

should be allowed.² SPP's filing in this docket should be rejected as a collateral attack on prior orders, rejected as unsupported, or, if not rejected, should be found to be unjust and unreasonable. The existing SPP rules on SRMC set the standard for the definition of a competitive energy offer for the organized electricity markets and should be preserved.

I. ANSWER

A. Generation Owners Fail to Support Cost-Based Offers Greater Than SRMC as a Matter of Policy and Economics.

There is no disagreement about the fact that a competitive offer is equal to SRMC. This lack of disagreement is not surprising given the fact that it is an essential part of the economics of competitive markets.

There is no disagreement about the fact that the Generation Owners are not experiencing a shortfall in revenues. This lack of disagreement is not surprising given that all the Generation Owners' costs are covered by customers under cost of service regulation.

The Generation Owners' issue is rooted in the incomplete nature of SPP markets and the consequences of that SPP market design. The Generation Owners' solution is a regulatory solution rather than a market solution. Because the competitive market outcomes do not meet the regulatory objective of the Generation Owners, the July 24th Filing proposes to change the market outcomes by proposing to redefine a competitive offer and explicitly reject a market solution that would address the incomplete market design.

It is not consistent with competitive wholesale power market design to change the definition of a competitive offer in order to meet an unrelated regulatory objective that derives from broader market design issues. Those issues should be addressed directly. The

² *Southwest Power Pool, Inc.*, 141 FERC ¶ 61,048 at P 420 (October 18, 2012) ("SPP must be more specific and establish that offers are to be mitigated to their short run marginal costs of the generating unit. Further, SPP must define the costs to be measured in the short run marginal costs.") ("2012 Order"), *reh'g denied*, 142 FERC ¶ 61,205 (2013)..

July 24th Filing should be rejected as a matter of law and, if not rejected, the proposed changes should be found not just and reasonable.

There is a fundamental confusion at the core of the arguments of the Generation Owners and SPP in this matter. Generation Owners confuse competitive outcomes with regulatory revenue guarantees and regulatory cost allocation. Competitive markets do not guarantee participants that they will cover all of their costs. Competitive markets do not guarantee participants that they will cover all their variable costs. Offers in competitive markets are not the result of regulatory cost allocation and rate design. The goal of the Generation Owners is to attempt to redefine the meaning of a competitive offer in order to achieve a regulatory cost allocation objective.

The definition of a competitive offer and competitive prices in a competitive market does not depend on the regulatory framework. It is essential to the design of competitive wholesale power markets that locational marginal prices reflect the short run marginal costs of the marginal generators.

A good wholesale electricity market design provides the opportunity to recover all costs through competitive offers in a complete set of markets, including a combination of energy markets, scarcity pricing, ancillary services markets and capacity markets. But a good wholesale market design does not guarantee participants that all costs or all variable costs will be recovered in the competitive energy market offers of individual units.

Some wholesale power markets operate in an environment that includes revenue from cost of service regulation and mandated bilateral contracts. All the wholesale power markets in the U.S. include some utilities subject to cost of service ratemaking, although the share of regulated utilities varies across markets. In PJM, for example, the share is much smaller than it is in SPP.

The SPP market design relies on energy markets, scarcity pricing and ancillary services markets, does not include a capacity market and operates in an environment that includes cost of service regulation for most generation resources. All of the Generation Owners are assured revenue adequacy through traditional cost of service regulation.

The Generation Owners' real issue is with broader elements of the SPP market design and not with market power mitigation rules. The Generation Owners recognize that revenue sufficiency is provided by cost of service regulation, and explicitly reject a market based approach to revenue sufficiency, for example a capacity market and/or an effective scarcity pricing mechanism. A capacity market and/or effective scarcity pricing would resolve their issue using a market based approach and obviate the asserted need to attempt to redefine competitive offers in the energy market.

The Generation Owners state (at 6): "The SPP market provides only energy, ancillary, and financial market revenue streams from which to recover variable costs. The Joint Filing Group does not believe that it is appropriate to include recovery of these costs in a capacity market."

But the Generation Owners fail to recognize the implications of their opposition to a capacity market. Without a capacity market and/or effective scarcity pricing, there is a risk of revenue shortfalls from the energy market. That is the situation in every wholesale power market and is the reason that the design of wholesale power markets incorporates explicit solutions to the problem. Generation Owners prefer the regulatory solution of cost of service regulation to a market solution but they are unwilling to accept the consequences of the regulatory solution of cost of service regulation.

The Generation Owners fail to recognize that competitive markets are not just another stream of regulated revenues that can be redefined to meet their needs. Competitive markets have their own logic which is very different from the regulatory logic of cost of service regulation.

The Generation Owners are explicit that their fundamental concern is cost allocation and the relationship between markets and cost of service regulation. The Generation Owners state (at 12): "In a traditional cost of service regulatory environment the captive customers of the generation-owning utility are often left 'holding the bag' for the difference if variable costs are left uncollected and unaccounted for by a regional market design deficiency." The Generation Owners do not explicitly address the related fact that the

captive customers also pay all the fixed costs of the units under cost of service regulation to the extent they are not covered by net revenues from the energy and ancillary services markets. The Generation Owners do not suggest that energy offers should also include fixed costs, but that is the logical conclusion of their stated position.

Holding aside the fact that their theoretical arguments are unsupported, the Generation Owners have not established the basic factual support for their claims about cost recovery. Generation owners receive revenues from the energy market which can exceed the offers of individual units and provide net revenues or inframarginal rents. The Generation Owners allege that when offers in the energy market reflect SRMC, local ratepayers have to pay for other costs, including variable costs. But the Generation Owners have not actually supported their claims about inadequate net revenue with any data. To support the July 24th Filing, the Generation Owners would have to show that net revenues from the energy and ancillary services markets have not covered the variable costs they identify. That showing has not been made. There has been no showing of a systematic underrecovery by mitigated units or a comparison to unmitigated units. Even if there were any evidence, the appropriate solution for SPP is to improve the market design and not to degrade the market design by distorting the definition of SRMC to increase market prices and revenues above competitive levels.

While well designed markets must provide the opportunity for revenue sufficiency, well designed markets do not rely on inflating competitive offers in order to provide revenue sufficiency. It is critical that market design reflect the correct definition of competitive offers and explicitly address revenue sufficiency without modifying that core definition.

Generation Owners and their witness Dr. Todd Schatzki argue that cost-based offers should include all variable costs regardless of whether they are short run marginal costs.³

³ Schatzki Affidavit at para. 9, 16.

They point out that generation assets, indeed all assets, are used up over time in order to provide goods and services.⁴ They argue that true cost of providing a good or service therefore must include costs incurred over the long run and the intermediate run, in addition to the short run.⁵ They assert that a rational seller would consider long run and intermediate run costs, in addition to short run costs.⁶

Although Dr. Schatzki concedes (at para. 6) that “competitive markets are desirable,” he misses some essential differences between rate making in a regulated framework and the definition of competitive outcomes in competitive markets. There is no debate among economists that competitive markets, particularly those with the characteristics of wholesale electricity markets, produce efficient and socially optimal prices because participants offer at their short run marginal costs and the markets clear based on such offers.

Despite all the assertions about what is included in PJM’s Cost Development Manual,⁷ the evidence in PJM electricity markets shows that sellers do, in fact, offer at their actual short run marginal costs.⁸ Coal units, combined cycle units and combustion turbine units offer at short run marginal cost in PJM, defined as the SPP MMU defines it and not as Generation Owners would define it. Although sellers in the PJM market do at times increase offers above short run marginal costs when sellers have market power, the same sellers offer at short run marginal cost when they do not have market power and face

⁴ *Id.* at para. 17.

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at para. 6.

⁸ See Monitoring Analytics, LLC, 2015 State of the Market Report for PJM: January through June (August 13, 2015) at 68.

competition. Allowing offers above short run marginal costs would explicitly permit the exercise of market power in wholesale electricity markets.

Cost-based (SRMC) offers are substituted by PJM and by SPP for price-based offers when a unit has local market power. The purpose of cost-based offers is to require offers that would be made by sellers facing competition. It is essential that cost-based offers be set at competitive levels in order to protect the markets from the exercise of market power.

Neither Generation Owners nor Dr. Schatzki provide any evidence that sellers in competitive markets behave as they assert. Generation Owners' arguments are unsupported and should be rejected.

Generation Owners' and Dr. Schatzki's approach to the definition of marginal cost is based in the cost of service regulation paradigm and not in the competitive wholesale power markets paradigm. Dr. Schatzki states that there is no difference between SRMC and variable costs: (at16) "that is relevant to regulation of energy and ancillary services prices in wholesale electricity markets;" or (at 17) when "used by regulators when setting mitigated rates." Dr. Schatzki asserts that (at 20) "Mitigated pricing in which resources fail to recover all of their variable costs may lead to a number of adverse outcomes ..." Dr. Schatzki states (at 23) that: "failing to include all variable costs in mitigated pricing could lead to inappropriate shifting of costs among customers to the extent that captive customers of certain suppliers have to make up for a utility's revenue shortfalls in the energy market."

Dr. Schatzki is making the same regulatory argument made in the Generation Owners' pleading. There clearly is a difference between SRMC and variable costs. There clearly is a difference between the behavior of competitors and regulated entities. Dr. Schatzki would ignore the fact that the SPP design relies on a competitive market and not regulatory guarantees about cost recovery. Prices in a market reflect competitive forces and not be designed for cost recovery objectives by regulators.

Dr. Schatzki cites Alfred Kahn's *The Economics of Regulation* while failing to note that the purpose of the cited section and the entire book is to help regulators think about how to set regulated prices in the fully regulated cost of service paradigm that are designed to

recover all costs including short run marginal costs, intermediate costs and fixed costs. Kahn's book recognizes the significance of the time period considered when defining marginal costs and the significance of the size of the incremental output when defining marginal costs. Kahn points out, consistent with standard economic theory, that "the longer the time perspective of the costing process, the greater the proportion of costs that become variable.⁹ As existing plant and equipment continue to be operated over time, they will ordinarily involve higher and higher variable costs—of shutdowns, repair and maintenance, and wastage of labor and materials." Kahn (at 71) also points out that if the time period is long enough, fixed capital costs are variable.

Dr. Schatzki ignores Kahn's point about the relevant time period and the associated definition of SRMC which Kahn clearly distinguishes from longer term costs like the repair and maintenance costs that Dr. Schatzki would include in SRMC.

Dr. Schatzki asserts that the SPP MMU is incorrect to focus on the timing of expenditures when defining SRMC. In fact, the SPP MMU is exactly right. Short run marginal cost is defined by the time period, short run. Fuel costs are short run marginal costs and repair and major maintenance costs like turbine overhauls are not short run marginal costs. Economic costs in a given time frame exclude sunk costs for that time frame, while such costs are included in accounting costs. The confusion introduced by Dr. Schatzki's concern about the price of fuel at the time of purchasing and the price of fuel at the time of burning the fuel is an example of confusing accounting and economic costs. The answer is clear. In the short term time frame of SRMC, the economic cost of fuel is incurred when it is burned and is not defined by an accounting entry at the time of purchase.

Bilateral contracts, including LTSAs, do not define short run marginal costs. The fact that two parties enter into a contract that includes payment of a profit to the supplier of

⁹ Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions* (MIT Press 1970) at 70–71.

services in the cost of every MWh does not make that profit a short run marginal cost. Short run marginal costs are defined by the underlying economics and not by contract. If contracts defined short run marginal costs, it would be straightforward to defeat market power mitigation rules by entering into bilateral contracts.

In markets there is a difference between SRMC and variable costs and in markets it is important that the two not be confused. The purpose of market power mitigation for local market power in SPP and in PJM is not to assure cost recovery or to address issues of cost allocation or to address the presence or absence of retail competition. The only purpose of market power mitigation in wholesale power markets is to ensure that energy offers are competitive and are not increased above competitive levels, and that market prices are consistent with a competitive outcome.

It is essential to the continued efficient operation of wholesale power markets that the definition and role of SRMC not be confused with other objectives and that other objectives be addressed explicitly through appropriate changes to the market design.

B. Generation Owners Fail to Support Mitigating Cost-Based Offers to a Level Other Than SRMC as a Matter of Law.

Generation Owners argue (at 3) that the “test for evaluating a proposed tariff change... is whether [it] is just and reasonable” and not that “the proposed change is superior to alternatives.” SPP argues (at 6) that it has not collaterally attacked “the order accepting the prior Tariff provision.”

The collateral attack targets the order directing SPP to including mitigation based on SRMC in its market design and the later order approving SPP’s compliance filing. A public utility is not entitled to propose a change that exactly contradicts a Commission directive to that utility, particularly when it identifies no material change in circumstances, offers no

new evidence and argues no new legal rationale.¹⁰ Neither Generation Owners nor SPP point to any material change to the facts and circumstances or any evidence as a reason for the proposed change, and they repeat arguments that the Commission considered and rejected.¹¹ SPP limits cost-based offers to SRMC because that is what the Commission required it to do as a condition for approving the SPP market design. SPP's filing establishing the current rule was not a voluntary filing; the filing was required for SPP to comply with the Commission order. No option to file a different approach was available in 2012 and there is no reason why that option should be available now.¹² The filing should be rejected as a collateral attack on the 2012 Order.

The July 24th Filing should be rejected on its merits even if it were not a collateral attack. Modifying rules to permit the exercise of market power is not just and reasonable. The proposed rules would result in discriminatory outcomes because only sellers with market power to which market power mitigation was applied would receive prices above competitive levels. Sellers facing competition would be forced by competitive pressures to offer competitively and would be limited to competitive offers, i.e. SRMC.

The Commission is not required to accept an inferior approach to calculating cost-based offers under Section 205 of the Federal Power Act, because no inferior approach meets the just and reasonable standard. The issue of what constitutes a competitive offer is

¹⁰ *Southwest Power Pool, Inc.*, 141 FERC ¶ 61,048 at P 420 (October 18, 2012) (“SPP must be more specific and establish that offers are to be mitigated to their short run marginal costs of the generating unit. Further, SPP must define the costs to be measured in the short run marginal costs.”) (“2012 Order”), *reh’g denied*, 142 FERC ¶ 61,205 (March 21, 2013).

¹¹ *See id* at PP 41 FERC ¶ 61,048 41; 142 FERC ¶ 61,205 at PP 96–99. For example, the Commission specifically held, contrary to SPP’s argument, “Mitigation measures can not be accepted simply because they are the result of stakeholder agreement.” *Id.* at P 441.

¹² *See Entergy Services, Inc.*, 130 FERC ¶ 61,026 (2010) (“We agree with Joint Parties that the policy against relitigation of issues (or requiring changed circumstances) applies to section 205 filings as well as section 206 complaints.”).

not susceptible to multiple answers, as may be case when the “zone of reasonableness” concept is applied to cost allocation or cost of service rate levels. Generation Owners cite cases where the Commission determined that possibly inferior rules met the just and reasonable standard, but those cases did not involve market price formation.¹³ *City of Bethany v. FERC*, decided in 1984, plainly does not concern competitive electricity markets which were implemented well after 1984.^{14 15}

Unlike cost of service rates, the rate or price established by the market may vary over time based on market conditions. The legitimacy of the rate depends upon the absence of or mitigation of market power and the presence of competition. Prices that result from offers at SRMC is the only metric for determining whether a market is competitive. The Commission has explained that the zone of reasonableness under market-based rates means that market power has not been exercised:

When the Commission determines that a seller lacks or has mitigated market power, it is making a determination that the resulting rates will be established through competitive forces, not the exercise of market power, and thus will fall within a zone of reasonableness which protects customers against excessive rates, on the one hand, but allows the seller the opportunity to recover costs and earn a reasonable rate of return, on the other hand. This is fully consistent with the fundamental rate principles set forth in *Hope and Bluefield*, *supra*, and their progeny. In addition, in developing its market-based rate regime, the Commission has

¹³ Generation Owners at 3.

¹⁴ 727 F.2d 1131, 1136 (D.C. Cir.).

¹⁵ The Commission cases cited by Generation Owners (at 3 n.10) concern rules for (i) cost allocation in MISO and (ii) whether “additional detail ... regarding the location at which title passes to CAISO” is necessary. See *Midwest Indep. Sys. Operator, Inc.*, 133 FERC ¶ 61,221 at P 384 (2010); *Cal. Indep. Sys. Operator Corp.*, 149 FERC ¶ 61,058 at P 38 (2014). Generation Owners also cite to a more recent order accepting rules filed by the CAISO that treat certain maintenance costs as marginal costs in the calculation of proxy start up and minimum load costs. Generation Owners at 4 & n.13, citing *Cal. Indep. Sys. Operator Corp.*, 145 FERC ¶ 61,082 at P 5 (2013). This case did not concern the definition of marginal cost.

taken into account non-cost factors, recognized as appropriate by the courts, associated with greater reliance on competition; specifically, where sellers do not have market power, the Commission believes it can encourage greater market entry, greater efficiency and greater innovation in meeting the nation's power needs through allowing such sellers a competitively set rate.¹⁶

The “rate” to which the zone of reasonableness applies is the market price, not the levels of participant offers. The competitive offer, including one established through mitigation, is the means to ensure that market prices, even as they fluctuate, reflect competition. Prices do not reflect competition and are not just and reasonable if prices are set based on market power. Sellers in SPP have a reasonable opportunity to recover their costs through a competitive energy market and through cost of service rates. A better approach would provide for sellers to recover all costs through a complete set of competitive market mechanisms. Offers in the energy market that exceed SRMC are never just and reasonable because such offers are not competitive and can result in prices that are outside of the zone of reasonableness because they reflect the exercise of market power.

SRMC is the only correct metric for determining whether an offer in the energy market is competitive. All other approaches are inherently unjust and unreasonable so long as promoting competition and avoiding the exercise of market power are the goals. Markets cannot be relied upon to produce just and reasonable rates, free of market power, if the approved rules are knowingly defective and the exercise of market power cannot be prevented.

Finally, it would be wrong to accord any deference to the July 24th Filing because SPP submitted it under Section 205, even if the filing were not a collateral attack on prior Commission orders and even if the filing were not inherently unjust and unreasonable. SPP

¹⁶ *Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities*, Order No. 697-A, 123 FERC ¶ 61,055 at P 409 (2008).

is the party that filed under Section 205 of the Federal Power Act, but it is Generation Owners that attempt to argue for the proposal on its merits. The Market Monitor does not claim that it has direct knowledge of what happened in the SPP stakeholder process.¹⁷ The Market Monitor relies on SPP's description of what happened in that process.¹⁸ SPP's further description of that process in its answer (at 6–7) does nothing to alleviate those concerns. Consistent with the independence of the market monitoring function and the independence of RTOs, participants who did not like the SPP IMM's determinations concerning market power should have raised their issues directly with the Commission. SPP's generation owners do not have Section 205 filing rights concerning the SPP tariff.¹⁹ Acceptance of a filing by an RTO presumes that the RTO acted on the basis of its independent evaluation of and belief in the merits of the proposal and not for other reasons.

SPP does not assert that it made any independent evaluation of the proposed revised rules. Any such assertion would be contrary to SPP's incorrect representation (at 2–3) of the filing as merely clarifying its current rules as opposed to changing their substance. SPP's argument that its proposal is clarifying the rules is not consistent with the Generation Owners' argument that rule changes are needed to address what Generation Owners characterize as a cost allocation issue that results from the continued reliance on cost of service regulation in SPP states to sustain investment. The Generation Owners know the July 24th Filing is about applying a cost review standard substantively different from SRMC.

¹⁷ See SPP at 7.

¹⁸ *Id.* at 6–7; July 24th Filing at 3–7.

¹⁹ See, e.g., *Regional Transmission Organizations*, Order No. 2000, FERC Stats. & Regs. ¶ 31,089 *mimeo* at 234 (1999) (“Based on the comments received, we reaffirm our determination that RTOs, in order to ensure their independence from market participants, must have the independent and exclusive right to make section 205 filings that apply to the rates, terms and conditions of transmission services over the facilities operated by the RTO.”), *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).

II. MOTION FOR LEAVE TO ANSWER

The Commission's Rules of Practice and Procedure, 18 CFR § 385.213(a)(2), do not permit answers to answers or protests unless otherwise ordered by the decisional authority. The Commission has made exceptions, however, where an answer clarifies the issues or assists in creating a complete record.²⁰ 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.

²⁰ See, e.g., *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); *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).

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.

Respectfully submitted,



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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 18th day of September, 2015.



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