UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

PJM Interconnection, L.L.C.	)	Docket No. EL03-236-000

REQUEST FOR REHEARING OF
THE ELECTRICITY CONSUMERS RESOURCE COUNCIL

Pursuant to 18 C.F.R. § 713, the Electricity Consumers Resource Council (ELCON) request rehearing of certain aspects of FERC's May 6, 2004 decision related to PJM's proposed tariff revisions and outlining a new policy for compensation issues for must run generators.

STATEMENT OF THE CASE

On September 30, 2003, PJM Interconnection, LLC filed a proposal to revise the offer price cap rules for reliability must run (RMR) generating units, and to establish a local market auction to address long-term scarcity that would produce unreliable operations in load pockets should such a condition arise in PJM. PJM proposed to continue to address local market power in the PJM region by capping offer prices of generation resources that are dispatched out of economic merit order to maintain reliability. PJM stated that it believed its existing offer capping mechanism effectively addresses local market power in load pockets when there is no scarcity of generation. However, PJM determined that modifications to its local market rules would be appropriate to effectively address long term scarcity should such a condition arise. To

that end, PJM proposed to establish a competitive auction that would be triggered when PJM identifies long-term scarcity in a load pocket.

On February 4 and 5, 2004, FERC held a Technical Conference on compensation for generating units subject to local market power mitigation in bid-based markets. The first day of the conference addressed general issues related to compensation for must run units, while the second day focused more specifically on the PJM proposal.

On February 20, 2004, the Electricity Consumers Resource Council (ELCON) intervened in the PJM docket. ELCON stated that while it generally supported the price cap provisions for reliability must-run generating units set forth in PJM's September 30, 2003 filing, it had some reservations concerning the treatment of RMR units in other markets or regions. ELCON also supported the notion that market mitigation measures should be required of all generators, regardless of when constructed, so long as there is the potential exercise of local market power within PJM's load pockets.

On February 27, 2004, in response to the Commission's call for comments following its February 4 and 5 Technical Conference, ELCON submitted post-conference comments and recommendations emphasizing that fixing RMR compensation cannot be done in isolation of other generic problems related to capacity markets and market design in general. The problem at hand results, in part, from the fact that when regional electricity markets were restructured by a combination of generation divestiture, retail access and the establishment of independent system operators with operational control of most transmission assets, it was not fully appreciated that some generators retained significant local market power.

On May 6, 2004, FERC issued an order on the PJM tariff proposal. The Order, however, reaches beyond the issues specific to PJM and sets out an "overarching analytical approach" for

addressing reliability compensation issues among market participants in general. FERC has transformed the PJM docket from a PJM-specific case to pronouncement of new policy of general applicability.

The Order directed PJM to change its market rules to define RMR units as units that are subject to frequent mitigation, specifically, 80% or more of the unit's run hours. Such units would receive higher offer caps or alternative compensation. (Order, Paragraph 39). However, the Commission clearly advocates in the Order that PJM make market design changes that effectively guarantee the qualifying RMR unit a series of locational capacity payments, as opposed to use of a simple RMR contract that would provide fixed cost recovery. (Order, Paragraph 40). The Order also rejected PJM's proposal to eliminate the blanket exemption from offer cap rules for generating units for which construction commenced on or after July 9, 1996.

While ELCON generally supported the price cap provisions for RMR generating units set forth in PJM's September 30, 2003 filing, ELCON is concerned about the effect of certain erroneous assumptions and methodologies underlying the Commission's May 6 Order. It is on these particular points that ELCON now respectfully requests rehearing.

SUMMARY LISTING OF ERRORS

1. The Order implies that it is customers (loads), rather than inadequate transmission infrastructure, natural geography and concentrated markets, that are responsible for load pocket congestion. This erroneous premise leads FERC to impose the entirety of RMR costs on customers in these load pockets. FERC states: "[T]o ensure that the costs incurred to correct the reliability problem are allocated to affected load, the costs of the selected infrastructure should be allocated at ideally a subzone level to the *load responsible for the problem.*" (Order,

Paragraph 74). This underlying assumption that load is responsible for congestion problems is erroneous and therefore cannot support the wholesale pricing policies FERC seeks to promote in the Order. Much of today's congestion stems from utility planning and expansion practices that were deemed prudent, least-cost, and just and reasonable under the old regime [1] but which verge on arbitrary with the switch to LMP without first ensuring adequate infrastructure. Further allocation of costs to those customers who have the ill fortune to be located in a load pocket represents an unfair and discriminatory allocation of costs in violation of section 205 which provides that FERC shall not authorize rates that "grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage." The better result is that load pocket generation should be refunctionalized as transmission and subject to economic regulation, cost of service plus reasonable rate of return.

2. In the May 6 Order, FERC announces a policy for using an administratively determined locational "pricing" mechanism as a means of "incenting" resource adequacy. There are two fatal flaws to this methodology. First, the investment banking community has made clear that RMR revenues will not spur new investment. Under these circumstances the RMR pricing methodology does not carry out the underlying regulatory objective and is thus arbitrary and capricious. Second, FERC cannot achieve competitive markets by its continuous reversion to administratively determined "pricing" methodologies that do not reflect true market mechanisms and that guarantee recovery to generators so that they are relieved of investment risk.

3. In the May 6 Order, FERC rejects PJM's proposal to eliminate the blanket exemption from offer cap rules for generating units for which construction commenced on or

[1] I.e., generation was sited as an economic substitute for additional transmission investments.

after July 9, 1996. All generators should be subject to the same market power and market mitigation standards. FERC itself has recognized the potential for generation built after 1996 to exercise market power and PJM has found that in fact such units can exercise market power. Accordingly the exclusion of post-1996 generation from market power and mitigation is arbitrary and capricious.

ARGUMENT ON REHEARING

1. The Assumption that Load is Responsible for the Congestion Problem is a Serious Error Which Leads FERC To Adopt A Faulty RMR Pricing Methodology

FERC states: "[T]o ensure that the costs incurred to correct the reliability problem are allocated to the affected load, the costs of the selected infrastructure should be allocated at ideally a subzone level to the load responsible for the problem." (Order, Paragraph 74). However, loads are not "the problem" or responsible for causing load pockets. Incumbent industrial facility siting was based on a host of factors particular to the business of the customer, on the availability of resources, markets, transportation, material supply, and on other factors. The existence of load pockets reflects geographic reality and utility planning and investment decisions. Transmission owners may have built generation in the pocket as prudent least cost alternative to transmission resources or may have deliberately under-built transmission to favor its generation resources. Transmission congestion is the result of past *utility* decisions that may or may not have been approved by regulators. As captive customers of a utility monopolist, they did not make or even have a voice in these decisions, and certainly were never informed of or anticipated the ultimate liability of siting their load (and jobs) at a specific location such that they were afforded a reasonable opportunity to locate their long-term investment elsewhere.

Under the locational pricing regime, loads are the victims of fate: fortuitously, some benefit from sub-zonal resource adequacy, and the rest do not. This allocation of winners and losers is clearly an arbitrary process. Winners took no action on their own to merit exemption from costs that are now shifted to other customers who may be their competitors. The Order also presumes that loads that are responsible for causing their own fate and should pay the penalty in the form of higher congestion costs, higher (administratively-determined) installed capacity costs, higher locational operating reserves, etc. Contrary to the implications of the Order, afflicted loads cannot avoid such payments by becoming their own utility and building generation or transmission lines to ensure resource adequacy at the node(s). Customers do not have an obligation to perform the utility's core business because the utility declines to undertake this service. There is no demonstration that this is economically or institutionally feasible. See *Shell Offshore v. Transcont. Gas Pipe Line*, 103 FERC P. 61,177 (2003) (finding that Transco and WFS possessed monopoly market power with respect to gas gathering and that Shell had no reasonable alternative to use of WFS' gathering pipeline and Transco's transmission feeder line).

ELCON urges the Commission to abandon these erroneous assumptions as a basis for the agency's wholesale pricing policies. As the Blackout last August reminded all of us, reliability is not just a local problem. All consumers in a region or pricing zone should share in the costs of ensuring reliability. The burden should not fall only on those who, whether for reasons of historic accident or misguided past policies, happen to be located in load pockets where transmission is inadequate. FERC states that payment obligations should be allocated to the local area benefiting from a reliability improvement. Reliability upgrades to remedy problems caused by transmission inadequacy benefit the region as a whole, therefore the costs should be shouldered equally by all consumers in that region or pricing zone.

Imposing all RMR costs on customers in load pockets is arbitrary and capricious, and is inconsistent with FERC's own precedent on cost causation. In Order 888-A, the Commission reiterated and emphasized the "long-established principle of assigning cost based on coast causation," that is, the principle that *all customers should be responsible for repaying costs incurred to provide service to them*, and the shifting of costs to customers who had no responsibility for causing them should be avoided. *See* Order 888-A, 78 FERC P61,220 (1997). Courts have frowned on such cost allocations without adequate explanation for the action. *See, e.g., Sithe/Independence Power Partners v. FERC*, 285 F.3d 1 (2002) (remanding for further consideration FERC's decision to approve a locational marginal pricing method applicable to transmission losses where "FERC failed to explain adequately its decision to depart from its longstanding cost-causation principle.")

In accordance with its own precedent, as well as with the Federal Power Act's mandate that FERC protect *consumers* from unjust and unreasonable rates, FERC should revise this policy so that the burden of reliability costs are appropriately spread among all who benefit.

2. The May 6 Order is Arbitrary and Capricious because it Does Not Meet the Regulatory Goals Given that Investment will be Spurred by the Assurance of Long Term Contracts Rather than Unstable Regulatory Fixes.

The Commission indicates in the Order "that market design features such as locational requirements for installed capacity may prove an effective approach to create stable revenue streams." (Order, Paragraph 21). This approach will not work. The financial sector has told FERC that it wants to use long-term contracts, and indeed, in the May 6 Order, FERC itself acknowledges this preference. (Order, Paragraph 20). During the February 4, 2004 Technical Conference, members of the financial investment community made presentations during which

the preference for long-term contracts and the reasons for that preference were clearly explained. [2] The prospect of higher revenues derived primarily from short-term profits will not satisfy lender requirements for financing infrastructure investment. The financial sector's preference for long-term contracts is not news to FERC. For example, in connection with the NYISO's proposal to implement an ICAP demand curve to stabilize generation revenues to attract investment, numerous commentators pointed out to the Commission that what is needed to engender lender confidence are long-term contracts with creditworthy counterparties and a stable regulatory environment. *See, e.g.*, April 11, 2003 filings of Energy East Companies and Morgan Stanley Capital Group, Docket No. ER03-647.

The Commission's preference for bid-based regulatory mechanisms discourages forward contracting. This problem will not be solved if only bid-based solutions are proposed. As ELCON suggested in its February 27, 2004 post-Technical Conference comments, generators must be exposed to a certain amount of price risk to encourage them to negotiate long-term contracts. By administratively eliminating this risk, FERC is perpetuating a real economic barrier to new investment. "Stable revenue streams" based on an administratively-determined "price" would have to be structured as regulatory assets to make them as credit worthy or effective as a long-term contract. Thus the Commission's proposal for a "stable revenue stream" can only be implemented by shifting generator risk to captive end-use consumers. The announced "market design" solution is also flawed because it does not ensure that a unit's owner will continue to operate the unit or that the owner will add new capacity at the appropriate location. There is no "market bargain" equivalent to the "regulatory bargain" in which the

[2] See, e.g., Transcript of February 4, 2002 Technical Conference in Docket PL04-2-000, at 19, 21, 28, 35, 37, 39. See also Technical Conference Discussion Materials, submitted by Frank Napolitano of Lehman Brothers and available on FERC's website in Docket PL04-2-000.

producer exchanges the virtual guarantee of recovery of its revenue requirement for the obligation to provide adequate service at reasonable rates.

During the February 4, 2004 Technical Conference, speakers repeatedly stressed that the resource problem is not simply local, or particular to certain localities. Rather, the problem is one of the market as a whole. If the regionally designed wholesale market structure is correct, then it will promote infrastructure and resource mix that is adequate to support competitive power markets, enhance supply response in load pockets, and ease the need for price caps, thus producing efficient price signals.

Locational requirements such as those FERC advocates in the May 6 Order run contrary to pricing and risk allocation in a competitive market context. A competitive market cannot be established with administratively determined "prices" of the government's choosing, especially in times of scarcity. Where there is scarcity, prices should reflect the situation. FERC's policy of price capping interferes with market signals necessary to encourage efficiency in competition and instead forces an inefficient hybrid of market and regulatory mechanisms that often work at cross purposes with each other.

ELCON urges the Commission to reject administratively-determined locational "pricing" mechanisms as the cure-all for all legacy problems in the transition from regulation to competition.

3. <u>All Generators Should be Subject to the Same Market Power and Market Mitigation Standards.</u>

The PJM September 30, 2003 filing proposes to eliminate the exemption of post-1996 units from PJM's offer price cap rules. In the May 6 Order, the Commission finds that "the record in this proceeding does not support a finding that the exemption for post-1996 units has

been unjust and unreasonable." ELCON takes issue with this finding. There is no basis for assuming *a priori* that any new generator cannot exercise market power and therefore should be immune from mitigation measures. It is arbitrary and capricious to exempt post-1996 units from a market power mitigation obligation given that PJM's market monitor has testified that while some post-1996 units were constrained by competitive forces, others were in fact, a position to exercise market power. *See* PJM September 30, 2003 filing at 22-25; Prepared Testimony of Joseph E. Bowring on behalf of PJM Interconnection, LLC, Docket PA03-12-000, filed July 30, 2003, at 24-25; Answer of PJM Interconnection, L.L.C. to Protests, Docket EL03-236, filed November 19, 2003, at 19 ("While it is important to be fair to the units that commenced construction after 199, there is no reason to believe that post 1996 units cannot exercise market power. There is simply no evidence to support the assumption that such units always have a salutary effect on competition… .").

PJM explained that the July 9, 1996 date represents a date the Commission established for exempting new generators from having to demonstrate a lack of market power in order to receive market-based rate authority, not for exempting new generating units from market mitigation measures. In fact, the Commission, in establishing the exemption, recognized that a new generator actually may have market power. *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, 61 Fed. Reg. 21,540 (May 10, 1996), FERC Stats. & Regs. ¶ 31,036 at 31,659 (1996), *order on reh'g*, Order No. 888-A, 62 Fed. Reg. 12,274 (March 14, 1997), FERC Stats. & Regs. ¶ 31,048 (1997), *order on reh'g*, Order No. 888- B, 81 FERC ¶ 61,248 (1997); *order on reh'g*, Order No. 888-C, 82 FERC ¶ 61,046 (1998), *aff'd in relevant part sub nom., Transmission Access Policy Study Group,*

et al. v. FERC, 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom. New York v. FERC*, 535 U.S. 1 (2002). As the Commission very recently explained:

> "As the Commission stated in Order No. 888, however, this does not mean that we will ignore specific evidence presented by an intervenor that a seller requesting market-based rate authority for sales from capacity for which construction commenced on or after July 9, 1996 nevertheless possesses generation market power. If such evidence is presented, we will evaluate whether the evidence disproves the premise that the seller lacks generation market power with respect to its new capacity."

See (April 14, 2004 SMA Order) (cite) at fn 59; *see also Delta Energy Center, LLC*, 98 FERC ¶61,124, at p. 61,373 (2002)("Codification of a blanket exemption for new generation does not mean that the Commission will ignore specific evidence … that a seller requesting market-based rates for sales from new generation possesses generation dominance.") Clearly, in a load pocket, a new generator at times can have the same market power that existing generators possess in load pockets.

PJM has correctly recognized an anomaly that the Commission ought seriously to consider: generators that decided to build after 1996 expect to be protected from the potential negative consequences of any changes in regulatory policies or markets, but are entitled to any potential positive consequences of any changes (e.g., new capacity markets). While ELCON is sympathetic to reliance on reasonable investment expectations, a regulatory guarantee of returns is not reasonable nor is it reasonable to assume that any class of market participants will be exempt from analysis whether they are exercising market power in the context of load pockets where risk of exercise of market power is at its zenith. Order 888 could not anticipate the developments in the market or the context of market power prevention for RMR units in emerging ISOs and RTOs. For example, while much new generations has emerged post 1996,

must of this is utility affiliated generation. Post-1996 was meant to signal an era when generators would be exposed to additional risks and rewards in a competitive market environment but not guaranteed returns and certainly not exempt from market power analysis.

NOTICES AND COMMUNICATIONS

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CONCLUSION

For the foregoing reasons, ELCON's request for rehearing should be granted.

Respectfully submitted,

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Dated: June 7, 2004

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Motion for Rehearing of the Electricity Consumers Resource Council was today mailed to parties on the service list of this proceeding by U.S. mail, postage prepaid.

Dated at Washington, D.C., this 7th day of June, 2004.

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