/markets/market-monitor/downloads/mmu-reports/2007-som-volume2.pdf> (emphasis added).

¹² RPM Buyers give numerous examples in their Complaint. *See, e.g.*, pages 44-54.

¹³ See RPM Buyers Motion for Technical Conference at 5-6 (March 19, 2008) FERC Docket Nos. ER05-1410 and EL05-148 and attached report "Raising the Stakes on Capacity Incentives: PJM's Reliability Pricing Model (RPM)," James F. Wilson, LECG, LLC at 42 (March 14, 2008).

any better than LMP to encourage investment in those identified locations.¹⁴ Indeed, it has not performed as anticipated. PJM has changed the local deliverability areas from one auction to the next. Locational prices were extremely volatile during the first three auctions, and since then, changes to the transmission system and strategic supplier conduct have effectively wiped out the locational price differences, leaving customers to shoulder the burden of higher rates with neither the competitive benefit of new capacity resources nor any significant additional reliability benefits.

D. RPM's Incentives to Suppliers Must Be Justified By Commensurate Benefits to Ratepayers and Must Be No More than Necessary to Achieve Their Stated Purpose

The incentive payments to suppliers during the RPM transitional period serve no purpose other than a straight wealth transfer from customers to existing suppliers. At best, they are an unearned reward for past investments. They are unjust and unreasonable, and would be vulnerable if submitted to judicial scrutiny.

Courts considering prior incentive ratemaking proposals have required that the Commission justify the incentive rate, including consideration of whether the incentive mechanism is excessively costly in relation to its benefits. The courts do not give FERC *carte blanche* on incentive pricing; rather, FERC must show that incentives are an efficient means to achieve the desired goal. For example, in *Sithe New England Holdings LLC v. FERC*, the First Circuit, discussing ICAP charges in New England, admonished that the capacity charges do not aim to provide “private compensations for past investment; instead it is designed to serve two different public purposes: one is to give providers an extra incentive to construct new plants and the other ... is to impose a hefty penalty on those buyers who fail to acquire the reserve capacity

¹⁴ See Industrial Customers' Comments at 52-53. Industrial Customers also questioned the need for a locational deliverability requirement based on the fact the PJM was built on a universal deliverability standard. *Id.*, at 52.

that FERC has decreed they shall have.” 308 F.3d 71, 77 (1st Cir. 2002). Likewise, in *Central Maine Power Co. v. FERC*, the court affirmed that FERC tariffs may set an appropriate level of capacity charges as a vehicle to “assure adequate energy supplies” and “to encourage suppliers to maintain marginal (*i.e.*, high cost) existing plants or to build new facilities for peak demand” but indicated that excessive charges are neither permissible nor sustainable. 252 F.3d 34, 48 (1st Cir. 2001).

Incentive rates are not *per se* unjust and unreasonable, however, they must be commensurate with the objectives they seek to accomplish. In *Farmers Union Central Exchange Inc. v. FERC*, 734 F.2d 1486 (D.C. Cir.) *cert. denied*, 469 U.S. 1034 (1984), the Commission remanded to FERC a generic ratemaking methodology for oil pipelines intended to stimulate new capacity. The opinion sums up several cases that establish that incentive rates must be justified with findings that the particular incentive increment will result in the intended outcome:

In the absence of such a reasoned inquiry, we cannot countenance FERC’s approval of oil pipeline rates which, by FERC’s own admission, ensure “creamy returns” to the carriers, 21 FERC at 61,650, and are “far more generous than those [rates] that [FERC] or other regulators give elsewhere,” *id.*, at 61,646.

Id. at 1503. *Farmers Union* concludes by reiterating the importance of carefully calibrated incentive rate mechanisms: “Departures from cost-based rates must be made, if at all, only when the non-cost factors are clearly identified and the substitute or supplemental ratemaking methods ensure that the resulting rate levels are justified by those factors.” *Farmers Union*, 734 F.2d at 1530.

E. Regardless of How the RPM Mechanism Is Characterized, It Fails to Pass Muster Under the Applicable “Just and Reasonable” Standard

Further, the RPM mechanism cannot be justified as an “experiment.” As a threshold matter, the time for any experimentation has long since passed. The PJM market was originally

established (as an ISO) in January 1998 - a decade ago - and approved as a RTO in 2001. FERC should recognize that the PJM market has utterly failed to achieve its promises and an alternative market structure is needed. In any event, as the D.C. Circuit found upon its consideration of “experimental” regulation by FERC in Maryland People’s Counsel v. FERC, 761 F.2d 768 (D.C. Cir. 1985), the just and reasonable standard still applies. This case involved a challenge to FERC’s approval of what it described as an “experimental increase in natural gas pipeline competition” through a special marketing program. Id., at 770. FERC had argued that it was not possible, nor was it appropriate at that time, to assess the full impact of the program it sought to implement. The Court (panel comprised of Ginsburg, Mikva and Scalia) disagreed, with the opinion of (then) Judge Scalia observed, FERC’s “experimental rationale” for its action was “most disarming”:

As we have recognized in a different regulatory context, there are situations in which “a month of experience will be worth a year of hearings.” But just as there are reasonable programs and arbitrary programs, so also there are reasonable experiments and arbitrary experiments. The law governing our review does not demand an impossible predictability, but it does demand an articulation, in response to serious objections, of the Commission’s reasons for believing that more good than harm will come of its action – even experimental action. As our discussion above suggests, that has not been provided.

Id. The fact that an approach is novel or innovative does not provide a bye from satisfying the criteria of the incentive ratemaking -- rates must still be just and reasonable.

As discussed above, none of the results of the transitional auctions should come as a surprise. ELCON and other industrial customers, as well as many other participants in the RPM proceeding, voiced concern about the very problems that have materialized. As FERC projected, 117 FERC ¶61,331 at P136, now is the time to revisit the matter. The capacity rates established under PJM’s RPM mechanism have failed to achieve their objectives and have not yielded any benefits; to the contrary, consumers have suffered exorbitant and volatile

transitional auction prices. Under the criteria set out by the courts, FERC must find that the result has been unjust and unreasonable rates.

* * * *

In consideration of the foregoing, ELCON respectfully requests that FERC grant its Motion to Intervene, issue a determination that implementation of PJM's RPM mechanism has led to unjust and unreasonable capacity prices, and grant the relief sought by RPM Buyers in this proceeding.

Notices and Communications

Notices and communications with regard to these proceedings should be addressed to:

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Dated: July 11, 2008

Certificate of Service

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary of this proceeding.

Dated at Washington, D.C.: July 11, 2008

/s/ Jennifer A. Morrissey
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