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# Performance Enhancement: FERC Approves Significant Restructuring of PJM's Capacity Market

On June 9, 2015, the Federal Energy Regulatory Commission (FERC) conditionally approved significant reforms to PJM's capacity market, implementing the Capacity Performance Resource product, with PJM's compliance filing due within 30 days.[1] FERC found such reforms were necessary to address "the confluence of changes in the PJM markets, including both recent performance issues…impacted by inadequate incentives and penalties for resource performance under its current construct and ongoing changes in PJM's resource mix that are projected to accelerate." PJM's resource performance fell well below expected levels during the extreme weather events of January 2014 (i.e., during the Polar Vortex) when PJM's 22 percent forced outage rate far exceeded its 7 percent historical average.

FERC found that PJM's Capacity Performance proposal is intended to ensure performance and the reliability of the PJM system during extreme weather events. As approved, capacity resources necessary to perform during these events can recover their costs of doing so while facing new and substantial penalties for non-performance.[2] Specifically, FERC noted that PJM's currently effective offer cap for existing generators does not allow sellers to include in their offers the costs attributable to natural gas firm transportation contracts.

The now-approved Capacity Performance regime should be partially incorporated into the upcoming Incremental Auctions this summer, and the Base Residual Auction beginning on Aug. 10, 2015, for the 2018-2019 delivery year. Such a quick adoption timeframe might lead to additional enforcement and market monitor scrutiny. The new capacity regime also might shake loose additional capacity resources for potential sale.

Unpersuaded by certain intervenors' arguments that generators already have improved cold-weather performance in response to the Polar Vortex outages, FERC stated that "it is not uncommon for performance to improve after an event,

[1] PJM Interconnection, L.L.C., 151 FERC ¶ 61,224 (2015).
[2] FERC noted that although its approval was not based solely on the recent degradation of resource performance in PJM in times of system stress, "this poor performance has led to significant and expensive price spikes."

only to trail off later." FERC noted that while PJM's currently existing capacity market construct has been "successful in procuring commitments three years into the future, it has not been successful in ensuring that resources *actually* perform when called upon three years in the future.

**Failure to Perform – Reasons and Solutions**

FERC concluded that there were three primary reasons for performance failures under PJM's existing structure: (1) a lack of an adequate penalty structure; (2) a limited ability to recover costs of necessary investments; and (3) an incentive to trim capital improvement plans and operating budgets.

*Lack of an adequate penalty structure:* FERC found even poorly performing resources could expect to pay only minimal penalties, placing most of the risk of under-performance on load. Indeed, for the 2013-2014 delivery year that saw the significant forced outage rates during the Polar Vortex days described above, Peak-Hour Period Availability Charges totaled approximately $39 million, a mere 0.6 percent of total capacity revenues. PJM showed that without more stringent penalties, there is little incentive for a seller to make capital improvements, or to increase its operating maintenance for the purpose of enhancing the availability of its unit during emergency conditions. The Commission agreed with PJM that under its existing rules, a seller could earn substantial revenues through PJM's capacity auctions by committing its resource as capacity, with little concern that it will lose significant revenue even if it performs poorly.

The Commission determined that by approving PJM's more stringent Non-Performance Charge, it will provide incentives to capacity sellers to invest in and maintain their resources by tying capacity revenues more closely with real-time delivery of energy and reserves during emergency system conditions. FERC accepted PJM's proposal to base the Non-Performance charge rate on the Net Cost of New Entry (Net CONE) (essentially a cap on performance penalties) as it "is likely to discourage non-performing resources from taking on capacity obligations, because over time the penalties are likely to fully offset the capacity revenues from the capacity market auctions."[3]

The Commission also ultimately accepted an annual Non-Performance stop-loss limit equal to 1.5 times annual Net CONE, which is higher than ISO-NE's pay-for-performance model. The Commission accepted two Non-Performance Charge exemptions – those PJM-approved generator planned or maintenance outages and those instances where a resource is not scheduled by PJM due to the seller's submission of a market-based offer price greater than its cost-based offer price. Non-Performance Charge revenues will be redistributed from under-performing resources to over-performing resources.

*Limited ability to recover costs of necessary investments*: FERC concluded PJM's existing rules limit a seller's opportunity to recover, as a capacity resource, the costs it must incur to improve the performance capability of its resource. Specifically, PJM's currently-effective offer cap for existing generators, while allowing for the recovery of certain capital costs (*e.g.*, investments in dual-fuel capability), skews investment decisions and does not allow sellers to include in their offers the costs attributable to other means of securing reliable fuel, such as natural gas firm transportation arrangements or priority fuel procurement contracts. The Commission concluded that deficiencies in PJM's existing rules will only be exacerbated if they remain in effect as additional natural gas-fired resources come online.

*Incentive to trim capital improvement plans and operating budgets:* PJM successfully argued that given its existing rules and minimal penalties, many resources offer into PJM's auction as price-takers, displacing resources that submit higher priced bids that account for such investments; thereby incenting resources to delay prudent investments that would enhance fuel security or otherwise improve their performance capability. FERC was concerned that such rules inadequately incent resource performance. Specifically, FERC determined that the current regime "perversely selects less reliable resources over more reliable resources" because a capacity seller's decision to forego investments that would improve performance allows that seller to offer into the capacity market at a lower price, and thereby be paid the lower clearing price while providing less reliable service.

[3] The Commission also accepted PJM's proposal to rely on an estimate of 30 hours of Emergency Actions to formulate the Non-Performance Charge rate. FERC determined PJM's reliance on the historical Emergency Action hours experienced during the 2013-2014 commitment period represented a reasonable approximation of the upper bound of hours during which the system is likely to experience Emergency Actions over the relevant commitment period.

**Some of PJM's Proposals Rejected, Others Require Clarification**

Interestingly, despite its determinations highlighted above, FERC rejected PJM's proposal to require a market seller submitting a Capacity Performance offer to make a good faith representation that (i) it has made, or will make, the necessary investment to ensure that its resource has the capability to provide energy when called upon; (ii) the resource meets the operational requirements and performance obligations applicable to Capacity Performance Resources; and (iii) the seller's offer contemplates the physical delivery of the Capacity Performance Resource by no later than the commencement of the applicable delivery year.

FERC also rejected PJM's proposed: (1) elimination of a generator's "Maximum Emergency Offer" day-ahead designation limiting dispatch in real time to such a PJM-declared emergency condition (although performance penalty failures would still apply); (2) requirement that a capacity resource's competitive offers be limited, based on the physical characteristics of the specific generator rather than its economics; and (3) resource start-up time notification period of 24 hours or less as unreasonable by failing to address adequately specific capacity resource operating characteristics.

FERC also rejected PJM's proposal that knowingly false representations may be determined by PJM to constitute a violation of, and may subject the seller to penalties under, PJM's market rules and/or the Commission's market rules. The Commission was not persuaded that PJM's proposed good faith representation requirement would provide any added value in incenting resource performance, and the scope of the required representations was unclear and could serve as an unnecessary barrier to entry for new Capacity Performance Resources.

Specifically, the Commission was concerned that significant aspects of the proposed representation were inappropriately vague and this ambiguity could incent well-performing resources to elect not to participate in the capacity market to avoid the risk of sanction under the provision, PJM's market rules and/or the Commission's authority. As an aside, while FERC here rejects PJM's proposed requirement as vague and thus a participation barrier, the Commission has sanctioned FERC enforcement staff efforts in *Maxim Power* to press manipulation claims based on a "conveyed impression" (a vague standard indeed) that responses by a generator to a market monitor, although truthful, may have been too narrow. *See our June 9, 2015 Client Alert*.

FERC also determined that some of PJM's proposals required clarification. FERC expressed concerns that external resources importing into PJM's system during emergency events will be treated differently than generators and other capacity resources located within PJM. With this in mind, FERC ordered that PJM must provide clarification on the method to judge external resource performance during emergency events.

**Other Resources: Demand, Energy Efficiency, Capacity Storage, Intermittent**

FERC approved PJM's proposed Capacity Performance construct to permit aggregated offers during emergency conditions for Demand Resources, Energy Efficiency Resources, Capacity Storage Resources, Intermittent Resources, and environmentally-limited resources. FERC stated that permitting such resources to submit aggregated offers will likely enhance their ability to provide reliability benefits to the PJM region and may increase competition in the capacity market.

Countering intervenors' arguments that permitting aggregated offers from only certain resource types was unduly discriminatory, FERC stated the aggregated offers would provide "an avenue to Capacity Performance participation by resources that otherwise may be unable or unwilling to participate on a stand-alone basis because no reasonable amount of investment in the resource can mitigate non-performance risk to an acceptable level within the Capacity Performance market design." FERC noted that "generally speaking, other resources do not face this same limitation."

Noting that the use of a must-offer requirement is both consistent with established capacity market practice and necessary to safeguard against manipulation in the PJM capacity market, the Commission accepted PJM's proposal to apply its existing must-offer requirement to Capacity Performance Resources to prevent physical withholding of resources. FERC accepted PJM's proposal, however, to exempt categorically from the Capacity Performance must-offer requirement Intermittent Resources, Capacity Storage Resources, Demand Resources, and Energy Efficiency Resources on the grounds that they do not raise the same physical withholding concerns as do existing generation resources because their ownership is not concentrated.

**A Vigorous Dissent – Billions of Additional Capacity Costs Bourne by Consumers**

FERC Chairman Norman Bay issued a scathing dissent, arguing that PJM's Capacity Performance Proposal is a "flawed, complex, highly technical market construct in which there is a potential mismatch between incentives and penalties, in which mitigation has largely been eliminated in a market characterized by structural non-competitiveness, and in which there may be billions in additional capacity costs borne by consumers."

Chairman Bay's overwhelming concern was that capacity market restructuring creates an opportunity for resources to profit from non-performance; indeed, stating that a "resource could be paid for doing nothing during the emergency hours of the year when it is most needed and for which it has been well compensated." Chairman Bay decried the absence of a cost-benefit analysis stating that, while he did not believe it is needed every time a market rule is changed, "here, given the potential multi-billion dollar cost of the CPP and the burden consumers will be asked to bear, any analysis, no matter how rudimentary, would have been helpful before concluding this proposal is just and reasonable." FERC enforcement and the market monitor may closely scrutinize higher capacity price auction results.

**What's Coming Next**

PJM's compliance filing is due by July 9, 2015, so anticipate more debate. Expect further stakeholder outreach by PJM and the possibility of rehearing and further review of the June 9 order as well as additional filings and comments regarding the expected compliance filing.

PJM will be implementing the transition to its new capacity regime over five years through 2020 to enable resources to make gradual improvements and to reduce the burden such improvements may impose. PJM also is required to annually report during this transition period the occurrence of emergency conditions and revenues associated with performance payments and penalties.

FERC noted at the outset that to the extent reforms to the number or design of PJM's incremental auctions are needed, the Commission has a pending proceeding under section 206 of the FPA to investigate whether PJM's capacity market fails to promote long-term reliability by possibly permitting speculative sell offers. [4]

This *GT Alert* was prepared by **Gregory K. Lawrence** and **Francesca E. Ciliberti-Ayres‡**. Questions about this information can be directed to:


- Gregory K. Lawrence | +1 617.310.6003 | lawrenceg@gtlaw.com
- Francesca Ciliberti-Ayres‡ | +1 202.331.3145 | ciliberti-ayresf@gtlaw.com
- Any member of Greenberg Traurig's Global Energy & Infrastructure team
- Or your Greenberg Traurig attorney

*‡ Admitted to practice in Virginia and Michigan. Practice in District of Columbia limited to Federal courts and agencies.*


[4] *PJM Interconnection*, L.L.C., 147 FERC ¶ 61,108 (2014).

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|---|---|---|---|
| **Albany**<br>+1 518.689.1400 | **Denver**<br>+1 303.572.6500 | **New York**<br>+1 212.801.9200 | **Shanghai**<br>+86 (21) 6391 6633 |
| **Amsterdam**<br>+ 31 (0) 20 301 7300 | **Fort Lauderdale**<br>+1 954.765.0500 | **Northern Virginia**<br>+1 703.749.1300 | **Silicon Valley**<br>+1 650.328.8500 |
| **Atlanta**<br>+1 678.553.2100 | **Houston**<br>+1 713.374.3500 | **Orange County**<br>+1 949.732.6500 | **Tallahassee**<br>+1 850.222.6891 |
| **Austin**<br>+1 512.320.7200 | **Las Vegas**<br>+1 702.792.3773 | **Orlando**<br>+1 407.420.1000 | **Tampa**<br>+1 813.318.5700 |
| **Boca Raton**<br>+1 561.955.7600 | **London***<br>+44 (0) 203 349 8700 | **Philadelphia**<br>+1 215.988.7800 | **Tel Aviv^**<br>+972 (0) 3 636 6000 |
| **Boston**<br>+1 617.310.6000 | **Los Angeles**<br>+1 310.586.7700 | **Phoenix**<br>+1 602.445.8000 | **Tokyo¤**<br>+81 (0)3 3216 7211 |
| **Chicago**<br>+1 312.456.8400 | **Mexico City+**<br>+52 (1) 55 5029.0000 | **Sacramento**<br>+1 916.442.1111 | **Warsaw~**<br>+48 22 690 6100 |
| **Dallas**<br>+1 214.665.3600 | **Miami**<br>+1 305.579.0500 | **San Francisco**<br>+1 415.655.1300 | **Washington, D.C.**<br>+1 202.331.3100 |
| **Delaware**<br>+1 302.661.7000 | **New Jersey**<br>+1 973.360.7900 | **Seoul∞**<br>+82 (0) 2 369 1000 | **Westchester County**<br>+1 914.286.2900 |
| | | | **West Palm Beach**<br>+1 561.650.7900 |