

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Price Formation in Energy and Ancillary
Services Markets Operated by Regional
Transmission Organizations and
Independent System Operators

Docket No. AD14-14-000

**POST-TECHNICAL WORKSHOP COMMENTS OF THE
ELECTRICITY CONSUMERS RESOURCE COUNCIL
(ELCON)**

The Electricity Consumers Resource Council appreciates the opportunity to provide written, post-technical workshop comments on price formation in energy and ancillary services markets operated by RTOs and ISOs. ELCON's President and CEO, Dr. John A. Anderson, served on a panel at the December 9, 2014 technical workshop on Operator Actions. Our written comments address the issues discussed during that workshop and touch on others.

ELCON members are large multi-national corporations who manufacture a wide range of industrial commodities, products and consumer goods. They have major facilities throughout the US and Canada and operate in all RTOs and ISOs. They are intimately familiar with global markets and are champions of competition and competitive markets. They bring that perspective to this discussion on "price formation" in US electricity markets.

The Commission noticed this proceeding in June 2014 as an outcome of a 2013 technical conference in which it considered how existing centralized capacity market rules and structures in the eastern RTO/ISO regions were supporting the procurement and retention of resources necessary to meet future reliability and operational needs. Some technical conference participants asked the Commission to evaluate whether the energy and ancillary services markets are being operated in a manner that produce

accurate price signals. In addition, similar concerns were raised in the aftermath of the January 2014 Polar Vortex events.¹

In this docket, the Commission directed staff to convene workshops to facilitate discussion on the existing market rules and operational practices related to the following topics:

1. Use of Uplift Payments
2. Offer Price Mitigation and Offer Price Caps
3. Scarcity and Shortage Pricing
4. Operator Actions that Affect Prices

Three workshops on price formation were held: (1) Uplift Workshop on September 8, 2014; (2) Shortage Pricing, Offer Price Mitigation, and Offer Price Caps Workshop on October 28, 2014; and (3) Operator Actions Workshop on December 9, 2014. Four staff reports were issued currently with the scheduled workshops on each of the subject topics identified by the Commission.²

ELCON COMMENTS

At issue in the discussion at the workshop attended by Dr. Anderson are the actions system operators take to avert a shortage, such as importing emergency energy or instituting a voltage drop. These actions implicate uplift payments and offer price caps and price mitigation.

Such operator-initiated, out-of-market resource commitments and *ad hoc* operator adjustments to market inputs are to be expected and a normal part of the utility business model. These events are relatively rare and short-lived, but for planning purposes, these events should take precedent over other operational challenges because

¹ See PJM Interconnection, LLC. *Analysis of Operational Events and Market Impacts During the January 2014 Cold Weather Events*, May 8, 2014

² The reports are: Staff Analysis of Uplift in RTO and ISO Markets (August 2014); Staff Analysis of Shortage Pricing in RTO and ISO Markets (October 2014); Staff Analysis of Energy Offer Mitigation in RTO and ISO Markets (October 2014); and Operator-Initiated Commitments in RTO and ISO Markets (December 2014).

of the wide reaching harm that would otherwise result if such actions failed. The near disaster of the January 2014 Polar Vortex event is a case in point.

Operator-initiated, out-of-market resource commitments are also “public goods” that require strong oversight – in this case in the form of oversight by FERC, IMMs, NERC and NERC Regional Entities. These commitments can never be left solely to the market to resolve. By definition, the operator actions at issue here are “out-of-market” and therefore market-based solutions are severely limited if not outright precluded. Price formation is irrelevant where workably competitive markets do not exist. The issues here are more accurately referred to as rate design.

It has not been shown, at least to the satisfaction of retail ratepayers who pay the bills, that existing ISO/RTO market rules for handling contingencies – all deemed just and reasonable by FERC – are now inadequate. In organized markets, merchant suppliers are not guaranteed recovery of their costs, and this should be true irrespective of cause whether the costs are due to unforeseeable circumstances, bad business decisions, or any other reason.

There should also not be any guaranteed recovery of “actual” costs. This would only incent supplier behavior that disregards the importance of seeking a least-cost resource mix at all times. The appropriate just-and-reasonable test under the FPA is to allow recovery of all “legitimate, prudent, and verifiable” costs. Any determination of prudently-incurred costs will likely raise issues of material fact that should be appropriately addressed by hearing and settlement judge procedures. For example, one value of an *ex post* review is the determination if the supplier appropriately used the hedging tools and intellectual resources necessary to competently engage in the organized markets.

Short-term price formation of resources committed to these operator actions provides no material value to the situation. Shortage conditions are always self-evident and more readily apparent – and useful from the operator’s perspective – by observing the level of operating reserves and location of constraints. NERC Reliability Standards

require actions to mitigate a shortage of operating reserves. There is no need for a pricing mechanism “to appropriately signal tight market conditions.”

There are three binding constraints that eliminate Price Theory as a practical rate design in these circumstances. First, inelasticity of demand. As is widely known, but typically ignored, the “vast majority of demand is not price responsive and thus provides no price signal regarding its willingness to stop consuming.”³ Second, the necessity to instantaneously balance supply and demand. Third, other technical and operational considerations, which are unique to the electric dispatch and grid management. One good example is the technical limitations in the market software that prevent ISOs and RTOs from accurately modeling all of the system’s physical constraints (*e.g.*, voltage constraints). If physical constraints are not accurately reflected in the system model used to clear the market, system operators will have to manually dispatch resources needed to resolve a constraint and manually redispatch or re-commit other resources. In these circumstances the cost of the resources are not included in the LMPs – an obvious market failure. These costs must otherwise be recovered in *ad hoc* make-whole payments or uplift payments

Asserting that short-term price signals will “incent performance of existing resources and help to maintain reliability” is a bit of a stretch. This hypothesis failed that test in PJM during January 2014 when at one peak demand hour, 22 percent of generation capacity – including coal, gas and nuclear – was out of service. The purest price could not have contained that event.

Thus, given these conditions, ELCON sees no benefit to knowing “what the market will bear” or the usefulness of allowing price spikes that bankrupt retail ratepayers. We urge the Commission to keep in mind that we are dealing with a highly regulated industry with complicated, administratively-determined “price” formation, not a lightly regulated, workably competitive commodity market.

³ Federal Energy Regulatory Commission, *Staff Analysis of Shortage Pricing in RTO and ISO Markets*, Price Formation in Organized Wholesale Electricity Markets, Docket No. AD14-14-000, October 2014 at 4.

EXPERIENCE WITH OPERATOR ACTIONS

Large manufacturers are entitled to reliable and affordable electric service. They should not have to worry about the consequences of operator actions or the costs associated with such actions. These events after all are relatively rare and short-lived. Nonetheless, for example, ELCON members were harmed in the January 2014 Polar Vortex event by PJM's extraordinary out-of-market uplift charges, which could not be hedged in advance. There is no venue where ELCON members can seek compensatory relief nor are they able to raise the price of their products to recover the extraordinary high costs from the customers of their products and services. Nonetheless, in the "competitive markets" operated by ISOs and RTOs, generators that cannot get what they want at Market-Based Rates, will routinely go to the Commission and ask to be "made whole" or to recover other "missing money." There is something wrong with this picture.

ELCON is not cavalier about the need for operator actions. In 2004, ELCON published a report on the economic impacts of the August 2003 blackout.⁴ That event resulted in the loss of 61,800 MW of electric load that served more than 50 million people in the US and Canada. The direct and indirect economic costs of the blackout were estimated to be between \$4 billion and \$10 billion. Thus the failure of operator actions can impose rather significant economic harm on thousands of businesses. Those businesses were not "made whole" with compensation provided by the utilities that callously disregarded prudent planning and operation of the electric grid and caused the blackout. Nor could they recoup the losses by increasing the prices of their products.

It would seem that either uplift payments or higher short-term rates is inevitable from a strictly retail end-user perspective. Based on a decade and a half of experience with FERC-jurisdictional ISOs and RTOs, we tend to put our faith in the justness and reasonableness of uplift payments rather than attempts to simulate competitive actions

⁴ Electricity Consumers Resource Council, *The Economic Impacts of the August 2003 Blackout*, February 2004.

by entities with substantial market power, which will always seek some form of “make whole” payments whenever the market turns against them.

RECOMMENDATIONS

1. First, do no harm, especially to retail customers. A purpose of industry restructuring that began almost two decades ago was to shift business risk to suppliers and away from ratepayers. The Commission should not be condoning the rent-seeking behavior of suppliers who attempt to shift the risk back to retail customers every time an ISO or RTO hits a new peak and runs the risk of shedding load. Since the formation of ISOs and RTOs there has been an endless cycle of market redesigns and fixes – a most egregious form of regulatory uncertainty. This cycle must end.
2. There is no compelling reason to raise the offer caps. Given the inelasticity of electric demand and the need to instantaneously balance supply and demand, offer caps are necessary to protect retail customers from paying excessive prices during times when supply resources are limited. They are essential for consumer confidence that rate structures are fair and nondiscriminatory.
3. Waivers from market rules must only be allowed when adequate procedural protections are in place. The Commission needs to be very careful when reviewing requests for waivers from market rules affecting short-term prices and avoid impermissible retroactive ratemaking or otherwise deprive stakeholders of their procedural and substantive due process rights.
4. Keep it simple and transparent. Part of the problem, if there is a problem, is the complexity of the market rules. Do not make them more complex. Shortage events and the need for operator actions are relatively rare. There is no compelling need to complicate an already complicated regulatory scheme. Theoretical purity is of no value here.
5. Identify the best practices among existing ISO/RTO market practices. Since the different ISOs and RTOs have different rules for managing operator actions it might be

useful for the Commission to ascertain which rules governing operator actions are more effective and least cost.

6. Encourage market intermediaries to develop new products and services that help suppliers manage the fulfillment of their commitments to system operators. Short-term pricing constructs based on marginal costs are inherently volatile. Generators who insist on a risk-free business environment should divest those assets and find another business.

7. Do not assume the problem is the absence of price formation. Short-term prices are a poor, if not totally useless, mechanism for funding long-term investments. The sole benefit of the short-term pricing construct is to enable efficient dispatch, which has less to do with markets and more to do with a proper engineering solution. The industry that pre-dated ISOs and RTOs accomplished the same with less administrative complexity. Further, the locational rate design of organized markets also comes with a big market defeating problem: higher spot prices send a signal where not to invest in order to sustain those higher prices.

8. The Commission is already taking steps to ensure better coordination between natural gas and electric markets. Any concerns regarding coordination of the scheduling processes of pipelines and ISO/RTOs should be and are appropriately being addressed in the FERC NOPR on this matter (RM14-2-000).

9. The real issue addressed in the technical workshops is rate regulation and the appropriate regulatory construct necessary to compensate the owners of existing resources. Market power mitigation is an essential feature of rate regulation whenever a regime of short-term ratemaking is instituted. It is another form of revenue requirement determination but with a more complex form of regulatory oversight.

10. The industry should explore the feasibility of cost-based, long-term contractual arrangements between suppliers and system operators that avoid the problems experienced with out-of-market or RMR contracts (i.e., with generators with local market power). These contracts might be a more effective and least-cost means for

funding investments in new resources that are specifically located to relieve constraints or other shortage conditions.

11. Finally, and most important, do not take any action – if action is deemed necessary – until there is a resolution of the Commission’s jurisdiction with respect to Demand Response. This issue should have the Commission’s highest priority. Demand Response must be allowed to participate in any energy, capacity or ancillary services auction or solicitation that is open to generators.

NOTICES AND COMMUNICATIONS

Notices and communications with regard to these proceedings should be addressed to:

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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 of this proceeding.

Dated at Washington, D.C.: March 6, 2015

/s/ W. RICHARD BIDSTRUP
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