Comment of the Harvard Electricity Law Initiative

As the Commission considers how to avoid raising wholesale capacity rates, it should discount generators' warnings that they may demand “stranded cost” recovery if the Commission does not approve their preferred approach to the PJM tariff. Stranded cost recovery at the Commission has been applied to contracts. Expanding this extraordinary relief from contracts to RTO markets would be contrary to foundational principles of the Commission’s market-based ratemaking regime and would be unjust and unreasonable.

Under section 206 of the Federal Power Act, a Commission order finding that an RTO tariff results in unjust and unreasonable rates could trigger refunds. However, in cases such as this one “involving changes in market design, the Commission generally exercises its discretion and does not order refunds when doing so would require re-running a market.”

Generators in this proceeding ignore the high bar for refunds and defend their stratospheric jump to stranded cost recovery by citing the Commission’s Open Access Orders. But Order No. 888 and its progeny counsel against the broad-based cost recovery mechanism that generators threaten to demand. In those orders, the Commission limited stranded costs to specific long-term requirements contracts and new municipalizations or annexations. Generators overlook these clear boundaries and suggest the Commission permitted recovery related to generalized costs of restructuring. The Commission should reject this misreading of its orders.

With no precedent to support stranded cost recovery claims, generators invent expectation and reliance interests. As a matter of law, these contract remedies are inapplicable. Critically, generators cannot identify any breach of contract that might entitle them to compensation based on expectation or reliance interests.

Generators' actual expectations about market rules and prices are premised on a mistaken view of the Commission’s ratemaking authority and have no equitable force. Generators

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1 The Harvard Electricity Law Initiative is an independent policy organization based at Harvard Law School’s Environmental & Energy Law Program. We produce legal analysis to inform public debate and promote practical approaches to solving legal challenges.


3 Ameren Services Co. et al. v. MISO, 127 FERC ¶ 61,121 at P 157 (2009); aff’d Ameren Services Co. v. FERC, 2018 WL 3525364 (D.C. Cir. 2018).
assert that the Commission must approve a “clean” market, untouched by direct and certain indirect government interventions, to ensure that the PJM capacity auction is “competitive.” But courts have held that the Commission’s authority to set just and reasonable rates through a market is not premised on “whether the market as a whole is structurally competitive.” Generators’ disappointment about market rules — even rules that might affect the auction’s “competitiveness” — does not create claims for stranded cost recovery.

Sellers should expect nothing more than a just and reasonable rate. Just and reasonable capacity rates do not guarantee profits or protect particular sellers. In claiming they may deserve stranded cost recovery due to low rates, generators conflate locational prices that signal reliability needs with profits that meet investors’ desired rate of return. The Commission has endorsed PJM’s view that “RPM was designed to provide long-term forward price signals and not necessarily long-term revenue assurance for developers.” The Commission should reject generators’ attempt to force a choice between a “clean” capacity auction and stranded cost recovery.

Commission Practice and Judicial Precedent about Stranded Cost Recovery Undermine Generators’ Claims

The Commission’s industry restructuring orders reveal salient differences between the former regulatory construct and the current ratemaking regime that sets prices through short-term markets. Under the old model, “prudent” utility investments met the long-term needs of customers who were held captive by anti-competitive utility practices. Once the Commission mandated open access, those formerly trapped customers could escape their monopolist providers.

In Order No. 888, the Commission allowed utilities to recover costs “for only a discrete set of requirements contracts for which the utility can demonstrate that it had a reasonable expectation of continuing service, as well as for retail-turned-wholesale situations in which the utility satisfies the necessary evidentiary criteria.” The Commission held that there must be a “causal nexus” between the open-access tariff and lost revenues due to a departing customer that could be recovered as stranded costs. Eligible costs had to be associated with serving a specific customer and had to be recovered directly from that departing customer.

In upholding the Commission’s approach, the D.C. Circuit emphasized the causal nexus between costs and recovery. It summarized that “[i]f a utility can demonstrate that it had a reasonable expectation of continued service to a particular customer, and incurred costs...

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4 Montana Consumer Counsel v. FERC, 659 F.3d 910, 916 (quoting Blumenthal v. FERC, 552 F.3d 875, 882 (D.C. Cir. 2009)).
5 PJM Interconnection, 126 FERC ¶ 61,275 at P 150 (2009).
6 See Order No. 888, 61 Fed. Reg. 21,540 (May 10, 1996) (stating repeatedly that stranded cost recovery is limited to costs that were “prudently incurred, legitimate and verifiable”).
7 Order No. 888 at 21,630.
based on that expectation, then it would be against the public interest to require other customers or shareholders to bear those costs.9

The Commission explicitly rejected the sort of “broad-based” recovery mechanism that generators in this proceeding threaten to request, concluding that it “would provide an incentive for a utility to try to recover the costs of all of its uneconomic assets whether or not they were prudently incurred.”10 Moreover, the Commission found that a broader recovery mechanism might shift costs to customers “that had no responsibility for stranding costs in the first place” and therefore be inconsistent with the cost causation principle.11

Generators in this proceeding overlook the required causal nexus and misleadingly suggest that the “change[d] rules of the game”12 justified stranded cost recovery. Of course, stranded costs were tied to the open-access mandate. The Commission recognized that stranded cost recovery could serve the public interest by “ensur[ing] that the transition [was] fair and equitable.”13 But the public interest was not boundless; it was rooted in utilities’ “reasonable expectations of continued service.”14

Generators in this proceeding have no similar expectations. PJM doles out capacity revenue primarily through annual auctions, not long-term contracts. Moreover, unlike the utilities who were harmed by open access, generators have not made any “prudent” investments. That concept has no relevance in a market. Extending stranded cost recovery from long-term contracts to short-term capacity auctions would eviscerate the justifiable limits that the Commission drew in its Open Access Orders. Allowing generators who are dissatisfied with the market rules to recover “stranded costs” would encourage unprofitable sellers to demand compensation whenever the Commission rules against them in a tariff proceeding.

Moreover, stranded cost recovery in the Open Access Orders did not protect market participants “from the normal risks of competition, such as self-generation.”15 Today, load-serving entities are free to leave PJM entirely or exercise the existing FRR option, either of which would shrink capacity demand. Generators in this proceeding deserve no protection from the possibility of a smaller market due to exiting resources and load.

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10 Order No. 888 at 21,635.
11 Id.
12 NRG Brief at p. 26 (quoting Order No. 888-A at 12,373).
13 Calpine Brief at p. 13 (quoting City of Daytona, 137 FERC ¶ 61,183 at P 42 (2011)).
14 Transmission Access Policy Group, 225 F.3d at 709.
15 Order No. 888 at 21,630.
Contract Remedies Are Irrelevant Because There Are No Contracts at Issue, the Commission Does Not Recognize Reliance and Expectation Interests Premised on Market Rules and Prices, and Generators’ Arguments Contradict Established Principles of Market-Based Rates

Generators evoke remedies for breach of contract, representing that their investments “were reasonably made in reliance on PJM’s competitive market structure,”16 and concluding that the Commission therefore must “address the expectation interests of investors” if it approves tariff provisions that generators disfavor.17 Generators do not identify any broken contract or name a counterparty that should pay damages for a breach. Nonetheless, they insist that this proceeding could expose unidentified market participants to stranded cost recovery claims.

Under black letter contract law, a contracting party’s “expectation interest is his interest in having the benefit of his bargain by being put in as good a position as he would have been in had the contract been performed.”18 A party’s “reliance interest is his interest in being reimbursed for loss caused by reliance on the contract by being put in as good a position as he would have been in had the contract not been made.”19 In the absence of an enforceable agreement, generators have no cognizable expectation or reliance interests. Generators’ actual reliance on market rules and expectations about future Commission orders cannot support a legal claim.

Allusions to contract remedies carry no equitable weight in this context. Just and reasonable rates must balance consumer and investor interests.20 As applied to an RTO market, this standard does not mean that rates must ensure the profitability of every investor.21 Rates may harm particular market participants or even disadvantage a class of investors. Such ordinary disparities in market outcomes cannot be a basis for awarding stranded cost recovery.

Generators insist that the stakes of this proceeding are so extraordinary that they warrant stranded cost recovery. They contend that the “investor interest” in this proceeding is the availability of a “competitive” market and warn that the PJM capacity auction may “mov[e] from a competitive to non-competitive framework”22 or “towards a residual market.”23 Generators’ misplaced reliance on a “competitive” market, as they narrowly define it, misunderstands market-based rates and cannot be a basis for stranded cost recovery.

As an initial matter, their argument is premised on a discriminatory notion of “competition.” Generators demand a “clean” auction and ask the Commission to erect barriers to participation for utilities that may own or contract with generation pursuant to

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16 Calpine Brief at 14 (emphasis added).
17 NRG Brief at 26 (emphasis added).
18 Restatement (Second) of Contracts § 344 (1981).
19 Id.
21 See notes 31—37 and associated text.
22 Calpine Brief at 13.
23 NRG Brief at 26.
state or local law and generation resources that benefit from certain state programs. Generators’ “clean” auction would harm their competitors, relegate historic investors to second-class participants, raise consumer costs, and impair state authority. Approving a “clean” market would penalize generators who had themselves relied on past Commission statements that they would not be excluded from the market.\(^{24}\) Surely the Commission can continue to use “competitive market mechanisms”\(^{25}\) to set just and reasonable rates without adopting generators’ cramped definition of that term.

More to the point, generators cannot possibly have expectation or reliance interests relating to an RTO market’s competitiveness, regardless of how that is defined. Their demands erroneously equate just and reasonable with “competitive.” Addressing a challenge to the Commission’s market-based rate authority, the Ninth Circuit “reject[ed] [the] contention that FERC has an additional obligation, beyond screening individual sellers for market power, to assess the overall competitiveness of the market.”\(^{26}\) The court held that the Commission’s market-based ratemaking regime is not premised on “whether the market as a whole is structurally competitive.”\(^{27}\) Generators’ demands for a “competitive” market or compensation for the Commission’s failure to deliver one are inconsistent with the law.\(^{28}\)

Summoning *Hope*,\(^{29}\) generators further claim that they are entitled to stranded cost recovery if the PJM capacity auction fails to “provide a reasonable opportunity to recover their fixed costs and a fair rate of return on their investments.”\(^{30}\) They contend that they will be denied that opportunity if the auction does not “produce price signals to guide investments in new resources.”\(^{31}\) “Unclean” auctions, according to generators in this

\(^{24}\) *PJM Interconnection*, 135 FERC ¶ 61,022 at PP 152–153 (2011) (accepting PJM’s proposal to allow wind and solar generators to offer into the RPM as price takers in part because “wind and solar resources are a poor choice if a developer’s primary purpose is to suppress capacity market prices”).

\(^{25}\) *PJM Interconnection*, 117 FERC ¶ 61,331 (2006) at P 141 (approving the RPM settlement and observing that the single-price clearing auction is such a mechanism).


\(^{27}\) *Id.*


\(^{29}\) *FPC v. Hope*, 320 U.S. 591 (1944)

\(^{30}\) NRG Brief at 23–34 (citing *Hope*); Calpine Brief at 12.

\(^{31}\) NRG Brief at 26.
proceeding, will not produce those price signals and therefore fail Hope’s standard and trigger stranded cost recovery. This theory misinterprets Hope, mischaracterizes the purpose of price signals in capacity auctions, and conflates “investor interests” with the Commission’s long-standing endorsement of locational prices. Neither Hope nor any supposed deficiency in locational prices supports generators’ stranded cost claims.

As the Commission has explained, Hope “reflects a ‘superseded cost of service paradigm’ that ‘envisioned neither competition among service providers nor any opportunity for them to earn market-based rates.’”\(^\text{32}\) In RTO markets,

regardless of what ‘investment-backed expectations’ a resource may have had at the time it chose to enter the [ ] markets, each entrant was aware of the possibility that at some times, it might earn substantially more than a traditional cost-based rate, but at other times, it might earn less than its costs. The Commission has made clear that ‘in a competitive market the Commission is responsible only for assuring that [a resource] is provided the opportunity to recover its costs, not ‘a guarantee of cost recovery.’”\(^\text{33}\)

Low capacity prices and dissatisfaction with auction rules do not demonstrate that sellers lack this opportunity. In a proceeding about New England’s Forward Capacity Market (FCM), the Commission dismissed generators’ arguments that the auction rules provided only an “illusory” opportunity to recover costs and were therefore confiscatory.\(^\text{34}\) The Commission rejected this line of reasoning in part because it would result in “grant[ing] resources an actual property right to continue providing capacity even when that would not be the most economic solution for customers.”\(^\text{35}\) The Commission held that it does “not construe the phrase ‘reasonable opportunity’ [in Hope] to include situations in which a resource seeks to remain in the market even when the market price is signaling that it is not needed” for reliability.\(^\text{36}\)

More recently, the Commission similarly held that its decision to approve a market design that generators disfavor does not violate Hope’s standards. Responding to New England generators’ claims about price suppression due to state policies, the Commission “disagree[d] with Generators’ assertion that the only way to evaluate the justness and reasonableness of the renewables exemption [under Hope] is to quantify the potential price impact that the Commission’s policy decision has on suppliers.”\(^\text{37}\) The Commission concluded that the FCM’s renewables exemption was consistent with Hope’s mandate to balance investor and consumer interests.\(^\text{38}\)


\(^\text{34}\) Id. at PP 248–250, reh’g denied, 138 FERC ¶ 61,027 at P 150 (2012).

\(^\text{35}\) Id. (rehearing order).

\(^\text{36}\) Id. at P 146.


\(^\text{38}\) Id. at P 42 (rehearing order).
These Commission orders flatly contradict generators’ attempts to use Hope as a shield from an unfavorable ruling. The Commission has explicitly stated that “a change to the rules of a Commission-regulated market does not constitute a taking of property” under Hope.39 “All participants in Commission-regulated markets are subject to just and reasonable changes in rates and market rules.”40

Generators’ arguments about price signals also miss the mark because they confuse locational prices with revenue assurance. Evaluating the early performance of RPM, the Commission in 2009 distinguished between price signals that connect investment to reliability from long-term revenue assurance that improves the financing of new projects. The Commission agreed with PJM that “RPM was designed to provide long-term forward price signals and not necessarily long-term revenue assurance for developers.”41 While RPM should “also [ ] assure that prices are sufficient to retain existing efficient capacity,” the Commission explicitly connected that goal to “ensur[ing] reliability.”42

Generators in this proceeding lose sight of the long-standing link between price signals and reliability. In approving the settlement agreement that created RPM, the Commission concluded that while “no market system can guarantee success,” the RPM was just and reasonable because it “creat[es] financial incentives within the context of a market system to encourage investment in additional infrastructure in the locations where they are needed.”43 In other words, “with its locational component and downward-sloping demand curve, [RPM] will send price signals more effectively than the current construct.”44 Commission orders about the New York and New England capacity auctions similarly connect locational prices to reliability.45

In this proceeding, the Commission has not found, nor has PJM argued, that higher capacity auction prices are needed to ensure reliability. Instead, generators seek to fine-tune capacity rates to match financial expectations of a particular class of investors.46 Their

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39 ISO New England and NEPOOL, 138 FERC ¶ 61,027 at P 151 (citing PJM Interconnection, 136 FERC ¶ 61,190 at P 80 (2011)).
40 PJM Interconnection, 136 FERC ¶ 61,190 at P 80 (2011).
41 PJM Interconnection, 126 FERC ¶ 61,275 at P 150 (2009).
42 PJM Interconnection, 128 FERC ¶ 61,157 at P 102 (2009); see also PJM Interconnection, 117 FERC ¶ 61,331 at P 146 (2006).
43 Id. at P 138; see also PJM Interconnection, 115 FERC ¶ 61,079 at P 29 (2006) (finding the pre-RPM capacity construct unjust and unreasonable in part because it did “not provide price signals that would elicit solutions to reliability problems”).
44 See, e.g., NYISO, 122 FERC ¶ 61,211 at P 86 (2008) (explaining that the “changing price of capacity [should] accurately reflect[] the changing value of capacity and will send the appropriate price signals to investors. As demand grows and units retire, the price for capacity should increase and send the appropriate price signals that additional investment is needed.”) ISO New England and NEPOOL, Remand Order, 155 FERC ¶ 61,023 at P 35 (2016) (stating that “the FCM's primary function [is] ensuring that the region has sufficient capacity to meet reliability needs”).
45 PJM’s Transmittal Letter in Docket No. ER18-1314 states that the “overwhelming preponderance” of investment in PJM is funded by private equity, and claims that “billions of dollars of private equity earmarked for investment in the sector” are currently sitting on the sidelines due to low prices. PJM concedes that investment is not “needed” to maintain reliability. Rather, PJM’s “ultimate goal” is to raise prices to increase private equity investor confidence, despite the fact that
proposed walled garden for private equity investors threatens to divorce price signals from reliability by raising rates when the region has sufficient capacity. Regardless of the outcome of this proceeding, RPM will continue to provide locational prices that signal where investment is needed to maintain reliability. Generators’ desires for higher returns cannot be a basis for stranded cost recovery.

In sum, generators’ stranded cost recovery claims based on expectation and reliance interests are premised on unexplained breaches of unidentified contracts. Generators ignore this threshold issue that dooms their claims as a matter of law. Generators’ actual expectations carry no equitable force. Market-based rates do not entitle investors to be “put in as good a position as they would have been in” 47 had the market been run under their preferred rules.

Conclusion

Generators’ extraordinary stranded cost claims relating to a capacity auction that did not exist a decade ago do not withstand scrutiny. The Commission’s Open Access Orders limited stranded cost recovery to specific long-term contracts and rejected the amorphous relief that generators threaten to request. Contract remedies are inapplicable, as no party has breached any contract. Participation in an RTO capacity auction does not create cognizable claims to profits under the Federal Power Act. Generators are entitled to a just and reasonable rate and nothing more.

Respectfully Submitted,

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