115 FERC ¶61,158
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

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

Midwest Independent Transmission System Operator, Inc. — Docket No. ER06-731-000

ORDER REJECTING EXTENSION OF
BROAD CONSTRAINED AREA MITIGATION

(Issued May 9, 2006)

1. In this order, the Commission rejects a request by the Midwest Independent Transmission System Operator, Inc. (Midwest ISO) for an extension of Broad Constrained Area (BCA) mitigation. The Commission stated previously that at the end of the one-year authorization period the Commission would assess the use of BCA mitigation to determine if it should be continued. Upon review of the data and reports associated with BCA mitigation, the Commission has decided to no longer authorize the use of BCA mitigation, as of April 1, 2006, and thus requires the Midwest ISO to submit revised tariff sheets removing language pertaining to BCA mitigation.

I. Background

A. Monitoring and Mitigation in Midwest ISO

2. On August 6, 2004 and November 8, 2004, the Commission issued orders that, among other things, established market monitoring and market power mitigation for the Midwest ISO,[1] as set forth in Module D of the Midwest ISO's Open Access Transmission and Energy Markets Tariff (TEMT).

3. The Midwest ISO's market monitoring plan is implemented by an Independent Market Monitor (IMM). The monitoring plan establishes that the IMM will monitor the markets run by and the services provided by the Midwest ISO, which would include the

[1] *Midwest Independent Transmission System Operator, Inc., et al.*, 108 FERC ¶ 61,163 (2004) (TEMT II Order), *order on reh'g*, 109 FERC ¶ 61,157 (2004) (TEMT II Rehearing Order).

imbalance energy market, any ancillary services market, any market for the purchase or sale of transmission rights, and any other market administered, coordinated or facilitated by the Midwest ISO.[2]

4. The Midwest ISO's market power mitigation plan imposes mitigation upon entities in constrained areas (areas in which a constraint is actively binding) that fail conduct and impact tests such that their conduct is significantly inconsistent with competitive outcomes (as indicated by conduct threshold levels) and would result in a substantial change in one or more prices in the energy market or in an Offer Revenue Sufficiency Guarantee (RSG) Payment (uplift charges to cover start-up and no-load costs) in the energy market (by exceeding impact thresholds).[3]

B. Tests for Mitigation under BCA and NCA Definitions

5. Electrical areas that may be subject to mitigation are classified as Narrow Constrained Areas (NCAs) or BCAs. NCAs are areas that are more likely to be subject to the exercise of market power abuse and are subject to more stringent thresholds for mitigation. An NCA is an electrical area defined by one or more transmission constraints that are expected to be binding for at least 500 hours during a given twelve month period and within which one or more suppliers is pivotal. A supplier is pivotal when the output of some of its generation resources must be changed to resolve the transmission constraint during some or all hours when the constraint is binding. Mitigation may be applied when a pivotal supplier violates both the conduct and impact thresholds. NCAs are determined annually (but can be determined more frequently) by the IMM.[4]

6. BCAs are not identified in advance by the IMM, but are defined dynamically when constraints arise on flowgates. A BCA is an electrical area in which sufficient competition usually exists, even when one or more transmission constraints are binding, or into which the transmission constraints bind infrequently, but within which a transmission constraint can result in substantial locational market power under certain market or operating conditions.[5]

7. When a transmission constraint becomes binding, the IMM identifies the generation units that are effective in managing the constraint, and defines them to be in the BCA. To determine which generation units are in the BCA, the resource's generation shift factor (GSF) for that flowgate is compared to a 6 percent Constraint Generation

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[2] Section 50.2 of the TEMT.

[3] TEMT II Order at P 245.

[4] Section 1.207 of the TEMT.

[5] Section 1.24 of the TEMT.

Shift Factor Cutoff (GSF Cutoff) for that same flowgate. A generation resource's GSF is the incremental increase or decrease in flow on the flowgate associated with an incremental increase or decrease in the generation resource's output. If the absolute value of the generation resource's GSF exceeds the GSF Cutoff, then it will be included in the associated BCA and will be subject to conduct and impact tests. At that point, if the generation resource fails the conduct and impact tests, it may be subject to mitigation, as defined in the TEMT.[6]

8. The conduct test determines whether the generation resource has exceeded the conduct thresholds set forth in section 64.1 of the TEMT. That section lays out the thresholds for behavior which could potentially be problematic, *i.e.*, "significantly inconsistent with competitive conduct."[7] Categories of potentially problematic behavior include economic withholding, physical withholding, uneconomic production, and uneconomic market participant bids or virtual transactions.

9. The impact test determines whether the generation resource has exceeded the impact thresholds set forth in section 64.2 of the TEMT. That section gives guidelines for price effects, *i.e.*, substantial changes in prices that will trigger mitigation if there is a binding constraint and the conduct test is also failed by the market participant. Impact thresholds set limits on the acceptable impacts on prices or on Offer Revenue Sufficiency Guarantee Payments to market participants.

C. <u>Additional Tools for the IMM</u>

10. The IMM also monitors the markets and services administered by the Midwest ISO for any conduct that may distort competitive outcomes, but that does not trigger the thresholds for the imposition of mitigation measures. If the IMM finds such conduct, the Midwest ISO makes a filing with the Commission under section 205 of the Federal Power Act (FPA), 16 U.S.C. § 824d (2000), requesting authorization to apply appropriate mitigation measures.[8]

11. Also in the TEMT II Order, the Commission accepted the Midwest ISO's proposal to adopt a $1,000 per megawatt-hour bid cap as a means of maintaining price stability prior to implementation of a comprehensive and permanent resource adequacy plan. Among other things, the Commission stated that the potential for unanticipated price volatility at the startup of a new market in which there is no history of pooled operations

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[6] TEMT II Order at P 265-67.

[7] Section 64.1.1 gives the specific thresholds for identifying physical withholding, section 64.1.2 gives those for economic withholding, and section 64.2.3 gives those for uneconomic production.

[8] Sections 62c and 64.2.3 of the TEMT.

strongly argues for such a safety measure and that experience to date with the $1,000 bid cap in other markets does not suggest that the cap is responsible for cost recovery problems or creates a major impediment to investment.[9]

D. Conditional Approval of BCA Mitigation

12. In the TEMT II Rehearing Order, the Commission noted that the difficulty in mitigating bids is to find the appropriate balance between under-mitigation and over-mitigation, because each has its costs. While under-mitigation may result in some exercise of market power that is not mitigated, over-mitigation means more frequent intervention in the market, and some competitive market results will be mitigated.[10] Mitigation is counterproductive to the extent it penalizes suppliers trying to resolve constraints, and when their higher offers reflect higher costs, not manipulation. Over-mitigation also can inadvertently lead to decreased confidence in the market and cause reliability problems to the extent that it keeps capacity out of the market over the long term.[11]

13. The Commission expressed concern that the application of mitigation, beyond the $1,000 bid cap, in BCA areas would result in excessive mitigation. Specifically, the Commission questioned whether the application of the GSF Cutoff captures the appropriate set of generators exerting possible market power and strikes the optimal balance between over-mitigation and under-mitigation. While we stated that we did not take lightly the potential for the exercise of market power in BCA areas, we also expressed concern that any mitigation be applied in an appropriate manner. We recognized our obligation to assure that monitoring and mitigation occur such that rates are just and reasonable for buyers and sellers.[12]

14. For these reasons, the Commission believed that the need for mitigation within BCAs should be re-evaluated after gaining some operational market experience. Thus, the Commission approved the use of BCAs as a method to screen for the use of mitigation in the Midwest ISO for a one-year period, ending April 1, 2006. In order to assess the BCA mitigation approach, the Commission required the IMM to submit quarterly reports to the Commission on BCAs and their associated mitigation. We stated that if we found problems with the IMM's discretion in the application of mitigation with BCAs, we would take appropriate action, including consideration of terminating the BCA

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[9] TEMT II Rehearing Order at P 302.

[10] TEMT II Rehearing Order at P 230.

[11] TEMT I Order at P 316.

[12] TEMT II Rehearing Order at P 230-231.

provision before the end of the original one-year period.[13] The Commission also stated that the Midwest ISO could file to extend the use of BCA mitigation beyond the original one-year period, based on whether the benefits of such mitigation exceed its costs, in terms of over-mitigating versus under-mitigating the market.[14]

II. <u>Midwest ISO's Filing</u>

15. On March 10, 2006, the Midwest ISO submitted a filing requesting that the BCA mitigation provisions contained in Module D of the TEMT be extended for at least one year, to April 1, 2007.

16. The Midwest ISO states that BCA mitigation was utilized on several occasions in the energy markets during 2005 when transmission constraints or local reliability requirements in certain areas created substantial market power. The Midwest ISO states that, in general, those conditions arose: (1) when important transmission lines and/or generation units were out of service and there was a corresponding "high value congestion" occurring that was not normally seen; (2) when market participants in an area bid their units inflexibly and the Midwest ISO had limited redispatch options for managing congestion; and (3) when the outage of baseload generation units caused unusual patterns of congestion or voltage support issues. The Midwest ISO states that the market power that existed in these cases can manifest itself to allow a supplier to raise energy prices substantially in a specific area or to cause the Midwest ISO to make inflated Revenue Sufficiency Guarantee payments to the supplier to commit units in a certain area. The Midwest ISO states that, while BCA mitigation was infrequent in 2005, in certain situations it was the only tool available to prospectively limit market power abuses.

17. The Midwest ISO states that the IMM has analyzed the use of mitigation procedures in BCAs during the first year of market operations and that the Midwest ISO and the IMM have discussed the need for continued BCA mitigation authority. Based on this work, the Midwest ISO contends that BCA mitigation was essential and will continue to benefit energy markets within the Midwest ISO Region. The Midwest ISO states that these reasons justify an extension of its BCA mitigation authority for at least one more year.

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[13] TEMT I Order at P 275.

[14] TEMT II Rehearing Order at P 231.

III. Notice of Filing and Responsive Pleadings

18. Notice of Midwest ISO's filing was published in the *Federal Register*, 71 Fed. Reg. 14,881 (2006), with motions to intervene and protests due no later than March 31, 2006. The Wisconsin Public Service Corporation, Upper Peninsula Power Company, WPS Energy Services Inc., and WPS Power Development, LLC (collectively WPS Companies) and Consumers Energy Company (Consumers Energy) filed timely motions to intervene in support of Midwest ISO's proposal. American Municipal Power-Ohio, Inc. (AMP-Ohio) and Midwest Transmission-Dependent Utilities (Midwest TDUs)[15] also filed timely motions to intervene and comments in support of Midwest ISO's proposal.

19. AMP-Ohio and Midwest TDUs suggest that the Midwest ISO's proposal and the IMM quarterly reports indicate that BCA mitigation has been appropriately applied when sellers exhibit substantial market power. AMP-Ohio references Midwest ISO's assertion that BCA mitigation was the "only tool available to prospectively limit market power abuses" to suggest that BCA mitigation should be extended. Midwest TDUs argue that the use of the conduct and impact thresholds and the GSF Cutoff in BCA mitigation have been sufficient to prevent over-mitigation. Because the IMM quarterly reports indicate that BCA mitigation was applied infrequently only to pivotal suppliers, Midwest TDUs contend that the Midwest ISO market has not been over-mitigated. Midwest TDUs also suggest that the GSF Cutoff has been sufficient to prevent the IMM from exercising undue discretion in applying BCA mitigation. While Midwest TDUs state that they strongly support continuation of BCA mitigation, they also suggest that the conduct and impact thresholds and the GSF Cutoff may be too high, allowing generation resources to exercise market power unrestrained by BCA mitigation.

20. The Midwest TDUs argue that the Commission should extend BCA mitigation to ensure that market-based rates are just and reasonable. Midwest TDUs suggest that, consistent with *Lockyer*[16] and *AEP Power Mktg.*,[17] in order to approve market-based rates, the Commission must find that an applicant "lacks market power (or has taken sufficient steps to mitigate market power)." Midwest TDUs also contend that, consistent

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[15] For purposes of this filing, Midwest TDUs include Great Lakes Utilities; Indiana Municipal Power Agency; Lincoln Electric System; Madison Gas and Electric Company; Midwest Municipal Transmission Group; Missouri Joint Municipal Electric Utility Commission; Missouri River Energy Services; Southern Minnesota Municipal Power Agency; and Wisconsin Public Power, Inc.

[16] *Cal. ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1013 (9th Cir. 2004) (*Lockyer*).

[17] *AEP Power Mktg., Inc.*, 107 FERC ¶ 61,018 at P 40 (2004) (*AEP Power Mktg.*).

with *Farmers Union*,[18] "the Commission must have 'empirical proof' that 'existing competition would ensure that the actual price is just and reasonable.'" Additionally, because *Edison Mission* indicates that automated mitigation measures are unreasonable when the Commission fails to document that a market was not workably competitive,[19] Midwest TDUs assert that the Commission must approve automated mitigation measures if a market is not workably competitive. Midwest TDUs thus argue that the Commission must continue BCA mitigation, because the Midwest ISO proposal and IMM quarterly reports document the Midwest ISO market's vulnerability to substantial market power abuse absent BCA mitigation.

IV. <u>Discussion</u>

A. <u>Procedural Matters</u>

21. Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.214 (2005), the timely, unopposed motions to intervene filed by AMP-Ohio, Consumers Energy, Midwest TDUs, and WPS Companies make them parties to this proceeding.

B. <u>Commission Determination</u>

22. We find that the Midwest ISO has not justified the continued appropriateness of prospective BCA mitigation in the Midwest ISO market. BCA mitigation of energy prices was applied to generation within only 6 constraints out of a total of 305 actively binding constraints, and during portions of only 13 hours out of 7,329 total hours of binding constraint activity over the entire seven month period documented by the IMM quarterly reports.[20] The Midwest ISO has not shown that BCA mitigation addressed the exercise of market power instead of, for the two binding constraints in the fourth quarter of 2005 that gave rise to BCA mitigation, altering legitimate price signals that reflect supply-demand imbalances and that would encourage market entry.[21] For three

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[18] *Farmers Union Cent. Exch., Inc. v. FERC*, 734 F.2d 1486, 1508, 1510 (D.C. Cir. 1984) (*Farmers Union*).

[19] *Edison Mission Energy, Inc. v. FERC*, 394 F.3d 964, (2005) (*Edison Mission*).

[20] The Midwest ISO also applied BCA mitigation to RSG payments during the third and fourth quarters of 2005.

[21] *See* IMM Quarterly Report on BCA Mitigation for the Period from October 1, 2005 through December 31, 2005 at 5. During the fourth quarter of 2005, energy price mitigation was applied to generation within only two infrequently binding constraints during "a transmission outage and some scheduled baseload generation outages that resulted in relative severe congestion into the Minnesota area that is not typical."

constraints in the third quarter of 2005, the BCA mitigation was fleeting at most.[22] Because BCA mitigation was applied so infrequently during 2005, the continued need for prospective BCA mitigation to address the exercise of market power has not been justified. Moreover, we disagree that such infrequent incidents reflect a lack of workable competition in the Midwest ISO region absent BCA mitigation.

23. Most of the generation that ultimately was subject to BCA mitigation of energy prices experienced only brief mitigation on a nonrecurring basis, and the Midwest ISO has available to it alternate mitigation tools to address such market power. In this regard, the Midwest ISO and IMM have a continuing obligation "to mitigate the market effects of any conduct that would substantially distort competitive outcomes in the Energy Markets or other markets administered by the Transmission Provider, while avoiding unnecessary interference with competitive price signals."[23] Absent BCA mitigation, the Midwest ISO may: (1) use NCA mitigation in areas with substantial potential for the exercise of market power for prospective mitigation; or (2) make a filing with the Commission under section 205 requesting authorization to apply appropriately targeted mitigation measures for conduct that distorts competitive outcomes but does not trigger the thresholds for the imposition of mitigation measures. Midwest ISO market participants are also protected from significant market power abuse by the $1,000 per megawatt-hour bid cap.

24. The Midwest ISO has not shown that BCA mitigation of energy prices is necessary to address market power abuse in the Midwest ISO region. The IMM quarterly reports indicate that the single most frequently binding constraint of the six mentioned above with generation subject to BCA mitigation of energy prices during 2005 was active for a combined total of 519 hours. Because that constraint was binding for over 500 hours and all mitigated generation served as a pivotal supplier, that constraint may qualify for NCA mitigation. The remaining five constraints, discussed earlier, may not qualify as NCAs. However, because they were actively binding on an infrequent basis for a combined total of only 173 hours and gave rise to BCA mitigation only briefly, during portions of only 9 hours total, the remaining mitigation tools would be available to address any possible exercise of market power.

25. The Commission will no longer authorize the use of BCA mitigation as of April 1, 2006 and requires the Midwest ISO to submit revised TEMT sheets removing language pertaining to BCA mitigation.

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[22] The remaining constraint, as discussed below, may qualify for NCA mitigation.

[23] *See* Section 62.a of the TEMT.

<u>The Commission orders:</u>

(A) Midwest ISO's proposed extension of BCA mitigation is hereby rejected, as discussed in the body of this order.

(B) The Midwest ISO is hereby directed to make a compliance filing, as discussed in the body of this order, within 30 days of the issuance of this order.

By the Commission. Commissioner Kelly dissenting with a separate statement attached.

(S E A L)

Magalie R. Salas,
Secretary.

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Midwest Independent Transmission System Operator, Inc. — Docket No. ER06-731-000

(Issued May 9, 2006)

KELLY, Commissioner, *dissenting*:

In the August 2004 TEMT II Order, the Commission approved the use of Broad Constrained Areas (BCAs) as a method to screen for the use of mitigation in the Midwest ISO for one year. The Commission stated that focusing mitigation on BCAs and Narrow Constrained Areas appropriately addresses market power where "well-defined structural barriers to competitive performance exists."[1] The Commission later affirmed the use of mitigation in BCA areas, but stated that the need for BCA mitigation would be re-evaluated to ensure that it does not result in excessive mitigation.[2] Today's order rejects the Midwest ISO's request for extending the use of BCA mitigation for an additional year on grounds that the mitigation was applied infrequently during 2005 and, therefore, the need for it in the future has not been justified. I disagree with this decision. I believe the Midwest ISO's filing, the IMM's Quarterly Reports, and comments filed in support of the requested extension indicate that BCA mitigation has been appropriately applied to address legitimate exercises of market power. This tool helps to assure that Midwest ISO's markets remain competitive. Accordingly, I would have granted the requested extension of BCA mitigation for at least one more year.

In its filing, Midwest ISO describes the conditions that occurred in the last year when transmission constraints or local reliability requirements in certain areas created substantial market power and resulted in the use of BCA mitigation. It states that the market power that exists in these cases can allow a supplier to raise energy prices substantially in a specific area or cause the Midwest ISO to make inflated Revenue Sufficiency Guarantee payments to the supplier to commit units in a certain area. Based on the IMM's analysis of the use of BCA mitigation during the first year of energy market operations, Midwest ISO states that such mitigation has been essential and will continue to benefit the competitive energy

[1] *See Midwest Independent Transmission System Operator, Inc., et al.*, 108 FERC ¶ 61,163 (2004) at P 271.

[2] *See Midwest Independent Transmission System Operator, Inc., et al.*, 109 FERC ¶ 61,157 (2004) at P 231.

markets in the Midwest ISO region. In addition, all comments submitted in response to Midwest ISO's filing supported the requested extension.

Today's order notes that BCA mitigation of energy prices was applied to generation within 6 constraints out of a total of 305 actively binding constraints, and during portions of 13 hours out of 7,329 total hours of binding constraint activity. Based on the infrequent application of BCA mitigation, the order concludes that Midwest ISO has not shown that BCA mitigation addressed the exercise of market power and that, instead, it might have altered legitimate price signals that reflect supply-demand imbalances. I disagree. I see nothing in the record of this case contrary to the Midwest ISO's finding that substantial market power existed on several occasions last year or contrary to the IMM's statements regarding the need for BCA mitigation to maintain a competitive market.[3] I do not share the view that the infrequent application of BCA mitigation means that it has been excessive or has distorted legitimate price signals. In fact, I believe that its infrequent application serves as an indication that BCA mitigation has not been applied excessively. Finally, no market participant has complained that mitigation has been excessive.

Therefore, I find that this order inappropriately rejects Midwest ISO's requested extension of the BCA mitigation. I would not have removed this useful tool for addressing exercises of market power from the IMM's toolbox.

Suedeen G. Kelly

[3] *See, e.g.,* IMM's October 1, 2005 Through December 31, 2005 Quarterly Report on BCA Mitigation, at page 6: "Absent the BCA mitigation, the potential exposure of the market to this form of market power abuse [with respect to Revenue Sufficiency Guarantee payments] is substantial."