

111 FERC ¶ 61,134
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
Nora Mead Brownell, Joseph T. Kelliher,
and Suedeen G. Kelly.

PJM Interconnection, L.L.C.

Docket Nos. ER05-10-000
ER05-10-002

ORDER ACCEPTING MARKET-BASED RATE FILING SUBJECT TO
CONDITIONS

(Issued April 29, 2005)

1. On October 1, 2004, PJM Interconnection, L.L.C. (PJM) filed (October 1 Filing), pursuant to section 205 of the Federal Power Act (FPA),¹ to revise the PJM Tariff to permit market-based rate offers, capped at \$100/MWh, for regulation service² in the

¹ 16 U.S.C. § 824d (2000).

² Regulation Service is necessary to provide for the continuous balancing of resources (generation and interchange) with load and for maintaining scheduled Interconnection frequency at sixty cycles per second (60 Hz). Regulation Service is accomplished by committing on-line generation whose output is raised or lowered (predominantly through the use of automatic generating control equipment) as necessary to follow the moment-by-moment changes in load. PJM Tariff, schedule 3.

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combined PJM West and PJM South regions (PJM West/South Regulation Zone).³ PJM requests that its filing be made effective upon Virginia Power's integration into PJM, which has not yet occurred, but no earlier than December 1, 2004.⁴ The Commission will accept for filing these tariff revisions, subject to the condition that AEP and Virginia Power's offers are capped at the operating cost of regulation service⁵ plus a \$7.50 adder.⁶

³ The PJM West region includes the geographic territories of Allegheny Power (Allegheny), American Electric Power Company (AEP), Commonwealth Edison Company (ComEd), Dayton Power and Light Company (DP&L), Dusquesne Light Company (Dusquesne), and their respective operating companies. The PJM South region includes Virginia Electric and Power Company (Virginia Power) and its respective operating company.

⁴ Virginia Power is currently expected to integrate into PJM on May 1, 2005.

⁵ PJM defines the operating cost of regulation service to include: "a. The costs (in \$/MW) to provide regulation service from steam units shall equal the fuel cost increase due to the heat rate increase resulting from operating the unit at lower MW output incurred from the provision of regulation. b. Plus (+) the cost increase (in \$/MW) of variable cost rate resulting from operating the unit at lower MW output incurred from the provision of regulation." Cost Development Task Force, *PJM Manual 15: Cost Development Guidelines*, Revision 4 at 36 (2004).

⁶ The October 1 Filing also proposed that, until market-based rate offers for regulation service are permitted in this region, PJM proposes to revise its tariff to state that cost-based rates for this service may include a \$7.50 adder, to be made effective retroactively as of May 1, 2004. The Commission accepted this aspect of the October 1 Filing by operation of law on November 30, 2004. Accordingly, PJM's request in this regard will not be further discussed in this order.

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2. This order benefits customers by permitting sellers that lack market power in PJM to submit market-based rate bids in the market for regulation service upon the entry of Virginia Power into the PJM West/South Regulation Zone, while mitigating the bids of AEP and Virginia Power, which PJM has not sufficiently demonstrated lack the potential to exercise market power in this market.

Background

3. In support of its application, PJM filed a market power study.⁷ PJM's market monitoring unit (MMU) designated the PJM West/South Regulation Zone as the relevant market. PJM's market power study found that the two largest suppliers, AEP and Virginia Power, each possessed market shares above 20 percent and a combined share of 58 percent.⁸ The results of the delivered price test, which includes only economically dispatched supply, exhibit even more concentration, indicating that the combined share of AEP and Virginia Power exceeds 60 percent at all load levels.⁹ Additionally, the largest supplier, AEP, exhibited market shares above 40 percent for all but the highest load levels.¹⁰ Subsequent studies of this market by PJM have concluded that two suppliers

⁷ PJM's market power study for this ancillary service generally follows the Commission's current methodology for assessing generation market power. See *American Electric Power Marketing, Inc.*, 107 FERC ¶ 61,018 (2004) (April 14 Order), *order on reh'g*, 108 FERC ¶ 61,026 (2004) (July 8 Order).

⁸ *PJM Interconnection, L.L.C.* Docket No. ER05-10-000, Exhibit A, Declaration of Joseph A. Bowring, Figure 2. (October 1 Bowring Declaration) (2004).

⁹ *Id.* at Figure 5.

¹⁰ *Id.*

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have market shares for regulation offered in excess of 20 percent and that the largest supplier's share is 48 percent.¹¹

4. PJM acknowledges that the market shares and results of the delivered price test are consistent with a finding of market power. However, PJM contends that the following factors mitigate the ability of any supplier to exercise market power: (i) supply substantially exceeds demand in the PJM West/South Regulation Zone; (ii) ease of entry due to PJM's oversight of the regulation market; and (iii) mitigation in the form of a \$100/MWh offer cap. PJM notes that the Commission has permitted the formation of market-based regulation and ancillary services markets in PJM East¹² and in other Independent System Operators (ISOs) and Regional Transmission Organizations (RTOs),¹³ despite market shares in excess of 20 percent, due to the presence of these mitigating factors, in particular excess supply.

5. Furthermore, PJM emphasized in its October 1 Filing that the large surplus of supply serves a role in mitigating the exercise of market power only if it actually exists. Based on its experience with the integration of the Northern Illinois Control Area (NICA) (i.e. ComEd) into PJM West, the actual regulation offered into the market was only about half (55 percent) of the total regulation capability declared prior to NICA's integration.¹⁴ In its experience of operating the PJM West Regulation Market after the integration of

¹¹ PJM Market Monitoring Unit, *State of the Market Report 2004* at 186 (*State of the Market Report*), available at: <http://www.pjm.com/markets/market-monitor/downloads/mmu-reports/pjm-som-2004.pdf>.

¹² *PJM Interconnection, L.L.C.*, 91 FERC ¶ 61,021 (2000).

¹³ *AES Redondo Beach, L.L.C., et al.*, 85 FERC ¶ 61,123 (1998), *order on reh'g*, 87 FERC ¶ 61,208 (1999), *order on reh'g and clarification*, 90 FERC ¶ 61,036 (2000) (*AES*); *New England Power Pool*, 85 FERC ¶ 61,379 (1998), *reh'g denied*, 95 FERC ¶ 61,074 (2001) (*NEPOOL*); *Central Hudson Gas & Electric Corporation, et al.*, 86 FERC ¶ 61,062, *order on reh'g*, 88 FERC ¶ 61,138 (1999) (*Central Hudson*).

¹⁴ October 1 Bowring Declaration at P 46.

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AEP, DP&L and Dusquesne, PJM has found that the amount of regulation actually offered into the PJM West Regulation Market was about three-fourths (77 percent) of the total regulation capability and the.¹⁵ Furthermore, while this amount was similar to the amounts offered into the PJM Mid-Atlantic Region's Regulation Market, different patterns of ownership in PJM West resulted in higher market concentration levels (with an HHI averaging 4012) than in the PJM Mid-Atlantic Region.¹⁶

6. On November 30, 2004, the Commission issued a notice accepting the October 1 Filing by operation of law (November 30 Notice), with two statements dealing with the proposal for market based rates for regulation service. As a result, the cost-based rates for regulation service and the \$7.50 adder went into effect by operation of law. However, the market-based rate proposal did not become effective because, under the proposal, it would not be effective until Dominion integrates into PJM.

7. On January 31, 2005, the Commission issued a notice dismissing a pleading entitled "request for rehearing" from American Municipal Power-Ohio (January 31 Notice). The Commission found that the pleading did not lie because the Commission had not issued an order in this proceeding.

Notices, Comments and Interventions

8. PJM's filing was published in the *Federal Register*, 69 Fed. Reg. 64,043 (2004), with comments, interventions and protests due on or before October 22, 2004. On October 17, 2004, Exelon Corporation filed an intervention, and, on October 18, 2004, Duke Energy North America, LLC and Duke Energy Trading and Marketing, LLC file an intervention. On October 22, 2004, Allegheny Power and Allegheny Energy Supply Company, North Carolina Electric Membership Corporation, and Rockland Electric Company filed interventions, and Steel Dynamics, Inc. filed interventions. On the same day, PJM Industrial Customers Coalition (PJM ICC) and AMP-Ohio filed motions to intervene and protest. On October 25, 2004, Consumers Energy Company (Consumers Energy) filed a motion to intervene out-of-time.

¹⁵ *State of the Market Report* at 186.

¹⁶ *Id.* at 185-186.

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9. PJM ICC and AMP-Ohio object that PJM's contention that regulation service suppliers will not be able to exercise market power is inconsistent with the findings of PJM's MMU, who found that certain suppliers fail both the market share screen and the delivered price test. Furthermore, these protesters emphasize that PJM's MMU admits that the data on excess regulation supply is unreliable because it was self-reported by generators and has not yet been validated in actual market operation within PJM or been subjected to PJM tests of regulation capability. PJM ICC and AMP-Ohio urge the Commission to require PJM to provide supplemental data and market analyses to confirm and validate the data on which PJM's filing is based before granting market-based rate authority. AMP-Ohio also contends that PJM's arguments regarding other mitigating factors such as ease of entry are similarly unsubstantiated.

10. These protesters also submitted a number of additional objections to PJM's filing. PJM ICC argues that the filing violates PJM's own governance rules because this filing involves changing the PJM Operating Agreement and that such a change cannot be made without Members' Committee approval. Furthermore, PJMICC contends that PJM's October 1 Filing constituted a request for incentive rates, rather than market-based pricing. AMP-Ohio contends that the filing is premature because there will not be a viable regulation market until Virginia Power joins PJM. Finally, AMP-Ohio argues that PJM has not submitted adequate cost justification for the imposition of a \$7.50 adder for cost-based regulation rates.

11. On November 17, 2005, PJM submitted an answer to the protests of AMP-Ohio and PJMICC. In its answer, PJM reiterates its position that the large amount of excess supply in the market mitigates any potential that suppliers may have to exercise market power and that PJM's Market Monitor supports market-based pricing when such excess supply is present. PJM also rejects PJMICC's contention that PJM had violated its own governance rules in submitting the proposal and that PJM's October 1 Filing constituted a request for market-based pricing. In particular, PJM notes that the approval required for market-based pricing in PJM's Operating Agreement is Commission approval, rather than approval by PJM's members.¹⁷

¹⁷ PJM Operating Agreement, Schedule 1, section 1.10A(e).

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12. On December 30, 2004, AMP-Ohio filed a pleading entitled “request for rehearing”. In this pleading, AMP-Ohio contends that the Commission’s action in this docket was arbitrary, capricious and an abuse of administrative discretion due to the following errors. First, AMP-Ohio argues that the Commission failed to make an affirmative finding about the competitiveness of the market, in violation the requirement that, before the Commission may authorize market-based price, it must first make an ex ante finding of the absence of market power or an express finding that competitive forces may be trusted to keep prices within a zone of reasonableness. Second, AMP-Ohio contends that the Commission erred by failing to address on the merits the protests filed by AMP-Ohio and the PJM ICC, outlined above, in violation of its duties under the Administrative Procedures Act. Finally, AMP-Ohio asserts that the Commission erred by disregarding the recommendations of the PJM Market Monitor, who proposed that regulation service should continue to be cost-based for an interim period until Virginia Power has integrated and until the Market Monitor is able to verify the supply of regulation service present in this region.

13. On March 17, 2004, AMP-Ohio filed a pleading entitled “motion for reconsideration” of the November 30 January 31 Notices. AMP-Ohio first argues that in these notices, the Commission violated fundamental principles of fairness and administrative due process because they did not address the legal and factual issues raised in the AMP-Ohio and PJMICC protests and the AMP-Ohio’s “request for rehearing”. Second, AMP-Ohio argues that the Commission violated its duties under the FPA and the APA by failing to address on the merits the issues raised in the AMP-Ohio and PJMICC protests and the AMP-Ohio “request for rehearing”. AMP-Ohio emphasized that, before permitting the adoption of market-based pricing, the Commission must make express findings that no party has market power and that market forces may be trusted to keep prices at just and reasonable levels and that the Commission had ignored the concerns raised by PJM’s Market Monitor. Third, AMP-Ohio contends that the Commission was required to explain why it deviated from its policy of approving bid-based pricing only after making findings about the competitiveness of the relevant market. Finally, AMP-Ohio argues that the new information submitted in the *State of the Market Report* substantiates the concerns expressed by the PJM Market Monitor and the Commissioners who dissented from the November 30 Notice.

14. On April 1, 2005, PJMICC filed an answer in support of AMP-Ohio’s motion for reconsideration.

15. On April 27, 2005, AMP-Ohio filed a pleading entitled “supplement to its motion for reconsideration and an emergency motion for the suspension of the tariff sheets” in the October 1 Filing, which will allow bid-based pricing to become effective in the PJM West Regulation Market on May 1, 2005. In this filing, AMP-Ohio draws attention to the filing submitted on April 25, 2005 (April 25 Bowring Declaration), PJM’s Market

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Monitor, who concludes based on his updated analysis of the PJM West Regulation Market that the PJM Western Regulation Market after the integration of Virginia Power is expected to fail the market power tests used by the Commission and that the presence of excess supply is not adequate to mitigate their results of the market share and market concentration results. Furthermore, if only price-competitive supply options were considered, that refinement “is likely to make the failure of the delivered price test worse.”¹⁸ AMP-Ohio urges the Commission to suspend the tariff sheets submitted in the October 1 Filing because, if the Commission fails to suspend those tariff sheets before that date, consumers will be deprived of a refund remedy should prices be distorted by the exercise of market power or other forms of competitive dysfunction. After that, the Commission would be forced to resort to the inferior alternative of a section 206 complaint proceeding.

16. On April 28, 2005, PJMICC filed an in support of AMP-Ohio’s supplement to its motion for reconsideration and an emergency motion for the suspension of the tariff sheets. PJMICC reiterates the points made by AMP-Ohio regarding the concerns expressed by PJM’s Market Monitor and urges the Commission to disregard the comments included by PJM in the transmittal letter accompanying the April 25 Bowring Declaration, in which PJM contends that there has not been any material change in the expected excess supply of regulation, which formed the factual bases for the requested market-based regulation authority in the October 1 Filing and that ample potential supply remains.

Discussion

Procedural Matters

17. Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.214 (2004), the notices of intervention and timely, unopposed motions to intervene serve to make the entities that filed them parties to this proceeding. Given the early stage of this proceeding and the absence of undue delay or prejudice, we find good cause to grant Consumers Energy’s motion to intervene out-of-time.

¹⁸ *Citing* April 25 Bowring Declaration at P 2, 57, 65.

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18. Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(2) (2004), prohibits an answer to a protest or answer unless otherwise ordered by the decisional authority. The Commission will accept the answers filed by PJM and PJM ICC because they have provided information that assisted us in our decision-making process.

Proposal for Market Based Rates

19. The Commission has not issued an order on the merits of the market-based rate proposal in the October 1 Filing.¹⁹ While the cost-based rates and \$7.50 adder have taken effect by operation of law, the proposal for market-based rates for regulation service has not yet taken effect, since this rate was not proposed to become effective until Dominion's integration into PJM. Thus, this aspect of the October 1 Filing is still outstanding. In this order, the Commission is accepting the market-based rate proposal, subject to conditions.²⁰

PJM ICC's Protest that Filing Requires Members' Approval

20. We reject the protest of the PJM ICC that section 1.10.1A(e) of Schedule 1 of the PJM Operating Agreement requires the approval of the members committee prior to PJM making a filing for market-based rates for regulation service. That provision states that regulation service "shall be cost-based ... until such time as market-based pricing is approved for regulation in the Control Zone." We agree with PJM that the reference to approval in this section refers to approval by this Commission, not to approval by the PJM members' committee. We further agree with PJM that the extension of the

¹⁹ The November 30, 2004, Notice was not an order by the Commission on the merits of the market-based rate proposal.

²⁰ The Commission may reject or suspend a filing after the statutory notice period has passed, provided that it acts prior to the effective date of the filing. *See, e.g., National Fuel Gas Supply Corp. v. FERC*, 899 F.2d 1244 (D.C. Cir. 1989); *see also New England Power Co.*, 53 FERC ¶ 61,106 at 61,341 (1990). Since the market-based pricing aspects of the October 1 Filing have not gone into effect, the Commission can still act on this aspect of the filing.

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\$100 bid cap from the PJM East Market to the West/South market is merely a conforming change. Further, PJM's Board has the authority under section 7.7 of the Operating agreement to make this filing pursuant to section 206 of the Commission's regulations. As a public utility, PJM has a general right to make section 205 filings. Issues about what stakeholder procedures should be followed before PJM makes section 205 filings need to be resolved between PJM and its members. Accordingly, PJM ICC's protest in this regard is dismissed, and we will consider this filing on the merits.

Market-Based Rate Offers

21. The Commission finds that PJM's market power study in the October 1 Filing has sufficiently demonstrated that, with the exception of AEP and Virginia Power, the suppliers of regulation service in PJM West and PJM South lack the potential to exercise market power. The Commission therefore will accept for filing PJM's tariff revisions to permit market-based rate offers for these suppliers of regulation service in PJM West and PJM South, to become effective the date on which Virginia Power integrates with PJM, which will not occur until at least May 1, 2005, subject to the condition that the offers by AEP and Virginia are mitigated at the operating cost of regulation service plus a \$7.50 adder. The mitigation imposed here is similar to the mitigation used in PJM's energy markets. Only the offers in the regulation market made by AEP and Virginia Power will be capped at their the operating cost of regulation service plus the \$7.50 adder; these companies will be able to receive the market clearing price and opportunity costs to the extent that these exceed their offers. Establishing a market at this time will allow nondominant suppliers to compete fully in a market and all customers to reap the benefits of competition. Moreover, establishing a regulation market can also provide signals for entry, which could expand the market and may encourage innovation in the regulation and related markets, such as spinning reserve.

22. Based on the data submitted, PJM has not demonstrated that AEP and Virginia Power should be permitted to submit market-based rate offers for regulation service without mitigation of their offers. As stated above, PJM's market power study indicates that AEP and Virginia Power's market shares each exceed 20 percent (and together approach 60 percent), and PJM's Market Monitor concludes that the results of

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the delivered price test are consistent with a finding of market power.²¹ Furthermore, the concerns about the potential of certain suppliers to exercise market power expressed by PJM's Market Monitor in the October 1 Filing have been substantiated by actual operation of the PJM West Regulation Market after the integration of AEP, DP&L and Dusquesne, as discussed in the *State of the Market Report*.

23. Further, it is not clear that the amount of excess supply, or the other factors referenced by PJM, is sufficient to justify market-based rate offers for AEP and Virginia Power. Based on PJM's historical experience with the integration of new control areas, the amount of regulation capacity declared by generators may exceed the amount of actual capacity, in some cases by nearly a factor of two.²² Again, the concerns of PJM's Market Monitor in the regard have been confirmed by actual operating experience in the PJM West Regulation Market after the integration of AEP, DP&L and Dusquesne. Before we can rely on the excess supply information, we will require additional operating experience after the integration of Virginia Power to determine if the excess supply is adequate to permit AEP and Virginia Power to submit unmitigated offers. Moreover, it is not clear from the data submitted whether the excess capacity is held primarily by AEP and Virginia Power or is more widely shared among the other participants. PJM's Market Monitor also recommends that further information be obtained after the integration of Virginia Power to determine whether excess supply, the nature of the associated supply curve for regulation, or other factors are appropriate mitigating factors.²³

24. However, the Commission believes that concerns regarding market power can be addressed at the participant level within the framework of a regulation service market. If dominant individual suppliers are mitigated through cost-based rates, while non-dominant participants are authorized to make market-based rate bids, the possibility of the exercise of market power is slight. With the mitigation applied to the bids of dominant firms, all

²¹ October 1 Bowring Declaration ¶ 44.

²² October 1 Bowring Declaration ¶ 46.

²³ *Id.*

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market participants can reap the benefits of a competitive regulation market, which have been well documented in PJM Mid-Atlantic Region.

25. Therefore, we will authorize market-based bids for regulation service and the offer cap of \$100, subject to the condition that AEP's and Virginia Power's offers for regulation service will be at cost-based rates, which, as of May 1, 2004, may include a \$7.50 adder. Further, the rates or the formulas and methods for determining rates must be on file with the Commission, and PJM, therefore, must, within 30 days of this order, make a compliance filing to reflect these provisions in the appropriate schedules of its operating agreement and tariff.

26. Our decision with respect to AEP and Virginia Power is without prejudice to future filings to permit market-based rate offers by these companies for regulation service that are based upon actual operating experience in the PJM West/South Regulation Zone for a period (e.g., six months) after the integration of Virginia Power. This assessment should also include an independent confirmation, under actual operating conditions, of the amount of excess regulation supply in these regions.

AMP-Ohio's Motion for Reconsideration

27. As discussed above, the Commission has not previously issued an order on the merits of the market-based rate proposal in the October 1 Filing. Consequently, AMP-Ohio's pleading entitled "motion for reconsideration" does not lie and will be dismissed.

The Commission orders:

(A) The Commission accepts PJM's filing to permit market-based rate offers for regulation service in the PJM West/South Regulation Zone, to become effective the later of December 1, 2004, or the date on which Virginia Power integrates into PJM, subject to the condition that AEP's and Virginia Power's offers are mitigated, and subject to PJM's making a compliance filing within 30 days of the date of this order to reflect the method for determining the rates for regulation service, as discussed in the body of the order.

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(B) AMP-Ohio's pleading entitled "motion for reconsideration" is hereby denied.

By the Commission.

(S E A L)

Linda Mitry,
Deputy Secretary.