

Prepared Comments¹

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PJM Long Term Capacity Issues Symposium

January 27, 2010

Panel #2: Challenges and Opportunities in an Uncertain Regulatory Environment

The questions as posed for the symposium:

With federal climate change legislation on the horizon and several states considering forms of re-regulation or targeted requests for proposals to construct capacity or install demand response, what are the implications for RPM?

Under the existing RPM rules, suppliers are required to commit three years prior to the delivery period at a time of significant change to the regulatory landscape and fluctuating fuel costs and commodity prices. Meanwhile, states are faced with pressure to keep retail rates low while also ensuring reliability.

This panel will focus on how the RPM construct should accommodate market and public policy risks and opportunities. Specifically, the panel will examine what, if any, changes are necessary to RPM given forward delivery commitments and climate change legislation. How do all stakeholders ensure that capacity committed three-years forward will deliver? The panel will also discuss state actions to procure generation and demand response in relation to RPM.

Discussion

The focus of my comments today is on one main area: where procurement actions by states for new generation or demand response and other targeted or discriminatory procurement intersects with the provisions of the PJM OATT Attachment DD—Reliability Pricing Model. This collision of interests takes place in the context of the potential for the exercise of market power by buyers via supporting the uneconomic entry of new resources. This is addressed in the provisions of Section 5.14 (h) of Attachment DD, “Minimum Offer Price Rule for Certain Planned Generation Capacity Resources”, otherwise known as MOPR. My comments go to the importance and appropriateness of the MOPR, and potential methods in which it can be strengthened to better accomplish its purpose. To hopefully make this flow a little quicker today, I have formatted this as questions and answers.

¹ My participation is at the designation of members of the Generation Owners Sector, but the opinions expressed herein are my own, and do not necessarily reflect those of any specific member(s) of the sector.

1. What is the Minimum Offer Price Rule (MOPR)?

Though written in a complicated manner, the operation of the MOPR is fairly straightforward. It is designed to prevent the exercise of buyer market power by making it difficult to offer uneconomic new generation or demand response at a low or zero price, and in turn to artificially depress all prices in the market. The rule works in several pieces. The first element looks for behavior that might be suspect. This is characterized by a low offer (less than 80% of a designated reference price) by a Planned Generation Capacity Resource that can both impact the overall market price, and is associated with a seller or an affiliate who is net short in the market. If this is observed, then the impact of the low offer is evaluated, and if the impact exceeds certain thresholds, the auction will be re-run with an appropriately higher mitigated replacement bid price for the Planned Generation Capacity Resource. There are lots of details and exceptions, but this is the gist of the rule.

2. Is It Easy and Profitable to Exercise Buyer Market Power?

For any large load serving entity or anyone acting on behalf of a large amount of load that is “short” in the PJM markets (e.g. the states), it would be relatively easy to exercise buyer market power. The RPM demand curve (VRR curve) has a negative slope, where prices decrease 20% from net CONE for every 1% of additional supply. Thus relatively small increases in supply cause large drops in price. With today’s approximate prices this means that a new unit of excess supply costs about \$200 per MW day, but every 1% excess of supply drops prices by about \$40 per MW day. In a 10,000 MW LDA this means that a buyer could depress the price of 10,000 MW of existing capacity by \$40 (saving \$400,000 per MW day) for the expense of buying 100 MW of excess/unnecessary capacity for only \$20,000 per MW day (100 x \$200). Clearly this type of market power can pay off. The same dynamics work for the market as a whole.

This strategy works even when the buyer only supplies a part of the market, and is particularly feasible for buyers who can be assured of the recovery of the expense of uneconomic entry, despite any competitive disadvantage. (e.g. the states or parties acting under state authority with respect to cost recovery).

3. Why Is the Exercise of Buyer Market Power Bad?

There are three primary reasons why artificially depressing prices by adding unneeded and uneconomic generation or demand response is harmful. First, it is a wasteful misallocation of resources. By definition, this situation only occurs when someone is purchasing resources that are not needed and are in excess of reliability standards. Second, it is explicitly discriminatory, by putting in a two-tiered pricing system: one price reflecting market rates for new generation; and the other the artificially depressed price for existing generation providing the exact same product. This obviously harms all suppliers who are discriminated against. Third, this type of action destroys any hope of private market entry and efficient allocation. No new

supplier of generation would ever enter the market without the assurance of receiving the type of discriminatory payments offered by the buyer with market power. Without access to this type of discriminatory payment, if they had to rely on the market alone they would never expect to see prices other than those reflecting the artificially depressed levels. By driving all new resources to require a ratebase-backed contract, the opportunity to exercise buyer market power in RPM undermines one of the primary goals of wholesale market restructuring.

4. Why Should State Procurements Fall Under the MOPR?

All procurements should be subject to MOPR. There is no reason why anyone should be allowed to exercise market power in the PJM RPM or any other FERC jurisdictional market whether a buyer or seller. Fortunately the MOPR applies to all market participants, and only would exempt state procurements specifically identifying/addressing reliability needs. This isn't to say that states can't have their own procurements, particularly for things like renewable resources. What it does say however, is that there is a limitation on how they can bid and recover the costs of such procurements in the PJM markets. To the extent that they wish to also spend state tax dollars or other revenue on what, within the context of the PJM markets, is uneconomic supply, they are free to do so. The MOPR ensures that the decision to procure additional resources is driven by the direct benefits of those resources, rather than the indirect (but potentially very large) benefit of depressing the RPM clearing price paid to other, unrelated resources.

This really isn't that new or different a perception of the role of the states in energy markets. Much of this would be obvious if seen in the context of the previous fully regulated markets. For example, assume there was never any deregulation, and all generation was rate based. Assume that we have the same concerns about environmental issues, green house gases and carbon. Assume as a result there is an initiative to switch 25% of all capacity to renewable resources. Do any of you think that as a result, even though there is "excess" capacity from the new 25% of environmentally friendly generation, that state regulators should, could or would eliminate or reduce rate based recovery on all of the previously existing resources, or that suddenly such existing generation would become an imprudent expense based on a change in state policy? The answer is obvious, and it should be no different now. The MOPR is one of the tools that helps us try to reach the same end result.

This can also be seen from another example. Assume one of the regulated utilities approached its state commission and said "I know we have excess generation now, but I think it would be good for the local economy to build a new plant, is it ok if I put it in rate base and charge electric customers for the excess?" Again the answer is obvious, and again, the MOPR is a tool to help steer us towards what was a clear solution in the fully regulated world.

It is only the temptation of benefiting from the exercise of market power that appears to blind people to the common sense solutions we see in the above examples. Without an effective MOPR, there would be a powerful incentive to build unneeded, costly resources to suppress RPM prices.

5. How Can the MOPR Be Improved?

The current rule has limited scope, and while it discourages the exercise of market power, it could be made better. The following are just a list of the types of improvements that could be made, and we can discuss them further in the rest of this panel if time permits.

- The MOPR only applies in LDA's with a separate VRR curve. The rule should apply to the market as a whole, and any LDA. The exercise of market power is still the exercise of market power, regardless of the scale.
- The wording of the MOPR implies that it only limits uneconomic entry to the period in which a new resource is planned, and that subsequent to the commencement of interconnection service, it could be used to exercise market power. This type of loophole should be eliminated.
- The "Impact" thresholds in terms of influencing price for uneconomic offers are reasonably broad, and should be tighter, or alternatively be evaluated on a case specific basis to determine if market power has been exercised.
- There are general exemptions for baseload or long lead time units. While the determination of "economic" may not be feasible at the BRA time window, demonstration of whether a unit is economic when committed to should also be considered as part of the MOPR type mitigation.
- The MOPR should apply to all potential resources including DR.