112 FERC ¶ 61,031
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
Nora Mead Brownell, Joseph T. Kelliher,
and Suedeen G. Kelly.

PJM Interconnection, LLC	Docket Nos.	EL03-236-004 EL03-236-005 EL03-236-006 EL04-121-000 (Consolidated)

ORDER ON REHEARING, CLARIFICATION, AND COMPLIANCE FILINGS, ESTABLISHING FURTHER HEARING PROCEDURES, AND CONSOLIDATING PROCEEDINGS

(Issued July 5, 2005)

1. On January 25, 2005, the Commission issued an order on rehearing and compliance filings in this proceeding concerning reliability compensation issues and other matters in the PJM Interconnection, LLC (PJM).[1] Various parties have requested rehearing and clarification. As discussed below, the Commission generally denies rehearing, but grants rehearing in part with respect to scarcity pricing; establishes a hearing with respect to the section 206 proceeding in Docket No. EL03-236-006 dealing with the test for examining when generators possess market power sufficient to trigger mitigation and with respect to the need for scarcity pricing within PJM; and accepts PJM's tariff revisions in its compliance filing in Docket No. EL03-236-005 with modifications. This order benefits the public by furthering the development of wholesale competitive markets and ensuring that they remain competitive.

[1] *PJM Interconnection, LLC*, 110 FERC ¶ 61,053 (2005) (January 25 Order).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

I. Background

2. This proceeding concerns compensation for generating units that are needed to run for reliability reasons. In PJM, such units include units that are in load pockets[2] and are subject to offer capping under PJM's local market mitigation rules and units that wish to deactivate and are needed for reliability. The history of this proceeding is given in detail in several prior Commission orders.[3]

3. In the Commission's most recent order issued in this proceeding on January 25, 2005, the Commission ruled on rehearing requests of its order issued May 6, 2004[4] and on PJM's compliance filings in Docket Nos. EL03-236-002 and -003.[5] The Commission denied rehearing with respect to its holdings on Frequently Mitigated Units (FMUs).[6] The Commission granted rehearing in part by terminating the exemption for units built after July 9, 1996 (post-1996 units) from PJM's local market power mitigation rules.

4. The January 25 Order also ruled on PJM's compliance filing in Docket No. EL03-236-002 which concerned the suspension of offer capping. The Commission accepted PJM's proposed no-three pivotal supplier test[7] because it would exempt generators from

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[2] A load pocket is an area that is separated electrically from the rest of the grid by one or more transmission constraints that limit the amount of energy that can be imported into the area. Often, there is limited competition among generators within the area to relieve the transmission constraints into the area.

[3] *See Reliant Energy Mid-Atlantic Power Holdings, LLC*, 104 FERC ¶ 61,040 (2003) (Reliant); *PJM Interconnection, L.L.C.*, 107 FERC ¶ 61,112 at P 2-9 (2004) (May 6 Order); *PJM Interconnection, L.L.C.* 110 FERC ¶ 61,053 at P 4-13 (2005).

[4] May 6 Order.

[5] 110 FERC ¶ 61,053 (2005).

[6] An FMU is a unit that is offer capped 80 percent or more of its run hours.

[7] PJM defines a "pivotal supplier" for purposes of the offer capping rule as one whose output is required to meet relevant load. More than one supplier can be pivotal at any given time, if the output of any supplier or combination of suppliers is required to meet load affected by that transmission limit. Exhibit A, Declaration of Joseph E. Bowring at 5, Compliance Filing, Docket No. EL03-236-002 (July 16, 2004). Four or more jointly pivotal suppliers are considered competitive, as are zero pivotal suppliers.

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20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

the mitigation requirement when a load pocket was found to be competitive. However, the Commission instituted a proceeding under section 206 of the Federal Power Act (FPA) to determine whether the no-three pivotal supplier test is just and reasonable or needs to be revised. The Commission also required PJM to respond to protests on this issue and explain why the Commission's existing market power screens or reasonable modifications of those screens would not be an appropriate means of determining market power in load pockets and whether modifications of its no-three pivotal supplier test would be appropriate.[8]

5. In the January 25 Order, the Commission found PJM's proposals concerning FMUs in Docket No. EL03-236-003 complied with the holdings of the May 6 Order. The Commission approved PJM's provision of a higher offer cap for units that are offer capped 80 percent or more of their run hours. The Commission also accepted higher offer caps set at incremental costs plus the greater of a $40 adder or unit-specific going forward costs. The Commission also upheld permitting the higher offer caps to set the Locational Marginal Price (LMP).

6. With regard to units that wish to deactivate but that PJM determines are needed for reliability, the Commission accepted PJM's proposal in Docket No. EL03-236-003 for two types of compensation at the election of the generator: a formula rate default compensation known as the Deactivation Avoidable Cost Credit (DACC) consisting of going forward costs and a cost of service rate, as discussed more fully below. The Commission rejected PJM's proposal to require generators to remain in operation for an indefinite period because PJM had not shown that it had the authority to require generators to operate beyond a reasonable notice period.

7. In the January 25 Order, the Commission also accepted PJM's report in Docket No. EL03-236-003 that alternative pricing was not needed to address scarcity conditions and denied requests to require PJM to adopt scarcity pricing or markets for non-spinning reserves.

8. PJM filed the revisions required by the January 25 Order to the deactivation provisions, the post-1996 exemption, and other matters on February 24, 2005 in Docket

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In later filings such as Docket No. EL03-236-006, PJM changed the name of this test to the no-three pivotal supplier test.

[8] January 25 Order at 84.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

No. EL03-236-005. It filed its response concerning the no-three pivotal supplier test on March 4, 2005 in Docket No. EL03-236-006.

II. Late Interventions

9. On February 24, 2005, PPL University Park, LLC (PPL University Park) made a late motion to intervene in this proceeding. PPL University Park is an affiliate of the PPL Parties that are parties to this proceeding. PPL University Park states that there is good cause for its late intervention because it was only integrated into PJM on October 1, 2004 and the Commission has acknowledged that companies recently integrated into PJM have an interest in this proceeding that did not exist earlier.[9] PPL University Park also states that the Commission has accepted late filed motions to intervene in this proceeding given that the scope of the proceeding has expanded.[10]

10. The Commission finds PPL University Park has not shown good cause for its late intervention and denies the motion. PPL University Park did not move to intervene on becoming a member of PJM. In addition, the post-1996 exemption in which PPL University Park asserts an interest has at all times been an issue in this proceeding and is not a result of the expansion of this proceeding. In any event, PPL University Park's interests are represented by its affiliates.[11]

III. Rehearing Requests in Docket No. EL03-236-004

A. Deactivation Provisions

11. The May 6 Order noted that PJM did not have a retirement policy and required PJM to propose one.[12] PJM made its retirement proposal in its November 2, 2004 filing

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[9] *Citing* the January 25 Order at P 94.

[10] *Citing* the January 25 Order at P 16.

[11] Old Dominion Electric Cooperative (ODEC) filed a motion to intervene and comments on March 17, 2005. Although this filing was listed in Docket No. EL03-236-004, ODEC did not seek rehearing in this filing and, in any event, the filing was made more than thirty days after the issuance of the January 25 Order and, therefore, would have been untimely as a rehearing request of the January 25 Order. ODEC, therefore, must take the record as it existed on March 17, 2005.

[12] May 6 Order at P 42.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

in Docket No. EL03-236-003. In the January 25 Order, the Commission accepted PJM's retirement proposal with some modifications.

12. The January 25 Order accepted PJM's procedural provisions that generators give 90 days' notice of their intention to deactivate and that PJM provide a determination within 30 days of receiving the notice as to whether a generator is needed for reliability. However, the Commission rejected PJM's proposal to require generators to remain in operation for an indefinite period. It held PJM had not shown that it had the authority to require generators to operate beyond a reasonable notice period.

13. The January 25 Order also accepted PJM's compensation provisions for generators that wished to retire but agree to remain in operation for reliability reasons. PJM provided that a generator could either file with the Commission for a cost-of-service rate or receive compensation under a default compensation mechanism known as the DACC. The DACC is a formula rate that consists of the unit's going forward costs and, where appropriate, up to $2 million for project investment.[13] The DACC is augmented by an increasing adder based on years of operation. The first-year adder may be increased for greater notice that the unit wishes to deactivate.

14. In the January 25 Order, the Commission found the DACC is a default mechanism; it can be used if a unit does not file for cost-of-service rates with the Commission. It also found the DACC is a short-term measure that provides compensation to units that are operating temporarily until transmission upgrades are constructed that will enable the unit to retire. The Commission concluded that, given these features, the DACC provides sufficient compensation to generation owners that agree to delay deactivation to assure the reliability of the system because it provides the unit with the costs incurred for continuing to operate.[14] The goal, explained the

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[13] Project investment is defined as "the amount of project investment required to enable a generating unit proposed for Deactivation to continue operating beyond its proposed Deactivation Date." Original Sheet No. 224F, PJM Interconnection, L.L.C., FERC Electric Tariff, Sixth Revised Volume No. 1.

[14] January 25 Order at P 146-47. The statement at P 146 of the January 25 Order that the compensation is for generation owners that are required to operate beyond a proposed Deactivation Date is incorrect. The Commission held in the January 25 Order that PJM could not require a unit to operate for an indefinite period and required PJM to remove such provisions from its Tariff and Operating Agreement. January 25 Order at P 137.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

Commission, is to support reliability needs by fully compensating any unit for all going forward costs for the period it delays its exit.

15. The Commission also found in the January 25 Order that PJM's proposed adders for continued operation beyond the deactivation date are a reasonable compromise for reflecting costs associated with delayed deactivation. It also stated it would not be appropriate to base the DACC on generator entry costs because those costs do not necessarily reflect the least cost solution to reliability concerns. The Commission stated the DACC is not intended to promote entry of any particular generator type or to support additional generation as the sole solution. The Commission found further that bids from units receiving the DACC can set LMP.

1. Compensation

a. Rehearing Requests

16. Mirant[15] and Cinergy Services, Inc. (Cinergy) assert the DACC formula should provide for full cost recovery, including return on and of fixed costs, and should not be limited to going forward costs. Mirant asserts a generator should not have to face the choice of engaging in protracted litigation over a section 205 filing that provides for full cost recovery or settle for the DACC formula. Cinergy states the Midwest Independent Transmission System Operator, Inc. (Midwest ISO) provides for full cost recovery for units that are required to run for reliability, including all costs for repairs and upgrades necessitated by environmental and local regulations,[16] and that PJM's deactivation rules should conform to the Midwest ISO rules and also provide such cost recovery. Mirant

[15] The following Mirant entities filed a request for rehearing and clarification and are referred to collectively as Mirant: Mirant Americas Energy Marketing, LP, Mirant Chalk Point, LLC, Mirant Mid-Atlantic, LLC, Mirant Peaker, LLC and Mirant Potomac River, LLC.

[16] Cinergy cites *Midwest Independent Transmission System Operator, Inc.*, 109 FERC ¶ 61,157 at P 291 (2004) and section 38.2.7, First Revised Sheet Nos. 407-423 of the Midwest ISO's Open Access Transmission and Energy Markets Tariff (TEMT).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

asserts that the DACC is inconsistent with the Commission's policy on Reliability Must Run (RMR) agreements, which it argues, is to provide for the recovery of fixed costs.[17]

17. PPL[18] and Mirant object to the $2 million limit on project investment costs in the DACC. PPL asserts the Commission failed to address whether this cap on cost recovery will adversely affect reliability in PJM by encouraging the retirement of needed units. PPL asserts that the hard recovery cap and other recovery limitations in the deactivation provisions are contrary to the Commission's stated goal of allowing full recovery of going forward costs of units required to preserve reliability.[19] PPL requests uncapped, full compensation of going forward costs for any unit that delays its exit from the PJM market based upon PJM's reliability concerns, including full costs for project investment (PI).[20] Cinergy seeks clarification that section 118 of the deactivation provisions does not limit a generation owner's ability to receive full compensation for PI costs.

b. <u>Commission Decision</u>

18. The Commission affirms its prior decision that the DACC is a reasonable method of default compensation for generators that defer deactivation for reliability reasons. The Commission reiterates that the DACC is not the exclusive form of compensation for these generators. A generator may file for cost-of-service rates with the Commission and seek a rate which would provide for the recovery of fixed costs, including return on and of capital. A generator is not limited to the DACC method of recovering its costs.

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[17] Mirant cites *PSEG Power Connecticut, LLC*, 110 FERC ¶ 61,020 at P 30 (2005) (*PSEG Power*); *Mirant Kendall, LLC and Mirant Americas Energy Marketing, L.P.*, 109 FERC ¶ 61,227 at P 36 (2004) (*Mirant Kendall*), *reh'g denied*, 110 FERC ¶ 61,272 (2005).

[18] The PPL parties filing a request for rehearing are PPL EnergyPlus, LLC; PPL Brunner Island, LLC; PPL Holtwood, LLC; PPL Martins Creek, LLC; PPL Montour, LLC; PPL Susquehanna, LLC; and Lower Mount Bethel Energy, LLC.

[19] PPL cites the January 25 Order at P 147.

[20] PI is defined as "the amount of project investment required to enable a generating unit proposed for Deactivation to continue operating beyond its proposed Deactivation Date." Original Sheet No. 224F, PJM Interconnection, L.L.C., FERC Electric Tariff, Sixth Revised Volume No. 1.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

19. The Commission disagrees with Mirant that it is unreasonable to require a generator to make a filing under section 205 of the FPA to recover fixed costs. Such a requirement cannot be unreasonable, since it is the procedure required under the FPA for regulated public utilities to change their rates.[21] PJM has offered a formula by which utilities seeking deactivation can recover their costs, but it is not unreasonable for PJM to require a filing with the Commission should the generator wish to pursue a different method of recovery. In the current restructured electric markets, such a filing provides an alternative option for utilities that are not satisfied with the level of their cost recovery under the formula.

20. Cinergy asserts that PJM should treat units that wish to deactivate in exactly the same manner as the Midwest ISO, which, in its opinion, makes all upgrades and repairs fully recoverable.[22] The Midwest ISO adopted a procedure in which it identifies units that want to deactivate as System Supply Resources (SSR) if they are needed for reliability. These units receive an SSR contract which provides for the recovery of "appropriate compensation" which may include consideration of the unit's book value and depreciation[23] so that it appears that SSR contracts can provide for the recovery of fixed costs such as depreciation and return on equity. The SSR contract must be filed with the Commission. There is no other procedure in the Midwest ISO Tariff for compensating SSR units except the SSR contract procedure.

21. The Commission will not require PJM to use the precise SSR procedures of the Midwest ISO for units that delay deactivation. Each Regional Transmission Organization and Independent System Operator (RTO/ISO) is developing different systems for handling deactivation, and the Commission is not insisting that exactly the same system

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[21] *United Gas Pipe Line Co. v. Memphis Light, Gas and Water Division*, 358 U.S. 103, 113-14 (1958). It is well settled that the comparable provisions of the Natural Gas Act and the FPA are to be construed *in pari materia*. *Kentucky Utilities Company v. FERC*, 760 F.2d 1321, 1325 n.6 (D.C. Cir. 1985), *citing Union Electric Co. v. FERC*, 668 F.2d 389, 392 n.1 (8th Cir. 1981); *Municipal Light Boards of Reading and Wakefield, Mass. v. FPC*, 450 F.2d 1341, 1347 (D.C. Cir. 1971).

[22] *Midwest Independent Transmission System Operator, Inc.*, 109 FERC ¶ 61,157 at P 291 (2004) and section 38.2.7, First Revised Sheet Nos. 407-423 of the Midwest ISO's TEMT.

[23] Sections 38.2.7.g.i and ii, First Revised Sheet Nos. 418 and 419, Midwest ISO, FERC Electric Tariff, Third Revised Volume No. 1.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

be applied in each RTO. Generators within PJM can negotiate with PJM for an SSR or other contract, just as they can with MISO, and then file that contract with the Commission. In addition, the generators within PJM retain their rights to seek a just and reasonable rate by filing a rate case with the Commission, and that is a sufficient vehicle for exercising their statutory rights to seek just compensation. A unit in PJM that wishes to deactivate but delays deactivation for reliability reasons has a choice. It can use either the DACC, negotiate a different rate with PJM, or file for cost-of-service rates with the Commission. Thus, generators retain their rights to seek just and reasonable rates.

22. Nor will the Commission require PJM to use only a procedure that provides a unit that delays deactivation with its full costs. Having the additional procedure provided by the DACC has advantages for generators, customers, and markets. It provides generators with clear market rules that save time and aid in deciding whether to remain in operation. The PJM process also provides for Commission review of cost-of-service filings by generators to ensure that the rates are just and reasonable.

23. The Commission affirms here that it accepts the $2 million limit on project investment as a reasonable limit in the DACC mechanism given the short-term nature of the arrangement, the stream-lined procedure, and the default nature of the DACC. The DACC is a short-term mechanism that provides compensation on a temporary basis while PJM seeks an effective solution to a reliability problem. The Commission finds that requiring more review for projects over $2 million through a section 205 filing is reasonable since the operation of these units is intended to be short-term. As stated above, generators that delay deactivation may seek more than $2 million for project investment by making a filing with the Commission.[24] The Commission does not agree with PPL that the $2 million limit and other recovery provisions of the DACC will encourage units to retire.[25] As discussed above, the DACC is not exclusive and does not foreclose recovery of more expensive upgrades through cost-of-service rates.[26]

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[24] Section 117, First Revised Sheet No. 224G, PJM Interconnection, L.L.C., FERC Electric Tariff, Sixth Revised Volume No. 1.

[25] For an example of a generator's use of the cost-of-service alternative, *see PSEG Energy Resources & Trade, LLC and PSEG Fossil LLC*, 111 FERC ¶ 61,121 (2005).

[26] PPL urges that the $2 million limit on project investment is inconsistent with the January 25 Order's goal of supporting reliability needs by fully compensating any unit for all going forward costs for the period it delays exit (January 25 Order at P 147) and will encourage units to retire. The Commission disagrees. The Commission expressed

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20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

24. Mirant contends that the DACC is inconsistent with the Commission's policy on RMR agreements, which, it asserts, is that RMR contracts provide for the recovery of fixed costs. The *PSEG Power* and *Mirant Kendall* cases on which Mirant relies describe cost recovery under RMR contracts that have been reviewed by the Commission. But the DACC is not an RMR agreement. It is a formula rate that a generator may elect to utilize as an administratively more efficient procedure, but the generator can still seek to negotiate a cost-based contract with PJM or file a rate case with the Commission. There is no requirement that the DACC have the same features or provide the same compensation as an RMR agreement.

25. Cinergy seeks clarification that paragraph 130 of the January 25 Order, which describes section 118 of PJM's Open Access Transmission Tariff (OATT),[27] does not limit a generation owner's ability to receive full compensation for project investment costs. It asserts that a generation owner should be fully compensated if it incurs costs to keep a unit operational at PJM's direction, PJM later determines the unit is no longer needed for reliability, and the owner then retires the unit. Cinergy states section 118 is unclear as to whether the generation owner would be fully compensated should the unit shut down prior to the generation owner having fully recovered its project investment costs.

26. Section 118 provides that a unit that continues to operate beyond the date on which it is no longer needed for reliability must refund a pro rata share of the amount of

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this goal in the context of explaining that the DACC was appropriate compensation for units that wish to deactivate rather than generator entry costs. The Commission's assertion was that going forward costs, rather than entry costs, are the appropriate compensation because generator entry costs do not necessarily reflect the least cost solution to the reliability concern. The Commission was not discussing the $2 million project investment limits to going forward costs in PJM's DACC proposal. In any event, as stated elsewhere in this order, the DACC is an optional method. If a unit wishes to delay deactivation, it may also file for cost-of-service rates and seek to recover more than $2 million in PI costs.

[27] Original Sheet Nos. 224G and 224H, PJM Interconnection, L.L.C., FERC Electric Tariff, Sixth Revised Volume No. 1. Further revisions proposed in Docket No. EL03-236-005 in First Revised Sheet Nos. 224G and 224H to comply with the January 25 Order.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

any project investment costs for which it received reimbursement.[28] Section 118 does not address the situation in which a generator that delayed deactivation is no longer needed for reliability and shuts down before it may have received the full amount of project investment costs it would have been permitted under section 115.[29]

27. The Commission agrees with Cinergy that in the situation in which a generator makes project investments to assure continued operations, and thereafter that capacity is no longer needed by PJM to maintain reliability, it should receive full recovery of those investments. The Commission directs PJM to revise its tariff accordingly.[30]

2. Procedures Relating to Deactivation

a. Rehearing Requests

28. Mirant urges various measures related to RMR contracts. It seeks a timeline for negotiating with PJM and filing the resulting RMR agreement; clarification as to when and how a unit can be retired or the owner can file an individual RMR agreement under section 205 of the FPA; and a *pro forma* RMR agreement with standard terms and conditions similar to one adopted by ISO New England, Inc (ISO-NE).[31] Without such measures, Mirant asserts the unit owner will face uncertainty, delay, and expense of litigation concerning all of the rates, terms, and conditions of an RMR agreement.

29. PPL asserts that if a generator gives notice that it wishes to deactivate and PJM finds it is not needed for reliability after 30 days, then it should be permitted to retire

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[28] The total amount of the reimbursement is equal to the number of additional months the PI enables the unit to operate over the number of total months the PI enables the unit to operate. Original Sheet No. 224G, superceded in Docket No. EL03-236-005 by First Revised Sheet No. 224G, PJM Interconnection, L.L.C., FERC Electric Tariff, Sixth Revised Volume No. 1.

[29] Section 115 provides the formulas that define the DACC.

[30] In addition, PJM has proposed further revisions to sections 115 and 118 in Docket No. EL03-236-005 in compliance with the January 25 Order that permit units to determine how long to run and when to shut down. These will be addressed infra.

[31] Mirant cites ISO New England, Inc., FERC Electric Tariff No. 3, App. A, Section III.A.6 & Exhibit 2.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

promptly without having to wait the additional 60 days. PPL asserts that the current rule in PJM Manual 14D should be adopted. PPL asserts this rule permits a unit informed by PJM within 30 days that the unit is not needed for reliability to "retire as soon as practicable."[32]

30. The Electric Power Supply Association (EPSA) asserts that, while units cannot be required to run, there should be sunset specifications or a process for determining a timeline for continued operation under the deactivation provisions. It asserts the Commission must provide a transitional mechanism or process that limits the time period a unit is required to operate under the deactivation provisions.

b. <u>Commission Decision</u>

31. We find PJM's Tariff already contains some of the procedures requested by Mirant and PPL. Within 30 days of receiving notice from a unit that it desires to deactivate, PJM informs the unit whether its deactivation would cause reliability concerns. If PJM notifies the unit that it is not needed for reliability, the unit may deactivate any time thereafter. If PJM notifies the unit that its deactivation would cause reliability concerns, the unit may deactivate 90 days after it gave its notice to PJM. If the unit needed for reliability chooses to continue to run, it may file a cost-of-service rate with the Commission upon receipt of PJM's notice.[33]

32. The Commission finds that PJM's tariff is not unjust and unreasonable without further procedures regarding a *pro forma* RMR contract or negotiating RMR contracts as Mirant requests. The Commission found in the January 25 Order that PJM may not require a unit to run indefinitely. As stated above, if a unit needed for reliability does continue to run, it may file for a cost-of-service rate with the Commission 30 days after

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[32] PPL cites PJM Manual 14D, Generator Operational Requirements, revision 03 at 66 (Effective Date: Feb. 1, 2005), available at www.pjm.com/contributions/pjm-manuals/pdf/m14dv031.pdf.

[33] Section 113.1, Original Sheet No. 224A; section 113.2, Original Sheet Nos. 224A and 224B ("In the event there are no reliability issues associated with the proposed Deactivation of the generating unit, Transmission Provider shall so notify Generation Owner or its Designated Agent, and the Generation Owner or its Designated Agent may deactivate its generating unit at any time thereafter."); and section 119, Original Sheet No. 224H, PJM Interconnection, L.L.C., FERC Electric Tariff, Sixth Revised Volume No. 1.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

giving notice to PJM that it desires to deactivate to seek a rate comparable to the rate the unit would receive under an RMR contract. While PJM's provisions for dealing with deactivation may be different from those of ISO-NE, it is not necessary that all RTOs use the same procedures as long as the generators retain options for filing rates with the Commission, as the generators do here.

33. EPSA wants a timeline for continued operations of a unit that is proposed for deactivation even though there is no requirement that the unit must run if needed for reliability. PJM's existing tariff provisions require PJM to provide an estimate of the period of time it will take to complete the transmission system upgrades necessary to alleviate the reliability impact.[34] In addition, these timelines are being addressed in the compliance filing in Docket No. EL03-236-005. PJM proposes in Docket No. EL03-236-005 that the generation owner will determine whether a unit it has proposed to deactivate will continue to run.[35] PJM also proposes in that filing that a generation owner may subsequently change its decision to continue to operate a unit it has proposed to deactivate and decide, instead, to deactivate the unit on 90 days' notice.[36] These issues, which concern, in part, the timeline for continued operation of a unit, will be addressed in the Commission's response in Docket No. EL03-236-005, and therefore the rehearing request is denied.

3. Requirement to Run

a. Rehearing Requests

34. Cinergy requests that PJM examine alternative options to requiring a generator to run and that PJM's assessment that a generator is required to run be reviewed by the Commission. Cinergy is also concerned that PJM not be permitted to require the continued operation of a plant if its operation would be contrary to applicable law, regulations, or court or agency orders.

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[34] Proposed section 113.2, First Revised Sheet No. 224A, PJM Interconnection, L.L.C., FERC Electric Tariff, Sixth Revised Volume No. 1 (Docket No. EL03-236-005).

[35] *Id.*

[36] Proposed section 113.3, First Revised Sheet No. 224B, PJM Interconnection, L.L.C., FERC Electric Tariff, Sixth Revised Volume No. 1 (Docket No. EL03-236-005).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

35. Mirant asserts the Commission should find that PJM not only did not show, but cannot show that it has authority under the FPA to require generators to run. Mirant asserts PJM cannot demonstrate it has such authority or file with the Commission to seek the authority to compel a generator to operate indefinitely. Mirant also argues the FPA does not give the Commission the legal authority to impose a service obligation on generation owners.

b. Commission Decision

36. Cinergy wrongly assumes that, under the tariff, PJM can require generators to remain in operation if they wish to deactivate. The Commission expressly found PJM had not shown that it has the authority to require generators to operate beyond a reasonable notice period and required PJM to remove provisions requiring generators to run from its Tariff.[37] Thus, there are no generators that are required to run in PJM and no need to impose conditions concerning such generators. Since the Commission found PJM could not require generators to continue operations under the circumstances of this case, the Commission will not provide an advisory opinion, as requested by Mirant, as to whether in other circumstances, through contract or otherwise, generators may have bound themselves to continue operations.

B. Termination of Exemption for Post-1996 Units

37. In the January 25 Order, the Commission granted rehearing in part with respect to the termination of the exemption for post-1996 units from PJM's market power mitigation rules. The Commission held that the exemption from the offer capping rules for post-1996 units was unjust and unreasonable under section 206 of the FPA.[38] It found that the same rules should be applied to all units in areas that are unlikely to be competitive, that the exemption will erode PJM's ability to address local market power in load pockets, and that the exemption should be removed to ensure competitive prices and markets within PJM. The Commission also found the exemption was unduly discriminatory because post-1996 generators have the same ability as pre-1996 generators to exercise market power when they are dispatched out of economic merit order for reliability reasons. The Commission noted that all other RTOs/ISOs apply local market mitigation rules to all generators within their areas.

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[37] January 25 Order at P 137.

[38] *Id.* at P 58-59 and 61.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

38. Accordingly, the Commission found under section 206 of the FPA that the just and reasonable practice is to terminate the exemption, with provisions to grandfather units for which construction commenced in reliance on the exemption.[39] The Commission concluded PJM could mitigate the grandfathered units only when PJM or its market monitor in a section 205 or 206 proceeding could show that these units exercise significant market power.[40] The Commission determined that units could have relied on the exemption only after the exemption became effective on April 1, 1999 and that such reliance could have lasted only until PJM made its filing to remove the exemption on September 30, 2003. The Commission held the grandfathered units in the original PJM zones,[41] all of which were part of PJM on April 1, 1999, were those for which construction commenced from April 1, 1999 through September 30, 2003. The Commission determined that units in zones joining PJM after April 1, 1999, through September 30, 2003 could only have relied on the exemption once their zone was approved for integration into PJM. The Commission held grandfathered units in the Rockland Electric Company Zone were those for which construction commenced after December 21, 2001 through September 30, 2003 and in the Allegheny Power Zone, units for which construction commenced after March 1, 2002 through September 30, 2003. The Commission required PJM to remove the exemption from its Tariff and Operating Agreement (OA) and grandfather the specified units.[42]

1. Whether Termination of the Exemption is Warranted

a. Rehearing Requests

39. PPL and the Dayton Power and Light Company (Dayton) request rehearing of the Commission's decision to remove the blanket exemption from offer capping for post-

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[39] *Id.* at P 61 and 62.

[40] *Id*. at P 60.

[41] The original PJM zones were Atlantic City Electric Company; Baltimore Gas and Electric Company; Delmarva Power & Light Company; GPU, Inc. (Jersey Central Power & Light Company); Metropolitan Edison Company; PECO Energy Company; Pennsylvania Electric Company; Pennsylvania Power & Light Company; Potomac Electric Power Company; and Public Service Electric and Gas. *Pennsylvania-New Jersey-Maryland Interconnection,* 81 FERC ¶ 61,257 at n.2 (1997).

[42] January 25 Order at P 61.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

1996 units while grandfathering units that relied on the exemption. They assert that neither PJM nor the Commission met the burden of proof under section 206 of the FPA of showing that the existing offer capping exemption was unjust and unreasonable and the proposed elimination of the exemption for post-1996 units is just and reasonable. Specifically, PPL and Dayton assert PJM did not provide substantial record evidence that post-1996 units were exercising market power to support its proposed changes.

40. Dayton asserts PJM did not demonstrate that the original rationale for the exemption is no longer valid. Dayton asserts the original rationale was that new entry would eliminate opportunities for local market power and that offer cap regulation may deter some potential entry. Dayton and PPL assert that elimination of the exemption will dampen price signals so that new entry will be impeded. PPL insists the Commission should rely on new entry alone to ensure competitive prices and markets. PPL argues that as long as new entry is anticipated, the Commission cannot conclude that existing units in load pockets have the potential to exercise market power. PPL asserts the finding unjustified that the local market power mitigation rules will become ineffectual as time goes by and the exemption covers more and more units.

41. PPL also objects the Commission was not justified in finding that the exemption was unduly discriminatory in relation to pre-1996 units. PPL insists there are rational bases for discriminating in favor of the post-1996 units, namely that the exemption would encourage the construction of new units; the costs of new units are not included in cost-of-service rate base like the costs of pre-1996 units; and new units built specifically to promote competition cannot be non-competitive.

42. PPL argues that removing the post-1996 exemption is inconsistent with the Commission's regulation at 18 C.F.R. § 35.27(a) (2004)[43] which, it asserts, exempts post-July 9, 1996 generators from having to demonstrate that they do not have market power in order to obtain market-based rate authority. Dayton asserts eliminating the exemption for post-1996 units results in unjust and unreasonable rates because the offer cap mitigation measures may prevent post-1996 units from recovering a reasonable return on equity and, in some circumstances, hinder recovery of capital costs.

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[43] PPL states section 35.27 was adopted in Order No. 888, 61 *Fed. Reg*. 21,540 at 21,626 (May 10, 1996).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

b. Commission Decision

43. The Commission denies these rehearing requests. We affirm our findings in the January 25 Order that the post-1996 exemption may render PJM's local market power mitigation rules ineffectual over time and that the exemption is unduly discriminatory. We also affirm removing the exemption as necessary to maintaining wholesale electric rates that are just and reasonable by ensuring that wholesale electric markets are competitive. Based on these findings and the reasons expressed below and in the January 25 Order, we affirm our holdings under section 206 of the FPA that the post-1996 exemption, with the exception of certain grandfathered units, is unjust and unreasonable and that the just and reasonable practice under section 206 is to remove the exemption from PJM's OATT and OA.

i. Just and Reasonable Wholesale Electric Rates

44. The Commission regulates wholesale electric rates for sales by public utilities according to the provisions of the FPA.[44] The markets that the Commission has established for wholesale electric rates and the rates within those markets must meet the requirements of the FPA. The basic requirement is that market-based rates, like any other wholesale electric rates, must be just and reasonable and not unduly discriminatory or preferential. The courts have held that market-based rates are just and reasonable only when competition is sufficient to limit market power.[45] While the Commission has found that overall the PJM marketplace is sufficiently competitive to grant market based rates,[46] it has also recognized that due to transmission constraints in load pockets, generators can

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[44] Sections 205 and 206, FPA, 16 U.S.C. §§ 824d and 824e. *See also, Reporting Requirement for Changes in Status for Public Utilities with Market-Based Rate Authority,* Order No. 652, 110 FERC ¶ 61,097 at P 36 (2005) ("The Commission has an independent statutory duty to ensure that rates are just and reasonable . . . .").

[45] *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 (D.C. Cir. 1993). Where there is a competitive market, the Commission may rely on market-based rates in lieu of cost-of-service regulation to ensure that rates are just and reasonable; s*ee also Farmers Union Central Exchange, Inc. v. FERC,* 734 F.2d 1486, 1510 (D.C. Cir. 1984) (discussion of regulation in terms of the oil industry).

[46] In considering the entire footprint of PJM, there is generally sufficient competition to warrant permitting the generators to charge market-based rates.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

exercise market power within these load pockets and it has accepted a mitigation plan to deal with these situations.[47]

45. In approving the post-1996 exemption initially, the Commission believed that such an exemption would encourage investment and would reduce market power through the addition of new generating units, without providing these new units with the ability to exercise market power. But the evidence put forward by PJM indicates that building new units in load pockets is not necessarily a guarantee that such units cannot exercise market power, and the Commission, therefore, has determined to apply the same mitigation to these units as to all other units. To try and protect investor expectations, the Commission exempted units built between 1996 and 2003, finding that these units could be mitigated in the event that PJM or its market monitor can show that they exercise significant market power. However, as discussed below, the Commission is setting for hearing the question of when units in load pockets have sufficient market power to warrant mitigation, and once the Commission determines the appropriate test for market power within load pockets, that test also would be appropriate to determine when the grandfathered units have sufficient market power to warrant mitigation.

46. The Commission disagrees with PPL and Dayton that PJM did not put forward substantial evidence that post-1996 units were exercising market power. The Commission accepted the post-1996 exemption to encourage investment. However, PJM put forward evidence in the record in this proceeding that some post-1996 units in load pockets in PJM could exercise market power due to the concentration of generator ownership.[48] In particular, PJM's submissions indicated that post-1996 units could exercise market power in the Delmarva Peninsula. Upon reconsideration of the evidence put forward by PJM, the Commission finds that this evidence shows that new units built in PJM can exercise market power, such that the removal of the exemption from mitigation for these units is warranted.

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[47] When transmission constraints are binding, buyers will not be able to purchase power from the entire footprint and the limited number of generators inside the load pocket may be able to exercise market power.

[48] Declaration of Joseph E. Bowring at 11-12, PJM Filing of September 30, 2003, Docket No. EL03-236-000; Answer of PJM Interconnection, L.L.C. to Protests at 19, Docket No. EL03-236-000 (November 19, 2003) (citing Prepared Testimony of Joseph E. Bowring, Docket No. PA03-12-000 at 24-25 (see also 23, 26-28) (July 30, 2003)); and Attachment at 13, Reply Comments of PJM Interconnection, L.L.C., Docket No. EL03-236-000 (March 1, 2004).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

47. Moreover, it is the Commission's policy that the elements of regional market design must include mitigation measures and that all of the elements of market design must be designed to work together to maintain competitive markets.[49] The mitigation measures we have accepted have included local market power mitigation rules that mitigate prices in load pockets. For such local market power mitigation rules to be effective, they must apply to all generators that may exercise market power in a load pocket, not only to those that were built before a certain date. Simply because a unit was built after 1996 does not guarantee that it cannot exercise market power when transmission into its service area is constrained. PJM's mitigation is specifically designed to deal with the potential for the exercise of market power in such situations, and PJM's evidence demonstrates that post-1996 units may exercise market power. The termination of the exemption is necessary to ensure that PJM's local market power mitigation rules are a meaningful component of its market design and that PJM can mitigate local market power in accordance with its Tariff and OA.

48. At the same time, the Commission has been concerned from the beginning of this proceeding with the effect of removing the exemption.[50] The Commission recognized that post-1996 units may have had a reliance interest on the exemption. Because of this equitable concern, the Commission has grandfathered the post-1996 units specified in the January 25 Order and in this order and permitted them to retain the exemption. The Commission finds it is reasonable to permit the specified post-1996 units to retain the exemption because the pricing behavior of some of the post-1996 units may be constrained by the presence of older generating units that, in effect, set the price level in the relevant load pocket. In addition, as stated above, after the outcome of the section 206 hearing, the test for market power in load pockets should be one that can be applied to the grandfathered units as well. This is an issue that will also be considered at hearing.

ii. New Entry and Market Design

49. Rehearing requesters argue that new entry will eliminate all opportunities for local market power and that the Commission should rely on new entry alone to ensure competitive prices and markets. While new entry will reduce the potential for market power in a load pocket, a new entrant in a highly concentrated market may still exercise

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[49] *California Independent System Operator Corporation, Further Order on the California Comprehensive Market Redesign Proposal*, 105 FERC ¶ 61,140 at P 214, 274 (2003) (CAISO Market Redesign Order).

[50] May 6 Order at P 55-56.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

market power. If that plant becomes the pivotal supplier, it could raise price without fear of competition. Moreover, a company with affiliated generators in the same load pocket could withhold output or price all of its plants in a way to raise the overall price applied to all the units in the load pocket. Thus, the effect of a post-1996 unit on the opportunities to exercise market power in a load pocket will depend on the facts of each particular case. New entry alone may or may not ensure competitive prices and markets in a load pocket, depending on the circumstances, and is not necessarily sufficient by itself to create or maintain competitive markets in load pockets.

50. The rehearing requesters also argue that the post-1996 exemption should be retained because, in their view, PJM's local market power rules dampen energy prices so that they are too low to encourage investment in new generators. Rehearing requesters assert that high prices in the energy market alone should be the means of encouraging such investment.

51. The Commission rejects these arguments. The Commission disagrees that permitting firms to exercise market power for the extended period that new entry requires is the most efficient method of encouraging the proper amount of entry. In this order, and in the hearings established by the order, the Commission is adjusting PJM's practices to ensure that they do reflect competitive prices with the proper incentives for investment

iii. Discrimination

52. PPL asserts there are rational bases for discriminating in favor of post-1996 units by exempting them from PJM's local market power mitigation rules. PPL asserts the Commission should discriminate in favor of post-1996 units because new units built specifically to promote competition cannot be non-competitive; the exemption would encourage the construction of new units; and the costs of new units are not included in cost-of-service rate base like the costs of pre-1996 units.

53. We reject PPL's proposed bases for discrimination in favor of post-1996 units. As we have already discussed, new units built in load pockets may be able to exercise market power and may not render a load pocket competitive, depending on the circumstances. Also as we stated above, permitting firms to exercise market power for the extended period that new entry requires is not an appropriate method of encouraging new entry. Finally, if a post-1996 unit believes it is not recovering its cost-of-service, it may provide further evidence that a higher bid cap is appropriate,[51] or it may file a cost-of-service rate

[51] See section 6.4.2(a)(iv) which provides the ability for parties to negotiate separate agreements with PJM.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

with its capital costs included in rate base under section 205 of the FPA. For these reasons, we find that PPL's proposed bases for discrimination do not warrant exempting post-1996 generators from PJM's local market mitigation rules.

iv. 18 C.F.R. § 35.27(a)

54. The Commission does not agree with PPL that removing the post-1996 exemption is inconsistent with 18 C.F.R. §35.27(a) (2004). Section 35.27(a) addresses the demonstration an applicant must make to obtain market-based rate authority for capacity for which construction commenced on or after July 9, 1996. Under certain conditions, section 35.27(a) relieves the applicant from the burden of going forward with evidence that the unit lacks market power.[52] But the approval of market-based rates can still be challenged, and, in that event, the applicant bears the burden of proof that it is entitled to market based rates. Section 35.27(a) does not address the post-1996 unit's behavior in

[52] The applicant's capacity must have been constructed commencing on or after July 9, 1996, and must be unaffiliated with pre-1996 units in the relevant geographic area. If a third party comes forward with evidence that the post-1996 unit has market power, the applicant must show (bear the burden of proving) that the post-1996 unit does not have market power or adopt measures to mitigate its market power in order to obtain market-based rate authority. If an applicant sites a post-1996 unit in an area where it or its affiliates own or control pre-1996 units, the applicant must address whether its new post-1996 capacity when added to the existing pre-1996 capacity raises generation market power concerns in order to obtain market-based rate authority for the new, post-1996 capacity. In this situation, the applicant must show that the post-1996 unit, together with its affiliated units, either does not have market power or adopt mitigation measures for the post-1996 units and its affiliates in order to obtain market-based rate authority for the post-1996 unit. 18 C.F.R. § 35.27(a) (2004); *AEP Power Marketing, Inc.*, 107 FERC ¶ 61,018 at P 38, 69 n. 59 (2004) (*AEP Power Marketing*), *order on reh'g*, 108 FERC ¶ 61,026 at P 110 (2004); *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Service by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, 61 *Fed. Reg.* 21,540 (May 10, 1996), *FERC Statutes and Regulations, Regulations Preambles January 1991-June 1996* ¶ 31,036 at 31,659 (1996), *order on reh'g*, Order No. 888-A, 62 *Fed Reg.* 12,274 (March 4, 1997), *FERC Statutes and Regulations, Regulations Preambles July 1996-December 2000* ¶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).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

the market, nor does it determine the type of oversight to be applied to the unit in the market. Nor does section 35.27 (a) address issues of mitigation when, as in PJM, the applicant is entitled to market based rates during the course of doing business within the entire footprint of PJM, but may be able to exercise market power within load pockets during transmission constraints.

55. Once a post-1996 unit has been granted market-based rate authority, it is in the same position as a pre-1996 unit that has been granted market-based rate authority. Both types of units may sell at market-based rates, but the transactions of both types of units are subject to scrutiny and to mitigation and other remedial measures, if necessary. The Commission has conditioned all grants of market-based rate authority on reporting, rules of behavior, and tariff provisions[53] that permit scrutiny of and remediation for actual market power behavior. These conditions apply to all units that receive market-based rate authority, whether pre-1996 units or post-1996 units and whether or not they are in an RTO. For units located in RTOs, the monitoring and mitigation measures of the RTOs also scrutinize and mitigate actual market behavior. As the Commission has stated, "markets with Commission-approved market monitoring and mitigation undertake daily and hourly oversight of seller's pricing behavior to ensure, consistent with clearly established Commission approved rules, that prices do not exceed competitive levels."[54]

56. In all other RTOs, both pre-1996 and post-1996 units have been subject to RTO market mitigation measures, including local market power mitigation rules. Only PJM had an exemption from local market mitigation rules for post-1996 units. We affirm this exemption should be removed with certain units grandfathered. Section 35.27(a) permits a post-1996 unit to obtain market-based rate authority without making a showing that it has market power, if unchallenged by third party evidence and unaffiliated with pre-1996 units. Section 35.27(a) does not exempt a post-1996 unit's exercise of that authority from Commission measures to monitor and mitigate the exercise of market power in the market. These measures include the local market power mitigation rules of RTOs. We find that both pre-1996 and post-1996 units that have market-based rate authority must be subject to PJM's local market power mitigation rules and that section 35.27(a) presents no obstacle to removing the exemption from those rules for post-1996 units.

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[53] These conditions are discussed in more detail below.

[54] *AEP Power Marketing* at P 190.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

v. Just and Reasonable Rates in Load Pockets

57. Dayton argues that removing the exemption may prevent post-1996 units from recovering return on equity and depreciation costs and therefore results in unjust and unreasonable rates. We reject this argument. The issues of return on equity and depreciation are concerns only with setting cost-based rates. The only issue here is whether generators should be able to exercise market power. As discussed earlier, permitting the exercise of market power is not the best method of encouraging entry or retaining companies when needed. As discussed earlier, the Commission has and is continuing to address the issue of whether the mitigation payments are sufficient. Thus, removal of the post-1996 exemption helps maintain just and reasonable rates in PJM's energy market.

2. Whether to Increase the Number of Grandfathered Units

a. Rehearing Requests

58. Several rehearing requesters seek to increase the number of grandfathered units. EPSA and Reliant Energy, Inc. (Reliant) ask the Commission to hold that all generators currently located in PJM for which construction commenced between July 9, 1996 and September 30, 2003 are exempt from offer capping. Alternatively, they ask the Commission to establish a rebuttable presumption that they relied on the exemption and are exempt from offer capping. EPSA argues these approaches are consistent with what it describes as the post-1996 exemption from the market power screens in market-based rate authority cases in 18 C.F.R. § 35.27(a) (2004). Reliant claims the proposed rebuttable presumption will not permit generators to exercise market power because in cases where PJM can show that market power is being exercised, PJM may make a section 206 filing with the Commission to seek to reimpose mitigation on the generator. Reliant also asserts that applying the reliance exemption to all units across the PJM footprint today for which construction commenced during this period would provide greater uniformity of rules on a going forward basis.

59. Reliant argues that, even if units were not in PJM at the time construction commenced, they were in areas with no mitigation and had an expectation of being able to operate free of mitigation. PPL asserts units for which construction commenced on or after the date of a proposed integration into PJM should retain the exemption because, in its view, investors may have reasonably relied on anticipated integration. PPL requests that the dates for grandfathering units be the dates when a proposed integration into PJM was announced.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

60. Dayton asserts it committed to join PJM in mid-2002,[55] in part, relying on the manner in which PJM treated generating units. Dayton states it owns fourteen peaking units constructed after April 1, 1999 that are now in the Dayton zone of PJM.[56] When it built these generating units in the late 1990s, Dayton states it expected the market would compensate it.[57] Dayton asserts the January 25 Order changed the ground rules for participation in PJM two and half years after Dayton made its commitment to join PJM and that this change constitutes an unconstitutional taking of private property without just compensation.[58] Dayton also asserts it is unduly discriminatory to exempt units in the zones originally constituting PJM and integrated into PJM prior to September 30, 2003, and not the units in the Dayton zone. Dayton asserts, in addition, that offer capping peaking units will adversely affect reliability because it may force generators that are not adequately recovering costs on their units to retire those units.

b. <u>Commission Decision</u>

61. The Commission removed the exemption for post-1996 units, but grandfathered units that could reasonably have relied on the exemption after it went into effect in their zone.[59] These included units for which construction commenced in the original PJM zones[60] from April 1, 1999 through September 30, 2003; in Rockland Electric Company

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[55] The Commission accepted Dayton's choice to join PJM on July 31, 2002. *Alliance Companies*, 100 FERC ¶ 61,137 (2002).

[56] Dayton's representations are that its parent company and an affiliate constructed 20 peaking units after July 9, 1996. Of these, 18 peaking units were built after April 1, 1999 and "[a]ll but four of these units are located within what is now the Dayton Zone of PJM." Dayton Request for Rehearing at 7.

[57] *Id*. at 17.

[58] Amendment V, United States Constitution.

[59] January 25 Order at P 60, 62.

[60] The original PJM and, thus the original PJM zones, consisted of Atlantic City Electric Company; Baltimore Gas and Electric Company; Delmarva Power & Light Company; GPU, Inc. (Jersey Central Power & Light Company); Metropolitan Edison Company; PECO Energy Company; Pennsylvania Electric Company; Pennsylvania Power & Light Company; Potomac Electric Power Company; and Public Service Electric and Gas. *Pennsylvania-New Jersey-Maryland Interconnection*, 81 FERC ¶ 61,257 at n.2

(continued…)

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

after December 21, 2001 through September 30, 2003; and in Allegheny Power, after March 1, 2002 through September 30, 2003. Rehearing requesters ask that the number of grandfathered units be increased by including all generators currently located in PJM for which construction commenced between July 9, 1996 and September 30, 2003 or by using the date of proposed integration with PJM rather than the actual date of integration as the date when the exemption begins or by recognizing claimed reliance interests. Requesters rely on section 35.27(a),[61] on mitigating market power after it has been exercised, and on claims of undue discrimination, adverse affects on reliability, and reliance prior to integration with PJM.

62. For the most part, we reject the rehearing requests, but increase the number of grandfathered units as specified below. But, as discussed earlier, the parties should address at the hearing the question of what market power test should be applied to grandfathered units to determine when mitigation is to apply.

63. The Commission finds unpersuasive the arguments of EPSA and Reliant that section 35.27(a) requires grandfathering all post-1996 units currently in PJM and that section 206 proceedings should be used to reimpose mitigation on post-1996 units that are found to exercise market power. As we have discussed previously in this order, section 35.27(a) does not provide a basis for exempting post-1996 generators from PJM's local market power mitigation rules. Approval of market-based rate authority, whether for a pre-1996 unit that must go forward with evidence to show it does not have market power, or for a post-1996 unit which may be relieved of this burden, does not exempt a seller from an RTO's Commission approved mitigation rules. The Commission's conditions on market-based rate authority and RTO mitigation rules, including local market power mitigation rules, and not section 35.27(a), address a seller's actual behavior in the market. And, as we have discussed previously in this order, market design features that create and maintain competitive markets comport better with the Commission's statutory obligations to ensure just and reasonable rates for electricity and have less disruptive effects on the market than after-the-fact section 206 proceedings, so that ongoing current market mitigation measures that prevent sellers from exercising market power are preferable to section 206 proceedings that seek a remedy after sellers have exercised market power.

(1997). These zones were part of PJM on April 1, 1999 and units in these zones could have relied on the exemption beginning when it went into effect on April 1, 1999.

[61] 18 C.F.R. § 37.25 (a) (2004).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

64. Reliant asserts that post-1996 units that were not in PJM were in areas with no mitigation and had an expectation of being able to operate free of mitigation. We disagree. The Commission has granted market-based rate authority to both pre-1996 and post-1996 units subject to conditions that have provided for market monitoring and limitations on market power. These conditions have included requirements to file quarterly reports of all transactions,[62] long-term service agreements, changes in status, and triennial market power updates. They have also included requiring sellers to adopt codes of conduct for relations with marketing affiliates[63] and tariff provisions to govern transactions with marketing affiliates.[64] More recently, the Commission has promulgated Standards of Conduct for energy affiliate transactions and has required sellers to adopt the Commission's Market Behavior Rules in their tariffs.[65] Based on these reports and requirements, to which all units with market-based rate authority are subject, both pre- and post-1996, the Commission could require disgorgement of unjust profits, mitigation, revocation of a company's market-based rate authority, or other remedies if it found a unit had engaged in prohibited conduct.[66] Post-1996 units outside PJM operated subject

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[62] *See, e.g., DPL Energy, Inc., Dayton Power & Light Co., TPC Corporation*, 76 FERC ¶ 61,367 at 62,714 (1996) requiring Dayton and its affiliates, among other things, to file quarterly summaries of sales to allow the Commission to evaluate the reasonableness of the charges and to provide for ongoing monitoring of the ability to exercise market power. More recently, s*ee Revised Public Utility Filing Requirements*, Order No. 2001, 67 *Fed. Reg.* 31,043 (May 8, 2002)**,** FERC Stats. & Regs., Regulation Preambles, ¶ 31,127 at P 28, 46, 94 (April 25, 2002) (Order No. 2001).

[63] *See, e.g., Northeast Utilities Service Company*, 87 FERC ¶ 61,063 (1999) (Commission Letter Order).

[64] *Detroit Edison Company*, 80 FERC ¶ 61,348 at 62,197-98 (1997).

[65] Order No. 2004, 105 FERC ¶ 61,248 (2003) (revised standards of conduct for relations between transmission providers and energy affiliates, codified at 18 C.F.R. Part 358 (2004)); *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 105 FERC ¶ 61,218 (2003) (establishing Market Behavior Rules to prevent market manipulation which were to be adopted as part of tariffs of all sellers with market-based rate authority).

[66] *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Service Into Markets Operated by the California Independent System Operator Corporation and the California Power Exchange*, 96 FERC ¶ 61,120 at 61,499-501, 61,516-520 (2001)

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20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

to many measures providing for monitoring and mitigation. These units had no reliance interest on a lack of mitigation.

65. PPL suggests using the date a proposed integration was announced to grandfather units rather than the date of integration. The Commission will grant rehearing on this issue. The Commission agrees that a reliance interest may have arisen in a zone when a transmission owner committed in a public, formal way to joining an RTO. For example, the Commission finds it reasonable for entities considering investing in new generation to rely on a transmission owner's filing with the Commission of an application to join a specific RTO. Thus, the Commission will grandfather units in zones other than the original PJM zones for which construction commenced beginning on the date a transmission owner made a filing with the Commission committing to join PJM rather than on the date on which the zone was integrated into PJM. For the original PJM zones, the commencement date for grandfathered units remains April 1, 1999, the date on which the exemption went into effect. The termination date for all grandfathered units remains September 30, 2003. Construction must have commenced on or prior to September 30, 2003 for a unit to be grandfathered.

66. Dayton asserts it relied on the exemption in deciding to join PJM. It asks the Commission to grandfather all generating units constructed after 1999 irrespective of when a zone was integrated into PJM or grandfather the twenty peaking units owned by Dayton and its affiliate DPL Energy, LLC. Dayton built the peaking units after July 9, 1996, but before it was integrated into PJM on October 1, 2004. Dayton also asserts that failure to grandfather its units would be an unconstitutional taking of property, unduly discriminatory, and could create reliability problems.

67. To answer Dayton, the Commission must examine the nature of Dayton's reliance on the post-1996 exemption and also the significance of the exemption for Dayton.

68. PJM became an ISO on January 1, 1998.[67] The Commission issued Order No. 2000 in January 2000 to encourage electric utilities to joint RTOs.[68] PJM sought RTO

(refunds, revised market rules). *See, also*, *AEP Power Marketing*, at P 150 (2004) (discussing revocation of market-based rate authority).

[67] *Pennsylvania-New Jersey-Maryland Interconnection*, 81 FERC ¶ 61,257 at 62,234 and Ordering Paragraph E (1997).

[68] *Regional Transmission Organizations*, Order No. 2000, 65 Fed. Reg. 809 (January 6, 2000), FERC Statutes and Regulations, Regulations Preambles July 1996-

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20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

status in October 2000 and the Commission granted it RTO status in December 2002.[69] At the same time, for almost two years following Order No. 2000, Dayton participated in a group of transmission owners known as the Alliance Companies that sought recognition as an RTO.[70] In December 2001 the Commission determined that the Alliance Companies lacked sufficient scope to exist as a stand-alone RTO and required them to explore joining the Midwest ISO.[71] In April 2002**,** the Commission issued an order requiring the Alliance Companies to inform the Commission which RTO they intended to join.[72] On May 28, 2002, in Docket No. EL02-65-000, *et al.*, Dayton made a filing in compliance with the April 2002 Order in which it chose to participate in PJM. Dayton stated it chose PJM because it believed that PJM offered the opportunity to participate in a mature RTO serving an existing energy market. The Commission approved Dayton's choice in an order issued July 31, 2002.[73] On September 30, 2003, PJM filed its proposal to remove the exemption for post-1996 units from its local market mitigation rules. On October 1, 2004, Dayton was integrated into PJM.

69. It is evident Dayton gravitated toward joining PJM after considering other possibilities and alternatives. At the earliest, Dayton's reliance interest on the post-1996 exemption arose in May 2002 when Dayton made a filing in which it chose to join PJM. It is also evident that any reliance Dayton placed on the post-1996 exemption was inevitably diminished by PJM's filing in September 2003 seeking to eliminate the exemption. PJM made this filing more than one year before Dayton was integrated into PJM. Based on these findings, the Commission concludes Dayton may have relied on the

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December 2000, ¶ 31,089 (1999) (Order No. 2000), *order on reh'g*; Order No. 2000-A, 65 Fed. Reg. 12,088 (March 8, 2000), FERC Statutes and Regulations, Regulations Preambles July 1996-December 2000, ¶ 31,092 (2000) (Order No. 2000-A), *aff'd, Public Utility District No. 1 of Snohomish County, Washington v. FERC*, Nos. 00-1174, *et al*. (D.C. Cir. Dec. 11, 2001).

[69] *PJM Interconnection, LLC*, 101 FERC ¶ 61,345 (2002).

[70] *Alliance Companies*, 97 FERC ¶ 61,327 at 62,525 (2001) (*Alliance I*); *Alliance Companies*, 99 FERC ¶ 61,105 (2002) (*Alliance II)*.

[71] *Alliance I* at 62,525 and 62,531.

[72] *Alliance II* at Ordering Paragraph C (2002).

[73] *Alliance Companies*, 100 FERC ¶ 61,137 (2002).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

exemption to some degree, but that reliance on the exemption was only one of a number of factors that led Dayton to join PJM and, in any case, was unavoidably reduced by PJM's filing to eliminate the exemption.

70. The Commission will also consider the significance for Dayton of not having the exemption. This involves inquiring how likely it is that Dayton's peaking units will be offer capped. Dayton states it has twenty peaking units, fourteen of which are in the Dayton zone and were built after April 1, 1999. It does not state whether these units are located in load pockets or subject to transmission constraints. PJM offer caps a unit only when there is a transmission constraint and a unit must be operated out of economic merit order for reliability reasons. All of these conditions must be met for a unit to be offer capped. Dayton has made no showing of the likelihood that its units will be offer capped at all or, if so, how many of its units' run hours are likely to be offer capped. In addition, if Dayton's units were offer capped 80 percent or more of their run hours, they would be FMUs and would be entitled to higher bid caps under PJM's Tariff.

71. Based on the above considerations, the Commission denies Dayton's request to grandfather all of its peaking units. The Commission finds Dayton's reliance on the post-1996 exemption in joining PJM was not so strong as to warrant granting its request for its peaking units for which construction commenced prior to its filing with the Commission that it intended to join PJM. As discussed above, units will be grandfathered based on the date on which a transmission owner announced it would join PJM. For Dayton, that date is May 28, 2002. Dayton units for which construction commenced from May 28, 2002 through September 30, 2003 are grandfathered.

72. The Commission also rejects Dayton's arguments that failure to grandfather all of its units would be an unconstitutional taking of property, unduly discriminatory, or the cause of reliability problems.

73. There is no unconstitutional taking when a unit, with market power, is offer capped and the mitigation provides a reasonable opportunity to that unit to charge a just and reasonable rate. The PJM mitigation program provides a reasonable opportunity for a unit to receive a just and reasonable rate, and the Commission is establishing a hearing to ensure that the rate is just and reasonable.

74. Nor is there undue discrimination, since, as discussed above Dayton is being treated similarly to all other units in determining the units subject to grandfathering. Only those units with reasonable reliance interest are eligible for grandfathered treatment. Prior to its May 28, 2002 filing stating that it chose to join PJM, Dayton could not have had any reliance interest on the exemption in PJM's Tariff.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

75. The Commission also has addressed the issue of units needed for reliability in this proceeding. We have accepted PJM's default mechanism for compensation for such units and also tariff provisions providing that these units can make a filing under section 205 of the FPA for cost-of-service rates. These measures allow the unit to receive remuneration until alternative infrastructure can be built[74] and alleviate reliability concerns when a unit wishes to retire.

C. Pricing for Deficiencies in Operating Reserves—Scarcity Pricing

1. The January 25 Order

76. In the January 25 Order, the Commission accepted PJM's report in Docket No. EL03-236-003 that its existing market design is successful in achieving high prices during periods of tight supply and that it does not need to consider alternative pricing to address scarcity conditions. It stated that currently, PJM's market design permits prices to rise through hockey stick bidding since there are no caps on generator bids other than those in load pockets that are dispatched out of economic merit order and the $1,000/MWh offer cap.[75]

2. Rehearing Requests

77. PPL urges the Commission to adopt scarcity pricing or markets for non-spinning reserves. PPL relies on *California Independent System Operator Corp.,*.[76] Mirant urges the Commission to set scarcity pricing[77] in PJM for hearing. It asserts the Commission

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[74] January 25 Order at P 108.

[75] The $1,000 MWh offer cap is an offer cap on all offers in the PJM day-ahead energy market. Section 1.10.1A (d) (viii), Second Revised Sheet No. 358, Attachment K—Appendix, PJM Interconnection, L.L.C., FERC Electric Tariff, Sixth Revised Volume No. 1. The $1,000 MWh offer cap is sometimes called the "safety net bid cap," the "system cap," and the "market cap."

[76] 105 FERC ¶ 61,140 at P 214 (2003).

[77] Mirant's scarcity pricing proposal is that there should be a "pricing protocol that moves prices to levels at or above the [system] offer cap [of $1,000/MWh] when actual physical scarcity results in the violation of PJM operating reserve requirements. This should also include the adoption of specific markets for any reliability service

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20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

found that changes should be made to PJM's market design in the May 6 Order to better reflect scarcity conditions.[78] Mirant asserts the Commission's reliance on hockey stick bidding to prove that scarcity pricing exists is unwarranted as there is no evidence in this record that any units in PJM are permitted to engage in this type of bidding. In addition, it asserts mitigated units may not make such bids, but are limited to incremental costs plus 10 percent or $40/MWh so that when mitigated units set the market clearing price in PJM, the price cannot include scarcity rents. PPL asserts that generator retirement requests in PJM have not been offset by interest in the construction of replacement generation.[79]

78. Mirant and PPL assert the Commission failed to address the expert testimony submitted with Mirant's protest in Docket No. EL03-236-003[80] concerning scarcity pricing.[81] PPL asserts PJM's report did not provide necessary details as to why illustrative price behavior on one day in 1999 when the price rose to $850/MWh is representative of current market operations, why prices did not rise even higher on that day, or whether and how an appropriate price signal was sent or the costs allocated instead to uplift.

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maintained, *e.g.*, 10 minute non-synchronized reserves." MIR-1 at 37, Protest of Mirant and NRG, Docket No. EL03-236-003 (November 23, 2004).

[78] *Citing* May 6 Order at P 23.

[79] PPL also cites to the Commission's Notice of Proposed Rulemaking in *Remedying Undue Discrimination through Open Access Transmission Service and Standard Electricity Market Design*, 100 FERC ¶ 61,138 at P 393 (2002) (Docket No. RM01-12-000) (SMD NOPR). However, the Commission never issued a final rule in this proceeding, and, consequently, does not rely on discussions in the SMD NOPR.

[80] In Mirant's November 23, 2004 Protest, Mirant cites MIR-1 at 31-38 and PPL cites MIR-1 at 34 and 36 and MIR-6.

[81] Mirant asserts *Edison Mission Energy, Inc. v. FERC*, 394 F.3d 964, 965, 968, 969 (D.C. Cir. 2005) (*Edison Mission*) requires generally that the Commission consider its expert testimony on scarcity pricing.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

79. Mirant and PPL assert PJM failed to include stakeholders in its investigation of scarcity pricing and to report on stakeholder processes, although it was required to do so by the Commission.[82]

3. Commission Decision

80. The Commission grants rehearing, and as discussed later, is setting for hearing in this docket, the issue of scarcity pricing, particularly with respect to the prices for units that are mitigated during scarcity conditions.

D. Test for Suspension of Offer Capping

81. The January 25 Order also ruled on PJM's compliance filing in Docket No. EL03-236-002 concerning the suspension of offer capping. The Commission accepted PJM's proposed no-three pivotal supplier test to determine when offer capping will be suspended because it would exempt generators from the mitigation requirement when a load pocket was found to be competitive using this test. However, the Commission instituted a proceeding under section 206 of the FPA to determine whether the no-three pivotal supplier test is just and reasonable or needs to be revised and required PJM to respond to the protests, to explain why the existing market power screens or reasonable modifications of those screens would not be an appropriate means of determining market power in load pockets, and to address whether other modifications of its no-three pivotal supplier test would be appropriate.

82. EPSA and Reliant raise a number of objections to the no-three pivotal supplier test and ask the Commission to adopt a different test for the period pending resolution of the section 206 proceeding. They also state that the Commission erred in adopting this test because it was not shown to be just and reasonable.

83. PJM proposed the no-three pivotal supplier test in its September 30, 2003 filing. The Commission accepted the test in the May 6 Order conditioned on revisions and further justification. The Commission accepted this test because it provided the generators with an opportunity for an exemption from mitigation, an opportunity that they do not enjoy under the current PJM tariff. Thus, the Commission's acceptance benefited both EPSA and Reliant because it provided that, in some circumstances, their units would not be subject to mitigation. Had the Commission not accepted this filing, all

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[82] *Citing* May 6 Order at P 83.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

units dispatched out of merit would be subject to mitigation until the outcome of the section 206 proceeding instituted by the Commission in the same order.[83]

84. As discussed in the portion of this order concerning Docket No. EL03-236-006, the Commission is setting the issue of the appropriate test for market power in load pockets for hearing. The alternative proposals of EPSA and Reliant can be considered during the hearing, as well as the other issues raised by rehearing requesters.

E. Clarification Concerning Marginal Costs

85. EPSA and Mirant both ask the Commission to clarify paragraph 25 of the January 25 Order, especially the following statement: "When a unit bids above its marginal cost, that is evidence that the unit has some ability to control price, and hence, has market power."[84] Mirant asserts that bidding and prices above short-run marginal cost can simply be evidence of scarcity conditions rather than market power. EPSA

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[83] The Commission has the authority to set an interim rate order. *See FPC v. Tennessee Gas Transmission Co.*, 371 U.S. 145, 150-52 (1962); *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 584 (1942); *BP West Coast Prods., LLC v. FERC*, 374 F.3d 1263, 1305 (D.C. Cir. 2004).

[84] Paragraph 25 of the January 25 Order reads in pertinent part:

> Under PJM's LMP pricing system, all generators that lack market power have an incentive to submit bids at their marginal costs, because any price above marginal cost will generate sufficient revenue to cover the unit's operating costs and contribute to the recovery of the unit's fixed costs.[29] This is the same incentive that exists in a competitive market, where competitors are expected to produce at the point where prices exceed their short-run marginal costs. When a unit bids above its marginal cost, that is evidence that the unit has some ability to control price, and hence, has market power. This principle has been used by PJM to determine those generators subject to mitigation.
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> [29] In the case of reasonably efficient generators, the market clearing price will be higher than the generator's bid, which will provide an opportunity for the generator to recover its fixed costs. In addition, generators are compensated for providing capacity through PJM's ICAP mechanism, which can also help to recover fixed costs.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

asserts that offer curves submitted by generators reflect scarcity, opportunity costs, and risk as well as short-run variable costs and that these offer curves approach long-run marginal costs. EPSA states that opportunity costs include the financial losses incurred when a resource with limited operating hours runs in low cost hours, for example hydropower or fossil units with limitation in air, water, or other environmental permits. EPSA states that the risk premium refers to the risk that a unit accepted in the day-ahead market will experience a real-time outage and be forced to purchase energy in the real-time spot market to meet its delivery obligations. EPSA asserts the Commission has stated marginal costs include not only variable costs but also the marginal opportunity cost of all legitimate opportunities, costs, and risks.[85]

86. The Commission will clarify the statement. Competitive firms in a short-run auction market like PJM's will submit bids at the marginal cost of each unit of output, because doing so assures the firm that it will make a profit. To the extent that a firm's bid sets the market clearing price, it will profit on all preceding units produced at lower marginal costs (assuming an upward sloping marginal cost curve). Also, if a higher bid from another generator is accepted, the generator will be paid the higher bid on all of its units. Thus, in a competitive auction market, all generators have the incentive to bid their marginal cost. Bidding above marginal cost carries risks, because the generator may not be dispatched when it, in fact, could have profited by bidding its marginal cost. Generators will bid above their true marginal costs, therefore, only when they perceive that they can have some influence on price, and are not at risk of losing the sale due to a lower bid unit.

87. This is not to say that accounting measures of out-of-pocket costs truly reflect all marginal costs for each unit. Opportunity costs for example are marginal costs that may not always be reflected in accounting costs. The opportunity costs of units with limited operating hours highlighted by Mirant and EPSA are representative of these non-accounting costs.

88. In addition, marginal costs alone may not reflect scarcity conditions. In an auction-type market where participants receive or pay a market-clearing price, suppliers are expected to bid their marginal costs and buyers are expected to bid their marginal value. In some cases, the marginal value of buyers will determine a market clearing price

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[85] EPSA cites "Strawman Discussion Paper for Market Power Monitoring and Mitigation Panel" at 2, 4-5, Docket No. RM01-12-000 (February 7, 2002). This document is attached to the Notice of Strawman Discussion Paper, Docket No. RM01-12-000 (February 1, 2002) (Accession No. 20020201-0284).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

that exceeds the highest marginal cost offer of sellers. In this shortage situation, the higher price will ration available supplies to the buyers who value the supply the most and maintain operating reserves. This higher price would not be the result of withholding and market power, since all supplies would be sold in the market. However, currently in PJM's real-time market, buyers typically do not submit price bids, and so demand side bids are not available that can set a shortage price. Under PJM's existing rules, when there are no demand-side price bids, the energy price is based on the highest accepted supply bid, even if that bid does not clear the market (i.e., equate the quantities supplied and demanded). In these circumstances, one would expect that sellers would submit bids during scarcity conditions that would be above their marginal cost in order to establish a higher price. For non-mitigated units, hockey stick bids are one way some generators attempt to guess at a market clearing price when a shortage seems likely. However, wrong guesses may result in higher costs than necessary if shortages do not develop.

89. The Commission is setting for hearing, however, whether mitigation prices need to be adjusted to reflect scarcity pricing. In addition, parties can raise whether even in non-mitigated markets, scarcity pricing may be necessary.

F. Frequently Mitigated Units

90. In the May 6 Order, the Commission addressed compensation for units that are required to run for reliability reasons when there are transmission constraints. The Commission held a unit that is mitigated 80 percent or more of its run hours is an FMU and established a rebuttable presumption that an FMU is needed for reliability. The Commission held further that PJM must provide an FMU with the opportunity to recover at least its going forward costs.[86] In its compliance filing in Docket No. EL03-236-003, PJM proposed to define FMUs as units that are mitigated 80 percent or more of their run hours and to provide a higher bid cap for all FMUs of incremental operating costs plus either $40/Mwh or unit-specific going forward costs. The January 25 Order accepted PJM's proposals as responsive to the May 6 Order.[87]

91. Mirant asserts the $40 adder and the negotiated higher offer cap are arbitrary and capricious because they deny a unit the opportunity for recovery of and on fixed costs. It

[86] May 6 Order at P 39 and 40.

[87] January 25 Order at P 106 and 113.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

also asserts that "unit pairs" should be eligible for the higher offer cap.[88] We find Mirant is foreclosed from requesting rehearing of these issues.[89] The Commission made its substantive determinations concerning the definition of FMUs and alternative compensation for FMUs in the May 6 Order. The January 25 Order ruled on PJM's compliance filing for the FMU measures required in the May 6 Order. The January 25 Order did not modify the May 6 Order in a significant way with regard to FMUs.[90] It did not change the basic requirements that a unit be offer capped 80 percent of its run hours to be considered an FMU or that such a unit receive at least its going forward costs. More than thirty days have passed since the May 6 Order and the Commission has made no substantive changes to its FMU requirements in the May 6 Order. Therefore, Mirant may not seek rehearing concerning the higher offer cap and unit pairs here.[91]

IV. Compliance Filing in Docket No. EL03-236-005

92. As has been discussed, the January 25 Order accepted most of PJM's proposed provisions governing the deactivation of generation units.[92] However, the Commission concluded that PJM lacked the authority to require continued operations for an indefinite period of time even if a generating unit was required for reliability.[93] The Commission concluded that PJM should clarify the performance standards that would apply to a

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[88] According to Mirant, a "unit pair" includes two similarly-situated units, one of which operates above the 80 percent threshold while the other operates below it, but which pass the 80 percent threshold when averaged together.

[89] Mirant's filing related to unit pairs is being addressed in Docket ER05-919-000.

[90] *See Town of Norwood, Massachusetts v. FERC*, 906 F.2d 772, 775 (D.C. Cir. 1990), in which the court explained that for an appeal, the FPA requires an application for rehearing of a Commission order on rehearing "when the later order modifies the results of the earlier one in a significant way, raising objections to the rehearing order that are substantially different from those raised against the original one."

[91] Section 313(a) of the FPA, 16 U.S.C. 825l(a) (2001).

[92] January 25 Order at PP 136, 146-49. The proposal is discussed in detail at PP 123-132 and need not be repeated here.

[93] *Id.* at P 137.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

generating unit that continued operations beyond its proposed retirement date.[94] PJM was directed to amend its tariff proposal accordingly.[95]

93. PJM included modifications to its proposed deactivation provisions in its February 24, 2005 compliance filing. PJM eliminated the language in several sections of proposed Part V of its FERC Tariff that would have authorized it to require continued operations for reliability purposes for an indefinite period.[96] In response to Commission direction in the January 25 Order, PJM also changed the language on performance standards to provide that continued operations would be subject to the existing standards applicable to generating units located in the PJM region.[97] PJM also added language requiring a generator that had elected to continue operation to give PJM at least 90 days notice if such a continuing generator decides to terminate the continuing service.[98] It also included new language clarifying the obligations of generating units that are now operating under black start agreements.[99]

94. Notice of PJM's February 24, 2005 filing was published in the *Federal Register*, 70 Fed. Reg. 11,228 (March 8, 2005), with comments due on or before March 17, 2005.[100] The Mirant Companies and the PPL Parties filed protests.[101] On March 17,

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[94] *Id.* at P 152.

[95] *Id.* at Ordering Paragraph E.

[96] Section 113.2, First Revised Sheet No. 224A; section 114, First Revised Sheet No. 224B; section 114, First Revised Sheets No. 224B.01, 224C; Section 115, First Revised Sheet No. 224F; and sections 117, 118, and 119, First Revised Sheet Nos. 224G and 224H .

[97] Section 121, First Revised Sheet No. 224I.

[98] Section 113.3, First Revised Sheet No. 224B.

[99] Section 122, First Revised Sheet No. 224I.

[100] The Old Dominion Electric Cooperative initially filed comments and a protest in this and other sub-dockets of this proceeding, but subsequently refiled those comments only in another sub-docket.

[101] The PPL Parties include PPL University Park in their filing. In its order in Docket No. EL03-236-004, the Commission denied PPL University Park's untimely

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20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

2005, the Public Power Association of New Jersey (PPANJ) filed an untimely motion to intervene, a request for hearing, suspension and a motion to consolidate this proceeding and Docket No. ER05-644-000. On April 13, 2005, PPANJ filed a motion to file reply and reply and supplemental comments. We accept the late intervention in Docket No. EL03-236-005, but in doing so PPANJ must accept the record as established to that point.

95. PPANJ does not assert that PJM's filing does not comply with the Commission's January 25 Order. Rather it attacks those portions of the tariff already accepted by the January 25 Order. It also raises issues related to Docket No. ER05-644-000, the section 205 filing by PSEG Energy Resources & Trade, LLC and PSEF Fossil, LLC (jointly PSEG) to recover costs as a reliability unit. These issues go beyond the scope of the PJM compliance filing here. PPANJ has raised these same issues on rehearing of the Commission's order in Docket No. ER05-644-000,[102] and that is the proper forum for consideration of those issues.

96. On the merits, Mirant asserts that the revised language does not comply with the requirements of the January 25 Order because it does not specifically state that if PJM determines that a unit is needed for reliability purposes, the unit proposing to retire may nonetheless do so after 90 days. It therefore requests that PJM be required to so state in its tariff. The Commission will grant Mirant's request. PJM must revise section 113.2 to provide that a unit that PJM determines is needed for reliability purposes may retire 90 days after its initial notice to PJM.

97. The PPL Parties make two requests. The first is that there be a reciprocal provision providing for 90 days notice by PJM if it no longer needs operations by a continuing generator for reliability. The PPL Parties assert that such notice is essential to provide an orderly wind down and to liquidate provisions for requiring fuel and other contractual obligations. The Commission will deny rehearing. The Commission notes that any continuing operator is guaranteed at least its going forward or avoidable costs of providing the continuing service and may file with the Commission a tariff to recover all the costs of operating the service until it retires. Thus a lengthy notice period will only increase the public costs while providing unnecessary protection to the operator.

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motion to intervene in the Docket No. EL03-236 proceeding. Thus, PPL University Park is not a party to any of the sub-dockets of this proceeding and the PPL Parties in Docket No. EL03-236-005 do not include PPL University Park.

[102] *PSEG Energy Resources & Trade, LLC*, 111 FERC ¶ 61,121 (2005).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

However, a short notice is appropriate so the operator can begin to redeploy personnel and resources to other projects or to cancel these requirements. Therefore the Commission directs PJM to modify proposed section 114 to provide 30 days notice of when the continued operations will no longer be required. This will provide some modest notice while assuring that the notice period is short enough that PJM can predict with accuracy when the additional capacity will come on line.

98. The PPL Parties' second comment addresses section 118 of the proposed tariff. That section provides for the refund of project reimbursement if the project investment permits the generating unit to continue operations beyond the date that is necessary for PJM to complete the transmission upgrades required to assure reliability. The section requires the refund of a pro-rata share of the project investment previously paid by PJM with the pro-rata share determined by the formula in the section. One component of the formula is the date PJM determines that the generating unit could deactivate. The PPL Parties assert that this latter component provides too much discretion to PJM. This point is resolved by the previous requirement that PJM must provide 30 days notice of when the unit may deactivate because the necessary additional transmission capacity has been provided. That will automatically determine the date for use in the formula at issue in section 118. Therefore rehearing is denied on this point.

V. Compliance Filing in Docket No. EL03-236-006

99. Pursuant to section 206 of the FPA, the January 25 Order required PJM to file a further justification of the no-three pivotal supplier test that was accepted on an interim basis by that order. The Commission expressed concern that the test might be too restrictive and would impose mitigation on markets that are workably competitive. The Commission also concluded that PJM had not satisfactorily explained why the other screens that have been adopted by the Commission, or reasonable derivations of those screens, are not appropriate for determining when load pockets are sufficiently competitive to permit relaxation of mitigation.[103]

100. PJM made a compliance filing in Docket No. EL03-236-006 on March 4, 2005. The filing consisted of a short summary plus a 15 page declaration by Joseph E. Bowring, Manager of the PJM Market Monitoring Unit. Notice of the filing was published in the *Federal Register* on March 17, 2005 at 70 *Fed. Reg.* 13022. Mirant, Constellation, and NRG filed for an extension of time which was granted on March 17, 2005. The Joint

[103] January 25 Order at PP 83 and 84. *See also, supra*, P 78-80.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

Consumer Advocates,[104] ODEC, and the American Public Power Association and National Rural Electric Association (APPA/NRECA) filed comments generally supporting PJM's filing. Constellation Energy Commodities Group, Inc., Mirant, the PPL Parties, and Reliant filed comments criticizing and opposing PJM's proposal. In addition, EPSA filed for late intervention and requested a technical conference on this matter. There was no need for EPSA to file for late intervention in this subdocket because it was granted intervention in an earlier phase of the broader proceedings. On May 13, 2005, PJM filed in support of the request for a technical conference. Because the Commission is setting PJM's filing for hearing, the request for a technical conference is denied.

A. The PJM Filing

101. The central matter raised by PJM's filing is whether "the no-three pivotal supplier test strikes a reasonable balance between the requirement to limit extreme structural market power and the goal of limiting intervention in markets where competitive forces are adequate."[105] PJM's filing asserts that the no-three pivotal supplier test now in effect will accomplish this goal and lead to results that are consistent with the market power tests developed by the Commission in *AEP Power Marketing, Inc.* in real time.[106] The Bowring Declaration further asserts that the no-three pivotal supplier test is an explicit derivation, within the context of the Commission's delivered price test,[107] of how to

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[104] Maryland Office of People's Counsel, Pennsylvania Office of Consumer Advocate, and D.C. Office of Peoples Counsel filing jointly.

[105] Declaration of Joseph E. Bowring (Bowring Declaration) attached to PJM's July 16, 2004 Compliance Filing at P 8.

[106] *AEP Power Marketing, Inc.*, 107 FERC ¶ 61,018 (2004).

[107] The delivered price test is used to analyze the effect on competition for transfers of jurisdictional facilities in section 203 proceedings, using the framework described in Appendix A of the Merger Policy Statement and revised in Order No. 642. It has been used routinely by the Commission to analyze market power in the merger context for many years, and it has been affirmed by the courts. The delivered price test defines the relevant market by identifying potential suppliers based on market prices, input costs, and transmission availability, and calculates each supplier's economic capacity and available economic capacity for each season/load condition. The results of the delivered price test can be used for pivotal supplier, market share and market

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20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

weight the various structural features of a particular type of local market, that in the case of offer capping for local market power PJM needs to dynamically apply a real time market test, and that any such market power test must be clearly defined and must be capable of automatic application without the exercise of judgment or discretion.[108] This is because market power could be determined to exist for a period of hours and not to exist for another period of hours in the same day and for the same constraint.[109]

102. The Bowring Declaration further asserts that while the Commission's delivered price test defines the relevant market to include all suppliers with costs less than or equal to 1.05 times market price, the no-three pivotal supplier test includes all suppliers regardless of their position on relevant market supply curve. This means that the pivotal supplier test includes more competitors in the relevant market than the Commission's *AEP* delivered price test, and as such is more likely to find that the relevant market is competitive.[110] The Bowring Declaration also asserts that the no-three pivotal supplier test is a significant relaxation of the previously existing PJM market rule. This relaxation is consistent with a historical context in which the local markets created by transmission constraints are generally very small and not structurally competitive. Thus, the no-three pivotal supplier test for market power would find only a small number of constraints with an insufficient number of competitors and would allow lifting of market capping consistent with PJM State of the Annual Market Report's conclusion that offer capping occurs relatively infrequently in PJM markets.[111] The Bowring Declaration also states that the no-three pivotal supplier test is intended to work in markets where there is very little demand elasticity and in which a pivotal supplier could extract significant monopoly rents because customers have few, if any, alternatives. The Bowring Declaration therefore concludes market power tests should be conservative in light of such a lack of alternatives, particularly those based on demand response.[112]

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concentration analyses. A detailed description of the mechanics of the delivered price test is provided in Appendix F of the *AEP Power Marketing* order.

[108] Bowring Declaration at P 8.

[109] *Id.* at P 10.

[110] *Id.* at P 11.

[111] *Id.* at P 14.

[112] *Id*. at P 16, *citing AEP Power Marketing*, *supra*, at P 72 and 103.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

103. After noting the correlation between various tests of market structure such as the number of suppliers, market share, HHI,[113] elasticity and the Lerner index,[114] the Bowring Declaration concludes that a no-one or no-two pivotal supplier test would result in too much market power given the inelastic nature of demand for electricity. As such, either a no-one- or no-two pivotal supplier standard would fail the competitive thresholds embedded in any of these market structure concepts. The Bowring Declaration uses an HHI analysis and residual supplier index to show the theoretical difference between a no-two- and no-three pivotal supplier tests.[115] Starting from this premise, the Bowring Declaration responds to previous criticism of the no-three pivotal supplier test filed in earlier phases of these proceedings. For example, it asserts that EPSA failed to adequately account for the highly inelastic nature of demand within a constrained load pocket and understated the level of the resulting HHI calculations.

104. The Bowring Declaration thus asserts that EPSA has failed to account for the restricted capacity that exists under constrained situations and the fact that most profit-maximizing models require a solution where a decrease in output is not fully compensated for by an increase in price, *i.e.* where demand becomes elastic. The Bowring Declaration asserts that this decrease in output does not occur in electric markets and the no-three pivotal supplier test recognizes that even where overall supply is adequate, a single supplier can still exercise monopoly power. Thus, an <u>increase in capacity</u> in a load pocket will not necessarily increase the <u>number of suppliers</u> and thereby may not increase competition within a load pocket.[116] PJM further asserts that use of a Cournot analysis, upon which EPSA and Reliant's protests are based, is misplaced because the no-three pivotal supplier test is more effective in detecting coordinated behavior in a narrow market and recognizes that suppliers have different marginal costs.

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[113] Herfindahl-Hirschman Index (HHI) is a commonly accepted measure of market concentration. It is calculated by squaring the market share of each firm competing in a market, and then summing the resulting numbers. The HHI number can range from close to zero to 10,000.

[114] Lerner's index is an index that measures the degree of monopoly power. The index equals the price minus the marginal cost of production, divided by the price. The index ranges from 0 to 1; the higher the value, the higher the monopoly power.

[115] *Id.* at PP 17, 19-22.

[116] *Id.* at P 30-36. Emphasis added by the Commission.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

105. The Bowring Declaration also addresses Reliant's arguments in earlier phases of this proceeding. Reliant asserts that the no-three pivotal supplier test will require a high level of divestiture to additional suppliers to obtain competitive results in a PJM load pocket. As noted, the Bowring Declaration states that the Reliant analysis is correct only under a very strong assumption that each of the additional suppliers has the same marginal cost, and as such would bid in or be called at the same point on the supply curve. It asserts that even under that assumption, Reliant's examples illustrate the important point that market power can be exercised in the hypothetical markets at peak load as high mark ups above the competitive price will result given the inelastic demand.[117]

106. The Bowring Declaration further asserts that the absolute number of competitors is not relevant to determining, at the margin, whether a market participant has market power precisely because they have different supply capabilities and cost structures. As such, the last supplier(s) can have market power even if their costs are relatively high and the supply provided relatively small. It asserts that that this is true both for the Commission's market power tests and for the no-three pivotal supplier test given the inelastic nature of the last units of demand in electric markets.[118] It further asserts that Reliant overlooks that the construction of small amounts of additional transmission capacity under PJM's Regional Transmission Expansion Planning (RTEP) protocol[119] would allow many markets to pass the no-three pivotal supplier test and eliminate the danger that the test may be unduly restrictive in its application. As such, the Bowring Declaration agrees with certain of Reliant's points, namely that the best way to improve markets is to add more competitors or to build additional transmission capacity.[120]

B. The Comments

1. Comments Supporting the Filing

107. ODEC supports PJM's no-three pivotal supplier test and urges its immediate adoption. APPA/NRECA also support the test with a concern that any weakening of the

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[117] *Id.* at P 39-40.

[118] *Id*. at P 42-43.

[119] *See* Operating Agreement of PJM Interconnection, L.L.C., Schedule 6.

[120] *Id.* at P 45, 49.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

test might result in weakened protection against market power elsewhere in the country. Rather than weakening this market power test, the Commission should encourage resolution of underlying structural problems, particularly inadequate transmission infrastructure and lack of diverse generation ownership, that give rise to load pockets in the first place. APPA/NRECA also include an affidavit which concludes that PJM markets face chronic congestion problems that increase the risk of the exercise of both unilateral and coordinated market power. They conclude that the no-three pivotal supplier test provides that PJM market monitor with a workable and reasonable tool to assess such market power risks on a real time basis and that other alternatives, including the Commission's interim screens,[121] are not adequate to the task because they are not sufficiently refined to address market power issues that can arise in dynamic local markets.

108. APPA/NRECA also express concern that the continued vestiges of market power have occurred in part because load serving entities (LSE) have failed to make the investments in the transmission system necessary to reduce market power in load pockets. APPA/NRECA cite to S. Blumsack and L.B. Lave, *Mitigating Market Power in Deregulated Electricity Markets*[122] for the proposition that one pivotal supplier is inadequate to protect consumers. They further conclude that data limitations make it impossible to perform the Commission's market screens in real time and that those screens require a fair amount of judgment in their application. Their comments also assert the complexities that result from suppliers with differing marginal costs and state that an important part of any test is the risk of false results. They argue that even if the no-three pivotal supplier test provides a greater number of false positives than a no-one pivotal supplier or no-two pivotal supplier test, there is no reason to conclude that no-three pivotal supplier test will provide more false positives than false negatives. As such, the test should be conservative given the damage that can result from the exercise of market power. They further note that in 2004 offer capping applied to only 1.3 percent of the total run hours in that year and to only 0.4 percent of the units in the PJM footprint.[123] Thus, because the risk of false positives and a negative impact from such errors is

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[121] *Citing AEP Power Marketing, supra,* and *order on reh'g*, 108 FERC ¶ 61,026 (2004).

[122] Undated Working Paper, Department of Engineering and Public Policy, Carnegie Mellon University, available at blumsack@cmu.edu.

[123] *Citing PJM 2004 State of the Market Report*, section 2, Energy Market, at 63-66 (March 8, 2005) (*PJM 2004 Report*).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

relatively small, the no-three pivotal supplier test is reasonable and appropriate. In contrast, the Joint Consumer Advocates state that a no-four pivotal supplier test should be used to assure that all opportunities to exercise market power are curtailed because serious damage may result from the exercise of market power.

2. Comments Opposing the Filing

109. EPSA filed short comments summarizing the premises of the no-three pivotal supplier test and noting the Commission's statement that the test may be too restrictive. It therefore requests an on the record technical conference to address the issues raised by PJM's compliance filing. The PPL Parties assert that PJM has again proposed actions that will keep generators from earning a return based on market supply and demand and that will reflect the intrinsic value of generation. They assert that PJM's proposal will discourage investment in the very load pockets in which it desires additional investment, *i.e.*, those with one or two units. They claim PJM would do so even though its 2004 State of the Market Report states that net revenues over a six month period were inadequate to support entry by either a combustion turbine or combined cycle units. In particular, the current cap of marginal cost plus 10 percent, or marginal cost plus $40 for a frequently mitigated unit, is inadequate to encourage investment for the marginal unit. They assert that PJM's proposal ignores the Commission's own statements that some prices in excess of marginal cost may be appropriate.[124] Thus, the Commission must intervene to expand the situations where offer capping is suspended.

110. Constellation, Mirant, and Reliant prepared more detailed criticisms of PJM's filing. Constellation analyzes principles of antitrust law that the Commission has applied in its analysis of broader energy markets and concludes the Bowring Declaration does not adequately address the issue of small transitory price increases. Constellation asserts that if small transitory price increases occur, then these would not violate anti-trust standards (and similar tests based on HHI calculations) and the market at issue would still be adequately competitive. Constellation asserts that Mr. Bowring does not adequately explain why such measures are appropriate measures for the short term energy market when tests based on anti-trust principles focus on the ability to sustain higher prices for a substantial period of time. It further asserts that the Commission's *AEP* interim market screens – a pivotal supplier and marker share screen – also embody the concept of materiality and duration. Constellation concludes that the screens do not consider

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[124] *Citing W. Sys. Power Pool*, 59 FERC ¶ 61,249 at 61,906 n. 11 (1992); *Ceiling Prices; Old Gas Pricing Structure*, FERC Stats. & Regs. ¶ 31,701 at 30,223 (1986), 51 Fed. Reg. 22 at 168 (June 18, 1986).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

whether there may be circumstances in one particular hour over the three year market-based rate authorization where a combination of plant outages and transmission curtailments may occur that could create conditions under which the seller would have the ability to charge rates in excess of incremental costs plus ten percent. It also notes that in the MISO mitigation scheme, suppliers are able to bid significantly over incremental costs without being subject to mitigation (exceed reference levels by the lesser of 300% or $100 per MWh) and the resulting bid has to have a significant effect on the clearing price (the lesser of 200 percent or $100).

111. Constellation therefore concludes that PJM has not established the need for a no-three pivotal supplier test. It asserts that Mr. Bowring's approach is based on the application of a distribution factor and a transmission constraint to define the geographic market to which the test would apply. It argues that if demand in a load pocket is 1,000 MW, then the no-three pivotal supplier rule would be satisfied by four generators of 1,000 MW each but not three suppliers of 1,000 MW each. It then suggests that under these circumstances a no-two pivotal supplier rule would be more than adequate since the danger of collusion is closely monitored by both Commission and the PJM Market Monitoring Unit. Constellation further asserts that Mr. Bowring has not provided any detail on the mechanics of why his test is equivalent to the Commission's delivered price test or any documentation supporting his assertions. It concludes that Mr. Bowring's attempt to incorporate tests designed for merger and longer term analysis into a dynamic, hourly situation does not address the element of non-transitory price increases in those tests when non-transitory increases may not exist in the dynamic PJM hourly market, and that in fact in 2004 offer-capping was infrequent and transitory.[125] It argues that this suggests that a traditional no-one pivotal supplier test would be more appropriate. Therefore, the Commission should reject the no-three pivotal supplier test and seek a more appropriate solution. This could include an administratively established cap in excess of the current $1,000 cap for circumstances such as reserve shortage.

112. Reliant reiterates its prior objections to the no-three pivotal supplier test. Citing *Edison Mission*,[126] it claims that this test would mitigate markets that would otherwise be competitive in violation of the court's finding that inappropriately suppressed prices deter entry to the detriment of the market. Reliant likewise asserts that there are significant

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[125] *Citing* PJM 2004 Report at 26, 48, 63-67.

[126] 394 F.3d 964 (D.C. Cir. 2005); *order granting clarification*, 2005 U.S. App. LEXIS 5795 (D.C. Cir. 2005) (Commission orders under review vacated only insofar as they apply to the Automated Mitigation Procedure outside of New York City).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

distinctions between a structural approach designed to measure the ability to exercise market power for a sustained period of time and the dynamics of a day ahead and hourly market where such impacts maybe more transitory. Reliant further claims that the wording of the proposal is unclear regardless of how appropriate the concept may be. Reliant further argues the Bowring Declaration does not rebut its earlier examples suggesting that excessive divestiture would be required to meet the no-three pivotal supplier test in PJM's energy market. It appends its previous examples to this filing and repeats its prior analysis.

113. Mirant advances many of the same points as Constellation and Reliant. It asserts that PJM candidly states that the test may not lift offer capping in any load pockets and that this is an indication that the test may be too restrictive. It therefore requests that technical conference to more clearly identify the issues, after which the Commission would issue an order directing how PJM's tariff language should be structured. Mirant asserts that PJM has provided no details on how the test is derived, its difference from the delivered price test (if any), or the justification for those differences and has provided no details or evidence of why it correlates well with the screens in *AEP*, *supra*. Thus, PJM has not established why a no-one or no-two pivotal supplier test would not be adequate and it should make its analyses available. Moreover, there is no distinction between the day-ahead and the hour-ahead market. Mirant states that the day-ahead market is more elastic because LSEs have the option of shifting demand to the hourly market. It suggests that a different, less rigorous test should be used in the day-ahead market. Mirant then turns to several more technical observations that appear to be based on its concerns with docket No. ER04-539-006 dealing with congestion at major transmission interfaces. It proposes a series of questions that are also grounded in that docket. Since these are not necessarily relevant here, they will not be repeated.

C. <u>Commission Discussion</u>

114. As PJM states in its filing, the central matter in this docket is whether "the no-three pivotal supplier test strikes a reasonable balance between the requirement to limit extreme structural market power and the goal of limiting intervention in markets where competitive forces are adequate."[127] Under current PJM rules, suppliers are offer capped when there is a transmission constraint and they are called out of merit for reliability reasons. Thus, the presumption under the existing PJM rules is that such a transmission constraint automatically creates the ability of suppliers on the import side of the constraint (i.e., within the load pocket) to exercise market power. PJM proposes to relax

[127] Bowring Declaration at P 8.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

this presumption for any supplier within the load pocket that can pass the no-three pivotal supplier test. Thus, only suppliers that are located within a load pocket and that fail the no-three pivotal supplier test would be presumed to have market power, and thus, would be offer-capped.

115. The January 25 Order directed PJM to respond to protests of PJM's November filing, to explain why the existing market power screens in *AEP* or reasonable modifications of those screens would not be an appropriate means of determining market power in load pockets, and to address whether other modifications of its no-three pivotal supplier test would be appropriate, such as using only two pivotal suppliers, rather than three. The Commission concludes that PJM's filing and the comments in opposition present issues that would best be resolved through an evidentiary hearing. In reaching this conclusion, we have not concluded that the concept is unsound, only that that PJM has not provided sufficient data and explanation to support its conclusions.

116. Specific deficiencies with the PJM filing and remaining general concerns with the no-three pivotal supplier test follow. First, one of PJM's principal justifications for the no-three pivotal supplier test, as stated in the Bowring Declaration, is that it represents the practical application of the Commission's market power tests in real-time. Moreover, the Bowring Declaration asserts that "the no-three pivotal supplier test is an explicit derivation, within the context of the Commission's delivered price test, of how to weigh the various structural features of a particular type of local market,"[128] and that the no-three pivotal supplier "is not more stringent than the complete delivered price test, taken as an integrated whole."[129] However, the Bowring Declaration does not adequately support these assertions. It does not show how the no-three pivotal supplier test was derived from the Commission's screens, nor does it provide support that the no-three pivotal supplier test is not more stringent than the delivered price test. The Bowring Declaration offers a few limited hypothetical examples and general assertions in support of these conclusions, but fails to provide data showing whether the assumptions underlying the examples are typical of actual conditions in the load pockets where offer capping occurs. Nor does the Bowring Declaration provide analytical, conceptual or

[128] *Id.* at P 8.

[129] *Id.* at P 9.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

theoretical analysis demonstrating why the no-three pivotal supplier test would produce results consistent with those of the *AEP* screens.[130]

117. Second, the discussion in the Bowring Declaration of whether other modifications of its no-three pivotal supplier test would be appropriate was insufficient. The discussion relies upon hypothetical examples and draws upon references to Cournot competition theory, particularly in the analysis of the deficiencies of a no-two pivotal supplier test. The brief analysis did not provide sufficient support to indicate that the conclusions contained in the Declaration were robust under a variety of operating conditions and configurations.

118. Finally, the Bowring Declaration did not adequately address why the existing market power screens or reasonable modifications of those screens would not be an appropriate means of determining market power in load pockets. In addition, the Declaration dismisses the use of the *AEP* screens as impractical or impossible to apply on an hourly basis and that the use of judgment cannot be applied in a real-time application, without providing any detailed examination of how such screens or subsets of these screens could be implemented within PJM's current systems.

119. Because PJM has not adequately supported the no-three pivotal supplier test, we will establish further hearing procedures for this matter. The primary focus of the hearing before the Administrative Law Judge (ALJ) will be to address what test or tests should be used to determine whether a supplier has market power in a load pocket and should be subject to offer capping. The hearing before the ALJ will examine whether the no-three pivotal supplier test accurately identifies whether suppliers within load pockets have market power in PJM's spot market at the nodes in the load pocket, or whether a different test should be used. Specific issues that the hearing should address include: (a) the appropriateness and strengths/drawbacks of applying market power screening test in real-time; (b) whether the no-three pivotal supplier test is no more stringent than the screens approved by the Commission for granting market-based rate applications, and whether the tests produce similar results; (c) the implications of using a no-one or no-

[130] For example, the Bowring Declaration states that PJM's no-three pivotal supplier test is equivalent to the 5 percent delivered price test because it includes all suppliers, regardless of their position on the relevant market supply curve, and therefore includes more competitors than the delivered price test. The Declaration does not provide any analytical support to demonstrate that the no-three pivotal supplier is equivalent to the delivered price test, nor respond to commenters who argue that the no-three pivotal supplier test is more stringent.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

two pivotal supplier instead of the no-three pivotal supplier test; (e) whether the Commission market screens (such as the *AEP* screens) can be implemented in real-time; (f) whether tests more or less stringent than the *AEP* screens should be used to monitor and mitigate actual transactions in the market on a real time basis; and finally, (g) whether any of the above market power tests are likely to pass a supplier that should fail (i.e., incorrectly conclude that a supplier lacks market power when, in fact, it has market power) or fail a supplier that should pass (i.e., incorrectly conclude that a supplier has market power when, in fact, it lacks market power). PJM and parties should support and defend their findings and assertions with as much analysis and specific data as possible. Since no test may be completely accurate in identifying suppliers with and without market power, the hearing should also explore the relative harm of mitigating suppliers without market power under the various tests versus failing to mitigate suppliers with market power under those tests.

120. Related to mitigation is the question of whether prices in PJM, particularly prices received by mitigated generators, appropriately reflect scarcity prices.[131] In its November 2, 2004 Compliance Filing in EL03-236-003, PJM argued that its market rules did not suppress prices during scarcity conditions and that there was no need to consider alternative pricing mechanisms to address scarcity conditions. The reason, according to PJM, is that generators can submit "hockey stick" bids during scarcity conditions. However, while unmitigated generators may submit hockey-stick bids, it is not clear that PJM's mitigation and offer capping permit such offer prices by units inside load pockets. Therefore, it is not clear whether PJM's existing market rules and mitigation measures together would permit prices in a load pocket to rise sufficiently to reflect scarcity conditions that occur only in the load pocket.

121. The Commission is therefore concerned that the overall scope of PJM's market plan may be unjust and unreasonable and, under section 206 of the FPA, is setting the issue of scarcity pricing for hearing in this docket. The hearing should address the relationship between PJM's mitigation measures, including the appropriate test for determining whether to apply offer caps, and the ability of prices in load pockets to increase appropriately during periods of scarcity. The hearing should address what changes to PJM's market rules, if any, may be necessary to adopt in combination with PJM's overall market power mitigation measures, so that prices in load pockets are not inappropriately suppressed during periods of genuine scarcity. For example, the hearing should explore the desirability of rules, such as those currently in place in the New York

[131] *See Edison Mission*, 394 F.3d 964 (D.C. Cir. 2005).

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

ISO[132] and in ISO New England,[133] that would automatically raise the LMP in a load pocket during periods of an operating reserve shortage in the load pocket. The hearing should also explore the desirability of raising or removing the offer caps when shortages arise in a load pocket that would otherwise apply to individual generators in the load pockets.

122. In addition, the hearing should consider whether scarcity pricing is necessary for unmitigated units. The hearing should examine whether relying on hockey stick bidding is the best method for addressing scarcity pricing.

VI. Consolidation of Docket No. EL03-236-006 and EL04-121-000 Hearings

123. The Commission set for hearing in Docket No. EL04-121-000 two proposals by PJM regarding offer caps on generating units dispatched out of economic merit for reliability within control areas newly integrated into PJM.[134] In the Docket No. EL04-121-000 filing, PJM also proposed to rely on the no-three-pivotal supplier test for determining when generators can exercise market power. In the order establishing the hearing in Docket No. EL04-121-000, the Commission recognized the interrelationship between the issues raised by the no-three pivotal supplier test in the Docket No. EL04-121-000 filing and in this proceeding, and instructed the ALJ to hold in abeyance any proceedings with regard to resolution of the no-three pivotal supplier issue until the Commission has determined how to proceed on that issue in Docket No. EL03-236-003.[135]

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[132] S*ee* New York Independent System Operator, Inc., FERC Electric Tariff (Services Tariff), Original Vol. 2. Sections 6.1A and 6.1B, Sixth Revised Sheet No. 299, Third Revised Sheet No. 299A, Fourth Revised Sheet Nos. 300 and 301, Schedule 4, and Sections I.A.2.a and I.A.2.b, Third Revised Sheet Nos. 331.01.02 - 331.01.06, Attachment B,

[133] *See* Original Sheet Nos. 7050-7051 and Section III.2.5(d), Original Sheet Nos. 7135-38, Market Rule 1 – Standard Market Design, ISO New England Inc., FERC Electric Tariff No. 3.

[134] *PJM Interconnection, LLC*, 111 FERC ¶ 61,066 (2005).

[135] *Id*. at P 20.

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

124. The Commission has determined to consolidate these proceedings for the administrative convenience of the parties and in the interests of having both proceedings resolved expeditiously. While the Commission recognizes that there may be somewhat different issues involved in the two proceedings, the issue of the no-three pivotal supplier test is common to both proceedings. The parties would have difficulty initiating litigation in the Docket No. EL04-121-000 without knowing the resolution of the no-three pivotal supplier test in this proceeding. By combining these two proceedings, evidence can be adduced that is relevant to both.

125. At the same time, the Commission recognizes that the application of the no-three pivotal supplier or any market power test may be different in the context of the yearly analysis proposed in Docket No. EL04-121-000, as compared to the real time analysis proposed by PJM in this docket. Thus, during the hearing, the parties should ensure that they separately address the issues raised by the two filings.

The Commission orders:

(A) The requests for rehearing and requests for clarifications of the January 25 Order are granted or denied as discussed in the body of this order. PJM is directed to make a compliance filing within 30 days of the date of this order to reflect the revisions discussed in the body of the this order.

(B) PJM's compliance filing in Docket No. EL03-236-005 is accepted with the modifications discussed in the body of this order. PJM is directed to file a compliance filing within 30 days of this order to reflect these modifications.

(C) The scope of the section 206 public hearing in the Docket No. EL03-236-006 proceeding is expanded to include the relationship between PJM's mitigation measures, including the appropriate test for determining whether to apply offer caps, and the ability of prices in load pockets to increase appropriately during periods of scarcity and related issues as discussed in the body of this order.

(D) The proceedings in Docket Nos. EL04-121-000 and EL03-236-006 are consolidated, as discussed in the body of this order.

(E) A presiding administrative law judge, to be designated by the Chief Administrative Law Judge, shall convene a prehearing conference in the Docket No. EL03-236-000 section 206 public hearing in this proceeding. The prehearing conference shall concern the appropriate test for exempting generators from mitigation as discussed in the January 25 Order and in this order and the expanded and related matters included in the section 206 public hearing in this order. The prehearing conference will be held

20050705-3045 Issued by FERC OSEC 07/05/2005 in Docket#: EL03-236-004

within approximately fifteen (15) days from the date of this order, in a hearing room of the Federal Energy Regulatory Commission, 888 First Street, NE, Washington, D.C. 20426. Such conference shall be held for the purpose of establishing a procedural schedule. The presiding judge is authorized to establish procedural dates and to rule on all motions (except motions to dismiss), as provided in the Commission's Rules of Practice and Procedure.

By the Commission.

(S E A L)

Linda Mitry,
Deputy Secretary.