

motion to intervene in that docket, and the Commission also issued an Order granting the temporary waiver (“Temporary Make-Whole Payment Waiver”).⁴

P3 respectfully submits comments in support of the PJM Waiver Request allowing cost-based offers to exceed the offer cap of \$1,000/MWh, and P3 also supports that this waiver supersede the Temporary Make-Whole Payment Waiver.⁵

P3 supports the PJM Waiver Request noting the following as further explained in the below comments:

- Due to current extreme weather conditions, the offer cap must be permitted to go over \$1000/MWh;
- An energy market based on the principle of a single market clearing price is a fundamental tenet of the PJM market that must be maintained; and
- Reflecting the marginal cost of fuel in uplift payments is a fundamentally flawed market design that must be stopped as soon as possible.

I. COMMENTS.

A. **Due to Current Extreme Weather Conditions, the Offer Cap Must be Permitted to Exceed \$1000/MWh**

As explained in the PJM Waiver Request, the weather conditions this January have created a situation in which certain generators are in the untenable position of being forced to offer their electricity below their marginal energy costs.⁶ Natural gas prices in the PJM Region hit record-setting prices averaging over \$120/MMBtu and including high prices up to \$140/MMBtu for trades on January 21 and delivered on January 22.⁷ These price spikes lead to

⁴ *PJM Interconnection, L.L.C.*, 146 FERC ¶ 61,041 (2014).

⁵ The comments contained in this filing represent the position of P3 as an organization, but not necessarily the views of any particular member with respect to any issue.

⁶ PJM Waiver Request, pp. 1-2, 4-6.

⁷ PJM Waiver Request, p.4.

corresponding increases in the cost of producing electricity from natural gas plants that needed to purchase gas at these levels in order to run. For example, natural gas prices were \$123/MMBtu on Wednesday, January 22, 2014 in New Jersey. The fuel portion of the operating cost of a marginal gas fired peaking plant, assuming 22,000 Btu/kWh heat rate, would be \$2,706/MWh, but because of the offer cap that unit could bid only \$999/MWh. Therefore, this hypothetical 1000 MW plant would be losing \$1,706,000 every hour if forced to run at a loss.⁸ As this example makes clear, with gas prices at the level seen in PJM this month, the \$1000/MWh offer cap is rendered completely impractical.

PJM appropriately describes the situation as “patently unfair.”⁹ As PJM stated, “Generators cannot lawfully be required to buy fuel at a cost of millions of dollars for the purpose of generating power and selling it at a loss.”¹⁰ Given the natural gas prices that have been experienced this winter, the PJM Waiver Request to allow generators to submit cost-based offers even if that causes their offer price to exceed the offer-price cap is a reasonable and appropriate reaction to current market conditions.

Moreover, the \$1000 MWh offer cap was never intended or designed to be a permanent feature of the PJM market. Indeed, the current events that are necessitating the lifting of the offer cap have been foreshadowed for over a decade. John Chandley and William Hogan opined in 2002, that the purpose of the offer-cap is a proxy for the absence of price-responsive demand:

“For the broader problem of inadequate demand-side response throughout the market, the Commission proposes a safety net bid cap of something like \$1000 per megawatt-hour (MWh) to be applied to all sources as a proxy for the absent price-responsive demand.

⁸ *Of Polar Vortexes and PJM Price Spikes*, ICF International, Inc., 2014, p.3. Available at <http://www.icfi.com/insights/white-papers/2014/polar-vortex-energy-pricing-implications-commercial-opportunities-and-system-reliability>

⁹ PJM Waiver Request, p. 5.

¹⁰ PJM Waiver Request, pp. 1-2.

The logic here is that where there is sufficient demand participation, the demand response would itself mitigate market power while allowing sufficiently high prices in times of true scarcity to provide proper signals for both operations and investment. But absent this demand response, there should be a limit on all bids that serves as a proxy for the missing demand bids.

The basic logic dictates that this safety net bid cap should be close to the price at which load would be prepared to voluntarily reduce if only the market institutions were in place to make this reduction possible. An attraction of this approach is in establishing a principled means of selecting the safety-net bid cap. In particular, the purpose of the safety-net bid cap is not simply to produce low prices in times of scarcity; rather it is intended to be a proxy for the scarcity price. Seen as this proxy for the true value of demand, the \$1000 per MWH number may well be too low.¹¹

Chandley and Hogan foresaw over eleven years ago that the cap would need to be increased stating “Part of the task for the Commission, therefore, will be to address the justification for any safety-net bid caps below this level and to consider a transition process that gradually increases the safety-net cap as we gain more experience with demand-side participation in the market.”¹² Certainly the growth in demand response in PJM since 2002 suggests that there may be good cause to address whether an offer cap is even necessary in today’s market.

Moreover in 2002, while PJM stated that \$1000/MWh was appropriate and reasonable, PJM is clearly a different market today than it was in over a decade ago. As PJM noted at the time, “Depending on fuel costs, \$1,000 is five to seven times higher than the marginal cost of production of the highest cost units in the PJM region. Furthermore, prices in PJM have approached the \$1,000 mark on only a few occasions. Thus, the \$1,000 safety-net bid cap serves to permit scarcity pricing while preventing the exercise of market power that would result if the

¹¹ *Remedying Undue Discrimination through Open Access Transmission Service*, Initial Comments of John D. Chandley and William W. Hogan on the Standard Market Design NOPR, Docket No. RM01-12-000, p.81 (filed Nov. 13, 2002).

¹² *Id.* p. 81-82.

cap were higher¹³ Clearly, the events this January show that \$1,000 is not five to seven times higher than the marginal cost of production of the highest cost units in the PJM region during times of stress. Certainly, the cost of marginal fuel this month is significantly higher than it was in 2002 necessitating the need to reconsider the current level of the offer cap.

B. An Energy Market Based on the Principle of a Single Market Clearing Price is a Fundamental Tenet of the PJM Market that Must be Maintained.

Although the Commission approved PJM's temporary emergency waiver request to allow generators to receive a make-whole payment covering their demonstrated costs above the offer cap, this action should be tolerated under the exigencies of the situation but only for the short time until PJM can implement the more appropriate solution presented by this waiver request allowing a bid over the offer cap to set the clearing price.¹⁴ To not do so would interfere with and harm the market, send incorrect market signals, and violate well-established Commission precedent.

As the Commission has stated on numerous occasions, clearing prices should reflect the marginal costs of the last resource needed to clear the market.¹⁵ In rejecting a return to cost-based ratemaking under which the price each resource receives is solely a function of its costs, the Commission has found in favor of a single clearing price market stating that:

....., a competitive market with a single, market-clearing price creates incentives for sellers to minimize their costs, because cost-reductions increase a seller's profits. And when many sellers work to minimize their costs, competition among them keeps prices as low as possible. While an efficient seller may, at times,

¹³*Remedying Undue Discrimination through Open Access Transmission Service*, Initial Comments of PJM Interconnection, L.L.C., Docket No. RM01-12-000, p. 45 (filed Nov. 15, 2002).

¹⁴ Note, in this filing, P3 is only addressing the narrow issue of why cost-based unit offers should set the clearing price even if they are over the offer-cap of \$1000/MWH. P3 will be commenting on the broader issues of updating the offer-cap value and reformulating the rules for applying the offer cap in response to the PJM Independent Market Monitor's Compliant filed on January 27, 2014 in Docket No. EL14-20-000.

¹⁵ See e.g., *PJM Interconnection, L.L.C.*, 117 FERC ¶ 61,331 (2006).

receive revenues that are above its average total costs, the revenues to an inefficient seller may be below its average total costs and it may be driven out of business. This market result benefits customers, because over time it results in an industry with more efficient sellers and lower prices. By contrast, sellers have far weaker incentives to minimize costs under cost-of-service, because regulation forces a seller to reduce its prices when the seller reduces its cost. The Commission has previously found single clearing price markets to be just and reasonable.¹⁶

Further, requiring the recovery of costs in uplift has been disfavored by the Commission. As the Commission stated when considering a similar issue, “We agree with PJM that the costs of resources procured to alleviate shortages should be reflected in transparent market prices whenever possible. Payments made only to individual resources and recovered in uplift fail to send clear market signals.”¹⁷

Although the PJM Waiver Request is only effective through March 31, 2014, P3 agrees with PJM that the single market clearing price principle should be upheld even during this period. As PJM stated, “basing clearing prices on the costs of cleared sell offers- is fundamental to PJM’s energy market design, and that principle should not be set aside, even for an interim

¹⁶ *PJM Interconnection, L.L.C.*, 117 FERC ¶ 61,331, at P 141 (2006).

¹⁷ *PJM Interconnection, L.L.C.*, 139 FERC ¶ 61,057, at P. 78, n. 72 (2012); *see also California Independent System Operator Corp.*, 119 FERC ¶ 61,076 at P 488 (2007), *order on reh’g*, 120 FERC ¶ 61,023 (2007), *reh’g denied*, 124 FERC ¶ 61,094 (2008), *aff’d, Sacramento Mun. Util. Dist. v. FERC*, 616 F.3d 520 (D.C. Cir. 2010) (“Williams’ request to change the nature of energy caps from “hard” to “soft” is based on the possibility that there may be occasions where the generation costs of producing energy bid into the market exceed the cap. We acknowledge there is a possibility that this could occur, depending on the circumstances, but remain unpersuaded that changing the nature of the caps is the best solution to this problem. A significant downside of “soft” caps is their lack of transparency and the uplift costs they create. For these reasons, if generation costs were to appear sufficiently likely to exceed the prevailing cap, our preferred approach would be to adjust the level of the energy cap, as has been done in the past. This way, instead of suppressing the market clearing price by regulatory fiat, all competitive bids would be allowed to clear supply and demand and send transparent price signals to encourage demand response, market entry and forward contracting”) (footnotes omitted); *California Independent System Operator, Corp.*, 141 FERC 61,069, at P 44 (2012) (“we note that we are concerned with the extent of CAISO’s reliance on out-of-market solutions, which tend to artificially depress market prices. It is important for the CASIO markets to have prices that accurately reflect the market value to operate certain resources so that the market will accurately communicate through the locational pricing model where the new transmission and generation are needed”).

period.”¹⁸ P3 further agrees that “the marginal-cost clearing price principle that is the essential feature of the PJM energy market”¹⁹ must be maintained, even during the PJM requested winter period time.

The relative cost of diverse resources measured at their respective nodes is important information for market participants and policy planners. Significant questions which the industry is currently struggling to answer - such as the value of fuel diversity and the quantity of available peak rents - can only be answered if the market clearing prices reflect the costs of the marginal supplier. Price caps were never intended to conceal from the market the legitimate cost-based behavior of a rational generation supplier.

P3 is greatly troubled that PJM, even for a short period of time, is governed by market rules that support something other than a single market clearing price where the cost of fuel is reflected in the marginal price of electricity. This tenet is so fundamental to the PJM market that the Commission should not allow it to stand – except on a very temporary basis given the exigencies of the circumstance.²⁰ It is facially discriminatory that bids below the \$1000/MWh offer cap are allowed to reflect the marginal costs of fuel in their bids while bids over that level cannot. Marginal costs pricing encourages all the right activities – whether it is hedging, consumption or conservation; while a market that clears at an outdated cap sends all the wrong signals and introduces the flawed concept of suppliers getting paid what they bid. As Susan

¹⁸ PJM Waiver Request, p. 3.

¹⁹ PJM Waiver Request, p.5-6.

²⁰ One of the justifications for approving the already-granted waiver is that it is limited in scope. However, if that already-granted waiver remains in place longer than necessary, the scope of that already-granted waiver would be expanded significantly as it would have the effect of upending a fundamental tenet of PJM’s market. In other words, a waiver that upends a fundamental principle of PJM’s market – single price clearing based on the marginal unit – for longer than necessary is not limited in scope. Another justification for approving the already-granted waiver is that it does not create undesirable circumstances. However, if that already-granted waiver remains in place longer than necessary, that waiver would harm the market and reliability in PJM as elaborated above.

Tierney, *et al*, has stated “[a]lthough pay-as-bid auctions may appear like a quick fix for rising prices, switching to a pay-as-bid approach likely would produce just the opposite result. This counter-intuitive outcome stems from the propensity for strategic-bidding behavior, as well as the resulting inefficiencies in plant dispatch and capacity investment. . . . Further, continued changing of market rules creates regulatory uncertainty and fears of regulator opportunism that may discourage investment in new generation and transmission facilities.”²¹

C. Reflecting the Marginal Cost of Fuel in Uplift Payments is a Fundamentally Flawed Market Design that Must be Stopped As Soon as Possible

It is critically important that the Commission act on the PJM Waiver Request as quickly as possible as the current interim relief fosters a market dynamic that the Commission should consider unacceptable. Namely, those market participants who will be asked to fund the uplift or make whole payment are being punished. The uplift charges will be paid by load who purchase directly from the energy market or LSE’s who provide wholesale power to retail customers (e.g. suppliers in auctions such as the New Jersey Basic Generation Service (“BGS”) auctions).²²

Perversely, these parties, many of whom hedged their market exposure remain totally exposed to these types of uplift payments without recourse. For example, consider an LSE who won a BGS tranche, e.g. 100 MW full requirements, and then entered into a hedge with a generator (a fixed for variable swap). The LSE receives a fixed payment from the BGS award, pays (presumably a lower fixed cost to the generator) and the generator sells at a fixed cost to the LSE. This entire process falls apart if material costs flow outside of the market price and the associated hedge. In the current circumstances potentially tens if not hundreds of millions of dollars of uplift will not

²¹ *Pay-As-Bid Vs. Uniform Pricing*, Susan Tierney, et al., *Fortnightly Magazine*, March 2008.

²² Note that uplift charges will also be paid by generators who have deviations between their day-ahead and real-time positions.

flow through this type of hedge process and be allocated to the LSE's. Because in the hypothetical (which is all too real) the LSE sold at a fixed price and the uplift is outside of the hedge, these extra charges translate directly to potentially enormous losses for the LSE.

Such a market dynamic sends completely the wrong incentive and is so fundamentally flawed that it demands immediate correction. PJM's uplift payment policies are well-established, and PJM has consistently expressed the desire to reduce uplift.²³ Given the current uplift tariff provisions in PJM, the Commission should allow PJM to allow the marginal cost of fuel to be reflected in the market clearing price – not in an uplift payment – consistent with the PJM Waiver Request.

In the short term a LSE in this position will lose money and potentially exit the business, voluntarily or involuntarily. But in the long run, with this suddenly recognized increased exposure to uplift, consumers ultimately pay for the lack of real market based signals that can be hedged. This will occur as (in the above example) future suppliers in the BGS raise their costs to account for out of market uplift that cannot be hedged.²⁴

Failure to address this fundamental inequity will leave a PJM market that encourages market participant to manage their uplift risk rather than responding to market signals. Generators offering in the energy market will need to price in their uplift exposure in addition to their marginal costs. Eventually, retail and default service providers will need to price in this risk as well. Such an upward price spiral can be avoided if the market clearing price is set by the marginal unit and uplift is avoided. The PJM market has been based on this tenet since the

²³ Note that PJM has convened the Energy Market Uplift Senior Task Force to discuss uplift related issues that could lead to eventual proposed tariff changes. Total uplift charges in PJM last year were nearly \$900 million dollars.

²⁴ This effect would be another example of a harm that would occur if the already approved waiver is not expeditiously replaced by the PJM Waiver Request as discussed above.

introduction of LMP in 1999. More than a very temporary departure from this tenet (in response to extreme circumstances), given the enormous problems it would create, should not be acceptable.

III. CONCLUSION

For the foregoing reasons, P3 respectfully requests that the Commission consider its comments, and accept the PJM Waiver Request to be effective by February 10, 2014.

Respectfully submitted,

On behalf of the PJM Power Providers Group

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Dated: January 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 Washington, D.C., this 30th day of January, 2014.

On behalf of the PJM Power Providers Group

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