

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

PJM Interconnection, L.L.C.

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Docket No. ER19-210-000

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 (“Market Monitor”) for PJM Interconnection, L.L.C. (“PJM”),² submits this protest to the filing submitted by PJM on October 29, 2018 (“October 205 Filing”). PJM seeks to give Market Sellers discretion whether to include avoidable costs, particularly maintenance costs, in cost-based offers in the energy market or in cost-based offers in the capacity market, known as the Avoidable Cost Rate (“ACR”). Such discretion is not consistent with competitive markets, would create inconsistent rules in the energy and capacity market, would create an inconsistency between the calculation of offers in the capacity market and actual behavior, would be inconsistent with PJM’s proposed approach to the redesign of capacity markets in Docket No. EL18-178 and would allow Market Sellers to benefit from market power. The purpose of energy market cost-based offers is market power mitigation, not avoidable cost recovery. PJM’s approach explicitly and consciously introduces lack of clarity into the definitions of short run marginal cost and avoidable cost. The Commission

¹ 18 CFR § 385.211 (2017).

² Capitalized terms used herein and not otherwise defined have the meaning used in the PJM Open Access Transmission Tariff (“OATT”), the PJM Operating Agreement (“OA”) or the PJM Reliability Assurance Agreement (“RAA”).

should reject PJM's filing, which undermines the Commission's goal of competitive markets.

The October 205 Filing is inextricably linked to the October 206 Filing. These two filings should be considered jointly, and, if these matters are set for hearing, be formally consolidated.³ PJM submits this filing pursuant to Section 205 because it does not require stakeholder support for changes to the capacity market rules in Attachment DD to the OATT. Stakeholder approval is required for changes to the energy market rules in Schedule 1 to the OA. The changes proposed in the October 205 Filing are predicated on the acceptance of changes to energy market rules propose in Docket No. EL19-8. The associated changes to the energy market rules did require stakeholder approval,⁴ and stakeholders explicitly and repeatedly rejected them. Such rejection included an explicit stakeholder rejection of the rules proposed in this proceeding. The October 205 Filing should be evaluated as a PJM proposal only, and as contrary to the approach favored by a majority of stakeholders.

The Commission should reject the October 205 Filing and the October 206 Filing. In addition, accepting PJM's proposals in the October 206 Filing and the October 205 Filing would create an inconsistency between the energy market and the capacity market. PJM's filings would only result in symmetry between energy and capacity offers after three delivery years. That would mean that the first BRA to which the rules would apply is for the 2022/2023 delivery year. If costs were included in the clearing of the intervening BRAs (2019/2020; 2020/2021; 2021/2022) that can now be shifted to the energy market, this would create the option to double recover such costs beginning with the adoption of PJM's

³ Accordingly, if the Commission sets the issues raised in the October 205 Filing and the October 206 Filing for hearing, the Market Monitor moves for consolidation of these proceedings.

⁴ OA §§ 8.4, 10.4.

proposal. That is unsupportable and inconsistent with competitive outcomes, even under the badly flawed PJM approach.

I. BACKGROUND

A. Competitive Markets Require Competitive Offers.

Competitive markets were introduced as an alternative form of regulation to ensure that wholesale power is provided at the lowest possible price. The PJM market design does not incorporate a laissez faire approach. The PJM market remains regulated. The PJM market design incorporates a variety of rules designed to help ensure competitive outcomes.

The application of market power mitigation rules helps ensure competitive market outcomes even in the presence of structural market power. But the efficacy of market power mitigation rules depends on the definition of a competitive offer. A competitive energy market offer is equal to short run marginal costs. The enforcement of market power mitigation rules is undermined if the definition of a competitive offer is not correct. The objective of efficient short run price signals is to minimize system production costs, not cost recovery.

It is essential that the approach to the PJM markets incorporate a consistent view of how the preferred market design is expected to provide competitive results in a sustainable market design over the long run. A sustainable market design means a market design that results in appropriate incentives to retire units and to invest in new units over time such that reliability is ensured as a result of the functioning of the market. Accurate signals for entry and exit are necessary for well functioning and competitive markets. Competitive investors rely on accurate signals to make decisions.

1. Avoidable Costs and Short Run Marginal Costs

There are three types of costs identified under PJM rules: short run marginal costs, avoidable costs, and fixed costs. Avoidable costs are annual costs that would be avoided if energy were not produced over an annual period. Fixed costs are associated with an

investment in a facility including the return on and of capital. From the perspective of the time of power production, avoidable costs and fixed costs are both fixed. Short run marginal costs are the only costs relevant to the energy market. Specifically, the competitive energy offer level is the short run marginal cost of production.

Short run marginal cost is the cost of inputs consumed and the net cost of byproducts created at the time of power production. A generator requires a specific quantity of short run inputs to start and achieve a specific output level. The primary input is fuel. A generator creates a specific quantity of byproducts, such as emissions and ash, for which the generator incurs a cost and may earn offsetting revenues. Market revenues fully provide for short run marginal costs as long as the market price equals or exceeds the level of short run marginal costs at the time of production, and uplift payments make up any shortfall. Emissions allowance costs and opportunity costs are short run marginal costs.

An avoidable cost divided by output is a measure of average cost. Dividing an avoidable cost or a fixed cost by output does not make such costs marginal costs. Unlike marginal costs, avoidable costs are not automatically recovered when the energy price equals or exceeds average cost at the time of production. Since avoidable costs are not actually incurred at the time of power production, only part of avoidable costs are generally recovered when the energy price equals or exceeds average cost at the time of production and there is no guarantee of covering avoidable costs by including them in the energy offer as there is for short run marginal costs. Avoidable costs are covered by cleared capacity market offers.

2. Shifting Costs Between Energy and Capacity Market Cost-based Offers Creates Inefficient Market Outcomes.

Any market outcome that results from a noncompetitive offer is a noncompetitive and inefficient market outcome. If some short run marginal costs are removed from the energy market offer and included in the capacity market offer, the energy market offer is below the competitive level and the capacity market offer is greater than the competitive level. As a result, the resource would generate energy when prices are less than short run

marginal costs, suppressing the energy market price. The resource would noncompetitively increase the capacity market price when the capacity price is greater than its competitive offer, or the resource may set an inefficiently high capacity price due to market power. If avoidable costs are included in the energy market offer and removed from the capacity market offer, the energy market offer is above the competitive level and the capacity market offer is below the competitive level. As a result, the resource would not generate energy when prices are greater than short run marginal costs, noncompetitively increasing the energy market price and suppressing the capacity market price. Prices in both markets clear at inefficient levels in both scenarios, affecting all market participants.

If a generator has local market power in the energy market and would not clear in the capacity market because its competitive offer in the capacity market does not clear, a generator could shift avoidable costs to the energy market, allowing the generator to exercise market power in the energy market even when mitigated. The shift of avoidable costs would also allow the generator to lower its capacity offer below a competitive level in order to maintain capacity revenues. As a result, the energy market clears at prices above competitive levels, and the capacity market clears at prices below competitive levels. As a result, uneconomic capacity remains in the market as a result of market power. Consumers pay an energy price higher than the competitive market price. The outcome is inefficient.

The inefficient outcome is not coincidental to the proposal. PJM previously proposed to its stakeholders to add the following language to OA Schedule 2, 1.1(a):

For Energy Resources and generating units that did not clear or have a capacity commitment for the current Delivery Year, costs shall include those that are allowed under the following categories of the Avoidable Cost Rate in Tariff, Attachment DD, section 6.8.

- Avoidable Operations and Maintenance Labor
- Avoidable Administrative Expenses
- Avoidable Fuel Availability Expenses
- Avoidable Maintenance Expenses
- Avoidable Variable Expenses
- Avoidable Taxes, Fees and insurance
- Avoidable Carrying Charges

Avoidable Corporate Expenses⁵

PJM's May 2018 proposal explicitly allowed Market Sellers with uneconomic capacity resources to use market power in the energy market to impose inefficient avoidable costs on customers. PJM removed this aspect of its proposed OA Schedule 2 after stakeholders rejected it. However, the October 2015 Filing is effectively similar, because OA Schedule 2 already lists fuel costs, labor costs, maintenance costs, and operating expenses.

II. PROTEST

A. PJM's Proposal is Inconsistent with the Fundamental Logic of Capacity Market Design.

The capacity market was introduced in its current form in 2007, the Reliability Pricing Model (RPM), to address the fact that net revenues from a competitive energy only market are not expected to provide the opportunity for generators to cover all the costs of building and operating a unit. The basic logic is that a marginal CT will never have the opportunity to recover more than its short run marginal costs. The capacity market was designed to provide the opportunity to recover generators' ACR and fixed costs. A competitive offer, under RPM, was defined to be net ACR (gross ACR less net energy and ancillary revenues). A competitive offer in the energy market continues to be defined to be short run marginal costs. The energy market and the capacity market were designed to work together to achieve the intended result. The capacity market design assumed that energy offers would be competitive and that any net energy revenues would be an offset to gross ACR.

⁵ "Item 3A3 – VOM OA Schedule 2," PJM draft proposal for the Markets Implementation Committee (May 2, 2018), <<https://www.pjm.com/-/media/committees-groups/committees/mic/20180502/20180502-item-03a3-vom-oa-schedule-2.ashx>>, last accessed November 17, 2018. Also see <<https://www.pjm.com/committees-and-groups/issue-tracking/issue-tracking-details.aspx?Issue={49DFD7B6-1E99-488F-BC00-D6750114DF15}>>>.

PJM's proposal would break that logical connection in the market design of both markets and permit offers that are not competitive in both markets.

If ACR can be included in the energy offers, the competitive offer in the capacity market becomes zero. That will tend to suppress the capacity market price for those generators who continue to offer competitively in both the energy and capacity markets.

B. PJM Removes Language that Defines the Competitive Level of Avoidable Cost Rates.

Under the current rules, generators cannot include costs in their ACR that are includable in cost-based energy market offers.⁶ Under the current rules, ACR cannot include short run marginal costs. This is the competitive level for all ACR calculations. PJM is proposing to remove the current rule. Instead PJM would allow generators to define their own ACR method by choosing whether to include certain variable costs. The definition of the competitive level of a capacity offer should not be defined by the generator.

The October 205 Filing does not limit the shifting of costs from ACR to cost-based energy market offers to maintenance costs. The proposed change to Attachment DD would allow Market Sellers to shift any costs to cost-based energy market offers, such as fuel availability costs, labor costs, and administrative costs. PJM provides no criteria to limit the proposed cost shifting between the markets.

There is no valid reason to introduce this lack of clarity and lack of definition into the definition of a competitive offer. PJM's approach implicitly recognizes that generators may want to redefine competitive offers for some purpose other than achieving competitive market outcomes. In particular, PJM cites cost recovery concerns.⁷ Avoidable cost recovery

⁶ See OATT Attachment DD § 6.8(c). "For the purpose of determining an Avoidable Cost Rate, avoidable expenses shall exclude variable costs recoverable under cost-based offers to sell energy from operating capacity on the PJM Interchange Energy Market under the Operating Agreement."

⁷ See October 205 Filing at 21.

is not the purpose of cost-based energy market offers. PJM is operating a market and not acting as a cost of service regulator. Cost recovery is not a PJM objective.

C. PJM's Proposal Is Inconsistent with the Commission's Goals to Develop a Sustainable Capacity Market Design.

PJM's proposal is inconsistent with the goal of a competitive capacity market that harmonizes with state renewable policy initiatives.⁸ Part of PJM's proposal in that docket, and part of others' proposals, is to define the competitive offer level in the capacity market for subsidized resources in order to ensure that offers are not below the competitive level in the capacity market. Part of PJM's proposal is to require the use of net ACR offers to ensure competitive outcomes in the capacity market in the presence of subsidies. PJM's proposed approach here of confusing which costs are marginal costs in which market would permit subsidized resources to arbitrarily shift costs between capacity market offers and energy market offers. This would permit subsidized resources, under PJM's approach, to artificially reduce their competitive capacity market offer in order to avoid PJM's defined offer floor by arbitrarily redefining avoidable costs and therefore arbitrarily reducing the applicable offer floor. The result would undercut PJM's stated intent in that docket and would artificially suppress capacity market prices.

D. PJM's Proposal Is Not Enforceable.

Generators make offers in Base Residual Auctions (BRA) three years prior to the PJM Delivery Year in which they are effective. PJM's proposal states that a "Market Seller that intends to recover variable costs under cost-based offers" in the energy market will not be able to include such costs in their ACR. It is impossible to make this determination.

Accepting PJM's proposals in the October 206 Filing and the October 205 Filing would create an inconsistency between the energy market and the capacity market. PJM's

⁸ Brief of the Independent Market Monitor for PJM, Docket No. EL18-178, ER18-1314-000,-001 and EL16-49 (November 6).

filings would only result in symmetry between energy and capacity offers after three delivery years. That would mean that the first BRA to which the rules would apply is for the 2022/2023 delivery year. If costs were included in the clearing of the intervening BRAs (2019/2020; 2020/2021; 2021/2022) that can now be shifted to the energy market, this would create the option to double recover such costs beginning with the adoption of PJM's proposal. That is unsupportable and inconsistent with competitive outcomes, even under the badly flawed PJM approach.

This issue is not limited to the first three years. There is no way for PJM to determine in advance whether a generator "intends" to move avoidable costs to its energy market offers. As a result, the double recovery issue is an inextricable part of PJM's proposal and another reason to reject it.

III. CONCLUSION

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

Respectfully submitted,



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Dated: November 19, 2018

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 19 day of November, 2018.



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