UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

PJM Interconnection, L.L.C.	)	Docket No. ER14-1461-000, -001

ANSWER AND MOTION FOR LEAVE TO
OF THE INDEPENDENT MARKET MONITOR FOR PJM

Pursuant to Rules 212 and 213 of the Commission's Rules and Regulations,[1] Monitoring Analytics, LLC, acting in its capacity as the Independent Market Monitor for PJM[2] ("Market Monitor"), submits this answer and motion for leave to answer the answer filed by PJM Interconnection, L.L.C. ("PJM") on April 16, 2014. PJM raises new arguments in an attempted defense of flawed components of its proposal and delayed implementation of its proposal, filed March 10, 2014 ("March 10th Filing"), identified by the Market Monitor in its comments filed April 1, 2014 ("IMM Comments"), to which the Market Monitor should have an opportunity to respond.

I. ANSWER

A. PJM's Proposal Cannot Be Effective Unless PJM Closes Two Loopholes Related to Bilateral Transactions.

While PJM is to be commended for addressing the bilateral market loophole in its initial proposal, PJM's proposal does not go far enough to address the issue.[3] In addition to

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1 18 CFR § 385.212 & 385.213 (2012).

2 Capitalized terms used herein and not otherwise defined have the meaning used in the PJM Open Access Transmission Tariff ("OATT").

3 See March 10th Filing at 36 ("This [replacement capacity adjustment] charge necessarily applies to all replacement capacity transactions (including via bilateral trades), rather than only replacements

recognizing that bilateral transactions are a way to purchase replacement capacity, PJM should recognize the potential ways that the bilateral market can be used to defeat the intent of the rule changes. Unless corrected, market participants can still easily evade the intent of the PJM rule using bilateral markets, and PJM's proposed rule cannot be expected to deter or prevent speculative behavior that uses bilateral transactions.

If the Replacement Capacity Adjustment Charge ("RCAC")[4] is to be implemented, the identified loopholes must be closed if the RCAC approach is to work as intended.

1. PJM's Proposal Is Defective Because It Allows a Loophole That Retains the Incentives to Buy Replacement Capacity in the Bilateral Market.

The first loophole is that by defining the Replacement Capacity Adjustment Charge as the difference between the Base Residual Auction ("BRA") clearing price and IA clearing price times the MW of the replacement transaction,[5] the proposed rules ignore the possibility that the bilateral replacement transaction could be at a price lower than the Incremental Auction price.[6] Thus the first loophole could result in participants continuing

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in the IAs. If it only applied in the IAs, it would be very simple to avoid it entirely by purchasing replacement capacity in the bilateral market.").

4 The term "Replacement Capacity Adjustment Charge" is used in the language included in PJM's errata filing dated March 14, 2014, but another term, "Incremental Auction Settlement Adjustment Charge" was used in the initial March 10, 2014, filing and remains the defined term used in proposed Section 2.34A of Attachment DD to the OATT.

5 *See* revised OATT Attachment DD § 5.14(g).

6 *See* IMM Comments at 4–5 ("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).").

to have an incentive to engage in speculative transactions which are replaced at a profit after the Base Residual Auction.

PJM objects (at 50) to the Market Monitor's approach because it "would require PJM to inquire into the prices in a bilateral arrangement—a role that PJM has not previously had to undertake" and because "it is not clear how much incremental benefit the IMM's approach would bring to the deterrence of speculative offers." PJM explains (at 51), "bilateral sellers' capacity prices will likely be substantially influenced by the expected IA clearing price, and so it is not obvious how the expected bilateral market prices could become a major impetus for speculation above and beyond the expected IA price."

PJM does not deny the existence of the loophole, but points out the difficulty of enforcing the rule and suggests that there is nothing to worry about. PJM states that PJM has never before had to inquire into prices in a bilateral arrangement. PJM also states that incentives are such that the loophole will probably not be taken advantage of. In other words, PJM does not have any good reasons not to close the identified loophole which will permit market participants to evade the intended goal of PJM's filing.

PJM's overall approach in the March 10th Filing relies on removing existing incentives to make speculative offers in Base Residual Auctions. PJM reasons that if a participant cannot profit through a replacement transaction, then there is no reason to submit offers in the BRAs that are not physical.[7] This approach only works in practice if the incentive is actually removed. If a participant can obtain capacity through a bilateral transaction at a price lower than the Incremental Auction price and the RCAC does not account for the lower price, an incentive remains to submit speculative offers.

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[7] The RCAC approach is not the approach that the Market Monitor preferred. The Market Monitor proposed an approach that would establish criteria to ensure that that offers are physical and that there is an enforceable commitment to be physical in the Delivery Year. Under the Market Monitor's approach, there is no problem if a participant happens to profit from a replacement transaction if it submitted a bona fide physical offer in the first instance.

There is no reason not to modify the proposed rule to close this loophole and PJM does not provide any good reasons not to close the 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) to the Market Monitor and to PJM, and the Market Monitor should be required to verify this information and identify violations of the rule so that PJM can appropriately bill participants.

2. PJM's Proposal Is Defective Because It Allows a Second Loophole for Speculative Offers in Base Residual Auctions Through the Use of Bilateral Transactions.

The second loophole is that the rule does not prevent the use of a second bilateral transaction to evade the proposed rules. The second loophole could result in participants continuing to have an incentive to engage in speculative transactions which are replaced at a profit after the Base Residual Auction. The Replacement Capacity Adjustment Charge only applies to Capacity Market Sellers who clear Sell Offers in RPM Auctions and who buy replacement capacity. If 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 some or all of 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.[8]

PJM's response (at 51) to the second bilateral market loophole identified by the Market Monitor is that such market behavior is "simply not a concern of the March 10 filing."

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[8] *See* IMM Comments at 5–6.

PJM objects (at 51) to the Market Monitor's approach because "it is not clear how a bilateral transaction between two parties that *did not commit capacity in the BRA* can affect the incentives of a party contemplating an RPM offer in the BRA." PJM provides an example (*Id.*):

> [C]onsider Seller A that commits capacity to PJM by clearing in a BRA. Now assume Seller A and Seller B enter a bilateral transaction by which Seller A's resource is relieved of the capacity obligation it incurred in the BRA, and Seller B now has that obligation. Finally, assume Seller C enters a bilateral with Seller B that relieves Seller B's resource of the capacity obligations and results in Seller C's resource holding that capacity obligation.
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> Under the March 10 Filing, Seller A will bear an RCAC, based on the difference between the BRA price and the IA price. That application of the RCAC (or more precisely the threat of that application) should be sufficient to discourage Seller A from submitting a speculative offer in the BRA. Applying the RCAC to Seller B for its replacement by bilateral purchase from Seller C adds little if anything to the deterrent effects of the RCAC.

PJM concludes (at 51–52):

> Speculation between one bilateral price and another bilateral price is simply not a concern of the March 10 Filing. The RCAC seeks to deter speculative offers *in the BRA* – where speculation's price suppressing effects are negatively impacting reliability. No speculation or price suppression concerns arise in the transactions the IMM seeks to regulate.

PJM's reply makes clear that even if Seller A replaces capacity at 100 percent of the BRA price in a bilateral transaction, Seller A will still have to pay the RCAC. This result is not consistent with the intent of the rules and does not provide the right incentives.

The Market Monitor's example of the second loophole in its comments (at 5–6) mistakenly assumed that if Seller A purchased replacement capacity at the full BRA price in a bilateral transaction from its affiliate B, Seller A would not pay the RCAC. But even given that RCAC payment, the second bilateral transaction still constitutes a loophole that must be closed in order to ensure that the intent of PJM's RCAC mechanism is actually fulfilled.

If A and B are affiliates, then the owner of A and B will benefit from the second bilateral transaction between B and Seller C if B obtains replacement capacity from Seller C at a price low enough that the gain on the transaction (the difference between the BRA price and the replacement price) exceeds the RCAC payment on the first bilateral between A and B. PJM is uninterested in detecting this behavior, as it makes clear.

There is no reason not to modify the proposed rule to close this loophole and PJM does not provide any good reasons not to close the loophole.

3. Conclusions on Loopholes.

If PJM is going to use the RCAC approach, the ability and requirement to evaluate all replacement transactions including bilateral transactions is essential to the effective performance of the capacity market. Additional tariff provisions are needed to apply the RCAC to all replacement transactions for all capacity obligations and to define the required level of the RCAC appropriately. Accordingly, the March 10th Filing should not be approved without a condition that PJM develop and file tariff language: that extends the Replacement Capacity Adjustment Charge to cover all replacement transactions for all capacity obligations incurred; that requires calculation of the Replacement Capacity Adjustment Charge based on the profit from all related or derivative transactions; that requires disclosure of the details of all related bilateral or derivative transactions to the Market Monitor and PJM; and that requires the Market Monitor to verify this information and identify violations of the rule so that PJM can appropriately bill participants.

B. PJM Should Preserve the Scope of Its Existing Must Offer Rule and Ensure Its Continued Effectiveness.

PJM's responds (at 75) to the Market Monitor's point that proposed Generation Capacity Resources that have cleared a prior auction should continue to be held to the existing must offer standard is for "the simple reason that generating resources that have yet to reach commercial operation cannot withhold any capacity from the market." PJM states (*Id.*), "New resources inherently cannot exercise market power, as they only add to competition among suppliers." PJM claims (at 75–76), [T]he must-offer requirement may act

as a barrier to entry for new resources reach [sic] commercial operation, because a resource not yet built faces significant uncertainty in completing the project on-time (e.g., delays in materials and equipment supply, permitting, etc.) and a must-offer requirement increases the risk that a resource will clear for a Delivery Year for which its *knows* it cannot deliver and will need to buy replacement capacity (perhaps at above the BRA clearing price)" [emphasis in the original].

None of PJM's arguments have merit. Under the existing tariff, once a new generating unit has offered into and cleared in an RPM Auction, it becomes subject to the must offer rule for RPM Auctions for subsequent Delivery Years. Once a new generating unit, or an increase in capacity at an existing generating unit, has cleared in an RPM market it has had an impact on the market outcomes. The new generating unit has displaced other resources and it has affected the market clearing price. Such a generating unit can withhold capacity from the market (the following auctions) and the impact of such withholding is indistinguishable from withholding by a unit that is in commercial operation. New generating units that have cleared in an auction clearly can exercise market power in exactly the same ways that a commercial resource can exercise market power. By failing to offer, the resource owner can increase prices above the competitive level, making its own portfolio more valuable and providing the option of a higher price bilateral contract for the resource. By removing the must offer requirement for new generating units that have cleared in an RPM Auction the PJM proposal would weaken the market power mitigation provisions of the RPM market and eliminate a protection from the exercise of market power by new units.

The fact that the definition of Planned Generation Capacity Resource includes all additions to existing units makes the frailties of PJM's proposal more evident. An existing unit that adds 50 MW of capacity through additional investment would not be required to offer that 50 MW in subsequent auctions until it becomes commercial.

The intent of the three year forward auctions in the RPM design is to encourage competition from new entry, but there is nothing about this or any other aspect of the

design that supports a special exemption for units that successfully clear in an auction. PJM fails to explain why such a resource is in a different position from a commercial resource that must invest substantial funds in an upgrade or environmental retrofits to maintain existing capacity. Both face risks. Both have a commitment to be physical in the Delivery Year. It is precisely that commitment to be physical that makes the three year forward auctions significant. If there is no commitment to be physical in the actual Delivery Year, then there is little purpose to requiring customers to buy new capacity three years forward. It is appropriate that both existing generating units and new generating units that have cleared an auction face such risks because they are being compensated for such risks by the clearing price in the RPM Auction that they entered voluntarily. PJM's proposal would not eliminate the risks but would simply shift the risks to customers.

PJM fails to appreciate the intent of PJM's own proposals in this matter, which is to enforce the fundamental principle that all capacity must be physical at the time of the auction and that all capacity must make a commitment to being physical in the relevant Delivery Year. PJM's unsupported proposal to reduce the requirement that new units that clear in an auction must be physical in the Delivery Year and thus attenuate the definition of capacity should be rejected. The point of the must offer rule for all cleared capacity is to enforce the requirement to be physical in the Delivery Year. PJM's proposed change to the rules would encourage the speculation that the March 10th Filing is meant to eliminate.

C. The Rules Should Require Use of the Highest Price Applicable to Replaced Capacity MW.

PJM did not respond to the Market Monitor's comments about the need to modify the proposed approach to calculating the capacity purchase price when defining the RCAC payment.[9] Failure to address this issue will result in another unintended weakening of the

[9] IMM Comments at 6–7.

proposed rule. The March 10th Filing should not be approved without a condition that PJM appropriately modify the definition of the RCAC for purposes of applying this rule.

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 calculation will not be correct in some cases. 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 or any MW level less than or equal to 60 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. For example, if the participant replaces 80 MW, it would be appropriate to use the weighted average price associated with the 80 MW, or $137.50 per MW-day.

D. The Proposed Changes, Revised to Correct the Identified Flaws, Should Be Implemented Immediately.

The proposed changes, revised to correct the flaws identified by the Market Monitor, should be implemented immediately. The proposed changes address identified flaws in the market rules which will result in inefficient and non-competitive outcomes.[10] In this case, as PJM points out (at 24), the proposed rules clarify obligations that were always implicit in the market design. The fact that some market participants may have anticipated the continuation of bad rules and bad outcomes is irrelevant. No party will be hurt by a rule

[10] PJM and the Commission have addressed faulty design issues without delay. *See*, *e.g.*, *PJM Interconnection, L.L.C.*, 143 FERC ¶ 61,090 (May 2, 2013) (Made revisions to the Minimum Offer Price Rule (MOPR) effective February 5, 2013, in order to have them in place prior to the May 2013 Based Residual Auction.); *PJM Interconnection, L.L.C.*, 132 FERC ¶ 61,244 (September 17, 2010) (Revisions to marginal loss revenues allocation made effective September 17, 2010.).

that prevents profiting on positions taken in BRAs through replacement capacity transactions. No party engaging in speculative transactions had a reasonable expectation that such behavior would be rewarded, particularly since the issue was identified as a priority concern in late 2012.[11]

II. MOTION FOR LEAVE TO ANSWER

The Commission's Rule 213 does not permit answers to answers or protests unless otherwise ordered by the decisional authority.[12] The Commission has made exceptions, however, where an answer clarifies the issues or assists in creating a complete record.[13] In this answer, the Market Monitor provides the Commission with information useful to the Commission's decision-making process and which provides a more complete record. Accordingly, the Market Monitor respectfully requests that this answer be permitted.

III. CONCLUSION

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

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[11] *See* "Analysis of Replacement Capacity for RPM Commitments: June 1, 2007 to June 1, 2012," <*http://www.monitoringanalytics.com/reports/Reports/2012/IMM_Report_Replacement_Capacity_Activity_20121211.pdf*> (December 11, 2012).

[12] 18 CFR § 385.213(a)(2).

[13] *See, e.g., N.Y. Indep. Sys. Operator, Inc.*, 121 FERC ¶61,112 at P 4 (2007) (answer to protest accepted because it provided information that assisted the Commission in its decision-making process); *PJM Interconnection, L.L.C.*, 119 FERC ¶61,318 at P 36 (2007) (accepted answer to answer that "provided information that assisted … decision-making process"); *California Independent System Operator Corporation*, 110 FERC ¶ 61,007 (2005) (answer to answer permitted to assist Commission in decision-making process); *New Power Company v. PJM Interconnection, L.L.C.*, 98 FERC ¶ 61,208 (2002) (answer accepted to provide new factual and legal material to assist the Commission in decision-making process).

Respectfully submitted,

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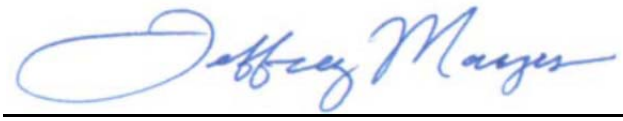
Dated: April 30, 2014

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 30th day of April, 2014.



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