

114 FERC ¶ 61,302
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

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

PJM Interconnection, LLC

Docket No. EL03-236-007
EL03-236-008
(consolidated)
EL04-121-003

ORDER ON REHEARING AND COMPLIANCE

(Issued March 22, 2006)

1. This order addresses requests for rehearing of the Commission's July 5, 2005 Order in the captioned proceedings¹ and accepts a compliance filing submitted by PJM Interconnection, LLC (PJM) with respect to that order. Most rehearing requests are now moot and will be dismissed. The Commission will deny the remaining active request, that was filed by Dayton Power and Light (Dayton).

Background

2. Prior to the start of this proceeding, PJM automatically offer-capped any unit that was called out of economic merit order due to a transmission constraint. PJM's Operating Agreement, however, made explicit that the offer-capping procedures only applied to a generation "resource for which construction commenced before July 9, 1996."²

3. On January 25, 2005, in response to a filing by PJM, the Commission eliminated the exemption from automatic mitigation.³ The Commission eliminated the exemption

¹ *PJM Interconnection, LLC*, 112 FERC ¶ 61,031 (2005) (July 5th Order).

² Section 6.1 of the PJM Operating Agreement, page 45 (revised April 27, 1999). See *PJM Interconnection, LLC* filing April 27, 1999, in Docket No. ER97-3729-000.

³ *PJM Interconnection, LLC*, 110 FERC ¶ 61,053, P 53-62 (2005) (January 25th Order).

because continuation of the exemption could permit generating units to exercise market power in load pockets and could render PJM's local market rules ineffectual over time.⁴

4. The Commission, however, grandfathered (continued the exemption from automatic mitigation) a limited number of units because these units were built in reliance on the exemption. The Commission held that with respect to these grandfathered units, PJM could seek mitigation if PJM's market monitor could show that these units exercised market power. In this way, the Commission sought to balance the reliance interest of the generators against the need to provide for mitigation in the event that an exempt generator exercised market power.

5. Generating units within the existing PJM footprint qualified for grandfathering if they were built after April 1, 1999,⁵ and before September 30, 2003, the date on which PJM filed to remove the exemption for all units. For units built in areas integrated into PJM after April 1, 1999, the determination of whether the generator was built in reliance on the exemption would depend on the date the area was approved for integration. Based on this standard for exemption, the January 25 Order found that Dayton's units were not grandfathered (and therefore not exempt from mitigation) because Dayton integrated into PJM after September 30, 2003.⁶

6. On rehearing of the January 25 Order, the Commission, in the July 5 Order, affirmed its general determination to eliminate the mitigation exemption. The Commission found that PJM had presented substantial evidence that post-1996 units could exercise market power.⁷ However, the Commission granted rehearing and established a different method for determining when units owned by utilities located outside the classic PJM eastern footprint qualified for grandfathering. Instead of basing grandfathering status for these units on the date of integration into PJM, as in the January 25 Order, the Commission found that these units would be grandfathered based on the date on which a transmission owner announced it would join PJM. In Dayton's case, that was May 28, 2002. The Commission also rejected Dayton's arguments, which

⁴ *Id.*, P 58, recognizing that congestion can cause a unit to be called out of merit order and that under these conditions the market is unlikely to be competitive.

⁵ The Commission approved PJM's Tariff provision that exempted post-1996 units effective April 1, 1999, in an order concerning PJM's market structure and market-based bids for PJM utilities. *Atlantic City Electric Co.*, 86 FERC ¶ 61,248 at 61,904 and 61,906 (1999).

⁶ January 25 Order at P 62.

⁷ July 5 Order at P 44-48.

asserted that eliminating the post-1996 exemption results in unjust and unreasonable rates and results in regulatory uncertainty and is arbitrary and capricious; that the standard for determining whether units were grandfathered was unduly discriminatory as applied to Dayton; and that the elimination of the exemption could constitute an unconstitutional taking of property.

7. In the July 5 Order, the Commission also established a hearing to examine whether further changes in the automatic mitigation provision should be made to ensure that automatic offer-capping would not apply in situations of scarcity pricing and when generators could not exercise market power. On November 17, 2005, PJM filed an uncontested offer of settlement resolving both issues, establishing a scarcity pricing regime within PJM and providing that automatic mitigation would not apply to units in markets that were deemed competitive under a three-pivotal supplier test.⁸ The Commission accepted the offer of settlement on January 27, 2006.⁹

8. In summary, the Commission made the following determinations in a series of orders. The Commission removed the exemption from offer capping for newly constructed units, because it found that its previous determination that newly constructed units could not exercise market power was incorrect. In recognition that certain units may have been constructed in reliance on the PJM mitigation exemption, the Commission grandfathered (continued the exemption from automatic offer capping) those units that were built in reliance on the exemption. While these units would be exempt from automatic offer-capping, these grandfathered units would still be subject to mitigation if PJM demonstrates that such grandfathered units exercise market power. The Commission established a hearing, and held the hearing in abeyance so that the parties could pursue settlement discussions. Ultimately, the parties reached a settlement, which the Commission accepted. The settlement provides an exemption from mitigation for all units, including Dayton's, when scarcity pricing occurs and ensures that automatic mitigation applies only when a generating unit fails the appropriate market power screen.

Rehearing Requests

9. On August 4, 2005, the American Public Power Association, the National Rural Electric Cooperative Association, Old Dominion Electric Cooperative, the Maryland

⁸ The settlement provides an exemption from mitigation for all units, including Dayton's, when scarcity pricing occurs and ensures that automatic mitigation applies only when a generating unit fails the appropriate market power screen.

⁹ Commission letter order dated January 27, 2006, 114 FERC ¶ 61,076 (2006).

Office of People's Counsel, and Dayton filed requests for rehearing of the July 5 Order. The rehearing requests relate to issues set for hearing in the July 5 Order and resolved by the November 17, 2005 settlement.

10. Only Dayton's request for rehearing involves an issue not resolved by the settlement: the Commission's determination of which generating units would be exempt from mitigation. Dayton asserts that the July 5th Order erred in holding that 18 of its 20 peak generating units built after July 9, 1996, are not exempt from the generic offer capping mitigation procedures contained in the PJM Open Access Transmission Tariff (PJM Tariff or Tariff). On August 4, 2005, PJM submitted a compliance filing in accordance with the Commission's directives.

Discussion

A. The Rehearing Requests

11. The Commission finds that the rehearing requests of the American Public Power Association, the National Rural Electric Cooperative Association, Old Dominion Electric Cooperative, and the Maryland Office of People's Counsel to our July 5th Order address issues that were resolved by the uncontested settlement. Accordingly, these requests for rehearing are dismissed as moot. The remainder of this order addresses Dayton's request for rehearing of the July 5th Order and denies it.

12. In its rehearing request and protest, Dayton renews the arguments that it initially made against the Commission's January 25th Order. It again argues that PJM and the Commission have the burden of establishing that removal of the post-1996 exemption was just and reasonable, and that neither PJM nor the Commission met that burden. It also asserts (1) that the July 5th Order uses a modified standard that unjustly discriminates against Dayton's units that were constructed after April 1, 1999; (2) that the modified standard changed existing rates without an adequate rationale and resulted in rates that are unjust and unreasonable; (3) that the modified standard raises equitable concerns and the possibility of an unconstitutional taking; (4) that the modified standard is not supported by substantial evidence and as such is arbitrary and capricious; and (5) that the modified standard is not the product of reasoned decision making and creates regulatory uncertainty. As explained below, the Commission reaffirms its prior holdings rejecting these contentions.

1. Standard for Grandfathering Units

13. The first issue raised by Dayton is whether the Commission acted unreasonably in allowing certain units to qualify for the exemption from the automatic mitigation provision and not permitting Dayton's units to qualify. The Commission affirms its finding that there was a reasonable basis for distinguishing between Dayton's units and the other grandfathered units.

14. The Commission's standard for determining whether a generating unit qualifies for the exemption from automatic mitigation is whether the generating unit's owner could reasonably have relied on PJM's exemption in going forward with plant construction.

15. The facts of this case show clearly that Dayton could not have relied on the mitigation exemption in PJM's Tariff in determining whether to construct its units, because its construction decisions were made well before Dayton entertained the prospect of joining PJM, and, in fact, occurred while Dayton had proposed to join another RTO. The construction of the Dayton units in question commenced between March 2000 and September 2001. At that time, Dayton had proposed to join the regional transmission organization (RTO) being put forth by a group of utilities called the Alliance Companies, not PJM. It was not until December 20, 2001, at least two full months after Dayton began construction on the last unit, that the Commission issued an order holding that the Alliance Companies' proposal failed to meet the standards for an RTO.¹⁰ Thus, Dayton began construction of its last unit before the Commission had rejected its proposal to join the Alliance RTO.

16. The members of the Alliance Companies subsequently filed a request for declaratory order raising certain issues regarding the future of the Alliance Companies, which the Commission granted in part and denied in part on April 25, 2002.¹¹ In that order, the Commission also directed the Alliance Companies to advise it within 30 days which RTO each of the companies would elect to join. Dayton advised the Commission on May 28, 2002 that it had elected to join PJM, and other members of the Alliance Companies made elections on the same date. The Commission held three hearings (June 12, June 26, and July 17), and on July 31, 2002, the Commission accepted those elections subject to the conditions stated in its order.¹²

17. Given these facts, Dayton cannot reasonably claim that it relied on the PJM mitigation exemption in determining whether to construct its generating units. At the time that construction of the units in question commenced, Dayton was a member of the Alliance Companies, and it was only on December 20, 2001 that it became clear that the Commission would not accept the Alliance Companies RTO proposal. Thus, it was not until the Commission's April 25, 2002, Order that Dayton could have had information to enable it to make a business decision to join PJM. It is telling that the March 2, 2002, request for declaratory order by the members of the Alliance Companies did not address what the Alliance Companies should do to join PJM, but rather what they should do to

¹⁰ *Alliance Companies*, 97 FERC ¶ 61,327 at 62,525 (2001) (*Alliance I*).

¹¹ *Alliance Companies*, 99 FERC ¶ 61,105 (2002) (*Alliance II*).

¹² *Alliance Companies*, 100 FERC ¶ 61,137 (2002) (*Alliance III*).

join the Midwest Independent System Operator (MISO), indicating that, even at that juncture, Dayton had not decided to join PJM.¹³ Under any reasonable construction of events, Dayton's decision to construct the units at issue occurred well before it made any decision to join PJM. Moreover, at the Commission hearing on June 26, 2002, Dayton expressly stated that its reason for joining PJM was to follow American Electric and Power in the development of an eastern market.¹⁴ There is no mention of any concern about regulatory protocols or limitations, including whether Dayton might be subject to PJM's market mitigation provisions if Dayton joined PJM. The emphasis was on the broader market issues involved and Dayton's own words contradict its representations here. Thus, Dayton cannot show that it met the reliance standard for exemption from mitigation.

18. Dayton also argues that it is entitled to a similar reliance interest exemption because it built its peaking units based on the Commission granting it market-based rates and the lack of mitigation rules in the East Central Area Reliability Council (ECAR) region prior to the creation of PJM. However, we find that the grant of general market-based rate authority does not carry the same reliance or expectation as did the explicit mitigation exemption in the PJM Tariff.

19. As explained in the July 5 Order,¹⁵ the grant of market-based rates to Dayton was always subject to mitigation in the event of the exercise of market power, and was not as unconditional as the PJM Tariff provision that exempted from mitigation generation "resource[s] for which construction commenced before July 9, 1996."¹⁶ Under the Commission's general market-based rate program (which would have applied to generators in ECAR),¹⁷ a utility is granted market-based rates only if it shows a lack of

¹³ See *Alliance II* at 99 FERC 61,429-30 and 436-37.

¹⁴ *Alliance Companies*, Docket No. EL02-65-000, *et al.*, June 26, 2002 transcript at pp. 271-273. The importance of the existing close interconnection with AEP is mentioned in two different paragraphs.

¹⁵ 112 FERC ¶ 61,031, at P 54-55 & n. 52.

¹⁶ Section 6.1 of the PJM Operating Agreement, page 45 (revised April 27, 1999). See PJM Interconnection, LLC filing April 27, 1999, in Docket No. ER97-3729-000.

¹⁷ Unlike PJM, ECAR is not an RTO, but a reliability area that has no independent OATT or mitigation program. Dayton's activities were governed by its individual OATT and the terms of its market-based rate authority.

generation dominance or that its market power was adequately mitigated.¹⁸ Utilities were required to provide an updated market analysis every three years that showed a lack of generation dominance or adequate mitigation.

20. At the time Dayton constructed its post 1996 peaking units, it was not exempted from the requirement to demonstrate a lack of market power in generation for units constructed after 1996,¹⁹ because Dayton also owned generating units constructed prior to 1996. Thus, Dayton was required to make a filing showing a lack of market power covering all its units, including the post-1996 units.²⁰

21. Indeed, the Commission made clear, in the order accepting Dayton's application for market-based rates, that the grant of market-based rates was conditional. Dayton was required to notify the Commission whenever a change in status, such as ownership of generation facilities, would result in a departure from the characteristics the Commission relied upon in approving market-based pricing. Alternatively, Dayton could elect to report such changes in conjunction with its three year updated market analysis. The Commission also made clear that it could require an updated market analysis at any time.²¹ For example, if Dayton's acquisition of additional generation capacity based on its newly built units resulted in a Commission finding that Dayton had generation market power, which was not adequately mitigated, Dayton would not have been permitted to continue to charge unmitigated market-based rates.²²

¹⁸ Other criteria also apply but this is the central one at issue here.

¹⁹ Section 35.27 of the Commission regulations provides that: "any public utility seeking authorization to engage in sales for resale of electric energy at market-based rates shall not be required to demonstrate any lack of market power in generation with respect to sales from capacity for which construction has commenced on or after July 9, 1996." 18 C.F.R. § 35.27(a) (2005).

²⁰ Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities, Order No. 888, 1991-1996 FERC Stats. & Regs. Regulations Preambles ¶ 31,036, at 31,657 (1996) (evaluation of market-based rates for existing capacity will include consideration of new capacity); *DPL Energy, Inc.*, 76 FERC ¶ 61,367, at 62,711 (1996) (Dayton submitted market power study because it owns generation and transmission facilities).

²¹ *Id.* at 62,714.

²² In cases where utilities have been unable to show a lack of generation dominance in their rate reviews, the Commission has acted to revoke their market-based rate authority. *See Duke Power*, 111 FERC ¶ 61,506 (2005).

22. Unlike the PJM Tariff exemption, the grant of market-based rate authority to Dayton, therefore, was conditional, was dependent on additional updates and review, and did not provide an unconditional exemption from mitigation for new units constructed after 1996. The grant of market-based rate authority did not create a reliance interest similar to the PJM Tariff provision.

23. Dayton further maintains that it should qualify for exemption because “in choosing PJM as its RTO, Dayton relied in part on the exemption from mitigation that was available to generators in PJM.”²³ But the focus should not be on the reason Dayton may have chosen to join PJM, as opposed to some other RTO; rather, it should be on whether Dayton relied on the exemption from mitigation in constructing its generating units in the first place. As the timeline shows, Dayton chose to build its post-1996 generating plants without giving consideration to the exemption from mitigation provision in PJM’s Tariff, and without a reasonable expectation that its general market-based rate authority would provide an exemption from mitigation.

24. Moreover, as the Commission pointed out in its July 5 Order, at the time Dayton joined PJM, it did not have the option of joining another RTO with an exemption from mitigation; Dayton would have been subject to mitigation in any other RTO it joined.²⁴

25. Dayton claims that reliance on May 28, 2002, the date of its announcement to join PJM, as the date for determining whether it qualifies for the exemption is not appropriate because by that date it had already reached the conclusion that it would join PJM based on the exemption. It therefore concludes that the use of the May 28 date is unfair. However, the Commission selected an objective date for measuring reliance interest, rather than relying on subjective, and hence less verifiable, recollections of when decisions may have been made. As the timeline shows, Dayton’s decisions to construct the generators at issue so far preceded any determination to join PJM that it could not have reasonably relied on the PJM exemption in making its construction decisions. At the time Dayton began construction of its last unit, it was still seeking to join the Alliance RTO, not PJM, and the Commission therefore concludes that Dayton did not rely on the PJM exemption in making its construction decisions.

26. Dayton further claims that the Commission engaged in “bait and switch” by denying it the mitigation exemption two and one half years after it first announced it would join PJM. As discussed above, Dayton knew, or should have known, when it built its generators that its market-based rates could be subject to mitigation if it could exercise, or did exercise, market power. Further, Dayton’s decision to join PJM was

²³ Request for Rehearing, at 8.

²⁴ 112 FERC ¶ 61,031, at P 56.

voluntary and entered into with full knowledge that the Commission has and could again act to mitigate the exercise of market power. Thus, the possible application of mitigation to Dayton under the PJM Tariff is the same regulatory risk it faced when it built its generating plants in the first place. In any event, in its July 5 Order the Commission explicitly rejected the argument that a generator should be permitted to exercise market power that results in unjust and unreasonable rates even to encourage investment. It is specious for Dayton to argue that a decision which prevents it from exercising market power and charging an unjust and unreasonable rate results in a “rate” that is in turn unjust and unreasonable.

27. It is for these fundamental reasons that the Commission provided a relatively narrow exemption of certain units from PJM’s mitigation of generators bidding out of economic merit. In fact, it did so only because certain generators could have relied on the exemption in deciding to construct their generation units in the first place. The resulting “grandfathering” is reasonably based on those generators’ expectation at the time they built their units that they would be exempt from mitigation, and is available on a non-discriminatory basis to all generators that successfully demonstrate such reliance. For the reasons discussed herein, Dayton is unable to show that it relied on the PJM mitigation exemption in deciding to build its generating facilities. When it built its facilities, it was still pursuing its initial efforts as an Alliance Company, and did so pursuant to the Commission’s general market-based rate authority which provided that generators are subject to mitigation in the event they can exercise market power. Given that the issue here is in fact the possible exercise of market power, the Commission reasonably concluded that a more objective standard should apply and reasonably relied on public statements, not internal perceptions, to make its determination.

2. The Commission’s Revocation of the Mitigation Exemption is Just and Reasonable

28. Dayton renews its contention that the Commission’s partial revocation of the mitigation exemption is not reasonable, because the Commission failed to find that the existing rate was unjust and unreasonable, that the replacement rate was just and reasonable, and that Dayton’s units could exercise market power. As has been discussed earlier in this order and in the prior orders,²⁵ the Commission concluded that continuing an absolute exemption from mitigation for all units built after 1996 was unjust and unreasonable. It did so based on the evidence presented by PJM that these previously exempt units, like any other unit, could exercise market power as a result of concentrated generation ownership in a load pocket and that they were called out of order to meet reliability requirements. The Commission also concluded that it was reasonable to permit

²⁵ July 25 Order, 112 FERC ¶ 61,031 at P 43-57.

PJM to mitigate any units exercising market power and established a hearing under section 206 of the Federal Power Act (FPA) to determine the appropriate test for deciding whether a generating unit in a load pocket can exercise market power. These actions, based on PJM's request to remove the mitigation exemption, reflect the Commission's authority under section 206 to modify the terms of a generator's participation in the wholesale electric market on a prospective basis.

29. In fact, under the provisions of the PJM Tariff arising out of the uncontested settlement in this proceeding, Dayton's units will be free from mitigation and less likely to suffer lower revenues if they do not exercise market power. As has been discussed, this is the same principle upon which Dayton was granted market based rates at the time it built its generating units. Under the settlement and PJM's Tariff,²⁶ generating units are exempt from mitigation for any hour in which (1) there are not three or fewer generation suppliers available for redispatch that jointly are pivotal to the relief of a transmission limit(s), and (2) the generation resource's owner, when combined with the two largest other generation suppliers, is not pivotal ("three pivotal supplier test"). Thus, under PJM's Tariff, Dayton will be subject to mitigation only when it can exercise market power, *i.e.* when its units fail the three-pivotal supplier test for determining market power. This reflects the same basic regulatory principles applicable at the time it built its units.

30. Moreover, the adoption of the three-pivotal supplier test in the settlement also means that Dayton suffers little, if any, harm from denial of its request for grandfathering. Under PJM's Tariff, PJM's market monitoring unit may seek to have the Commission impose mitigation on grandfathered generators when they exercise market power.²⁷ Thus, even if Dayton were granted an exemption for some of its units, it would be subject to mitigation if it can exercise market power and fails the three-pivotal supplier test. As the Commission explained in the July 25 Order: "once the Commission determines the appropriate test for market power within load pockets, that test also would be appropriate to determine when the grandfathered units have sufficient market power to warrant mitigation."²⁸ Thus, while a mitigation exemption may have been valuable to generators prior to the acceptance of the three-pivotal supplier test for market power, the exemption has far less value now since the same market power test can be applied to exempt units to determine if mitigation is needed.

²⁶ Attachment K, section 6.4.1.

²⁷ Attachment K, section 6.4.1.

²⁸ July 25 Order, 112 FERC ¶ 61,031 at P 45.

31. Dayton maintains that the Commission's action in imposing mitigation represents an unconstitutional taking of property. The Commission's proper exercise of its authority under section 206 to prevent the exercise of market power and to establish just and reasonable rates does not represent an unconstitutional taking of property.²⁹ Rather, it is the proper exercise of the Commission's statutory authority to ensure just and reasonable prices under the FPA. As the Commission explained in its orders in this proceeding, the mitigation paid to generators in load pockets with market power provides them with a reasonable opportunity to recover their costs.³⁰ In fact, if mitigated generators believe they do not receive adequate compensation under the mitigation rules, they can seek such compensation from PJM or the Commission.³¹ Thus, the imposition of mitigation with respect to Dayton's units in the event they can exercise market power does not represent an unconstitutional taking of property.

B. The Compliance Filing, Notice and Responsive Pleadings

32. The July 5 Order required PJM to: (1) exempt units in zones other than the original PJM zone, for which construction commenced beginning on the date a transmission owner made a filing with the Commission committing to join PJM, rather than the date the zone was actually integrated into PJM; (2) to clarify that a generator may deactivate a generating unit ninety days after it notifies the transmission providers of its intent to deactivate the unit; (3) require the transmission providers to give at least thirty days notice to a generation owner or its designated agent of the date when the continued operation of its generating unit is no longer required for reliability; and (4) give generators the right to continue to recover project investment costs incurred, if, subsequent to making the investment, it is determined by PJM that the generating unit is no longer needed to maintain the reliability of the transmission system, and the generator retires prior to recovering all of its relevant costs.

33. On August 4, 2005, PJM made a filing to comply with these directives. Notice of PJM's August 4, 2005 compliance filing was published in the *Federal Register*, 70 Fed. Reg. 48,696 (2005), with interventions or protests due on or before September 2, 2005. On September 1, 2005, Dayton filed a protest raising the same arguments against PJM's rules exempting generators from market power mitigation rules that it presented in its August 4, 2005, rehearing request of the July 5th Order. For the same reason that the Commission denied Dayton's rehearing request, the Commission will accept PJM's

²⁹ See *Market St. R. Co. v. Railroad Comm'n of California*, 324 U.S. 548 (1945); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

³⁰ 110 FERC ¶ 61,053, at P 18-40.

³¹ 110 FERC ¶ 61,053, at P 39.

August 4, 2005, compliance filing with the requested effective dates to the extent that the compliance filing does not conflict with the tariff sheets that were adopted as part of the November 17, 2005 settlement approved on January 27, 2006. The approval here is subject to PJM re-filing its tariff sheets in compliance with Order No. 614 designation requirements.³²

The Commission orders:

(A) PJM's compliance filing is hereby conditionally accepted, as discussed in the body of this order. PJM must file revised tariff sheets to include any necessary modifications within 30 days of the issuance of this order.

(B) The requests for rehearing filed by the American Public Power Association, the National Rural Electric Cooperative Association, Old Dominion Electric Cooperative, and the Maryland Office of People's Counsel are dismissed as moot.

(C) The Commission denies Dayton's request for rehearing, as discussed in the body of this order.

By the Commission.

(S E A L)

Magalie R. Salas,
Secretary.

³² See Designation of Electric Rate Schedule Sheets, Order No. 614, FERC Stats. & Regs. ¶ 31,096 (2000), and 18 C.F.R. § 35.9 (2004). Because the designations of some or all of the filed tariff sheets have been superceded by intervening filings, PJM should revise as necessary and re-designate the tariff sheets filed in this proceeding to reflect currently effective tariff provisions.