UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

PJM Interconnection, L.L.C.	)	Docket No. ER14-1461-000

COMMENTS 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"),[2] submits these comments on the filing submitted in the above captioned proceeding by PJM Interconnection, L.L.C. ("PJM") on March 10, 2014 ("March 10th Filing").[3] PJM explains the need to "reform current Reliability Pricing Model ('RPM') market rules that do not explicitly bar, and even incent, sellers in RPM's three-year forward auction submitting speculative offers that can undermine the long-term reliability of the PJM Region." The Market Monitor agrees with this concern and the clear explanation of why speculative offers are incompatible with RPM market design provided in the March 10th Filing (at 3–22).

However, the rules proposed for correcting the identified problem require further refinement. The March 10th Filing should be approved subject to four conditions: (i) that the rules apply to all RPM Auctions going forward; (ii) that PJM develop rules that close two identified loopholes that would allow a seller to profit from a replacement transaction

---

1 18 CFR § 385.211 (2013).

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").

3 PJM filed an errata on March 14, 2014, correcting certain errors in its proposed tariff sheets at OATT Attachment DD § 5.14(g).

despite the proposed changes; (iii) that PJM appropriately modify the definition of the proposed Replacement Capacity Adjustment Charge to be based on the highest price applicable to the replaced MW rather than the weighted average Capacity Resource Clearing Price; and (iv) that PJM continue to apply the must offer rule to Existing Generation Capacity Resources which are not yet in service but have a capacity obligation for a prior Delivery Year and are developing on schedule.

The Market Monitor has concerns that the March 10th Filing is not the optimal approach to address speculative offers for Capacity Resources.[4] The Market Monitor does agree that the proposed rules, if revised to address the loopholes that would prevent them from performing as intended and to restore the full protection of the must offer rule, would be better than the current rules. Accordingly, the proposed approach, with its flaws corrected, should be implemented in time to be effective for the 2017/2018 Base Residual Auction ("BRA").

I. COMMENTS

A. The Proposed Rule Should Apply to All Future Incremental Auctions.

The proposed Replacement Capacity Adjustment Charge would apply only to resources clearing in the 2017/2018 Delivery Year or subsequent Delivery Years. Given that the proposal is designed to provide an incentive to comply with existing requirements of the tariff to provide physical resources, there is no reason not to make the rule applicable to all auctions going forward including all Incremental Auctions ("IAs") for all upcoming Delivery Years. The failure to apply the rule to all such auctions would retain the strong

---

[4] In stakeholder discussions leading to the March 10th Filing, the Market Monitor recommended an alternative proposal, which can be accessed at: <*http://www.pjm.com/~/media/committees-groups/task-forces/cstf/20140117/20140117-package-9-physical-offers-specific-performance-and-exceptions.ashx*>. That proposal focuses on clear, enforceable requirements to be physical resources without changing the price for all participants, including those bona fide physical sellers who must replace capacity commitments for legitimate reasons.

incentive to receive a payout based on speculative offers in prior BRAs. There is no reason to validate such speculative offers. There is no reason not to apply the rule immediately.

B. Participants Can Evade the Replacement Capacity Adjustment Charge, and PJM Should Be Directed to Close The Loopholes.

The approach taken in the March 10th Filing relies primarily on a Replacement Capacity Adjustment Charge to remove the incentive to engage in speculative behavior by attempting to ensure that participants cannot profit from replacement transactions. PJM explains (at 35) that "One critical reform in this filing ... proposes to deal directly with this pricing discrepancy by eliminating the opportunity to profit from that pricing discrepancy."

The March 10th Filing provides that a Replacement Capacity Adjustment Charge equal to the difference between the BRA and the Scheduled Incremental Auction clearing prices be levied on replacement capacity transactions for an obligation incurred from clearing an RPM Auction. Replacement transactions can be completed within the portfolio of a single seller or through bilateral transactions. PJM explains, "If [the Replacement Capacity Adjustment Charge] only applied in the IAs, it would be very simple to avoid it entirely by purchasing replacement capacity in the bilateral market."[5]

PJM's proposed rule for application of the Replacement Capacity Adjustment Charge provides:

> Each Capacity Market Seller that clears a Sell Offer based on a Capacity Resource in one or more RPM Auctions for the 2017-2018 Delivery Year or for any subsequent Delivery Year, and thereafter replaces (by any means) such resource, shall, when the Capacity Resource Clearing Price in the Scheduled Incremental Auction for such Delivery Year is less than the weighted average Capacity Resource Clearing Price in the RPM Auctions in which such resource cleared for such Delivery Year, pay a Replacement Capacity Adjustment Charge equal to [the weighted average

[5] PJM's initial filing did not include the correct tariff sheets addressing the bilateral issue, but PJM submitted the correct sheets in the filing in ER14-1461-001 dated March 14, 2014.

> Capacity Resource Clearing Price in the RPM Auctions in which such resource cleared minus the Capacity Resource Clearing Price in the Scheduled Incremental Auction] multiplied by the replaced Unforced Capacity megawatt quantity. Revenues from all Replacement Capacity Adjustment Charges for a Delivery Year shall be summed for the PJM Region and all LDAs and allocated to Zones based on the proportion of all Locational Reliability Charges assessed in each Zone to the total Locational Reliability Charges assessed in all Zones. Within Zones, such revenues shall be allocated among LSEs responsible for paying Locational Reliability Charges in such Zone pro-rata based on the Unforced Capacity Obligation of each LSE in the Zone.[6]

The Market Monitor agrees that the efficacy of the approach taken in the March 10th Filing depends upon eliminating the opportunity to profit from pricing discrepancies between the BRA and a later Incremental Auction or a bilateral purchase for the same Delivery Year. The Market Monitor also agrees that that the proposed rules cannot work as intended if bilateral transactions provide a loophole for participants to profit from pricing discrepancies between the auctions. The Market Monitor does not agree that the March 10th Filing effectively closes the identified loophole.

There are at least two loopholes in PJM's proposed rules addressing the incentive to purchase replacement capacity. Both of these loopholes should be closed consistent with PJM's stated intent to remove the current incentives to purchase replacement capacity rather than provide physical capacity. Both loopholes would permit circumvention of PJM's stated intent.

The first loophole is that by defining the Replacement Capacity Adjustment Charge as the difference between the BRA clearing price and IA clearing price times the MW of the replacement transaction, the rules ignore the possibility that the bilateral replacement transaction could be at a price lower than the Incremental Auction price.[7]

---

6 *See* proposed revised OATT Attachment DD § 5.14(g)(ii).

7 Revised OATT Attachment DD Section 5.14(g).

For example, if a participant sells one MW at $150 per MW-day in the BRA and buys bilateral replacement capacity at $25 per MW-day and the Incremental Auction clears at $100 per MW-day, the participant would receive a substantial profit as a result of the replacement transaction. The unadjusted profit on the replacement transaction would equal the difference between the BRA price received and the replacement price paid ($150 less $25 equals $125 per MW-day). The Replacement Capacity Adjustment Charge would equal the difference between the BRA price received and the IA price ($150 less $100 equals $50 per MW-day). Thus the profit received after adjustment would equal the unadjusted profit less the Replacement Capacity Adjustment Charge ($125 less $50 equals $75 per MW-day).

There is no reason not to modify the proposed rule to close this loophole. Calculation of the Replacement Capacity Adjustment Charge should be based on the actual replacement cost, whether determined in an Incremental Auction, in a bilateral replacement transaction or other replacement transaction. Participants should be required to provide all the information necessary to determine the profit on the replacement transaction(s) and the Market Monitoring Unit should be required to verify this information.

The second loophole is that the rule does not prevent the use of a second bilateral transaction to evade the rule. The Replacement Capacity Adjustment Charge only applies to Capacity Market Sellers who clear Sell Offers in RPM Auctions and who buy replacement capacity. It the seller of such replacement capacity, in turn, buys replacement capacity from a third party, no additional charge applies. A Capacity Market Seller could evade the Replacement Capacity Adjustment Charge by contracting first with another party, including its own affiliate, and then having that party or affiliate enter a bilateral transaction for replacement capacity with a third party.

For example, A sells capacity from resource 1 in a BRA and then buys replacement capacity from B based on resource 2 at exactly the same price so the Replacement Capacity Adjustment Charge is zero dollars (A and B could be affiliates). B then buys replacement capacity at a lower price from C based on resource 3. The effect is exactly the same as if A had purchased replacement capacity from C. Resource 3 will be the resource providing

capacity in PJM. The profits from the transactions will be exactly the same as if A had purchased replacement capacity directly from C for the lower price and no Replacement Capacity Adjustment Charge applied. The actual structure of the transactions could include an affiliate B, in which case the intent of the rule is evaded. The actual structure of the transaction could include an intermediary B who participates in return for a transaction fee, in which case the intent of the rule is also evaded. There are multiple ways to structure the transactions but all would result in evading PJM's intent.

There is no reason not to modify the proposed rule to close this loophole. Additional tariff provisions are needed to apply the Replacement Capacity Adjustment Charge to all replacement transactions for all capacity obligations and to define the required level of the charge appropriately. Accordingly, the March 10th Filing should not be approved without a condition that PJM develop and file a mechanism that extends the Replacement Capacity Adjustment Charge to cover all replacement transactions for all capacity obligations incurred, to calculate the Replacement Capacity Adjustment Charge based on the profit from all related or derivative transactions, and that requires disclosure of all related or derivative transactions.

There is an additional definitional issue in PJM's proposed rules. The March 10th Filing uses the weighted average Capacity Resource Clearing Price in the RPM Auctions in which such resources cleared for such Delivery Year as the measure of the revenues received for such Delivery Year. But this language needs refinement. If a 100 MW unit clears 60 MW in one auction at a price of $150 per MW-day and 40 MW in another auction at a price of $100 per MW-day, the weighted average price is $130 per MW-day. But if the participant replaces only 60 MW, then the appropriate price to use is $150 per MW-day and not $130 per MW-day. The same $150 per MW-day price would be appropriate if the participant replaces only 40 MW. The participant should not be permitted to use the lower price. The rule should require use of the highest price applicable to the replaced MW.

The March 10th Filing should not be approved without a condition that PJM appropriately modify the definition of weighted average Capacity Resource Clearing Price for purposes of applying this rule.

C. The Must Offer Rule Should Continue to Apply to Proposed Generation Capacity Resources That Have Cleared a Prior Auction and Remain on Schedule.

Planned Generation Capacity Resources account for a significant portion of the replacement activity in the PJM capacity market.[8] The March 10th Filing includes revisions to address that issue, including changes to the definition of a Planned Generation Capacity Resource. However, one consequence of the proposed definition changes is the weakening of the must offer rule as applied to Existing Generation Capacity Resources which are not yet in service but have capacity obligations based on clearing auctions for prior Delivery Years. The current must offer rule provides specific protection for the market against withholding.[9] The definition of a Planned Generation Capacity Resource can be changed, consistent with PJM's intent, without removing protection from the exercise of market power.

The current rules apply the must offer requirement to Existing Generation Capacity Resources, including resources not yet in service that have already cleared an RPM Auction and therefore have incurred a capacity obligation. By applying a must offer rule to resources that clear an auction before they are in service, the current must offer rule discourages speculative offers. The current must offer rule also prevents withholding capacity from Generation Capacity Resources, regardless of whether they are in service. This protection is needed, has been effective and should be preserved.

---

[8] *See*, *e.g.*, IMM, Analysis of Replacement Capacity for RPM Commitments: June 1, 2007 to June 1, 2013 (September 12, 2013), which can be accessed at: <*http://www.monitoringanalytics.com/reports/Reports/2013/IMM_Report_on_Capacity_Replacement_Activity_2_20130913.pdf*>.

[9] *See* OATT Attachment DD § 6.6.

Failure to apply an effective must offer rule will, by inadequately discouraging speculation, have negative consequences for capacity market prices and reliability. There is no reason for PJM's proposed exception. PJM's proposal weakens the current must offer rule which discourages speculation, in direct contradiction to PJM's stated overall intent for these tariff revisions.

PJM's proposed changes are intended to ensure that Generation Capacity Resources are physical and that PJM reject offers from such resources if it believes a proposed resource, even one that already has a commitment for a prior Delivery Year, may not meet its physical commitment. The concern is that a developer may offer a proposed resource year after year and never commence development. The developer would meet its obligation with replacement capacity and profit from the transaction, exactly the speculative behavior that PJM is seeking to eliminate. This behavior also suppresses capacity prices and negatively affects reliability.

Under the current rules, there are no provisions that explicitly address the case of a proposed Generation Capacity Resource with a capacity obligation, subject to the must offer rule, that is not developing the project on schedule.

PJM proposes changes to the definition of Planned Generation Capacity Resource that would resolve this problem by defining the difference between existing and planned resources based on whether the resource is in full commercial operation and interconnection service has ever commenced.[10]

PJM's proposed revised definitions create a loophole in the must offer rules that must be closed. If the proposed rule is approved, a proposed Generation Capacity Resource that has an obligation in a future Delivery Year and is developing on schedule would not have a must offer requirement. This unnecessarily provides an opportunity for

---

[10] PJM at 32–33, citing proposed revised RAA § 1.20B.

withholding. The rules should deter suppliers from withholding capacity that should be offered, and deter speculators from offering capacity that they intend to replace.

Accordingly, the March 10th Filing should not be approved without including a condition that PJM develop and file a provision that would continue to apply the must offer rule to proposed Generation Capacity Resources when they have cleared an auction for a prior Delivery Year and are on schedule to meet that obligation.

II. CONCLUSION

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

Respectfully submitted,

Joseph E. Bowring
Independent Market Monitor for PJM
President
Monitoring Analytics, LLC
2621 Van Buren Avenue, Suite 160
Valley Forge Corporate Center
Eagleville, Pennsylvania 19403
(610) 271-8051
joseph.bowring@monitoringanalytics.com

Jeffrey W. Mayes

General Counsel
Monitoring Analytics, LLC
2621 Van Buren Avenue, Suite 160
Valley Forge Corporate Center
Eagleville, Pennsylvania 19403
(610) 271-8053
jeffrey.mayes@monitoringanalytics.com

Dated: April 1, 2014

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 1st day of April, 2014.

Jeffrey W. Mayes
General Counsel
Monitoring Analytics, LLC
2621 Van Buren Avenue, Suite 160
Valley Forge Corporate Center
Eagleville, Pennsylvania 19403
(610) 271-8053
jeffrey.mayes@monitoringanalytics.com