UNITED STATES OF AMERICA
BEFORE THE
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

WRITTEN STATEMENT OF
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WPPI ENERGY AND THE
TRANSMISSION ACCESS POLICY STUDY GROUP
REGARDING IMPACTS OF OFFER CAPS AND
MARKET POWER MITIGATION

I appreciate the invitation to speak today on issues related to price formation in RTOs, particularly the impacts of offer caps and market power mitigation.

My name is Pat Connors, and I am the Senior Vice President - Power Supply for WPPI Energy, a municipal joint action agency providing bulk power and other services to its 51 members (50 municipalities and one cooperative in Wisconsin, Michigan, and Iowa), each of which operates a distribution utility and sells electricity at retail to the residences, businesses, and industries in and around its municipality. I am speaking on behalf of WPPI and the Transmission Access Policy Study Group ("TAPS"), an association of transmission-dependent electric utilities in more than 35 states.

While WPPI is a load serving entity, WPPI is also a generator owner and purchases output under long-term contracts. We own or have long-term contracts for generation both within the Wisconsin Upper Michigan System area ("WUMS") and outside WUMS—in Minnesota and Illinois. As a generator, we are potentially subject to market mitigation measures and are confined by the offer caps now in place. Although

we can therefore look at the issue from both sides, we come down strongly on the side of maintaining existing market power protections, including the $1,000/MWh offer caps now in place in MISO and a number of other RTOs.

A. Competitive markets ideally would rely on competitive pressure to ensure offers reflect marginal cost.

Ideally, prices in an RTO market would always be set by multiple competitive offers to satisfy the last megawatt of incremental load. When markets are perfectly competitive, economic theory suggests that generators would always make offers that reflect their short-run marginal cost. Whenever possible, it is more efficient to rely on market competition to discipline supplier's offers.

But RTO markets are not always perfectly competitive. Demand is basically inelastic at all price levels, the system operators' models are imperfect, operators regularly take out-of-market actions to improve reliability, and most importantly, generators can take advantage of opportunities to exercise market power to obtain supra-competitive prices. The problems are most acute when there are limited supply options to satisfy forecasted demand.

To ensure just and reasonable rates at times when markets are not workably competitive, it is essential that offers be mitigated to levels that approximate competitive conditions. RTOs use a combination of tools—most notably market power mitigation and offer caps—to protect consumers and improve the likelihood that prices will remain at a level consistent with competitive conditions. Market power mitigation and offer caps work in tandem to prevent supra-competitive profits while ensuring that suppliers recover at least their marginal costs when they are dispatched.

B. Offer caps continue to be necessary.

Offer caps are needed to protect load from paying excessive prices during times when limited supply options exist, given the general inelasticity of electric demand. The Commission has recognized that "[e]lectricity markets possess unique characteristics including, but not limited to, inelastic demand and the need to balance the entire transmission grid in real-time."[1] According to the Commission, "[e]conomic theory and empirical estimates of the short-run elasticities of electricity demand suggest that these unique conditions allow sellers in wholesale electricity markets to exercise market power using a much more limited withholding of supply than [other] industries."[2]

While there has been some increase in the role played by demand response since the time offer caps were first put in place, electric demand continues to be largely inelastic. In most regions, the bulk of load is not sensitive to short-term price changes. In MISO, most load is served by utilities regulated by state public utility commissions, often at retail rates that do not vary by time of day or wholesale electric market conditions. Even in regions with more retail competition, retail loads often do not see real-time wholesale market price signals.

And the Commission's demand response policies are currently in flux. The Commission has issued numerous orders in an effort to increase the participation of demand response in RTO markets. But the future of its primary approach—i.e., treating demand response as a resource that can be bid into the supply side of RTO wholesale markets, and paying those demand response providers full LMP when the "net benefits"

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[1] Order 697-A, 123 FERC ¶ 61,055, P 37 (2008).

[2] *Id*.

test is satisfied—is uncertain given recent court decisions.[3] While there will be opportunities to restructure the participation of demand response in wholesale markets, this is not the right time to make a major policy change regarding offer caps based on the assumption of ample demand response.

In the absence of large quantities of price-responsive demand, there is a significant potential for market power abuse when resources are tight and individual sellers may become pivotal suppliers. This problem can occur market-wide; or it may exist only in locally constrained areas, while the remainder of the market is competitive. Price caps provide a crucial circuit-breaker for such situations, and may play an increasingly important role in market power mitigation as the national economy recovers and the capacity surpluses of the past several years become smaller in the face of generation retirements due to environmental compliance efforts.

The Commission's current approach—establishing and maintaining offer price caps as a backstop, before specific market power problems emerge—should be maintained. Unlike stock markets in which trading can be halted if supply and demand are significantly out of balance, RTO electricity markets cannot be taken out of service without threatening reliability. As a result, consumers may incur huge costs before market power abuse is recognized and regulators can respond. And as the experience of the California energy crisis of 2000 demonstrates, the costs and resources required to address non-competitive markets outcomes after-the-fact, perhaps including through litigation and complicated RTO re-settlement procedures, can be massive.

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[3] *Elec. Power Supply Ass'n v. FERC*, 753 F.3d 216 (D.C. Cir. May 23, 2014), *reh'g en banc denied*, No. 11-1486 (D.C. Cir. Sept. 17, 2014).

C. Increasing the offer cap will not get more generation constructed.

Not only are offer caps necessary, there is no reason to increase the prevailing offer cap of $1,000/MWh.

Some might argue that the offer cap is too low, and that it must be increased to avoid distorting market prices. The current offer cap, they would say, is not allowing the market to send the right price signals to incent new generation.

In reality, however, increasing the offer cap will not have any practical impact on investment decisions. Increasing the offer cap will not directly raise LMPs; and in the vast majority of hours, the marginal resource is not bidding anywhere near the price cap. Often, the offer cap will only affect prices in a few hours of the year. No utility—regulated or unregulated—will invest in a new generator in the hope that energy prices will be extremely high for a few hours every year; utilities base those investments on projections of adequate margins on both capacity and energy sales over the long-term.[4] In fact, generation owners may have a disincentive to build new resources in areas that would reduce LMPs for their existing resources. So regardless of how high the offer cap is set, it is unlikely to create any incentive for entities to make long-term investment decisions. Rather, given the enormous size of the RTO markets, an increase in the offer cap could simply result in a very significant transfer of wealth from electric customers to generators and harming consumers. Indeed, the intolerability of such a result has caused policymakers to steer a way from an energy-only market and allow for additional revenue

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[4] *Power Plants Are Not Built on Spec: 2014 Update*, American Public Power Association, *available at* http://appanet.files.cms-plus.com/PDFs/94_2014_Power_Plant_Study.pdf.

streams to support generation (e.g., through ancillary services, bilateral arrangements, and/or various forms of capacity markets).

D. Offer caps should not be raised above $1,000/MWh.

The $1,000/MWh offer cap that has been used in all RTOs continues to be appropriate. In a well-functioning market, resources would offer energy at their short-run marginal operating cost, and no higher. Under normal circumstances, there are no generators—regardless of fuel type—that have a marginal operating cost even approaching $1,000/MWh. Thus, there is no reason to increase the offer cap above its current level.

Even taking into account opportunity costs, the $1,000/MWh offer cap is generally more than sufficient. Use-limited resources may have legitimate opportunity costs—e.g., a unit that can only run 2,000 hours a year due to environmental restrictions—will only want to run in the highest priced hours. Those resources can legitimately bid higher than their short-run marginal cost to account for the opportunity cost (provided, of course, that the opportunity cost is verifiable and monitored by the RTOs market monitoring unit). So even if a use-limited resource in WUMS wanted to include an opportunity cost component to its offer, it is highly unlikely that the resource's total offer would exceed $1,000/MWh.

Of course, there are rare circumstances in which a generator's actual marginal cost would increase above $1,000/MWh. That happened earlier this year in PJM, when a combination of factors—including record low temperatures—caused natural gas prices to spike. In that situation, PJM claimed that many gas-fired generators had actual marginal costs greater than $1,000/MWh.

But the PJM example also demonstrates the appropriate remedy in those rare circumstances—PJM made an emergency filing for a temporary waiver of the offer cap. Gas prices spiked on January 21, and PJM made a filing two days later, with an effective date of January 24. There was very little delay in implementing this emergency relief, and the Commission and all other affected parties had an opportunity—on an expedited schedule—to review the request to determine that it was justified and thereby met the Commission's statutory obligations to ensure that resulting prices were just and reasonable. Allowing offers to exceed $1000/MWh without such procedural protections (as some have urged) would expose consumers to unjust and unreasonable rates.

E. Market mitigation of resources located in transmission constrained areas continues to be necessary.

Although regional energy markets reduce the risk that suppliers will be able to exercise market power and earn supra-competitive profits, the problem has not been eliminated. In particular, transmission constraints can create the opportunity to exercise local market power. And there are some regions of the country in which ownership of generation resources remains consolidated in just a few large companies. For example, in "Narrowly Constrained Areas" that are frequently subject to constraints, MISO, for example, has provided for more stringent market power mitigation than in areas less frequently subject to constraints that limit supply options. Maintenance of continued robust protections against the exercise of market power is thus essential.

CONCLUSION

Ultimately, the Commission is responsible for ensuring just and reasonable rates. Ideally, the energy markets would be competitive and suppliers would always offer energy at their marginal cost. In practice, markets are not always competitive, so is

essential that offers be mitigated to levels that approximate competitive conditions. Market power mitigation, particularly in transmission constrained areas, is therefore indispensable. Offer caps are also an important and necessary tool in this regard to prevent abuse of market power. The current offer cap of $1,000/MWh is appropriate; raising it is unnecessary and would not result in new investments in generation. So, in order to ensure just and reasonable rates, I believe we should maintain the existing market power protections including the current offer cap.

Again, I appreciate the opportunity to address these important issues and look forward to your questions.