UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

	)	
Southwest Power Pool, Inc.	)	Docket No. ER15-2268-000
	)	

PROTEST OF THE INDEPENDENT MARKET MONITOR FOR PJM

Pursuant to Rule 211 of the Commission's Rules and Regulations,[1] Monitoring Analytics, LLC, acting in its capacity as the Independent Market Monitor for PJM ("Market Monitor"), submits this protest to the filing submitted by Southwest Power Pool, Inc. ("SPP") on July 24, 2015, to revise the rules for development of mitigation inputs based on short run marginal costs ("July 24th Filing"). The July 24th Filing proposes, with reference to the rules in PJM Interconnection, L.L.C. ("PJM"), to include costs in the calculation of short run marginal costs ("SRMC") that are not short run marginal costs.

When the Commission approved SPP's current mitigation rules just two years ago, the Commission directed SPP to "be more specific and establish that offers are to be mitigated to the[] short run marginal costs of the generating unit" and "define the costs to be measured in the short run marginal costs."[2] The Commission found that SPP's revisions filed on compliance did so, rejecting arguments that variable and fixed costs that are not short run marginal costs should be included in the defined costs.[3] The July 24th Filing seeks to circumvent the Commission's explicit directive by proposing to redefine SRMC as

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1 18 CFR § 385.211 (2014).

2 *Southwest Power Pool, Inc.*, 141 FERC ¶ 61,048 at P 420 (Oct. 18, 2012), *order on reh'g*, 142 FERC ¶ 16,205 (March 21, 2013).

3 142 FERC ¶ 16,205 at PP 95–96.

variable costs. The July 24th Filing is an attempt by SPP participants to overrule the SPP market monitor's refusal to allow costs in mitigated offers that are not SRMC. The SPP market monitor is acting consistent with tariff and the Commission directives. The July 24th Filing is a collateral attack on the Commission's prior orders. Participants acting through SPP should not be allowed to interfere with independent market monitoring and to introduce confusion into the tariff on a matter that the Commission has found to be clear.

References to PJM rules in support of the approach in the July 24th Filing are out-of-date and inaccurate, and reliance on the PJM rules to justify the proposed rules is misplaced.

The Commission has found SPP's current rules adequate to reliably and consistently calculate SRMC. SPP's current rules for calculating SRMC are better than PJM's rules. To the extent that PJM's rules are not as clear as SPP's rules defining SRMC, it is PJM's rules that need to be modified and not SPP's rules. The Market Monitor supports the definition of SRMC included in the Commission's orders on this matter in SPP.

PJM recently has made progress in clarifying the definition of SRMC to make explicit that long term maintenance costs are not included in SRMC. Long term maintenance costs are a form of variable costs that are not short run marginal costs. PJM's improved rules for explicitly excluding long term maintenance costs from the definition of SRMC address the same cost area as the SPP rules that would be degraded by the changes proposed in the July 24th Filing. The current PJM rules are consistent with the current SPP rules and are not consistent with the proposed change to SPP's rules. The PJM rules contradict the July 24th Filing's proposed approach.

It would be unjust and unreasonable to permit the replacement of SPP's current approach, which is approved by the Commission, consistent with competition, consistent with economic principles, clearly defined and properly implemented, with an approach that contradicts prior Commission directives to SPP and other precedent, and that will not protect SPP customers from the exercise of market power and that is inconsistent with the correct, economic definition of SRMC.

The arguments in the July 24th Filing related to cost recovery are misplaced for a number of reasons. For example cost recovery for the generation owners in the SPP market is covered by state cost of service regulation. If SPP's goal is to create a mechanism allowing for the recovery of long term maintenance costs and investment costs in generation on a competitive basis, then it could consider a functional, competitive capacity market, administrative scarcity pricing, a combination of the two, or an equivalent mechanism.

I. COMMENTS

A. Regulation Through Competition Requires Competitive Pricing.

In the approximately three decades that the Commission has pursued its reform of the electric industry, the Commission's principal rationale for its effort has been the promise that the forces of competition can improve efficiency in the industry and lower prices for wholesale electric power.[4] The Commission's goal is not to deregulate, or to free market participants to conduct themselves as though they operated in an unregulated industry.[5] It follows that to any extent that market power rather than competitive forces are permitted to set the wholesale price of electricity, anywhere or for any time, it compromises the fundamental objective of restructuring for competition.[6]

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[4] *See Entergy Services, Inc.*, 58 FERC ¶61,234 at 61,753 (approving market-based rates for large wholesale power sales because rates set through competitive forces will result in cost savings to ratepayers); *Public Service Company of Indiana, Inc., Opinion No. 349*, 51 FERC ¶61,367 at 61,224–25 (stating that competitive pricing improves efficiency by creating incentives for full utilization of existing capacity and innovation), cited by Joseph T. Kelliher, "Market Manipulation, Market Power, and the Authority of the Federal Energy Regulatory Commission, ENERGY L. J., Vol. 26, No. 1 at 9 n.40 (2005).

[5] *See* Kelliher, Market Manipulation at 11 (2005) ("It is important to note that the Commission's policy was never intended to deregulate wholesale power markets. Notwithstanding great debates that have taken place in the United States over deregulation, our economic markets are not truly unregulated in the sense that they are completely free from rules.").

[6] *Cf. Tejas Power Corp. v. FERC*, 908 F.2d 998, 1004 (D.C. Cir. 1990) ("In a competitive market, where neither buyer nor seller has significant market power, it is rational to assume that the terms of their

Few have stated this goal as powerfully as Chairman Kelliher:

> Our goal is perfect competition, textbook competition, competition that is so beautiful it would make an economist weep.
>
> I accept that we may not achieve that goal, and that perfect competition may not exist outside the textbook. In our pursuit of perfect competition we may fall short. But if so we will at least have achieved more perfect competition.
>
> …
>
> It is important to appreciate that U.S. wholesale competition policy was not inadvertent. It was a deliberate choice reflected in three major federal laws enacted over the past 30 years. The U.S. consciously embraced competition policy after the comprehensive failure of traditional regulation to assure security of supply at reasonable cost.[7]

The Commission is correct to rely upon the forces of competition to achieve its goals of lower wholesale electric power costs because competitive markets impose discipline upon suppliers.[8] To prosper in this environment, a supplier must eliminate inefficiency and strive for continual innovation and improvement.

The test of competition is not whether any particular resource is able to fully recover its costs. Competitive pricing does not guarantee that any or all suppliers will recover their costs for every investment and some suppliers may experience losses. Even cost of service

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voluntary exchange are reasonable, and specifically to infer that price is close to marginal cost, such that the seller makes only a normal return on its investment.").

7 Statement of Chairman Joseph T. Kelliher State of US Competitive Wholesale Power Markets CERAWEEK 2008—Quest for Security: Strategies for a New Energy Future (February 15, 2008).

8 *See* ALFRED E. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS at 326 (John Wiley & Sons, Inc. 1971) ("In a competitive industry, firms are motivated to produce efficiently—to find ways to cut production costs—by the hope of increased profits and by the fear that failure to keep costs low will cause more efficient firms to capture their customers by lowering price. In a regulated industry, the stick is usually unavailable.").

regulation, which is the model on which SPP still continues to rely for long term maintenance cost recovery and investment cost recovery, does not guarantee investors full recovery of costs. In a market, the only means to recover costs and earn profits is to become a more efficient supplier, to earn inframarginal rents, to participate in reserve markets, take advantage of the opportunity posed by scarcity when it occurs and to participate in capacity markets. To the extent that market power is tolerated, consumers are denied the promise of the lowest possible cost of electricity and the incentives for innovation and increased efficiency are muted. If, as in the case of SPP, PJM and the other organized wholesale electricity markets at issue here, the Commission intends to "rely on the interaction of supply and demand in all instances to ensure that prices are competitive and thus just and reasonable,"[9] then the preservation of competition and the attainment of just and reasonable prices are indistinguishable.

B. SPP's Current Rules Appropriately Include Only SRMC in Mitigated Offers.

It is well established that just and reasonable competitive locational marginal pricing requires participants to offer at marginal cost.[10]

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[9] *See Remedying Undue Discrimination through Open Access Transmission Service and Standard Electricity Design*, Notice of Proposed Rulemaking, 100 FERC ¶61,138 at P 390 (2002) ("Market Design Order").

[10] *See*, *e.g.*, *Houlian Chen, Powhatan Energy Fund, LLC*, 151 FERC ¶ 61,179 at P 23 (2015) ("In calculating the cost of line loss, as part of LMP, PJM sets the price at marginal cost, rather than average cost…"); *Midwest Indep. Transmission Sys. Operator, Inc.*, 134 FERC ¶ 61,141 at P 83 (2011) ("[s]ince any such negative offer prices would reflect the resources marginal cost for producing energy, settling excessive energy credits at $ 0 or at a non-negative market price instead of the resources negative offer prices would provide an incentive for Dispatchable Intermittent Resources to overproduce and gain revenues in excess of their marginal costs (e.g., via production tax credits)."); *Atlantic City Elec. Co., et al. v. PJM Interconnection, L.L.C.*, 115 FERC P 61,132 at P 22 (2006) ("Billing on the basis of marginal costs ensures that each customer pays the proper marginal cost price for the power it is purchasing."); *PJM Interconnection, L.L.C.*, 150 FERC ¶ 60,120 at P 35 (2015) ("this is consistent … with the construct of the PJM market, in which LMPs reflect the marginal cost of production"); *Midcontinent Indep. Sys. Operator*, 149 FERC ¶ 61,225 at P 53 (2014) ("Under locational marginal pricing, all parties at a location pay the same marginal cost of serving the next increment of load."); *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services, etc.*, 149 FERC

In discussing the nature of SRMC, the Commission recognizes that SRMC are short run marginal costs. SRMC is not defined as "variable costs" because the terms are not equivalent.[11] The July 24th Filing, which proposes to the replace SRMC with "variable costs" contradicts this precedent.

The July 24th Filing not only contradicts precedent applied to others, it contradicts Commission directives on the costs that SPP may include in mitigated offers. The July 24th Filing is a collateral attack on the orders requiring SPP to use SRMC as the definition of offer caps.

Just two years ago, the Commission rejected arguments that mitigation should include costs that are not SRMC, succinctly explained the objectives of mitigation, and found that SPP's current tariff language clearly defines the costs that may be included in mitigated offers. [12]

The Commission explicitly excludes from SRMC fixed costs and "variable costs, exactly the category of costs that the July 24th Filing seeks to include in mitigated offers.

The decisions on SRMC are correct, should be affirmed and collateral attacks on them should be rejected. It is unjust and unreasonable to determine competitive offers and the inputs used to mitigate market power on any other basis than SRMC.

C. The July 24th Filing Would Degrade SPP Mitigation Rules By Replacing SRMC with Variable Costs.

The July 24th Filing argues (at 6–7) that the problem with the current rules is the lack of certainty about what SRMC includes and/or the complexity of determining SRMC. The

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¶ 61,116 at P 7 (2014) ("To mitigate these transactions, the Commission used the Mitigated Market Clearing Price (MMCP). The MMCP serves as a proxy price based on the marginal cost of the most expensive unit dispatched to serve load in CAISO's real-time imbalance energy market.").

[11] The Commission has made clear the difference between SRMC and variable costs. 142 FERC ¶ 16,205 at P 92 & n.137.

[12] *Id*. at PP 98–99.

context makes plain that for participants acting through SPP the problem is exactly the opposite. The SPP market monitor came to firm and accurate conclusions on what SRMC includes and participants did not like it.

The July 24th Filing proposes (at 7) to "replace[] 'short-run marginal costs' with language that describe[s] these costs in terms of 'variable costs' vs. 'fixed costs.'" The SPP market monitor would be limited to determining what is and is not a variable cost. The difference between SMRC and variable costs is significant. If approved, the new rules would allow all variable costs in mitigated offers regardless of whether they are short run marginal costs.

The July 24th Filing is meant to overrule the SPP market monitor's "interpretations" of SRMC while evading Commission review of what those "interpretations" were and whether they were consistent with fundamental economics, justified to mitigate market power and consistent with the principles of regulation through competition.[13]

SPP's proposed rules would require that the SPP market monitor include all variable costs as SRMC even if the costs are not SRMC. To the extent that a rule requires the SPP market monitor to allow a participant to include a cost that is not SRMC in its mitigated cost-based offer, the rule would interfere with the ability of the market monitor to prevent the potential exercise of market power.

SPP has not shown it is just and reasonable to exclude "short run" from the definition of SRMC. SPP participants should not be allowed to define SRMC in whatever manner suits their interests.

The problem that the July 24th Filing confronts is that the SPP market monitor had a clear and theoretically sound interpretation of what SRMC means and some SPP participants did not like it.

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[13] *See* July 24th Filing at 4–5.

The July 24th Filing explains (at 5) that some participants objected that the rules "result[] in the submission of bids at or near their mitigated offer." Another way to put this is that the rule encouraged competitive behavior. The July 24th Filing confuses achievement of a fundamental regulatory objective with a problem.

The July 24th Filing also relates that the current mitigated offer design meant that certain resources "were not recovering their actual costs." It is correct and irrelevant that SRMC does not include all a unit's costs. It is correct and irrelevant that the energy market does not guarantee the recovery of all actual costs. The SRMC does not include long term maintenance costs, like the costs of turbine overhauls, and it does not include fixed or investment costs. In a competitive wholesale market design, costs that are not SRMC are recoverable through a combination of inframarginal rents, frequently mitigated unit adders, reserve markets, scarcity pricing, capacity markets, regulated bilateral contracts and cost of service regulation. Although market power is an alternative mechanism to achieve cost recovery it is not appropriate to permit market power in the design of competitive wholesale power markets for any reason. The SPP market design relies on cost of service regulation for recovery of all costs not recovered through the energy market.

In the PJM markets, prices are generally set by units offering at their actual SRMC even when not subject to any mitigation rules.[14] Offers at SRMC define actual competitive behavior and such behavior is a key metric for defining competitive outcomes in a market. The documented results in PJM show that competitive offers equal SRMC in actual competitive wholesale power markets.

The definition of SRMC is not complicated and is quite straightforward, contrary to the representations in the July 24th Filing. In fact, the issues only become more complicated when there is an effort to define non-SRMC costs as SRMC. That is what happened in the

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14 *See* Monitoring Analytics, LLC, 2015 Q2 State of the Market Report for PJM: January through June (August 13, 2015) at 15.

SPP stakeholder process. Notwithstanding claims that the meaning of SRMC is unclear and too complex to implement, the SPP market monitor was able to apply the rule even when under pressure to apply it badly. The reality is exactly the opposite of the stakeholder claims. In addition to all the fundamental reasons to reject the July 24th Filing, the inclusion of non-SRMC costs in the definition of SRMC would make it difficult and complex to define which costs were acceptable.

It is of concern that when the SPP market monitor made interpretations that participants did not like related to an input to market power mitigation, the response described in the July 24th Filing was the initiation of a stakeholder process to apply pressure on the SPP market monitor to compromise or change those interpretations.[15] The July 24th Filing does not explain how the merit of the SPP market monitor's initial position was evaluated as it relates to the effective mitigation of market power. The filing describes only non-legitimate objectives, in particular the recovery of non-SRMC costs through offers inflated above competitive levels. It is not clear from the July 24th filing what recourse was available to the SPP market monitor if it determined that no stakeholder proposal was acceptable.

The Commission has recognized that the independence of the market monitor is essential to the market monitoring function and the detection and deterrence of the exercise of market power in Commission regulated markets.[16] The description in the July 24th Filing raises questions worthy of investigation, and the Market Monitor recommends examination of whether SPP could do more to protect and promote the independence of its market monitoring function, including the adoption of structural safeguards.

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15 *See id*. at 4–7.

16 *See*, *e.g.*, *Organization of PJM States, Inc. v. PJM*, 122 FERc ¶ 61,257 (2008).

D. The Reformed PJM Rules Do Not Support the SPP Proposed Approach for Calculating SRMC.

The reference to PJM rules in the July 24th Filing (at 11) in support of the proposed approach to mitigation is out of date and inaccurate, and reliance on the PJM rules to justify the proposed approach is generally misplaced. The Market Monitor supports the prior determinations of the Commission related to the definition of SRMC in the SPP orders.

The PJM Cost Development Guidelines have improperly allowed the inclusion of some costs in SRMC that are not short run marginal costs, including a category referred to as "Long Term Maintenance Expenses." PJM participants have recognized that the inclusion of these costs is not appropriate. Participants effectively recognized the error by routinely submitting price-based offers lower than their cost-based offers when they experience competitive market conditions.[17] More recently, PJM participants explicitly agreed to remove long term maintenance expenses from the Cost Development Guidelines, effective June 1, 2015.[18]

The pace of reform of the cost development rules in PJM has been too slow, but has been in the right direction. The July 24th Filing proposes to degrade the protection from market power that SPP's current rules afford. The proposed changes are not just and reasonable and should not be approved.

E. Stakeholders Who Sell Into Markets Should Not Design the Market Mitigation Rules.

Although SPP concedes (at 3–4) that "stakeholder approval does not by itself cause a filing to be just and reasonable," SPP nevertheless "requests that the Commission extend appropriate deference to the wishes of SPP's stakeholders, consistent with Commission

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[17] *See* Protest of the Independent Market Monitor for PJM, Docket No. EL14-36 (April 18, 2014) at 10 & n.13; Monitoring Analytics, 2013 State of the Market Report for PJM (March 13, 2014) at 95.

[18] *See* PJM Manual 15 (Cost Development Guidelines) at 41 & 47.

precedent." According deference to SPP stakeholders on the regulation of electric market pricing would be contrary to the Federal Power Act because the determination of what is just and reasonable cannot be properly delegated to the electric utilities regulated under that act.

It appears that SPP stakeholders were afforded too much deference in preparation of the July 24th Filing. Order No. 2000 provides that a Regional Transmission Organization "must have a decision-making process that is independent of control by any market participant or class of participants."[19] When the matter concerns, as it does here, the establishment of rules intended to the prevent the exercise of market power, deference to stakeholder views is not appropriate particularly when those stakeholders are directly affected by the proposed rule change, as is the case here. The public interest goals of the Federal Power Act exclude such deference.

SPP cites a number of cases (at 4 n. 16) where it argues that the Commission has "previously recognized that provisions approved through RTO stakeholder processes are due deference." Reliance on this precedent is misplaced. The decision in *Public Service Commission of Wisconsin v. FERC* was based on a finding that the Commission independently determined that the proposal was just and reasonable.[20] In other words, the Court found that the Commission's decision was not the based on deference to stakeholders. Moreover, the Court also noted the absence of "any evidence of majority overreaching" or any assertion that the process "'was not 'open" or did not 'allow[] for extensive participation."[21] Representations in the July 24th Filing (at 4–7) constitute sufficient

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[19] *Regional Transmission Organizations*, Order No. 2000, FERC Stats. & Regs.¶ 31,089, *mimeo* at 152 (1999), *order on reh'g*, Order No. 2000-A, FERC Stats. & Regs. ¶ 31,092 (2000), *aff'd sub nom. Pub. Util. Dist. No. 1 of Snohomish County, Washington v. FERC*, 272 F.3d 607 (D.C. Cir. 2001).

[20] 545 F.3d 1058 at 1062–63 (D.C. Cir. 2008).

[21] *Id*.

evidence for investigating whether there was majority overreaching, a sufficiently open process and sufficiently extensive participation from affected interests.

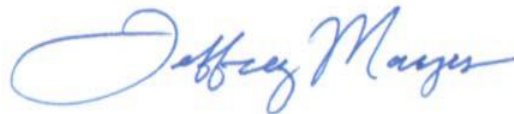
In the cited Commission cases, the Commission approved the proposal on the record evidence.[22] The Commission also mentions "appropriate" deference to the stakeholder process and the lack of anything in the record "to indicate that the stakeholder process did not work in the way it is intended."[23] For the issues identified in the July 24th Filing, no deference is appropriate and there is reason to question how the stakeholder process worked.

The Federal Power Act provides the tools and discretion needed to ensure just and reasonable rates.[24] It can never be appropriate to accord deference to proposals from sellers concerning the rules for mitigating their own market power. On the contrary, the description in the July 24th Filing of how and why the filing was prepared is a reason to afford it careful scrutiny. Indeed, there is good cause to examine that process.

II. CONCLUSION

The Market Monitor respectfully requests that the Commission afford due consideration to this protest as the Commission resolves the issues raised in this proceeding.

Respectfully submitted,



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22 *See Southwest Power Pool, Inc.*, 127 FERC ¶ 61,283, at P 33 (2009); *New England Power Pool*, 105 FERC ¶ 61,300 at P 34 (2003).

23 127 FERC ¶ 61,283 at P 33; 105 FERC ¶ 61,300 at P 34.

24 *See*, *e.g.*, 16 USC § 824e.

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Dated: August 14, 2015

CERTIFICATE OF SERVICE

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

Dated at Eagleville, Pennsylvania,
this 14th day of August, 2015.

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