

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

New York Independent System	)	Docket Nos. ER09-1682-000
Operator, Inc.	)	ER09-1682-004
	)	ER09-1682-005

**REQUEST FOR CLARIFICATION OR, IN THE ALTERNATIVE, REHEARING  
OF THE ELECTRIC POWER SUPPLY ASSOCIATION**

Pursuant to Section 313(a) of the Federal Power Act (“FPA”),<sup>1</sup> and Rules 212 and 713 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (the “Commission” or “FERC”),<sup>2</sup> the Electric Power Supply Association (“EPSA”)<sup>3</sup> hereby requests clarification or, in the alternative, rehearing, of the Commission’s May 20, 2010 Order in the above-captioned dockets.<sup>4</sup> The Mitigation Order states that including costs in bids in excess of actual operating costs, including fixed costs, when generators are required to run for reliability is evidence of the exercise of market power.<sup>5</sup> As described in more detail below, EPSA requests clarification that the Mitigation Order is limited to the facts and circumstances in this proceeding, and that it is not intended to set a new policy equating bids in excess of operating costs to the exercise of market power generally. To the extent that these clarifications are denied, EPSA seeks

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<sup>1</sup> 16 U.S.C. § 825l(a) (2006).

<sup>2</sup> 18 C.F.R. §§ 385.212, 385.713 (2009).

<sup>3</sup> EPSA is the national trade association representing competitive power suppliers, including generators and marketers. These suppliers, who account for 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities. EPSA seeks to bring the benefits of competition to all power customers. The comments contained in this filing represent the position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

<sup>4</sup> *Order on Proposed Application of Mitigation Measures and Compliance Filings*, 131 FERC ¶ 61,169 (2010) (“Mitigation Order”).

<sup>5</sup> Mitigation Order at P 73.

rehearing of the Mitigation Order on the basis that the new cost recovery policy set forth therein is arbitrary and capricious, as well as confiscatory.

## **I. BACKGROUND**

On September 4, 2009, the New York Independent System Operator, Inc. (“NYISO”) filed with the Commission, pursuant to Section 205 of the FPA and Sections 1(b) and 3.2.3 of the NYISO’s Market Mitigation Measures (“MMM”), a request for authorization to apply prospectively proposed new market power mitigation rules in the form of a separate Rate Schedule M-1 to three generators<sup>6</sup> bidding into the NYISO’s Day-Ahead Market (“DAM”).<sup>7</sup> Before the NYISO may invoke Section 1(b) and 3.2.3 of the MMM to propose new, generator-specific, mitigation measures, the NYISO must find that conduct has occurred that departs significantly from the conduct that would be expected under competitive market conditions, but does not trigger the thresholds in Sections 3.1.1 to 3.1.3 of the MMM, and that such conduct has a significant impact on market prices or guarantee payments as measured by predefined thresholds set forth in Sections 3.2.3(1) and 3.2.3(2) of the MMM.

In support of its request to impose mitigation measures on the Specified Generators, the NYISO explained that the Specified Generators were submitting bids into the DAM that did not clear the market, but were committed by the NYISO to operate for reliability, out-of-merit. By virtue of the fact that the Specified Generators’ bids exceeded their marginal costs (*i.e.*, had exceeded the

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<sup>6</sup> The three specifically identified generators to whom the new market mitigation measures apply are collectively referred to herein as the “Specified Generators”.

<sup>7</sup> *New York Independent System Operator, Inc.*, Docket No. ER09-1682-000 (filed Sept. 4, 2010) (“September 4 Filing”).

impact threshold), the NYISO claimed that the Specified Generators' bidding behavior departed significantly from conduct that would be expected under competitive market conditions. The NYISO also alleged the Specified Generators' bids caused their guarantee payments to exceed the applicable impact threshold specified in Section 3.2.3 of the MMM.

The NYISO's Proposed Rate Schedule M-1 would impose thresholds on each of the Specified Generators' bids that are significantly tighter than the existing thresholds in Section 3.1.2 of the MMM. When these tighter thresholds are exceeded, the NYISO would determine the generator's guarantee payment based on the generator's reference level, not its submitted offer. In an order issued on November 3, 2009,<sup>8</sup> the Commission conditionally accepted Rate Schedule M-1, subject to further orders. In its May 20 Mitigation Order, the Commission found Rate Schedule M-1, as modified, just and reasonable as applied to the Specified Generators. The Commission also encouraged the NYISO to continue efforts to develop generally applicable market mitigation measures to address the circumstances at issue in this proceeding in its stakeholder process, and directed the NYISO to submit a progress report within 90 days of the Mitigation Order, if such a measure is not filed with the Commission by that date.

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<sup>8</sup> *New York Independent System Operator, Inc.*, 129 FERC ¶ 61,103 (2009) ("November 3, 2009 Order").

## II. MOTION FOR CLARIFICATION

In the Mitigation Order, the Commission does state that Rate Schedule M-1 applies only to the Specified Generators:

We find that the application of NYISO's mitigation proposal, as modified below, only to the three Specified Generators effective as of September 8, 2009, is appropriate and fully consistent with section 3.2.3. Accordingly, we direct NYISO to indicate within Rate Schedule M-1 that it applies only to [the Specified Generators].<sup>9</sup>

Other statements in the Mitigation Order, however, could be interpreted to apply more broadly and cause confusion in the industry. For example, the Mitigation Order contains the blanket statement that “the ability to include and recover costs in excess of marginal cost, including fixed costs, in bids during periods when the generators are required to run for reliability is evidence of market power.”<sup>10</sup> While the context of the statement implies that the Commission intends for its assessment to apply only to the Specified Generators and their unique circumstances, the broad language of this statement could be misconstrued as setting new precedent that certain bidding behavior constitutes the exercise of market power generally.

As this proceeding deals specifically with three generators, other market participants, including those operating outside of the NYISO, could not have known it was necessary to fully respond to general issues concerning acceptable bid prices and practices in this proceeding. In addition, the bidding data related to the Specified Generators has been highly confidential, making it impossible for

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<sup>9</sup> Mitigation Order at P 96.

<sup>10</sup> *Id.* at P 73.

intervenors to meaningfully comment on the just and reasonable nature of Rate Schedule M-1 in this proceeding.

In light of these facts, it is critical that the Commission clarify that the rulings and findings in the Mitigation Order are limited to the Specified Generators on an interim basis. As such, the generally applicable mitigation measures coming out of the NYISO stakeholder process will, once approved by the Commission, apply to all resources operating in the NYISO Rest of State (“ROS”) area, including to the Specified Generators. The Commission should also clarify that statements in the Mitigation Order on marginal cost policy are limited to the specific circumstances of the Specified Generators, and that it does not intend to apply a stricter marginal cost policy generally.

### **III. ALTERNATIVE REQUEST FOR REHEARING**

#### **A. *Specification Of Errors/Statements of Issues***

In accordance with Rule 713(c) of the Commission’s Rules of Practice and Procedure,<sup>11</sup> EPSA hereby lists each error and each issue on which it seeks rehearing of the Mitigation Order if the above clarifications are not granted, and provides representative precedent in support of its positions on these issues:

1. The Mitigation Order is not the product of reasoned decision-making and is not supported by substantial evidence because in articulating a new marginal cost policy, the Commission has failed to explain its departure from established economic theory, the Commission’s own rulings in prior proceedings, and the just and reasonable ratemaking requirements under the FPA. *See, e.g., Motor Vehicles Mfrs. Ass’n. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (“Nevertheless, the agency must examine the relevant data and articulate a satisfactory explanation for its action including a ‘rational connection between the facts found and the

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<sup>11</sup> 18 C.F.R. § 385.713(c) (2009).

choice made.’) (quoting *Burlington Truck Lines v. U.S.*, 371 U.S. 156, 168 (1962)); *Panhandle Eastern Pipe Line Co. v. FERC*, 196 F.3d 1273, 1275 (D.C. Cir. 1999) (holding that the agency may not abandon its prior policy without providing a reasonable explanation for “the reason for its departure”); *Airmark Corp. v. FAA*, 758 F.2d 685, 695 (D.C. Cir. 1985) (“[W]hen an agency decides to reverse its course, it must provide an opinion or analysis indicating that the standard is being changed and not ignored, and assuring that it is faithful and not indifferent to the rule of law.”) (quoting *Columbia Broadcasting System, Inc. v. F.C.C.*, 454 F.2d 1018, 1026 (D.C. Cir. 1971)). See also *Wisconsin Valley Improvement Co. v. FERC*, 236 F.3d 738, 745 (D.C. Cir. 2001) (holding that an agency’s decision is arbitrary and capricious if factual determinations lack substantial evidence).

2. The Mitigation Order violates the FPA and the U.S. Constitution, because the new marginal cost policy would deny generators a reasonable opportunity to earn a return of, and on, invested capital, and thereby result in confiscatory rates. See *Bluefield Waterworks & Imp. Co. v. Pub. Serv. Comm’n of West Virginia*, 262 U.S. 679, 692 (1923) (“*Bluefield*”) (“A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time . . . in other business undertakings which are attended by corresponding risks, and uncertainties.”); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (“*Hope*”) (“The return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.”)

***B. The Mitigation Order is Arbitrary and Capricious, and Unsupported by the Evidence***

If the above clarifications are not granted, EPSA requests rehearing on the Mitigation Order’s ruling that including costs in energy bids in excess of actual operating costs, including fixed costs, when generators are required to run for reliability is evidence of the exercise of market power. Such a Commission determination is arbitrary and capricious, and should be reversed on rehearing as unsupported. Established economic theory, the Commission’s own rulings in

prior proceedings, and ample precedent under the FPA require that utilities – which include generators needed for reliability – have an opportunity to recover all of their costs, including a return of and on their fixed costs.

A Commission ruling that the recovery of fixed costs in bid price is evidence of an exercise of market power mischaracterizes the way markets must work if they are to be sustainable over the long term. It is well-established that generators in a competitive market can be expected to submit bids reflecting not just their short-run operating costs (*i.e.*, the reference price), but rather all of their short-run marginal costs at the time bids are submitted. The Commission has clearly found that, “[m]arginal costs include not only variable costs but also the marginal opportunity cost of all legitimate opportunities, costs, and risks.”<sup>12</sup> Opportunity costs vary by hour and are integral to the market because they account for scarcity conditions.<sup>13</sup> The Mitigation Order is unreasoned because by suggesting that bidding should be at operational costs, it takes out the mechanism that accounts for scarcity pricing (and that accounts for long-term

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<sup>12</sup> FERC “Strawman Discussion Paper on Market Power Monitoring and Mitigation,” Docket No. RM01-12-000, February 7, 2002, p 2. On pages 4-5, the Commission notes “Marginal opportunity costs include variable operating cost, the opportunity cost of selling to neighboring regions, forced outage risk costs, start-up and no-load costs, other technical inflexibilities, and the opportunity cost of selling at other time periods due to limited hydropower reservoirs or environmental constraints, and any other legitimate opportunity cost or risk. In times of scarcity, prices should be expected to exceed variable operating cost and reflect the marginal value placed on the product by customers. The marginal costs of some resources, such as the highest levels of output on a unit, may be very high due to the expected value of the risk of failure or damage to the unit.” This definition of marginal costs has been reiterated in subsequent proceedings before the Commission. See *Midwest Independent Transmission System Operator, Inc.*, 109 FERC ¶ 61,285 at P 221 (2004) (requiring the independent market monitor to consider legitimate risk and opportunity costs in marginal cost calculations).

<sup>13</sup> It is fundamental economics that bidding and prices above short-run marginal cost can simply be evidence of scarcity conditions rather than market power. See Alfred E. Kahn, *The Economics of Regulation: Economic Principles and Institutions*, 65-75, 87-89 (1988); Steven Stoff, *Power System Economics: Designing Markets for Electricity*, 126-129 (2002).

marginal cost recovery).<sup>14</sup> This is clearly mistaken, as basic economic principles show that scarcity pricing exists and prices rise when supply is tight even though the inputs to producing the power likely do not change.

In addition, if only short-run operating costs are recovered by generators in a market, there are no price signals to the marketplace to provide proper incentives for the development of future resource adequacy whether from new generation, demand response or transmission or to ensure the viability of existing economic generation.<sup>15</sup> In discussing competitive bidding behavior in uniform-price auction markets that “guides the market toward long-run efficient outcomes,” noted economist Peter Cramton stated the following:

As a matter of economic theory and sound market design for wholesale electricity bid-based auction markets, there is and should be no competitive norm stipulating that suppliers’ bids should equal marginal costs. The lack of marginal cost bidding is not evidence of anticompetitive or manipulative behavior by market participants, nor is it evidence even that

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<sup>14</sup> EPSCA recognizes that the Mitigation Order attempts to limit its scope by stating “if NYISO’s current market measures that allow for fixed cost recovery are inadequate, those issues may be addressed in other appropriate proceedings but they are not within the scope of the instant proceeding, which rather, is focused on market power mitigation.” *Id.* at P 82. EPSCA is concerned, however, that because FERC opined that bids including fixed costs are evidence of the exercise of market power (and are thus subject to mitigation and other measures), the Mitigation Order could be read as affirming the general notion that bidding above marginal costs indicates market power.

<sup>15</sup> Recent NYISO reports indicate market prices are unable to attract investments as reflected. For example, in discussing long-term economic signals, the 2008 State of the Market Report states that “This comparison for 2008 shows that the Vernon/Greenwood load pocket within New York City is likely the only area of New York where an investment in a new combustion turbine might have been profitable.... Prospective investors must consider that net revenues are likely to change in subsequent years for several reasons. First, the retirement of nearly 1 GW of New York City capacity before the Summer 2010 capability period will substantially increase net revenues from the capacity market and, to a lesser degree, the energy and reserves markets. Second, net revenues tend to rise with natural gas prices, so if natural gas prices decline from 2008 levels, it is likely to reduce net revenues. Third, clockwise loop flows around Lake Erie tend to increase energy and reserves prices in Eastern New York, so the decline in those loop flows will contribute to lower net revenues for generators in Eastern New York.” David Patton, *2008 State of the Market Report: New York ISO*, September 2009, page vi.

competition is failing or that markets are broken. In any real-world market in which suppliers are not forced by conditions or rules to be price takers, bidding above marginal cost is consistent with and, indeed, is impelled by independent, non-collusive, profit maximizing behavior. Bidding above marginal cost should be viewed as an inevitable and desirable response of independent, profit maximizing decisions in real-world markets where the ideal conditions of a perfectly competitive market do not prevail.

Bidding behavior in electricity markets should not, therefore, be assessed against a norm of marginal cost bidding, which applies only in the theoretical extreme of perfect competition. While some may use this extreme point as a convenient benchmark, it is not the norm for rational, profit maximizing behavior by independent competitors. In real bid-based electricity markets operating under a range of supply and demand conditions, individual suppliers should be bidding to maximize their profits, which, as this paper explains, will inevitably involve bidding above marginal cost. Bidding above marginal costs is and should be the competitive norm in uniform-price electricity auction markets.<sup>16</sup>

In addition to being unsupported by economic policy, the Commission's ruling is an unexplained departure from its precedent in other proceedings addressing bid mitigation. In a decision involving the Midwest Independent System Operator, Inc., for instance, the Commission stated that "[w]e believe that competitive prices over the long run should recover both the fixed and variable costs of efficient generating units and we fear investors may decline to invest in needed generation, transmission, and demand-side projects if they do not see a

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<sup>16</sup> "Competitive Bidding Behavior in Uniform-Price Auction Markets" at 1, Peter Cramton, University of Maryland, Published in the Proceedings of the Hawaii International Conference on System Sciences, January 2004.

reasonable expectation of recovering their costs.”<sup>17</sup> Consistent with this notion, the Commission implemented the peaking unit safe harbor (“PUSH”) mechanism in New England, whereby certain generators were allowed to include fixed costs in energy bids, in order to afford them an opportunity “to recover their costs and earn a fair rate of return.”<sup>18</sup> It should be noted, however, that even with a higher bid cap such as the PUSH bid cap, concerns remained about adequate cost recovery because generators were not, in fact, provided with sufficient opportunity for recovery of and on their fixed costs.<sup>19</sup> Likewise, in PJM the Commission required the application of a frequently mitigated unit adder under which PJM sellers that are cost-capped more than 60%, 70% or 80% of their run hours can add, at a minimum, \$20, \$30 or \$40, respectively, to their cost-based bids.<sup>20</sup>

Finally, if the Mitigation Order intends to hold that bidding in excess of short-run operating costs involves an exercise of market power in all circumstances, the Mitigation Order violates the FPA and the U.S. Constitution, because it fails to provide an opportunity for generators to obtain adequate cost

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<sup>17</sup> See *Midwest Independent Transmission System Operator, Inc.*, 102 FERC ¶ 61,196 at P 49 (2003).

<sup>18</sup> *Devon Power LLC, et al.*, 109 FERC ¶ 61,154 at P 43 (2004) (Devon II). See also *Devon Power LLC et al.*, 103 FERC ¶ 61,082 at P 33 (2004) (Devon I) (holding that PUSH bids would properly include both a variable cost component and a fixed cost adder designed to recover unit-specific fixed costs).

<sup>19</sup> *A Review of PUSH Implementation and Results*, ISO-NE, December 2003 at 1. (The actual operating experience of generators in New England has been that they recover only a fraction (about 35%) of the approved levels of fixed costs for PUSH bid units.)

<sup>20</sup> See *PJM Interconnection, L.L.C.*, 107 FERC ¶ 61,112 at P 39 (2004) (requiring PJM’s rules to “clearly spell out the rights generators have to higher bid caps when they are subject to frequent mitigation”).

recovery to provide reliability services.<sup>21</sup> Although the Commission noted that fixed cost recovery issues are not “within the scope of the instant proceeding, which, rather, is focused on market power mitigation,”<sup>22</sup> if the Mitigation Order is not narrowly tailored to the Specified Generators, and does indeed set a new marginal cost recovery policy, then the order does directly affect fixed cost recovery. Even a short-term measure, such as that approved in this proceeding, must meet the just and reasonable ratemaking requirements under the FPA. Tightening mitigation rules to the point where generators cannot recover their variable and fixed costs is clearly not just and reasonable. FERC must allow submittal of energy bids that are designed to yield rates that provide a generator the opportunity to recover its variable *and fixed* costs, including a reasonable return on invested capital. Unless clarified or reversed on rehearing, the Commission’s decision in the Mitigation Order would not allow such adequate cost recovery and is thus confiscatory.

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<sup>21</sup> See *Bluefield* at 692; *Hope* at 603.

<sup>22</sup> Mitigation Order at P 82.

#### IV. CONCLUSION

For the foregoing reasons, EPSA respectfully requests the Commission grant its request for clarification, or in the alternative, grant rehearing of the Mitigation Order on the issues raised herein.

Respectfully submitted,



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On behalf of the  
**Electric Power Supply Association**

June 21, 2010

**CERTIFICATE OF SERVICE**

I hereby certify that I have served a copy of the foregoing document via email upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C., on this 21st day of June, 2010.



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Nancy Bagot, VP of Regulatory Affairs