# Comments of Midwest Generation EME, LLC
# Submitted to the ICC Staff on July 28, 2005

## INTRODUCTION

The Staff of the Illinois Commerce Commission ("ICC") has provided to Midwest Generation EME, LLC ("MWGen") a copy of an April 2005 draft of a report entitled "Evaluating the Potential Impact of Transmission Constraints on the Competitive Electricity Market in Illinois" that was prepared by consultants working for the ICC (hereafter referred to as the "consultants' draft report"). The ICC Staff has provided this draft report to MWGen and other interested and affected parties for the purpose of seeking comments on the analysis and conclusions in the consultants' draft report. MWGen appreciates very much the opportunity to provide comment on the draft report and submits these comments and observations in order to assist the ICC and the ICC Staff in their ongoing efforts in providing regulatory oversight of the ever-changing electric industry in Illinois.

MWGen has reviewed the consultants' draft report and finds that it contains a number of out-dated and flawed assumptions and for this and other reasons reaches unjustified and misleading conclusions. Most importantly, the draft report fails to take account of the recent integration of the northern Illinois market into PJM Independent System Operator and the role of PJM's independent market monitoring function, which provides critical consumer protections for the northern Illinois market. Further, in assessing market power, the draft report relies on significantly outdated data and ignores the critical fact that Midwest Generation decommissioned 37 percent of its generation capacity in Illinois in 2003 and 2004.

In describing the purpose of the study, the consultants' draft report indicates that the intent was to evaluate a "set of reasonably expected conditions." (Consultants' draft report at p. 3). The drafters state later that the report is "only an initial indication of how the Illinois electricity market might function." (Consultants' draft report at p. 167). This statement, taken at face value, essentially is an acknowledgement that the analysis and conclusions in the report rest entirely on a hypothetical construct of the Illinois electricity market. MWGen appreciates that such a qualified statement might have been appropriate, and perhaps even necessary, in 2003 when the first draft of this report was commissioned and when the functioning of the market was less developed and known than it is today. However, given what we now know of the market and how it functions, this caveat in the draft report is an inadequate excuse for the shortcomings that pervade the analysis in the draft report. For example, the assumption of a single independent system operator for the State and a narrowly defined Illinois market are at odds with the fact that utilities in Illinois buy and sell power in broad regional markets and belong to two different and very extensive regional transmission organizations, PJM in the case of ComEd and MISO in the case of Ameren. The gap between the consultants' hypothetical market construct and the actual marketplace in which Illinois utilities operate is so significant and fundamental that every conclusion in the report must be considered suspect, especially as a basis on which to found public policy.

MWGen has not attempted to catalogue and rebut all of the errors and omissions in the consultants' draft report. The comments provided below are only an overview. It should be noted, however, that the common denominator behind many of the flaws in the consultants' draft report is that they contribute to creating a picture of market power that is misleading. Certain of the errors have the tendency to overstate the level of market concentration while others tend to understate the size of the market. In addition, the analysis fails to take into account regulatory and practical safeguards that would prevent the exercise of market power even if it were found to be a matter of concern. Essentially the consultants' draft report describes not just a hypothetical world, but given what we know today, a fictional one—a world that is based on incorrect assumptions that are biased toward finding that there is a market power concern. Rather, MWGen respectfully recommends that in order to understand and assess the operation of the market in which Illinois utilities participate, the ICC and the ICC Staff should rely, not on this draft report, but on the PJM Market Monitor's 2004 State of the Market Report to FERC and to expert evidence filed in recent and pending dockets at the FERC and the ICC. The PJM Market Monitor's 2004 State of the Market Report, dated March 8, 2005 can be found at http://www.pjm.com/markets/market-monitor/som.html).

**<u>THE CONSULTANTS' DRAFT REPORT OVERSTATES THE LEVEL OF MARKET CONCENTRATION.</u>**

A critical flaw in the consultants' draft report is that it incorrectly focuses on an "Illinois power market" rather than the broader regional power market in which Illinois utilities actually operate. The result is that the report finds a higher degree of market concentration than in fact exists. While the analysis utilizes a detailed representation of the in-state transmission network, it relies on a simplified representation of the out-of-state transmission network with the effect that the actual size and shape of the market is artificially restricted. Indeed, the consultants' draft report includes an explicit acknowledgement that the "large eastern markets (e.g., PJM, NYISO) and southeastern markets, which could have an impact on the behavior of the Illinois market, are not represented." (Consultants' draft report at p. 35). The consequence of this over-simplification is that the consultants reach flawed and unjustified conclusions about market concentration and market power. Considering the size and competitiveness of the PJM market with over 160,000 MW of capacity and over 1,000 generation sources, this analytical short-coming results in an unjustified overstatement of the level of market concentration.

A sanity check comparison of the HHI analysis in the consultants' draft report with HHI calculations prepared by the PJM Market Monitor for the FERC illustrates the magnitude of the consultants' error in evaluating the level of market concentration. The PJM Market Monitor calculates HHI for the more relevant PJM regional market as opposed to the artificially limited Illinois market defined in the consultants' draft report. By virtue of overly restricting the market and other errors in assumptions, the consultants calculate an HHI of 2,130 for coal generation which would indicate a high level of market concentration. (Consultants' draft report at p. 39). On the other hand the PJM Market Monitor, using actual data and the functioning regional market, reports that the HHI for base loaded generation is 1,291 which indicates moderate concentration. (PJM 2004 State of the Market Report at p. 55).

The consultants' draft report also exaggerates concerns about market power by relying on out-dated capacity numbers that are no longer accurate. Specifically, MWGen has retired generation that is still being counted by the consultants, who report MWGen's capacity as 9,323 MW when in fact it is now only approximately 5,800 MW. Even using the consultant's inaccurate figures, MWGen's putative market share of 19.6% would fall below the 20% market share used by FERC as its initial market screen for market power potential. (see Table 3.5-1 in the consultants' draft report at p.39). Moreover, when the appropriate analysis is applied by reference to MWGen's capacity in the PJM market (instead of in-Illinois only), it quickly appears that MWGen has approximately 7,684 MW of capacity (including 1,800 MW of capacity from generation assets in Pennsylvania) out of a PJM market capacity of over 160,000 MW, or a 4.7% market share. This is significantly below FERC's market share screen of 20% and well below the percentage share inappropriately presented in the consultants' draft report.

The market concentration errors in the consultants' draft report are compounded when the exaggerated concentration levels and artificially defined market are used as a basis for drawing the conclusions that "it would be difficult for new generation companies to enter the deregulated market" and that natural gas plants "would have difficulty competing in this market." (Consultants' draft report at p. 165). MWGen takes issue with these conclusions. There is no indication that market power concerns are keeping new generation from being built. In fact, significant amounts of new generation have come on-line in both PJM and Illinois in the past five years. So much has come on-line that there is currently a surplus of capacity. The more logical conclusion would be that it is this surplus condition that may make it difficult for natural gas units to compete at this time, not a concern over the possible exercise of market power.

**<u>THE CONSULTANTS' DRAFT REPORT OVERSTATES TRANSMISSION CONSTRAINTS.</u>**

The consultants' draft report expresses concern that there is a high level of transmission congestion in the Northern Illinois zone and that this makes it vulnerable to the exercise of market power. (Consultants' draft report at p. 71). In particular, the simulation used by the consultants projects thousands of hours of congestion for the ComEd zone. (Consultants' draft report at pp. 52-53). In actuality, this is far beyond the level of congestion actually experienced. For example, the PJM Market Monitor reported that in 2004 there were less than 200 hours of congestion in the ComEd zone. (See PJM

2004 State of the Market Report, at p. 219, Figure 6-8). The Market Monitor further reported that: "Since May 1, congestion frequency levels in ComEd have been comparatively low, with only 130 congestion-event hours during the eight-month period comprising Phase 2 and 3 of calendar year 2004. The most significant constraint was the Waukegan-Round Lake 138 kV line with 97 congestion-event hours. Congestion experience in the ComEd zone was minimized by postcontingency switching procedures which are employed where PJM would traditionally have initiated out of merit dispatch." (PJM 2004 State of the Market Report at p. 234). Thus, MWGen believes that the consultants' draft report vastly overstates the level of transmission congestion in Illinois and that any conclusions about market power based on transmission congestion must be considered without foundation.

MWGen can not determine with certainty from the report why the consultants' simulation shows so much more transmission congestion than has recently been experienced. However, given the hypothetical and simplified nature of the analysis, MWGen suspects that the study did not account for multiple phase shifter adjustments that distribute the flow of power in and around the City of Chicago to avoid the overloading of equipment. Such adjustments, as well as multiple Operating Procedures that can be used to mitigate post contingency congestion, are available to minimize transmission constraints. These factors need to be considered in any assessment of transmission congestion. To fail to do so is to ignore reality.

**THE CONSULTANTS' DRAFT REPORT FAILS TO CONSIDER REGULATORY AND PRACTICAL CONSTRAINTS TO THE EXERCISE OF MARKET POWER.**

The consultants' draft report reaches the unsubstantiated conclusions that there are circumstances in which physical or economic withholding of units by Exelon Generation or MWGen might be profitable. First, it must be noted that these conclusions are based upon an analysis that is riddled with the errors and false assumptions described above. But, perhaps an even greater failing, the report fails to consider the regulatory safeguards and practical constraints that prohibit and prevent any such attempt to exercise market power by the physical or economic withholding of generating units. Simply stated, it is not possible for MWGen physically or economically to withhold power from the market in order to increase market prices and the company profits.

One of the principal constraints on inappropriate market behavior is a FERC order setting forth market behavior rules that govern how wholesale power generators operate and how they must bid supply into the market. (See FERC's Investigation of Terms and Conditions of Public Utilities Market Based Rate Authorizations Order on Rehearing, Docket No. EL01-118-003, dated May 19, 2004). These rules explicitly state that "(a)ctions or transactions that are without legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for electric energy or electricity products are prohibited." (Market Behavior Rule 2—Market Manipulation). Elsewhere in this same order, FERC makes clear that physical or economic withholding for the purpose of raising the market clearing price are examples of such prohibited market manipulation. (See Footnote 22 of the FERC's Market Behavior Rules Order together with Market Behavior Rule 1—Unit Operation). This explicit prohibition and the ongoing day-to-day oversight of the PJM Market Monitor serve as strong regulatory safeguards to prevent any attempt to engage in the physical or economic withholding of supply in order to increase market prices.

Indeed, the primary objective of the PJM Market Monitor is to "monitor and report on issues relating to the operation of the PJM Market, including the determination of transmission congestion costs or the potential of any Market Participant(s) to exercise market power within the PJM Region." (See PJM's Market Monitoring Plan). In situations where transmission constraints require the dispatch of generating units out of economic merit order, PJM caps the price of energy from such units at a level consistent with cost-of-service pricing as a further safeguard to prevent any exercise of market power. Units that are pivotal as a result of transmission congestion in the Northern Illinois Control Area are capped at their incremental operating cost plus 10% and are not allowed to set the market clearing price. (See Schedule 1-PJM Interchange Energy Market-Section 6.4).

The consultants' draft report fails to consider these important rules and monitoring procedures and instead bases its conclusions on the false assumption that there is no regulatory oversight to prevent physical or economic withholding and no regulatory mechanism to cost cap when needed. These omissions highlight the lack of justifiable analytical support for the conclusions reached in the report about the possibility that market power could be exercised to increase the market clearing price.

Further exacerbating the consultant's flawed conclusions about the potential for market power is yet another flawed assumption, namely that there will be no bilateral contracts in place in 2007. (See consultants' draft report at p. 26). In fact, substantial bilateral contracting in Illinois can be expected in the post-2006 time period. ComEd and Ameren are proceeding with plans to procure power from suppliers in full requirements contracts ranging in duration from one to five years. Wholesale generators with significant capacity can be expected to engage in bilateral contracts either with the utilities directly, or with other suppliers to the utilities, as a hedge to their own price risk. Such bilateral contracting by generators will reduce any incentive there might be for a generator to attempt to exercise market power. As the consultants' draft report recognizes, the withholding of supply is profitable only if the entity withholding the supply has enough other generation in the market such that any increased profit realized on the supply remaining in the market more than offsets the sales lost from the withholding. Consequently, forward bilateral contracting is a practical disincentive to physical or economic withholding because it ends up making it less likely that the withholding could be profitable for the generator. The consultants' failure to consider that bilateral contracting by large generators is likely in the post-2006 period results in yet another exaggeration of their concern about market power.

## CONCLUSION

On the basis of its flawed assumptions, outdated and incorrect data and the admittedly limited nature of their study, the consultants' draft report makes the broad-brush, declarative conclusion that: "Overall, the answer to the basic question of the study, *'Can a company, acting on its own, raise electricity prices and increase its profits?'* is affirmative. There is a concentration in the generation market and evidence of transmission congestion, at least during high load periods. This will give rise to the ability of some companies to unilaterally raise prices and increase their profits."

(Consultants' draft report at p. 167). While this conclusion may be true for the fictional, hypothetical market construct that was evaluated in the report, it seems at best to be irrelevant to the market that actually exists. Thus, MWGen respectfully submits that the report, at least with its existing manifest errors, should be disregarded as a basis on which to found public policy. Better and more accurate descriptions of the competitive market can be found in the PJM Market Monitor's State of the Market Report and in the expert testimony filed in recent ICC and FERC dockets, including the testimony of ComEd witnesses Naumann, Hogan and Hieronymus in ICC Docket No. 05-0159 and the testimony filed by MWGen in support of its application for market-based rate authority.

MWGen appreciates the opportunity to provide these comments and hopes that they will be useful in bringing to light the flaws and weaknesses in the consultants' draft report. MWGen offers its continuing cooperation in helping to enhance the ICC's understanding of the competitive market. MWGen commends the Commission for its commitment to anticipating, rather than reacting to, potential market problems, and we genuinely regret the need to take such a negative view of the consultant's report. We do believe, however, that since the consultant's report was commissioned, significant new developments, primarily with respect to PJM and MISO, have overtaken the original intent of this report and have made available numerous "real-time" reports, regulatory filings and data that the Commission and Staff can use to assess how the market actually is functioning. It is no longer necessary or appropriate to rely on a hypothetical market construct when the real thing is there for all to see and judge.