

**GETTING THE PRICES RIGHT IN PJM:
April Analysis and Summary**

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The connection between prices and operating decisions often receives cursory treatment in the electricity restructuring process. Market participants want flexibility and choice, but object to consistent pricing as too complex. This is a mistake, and produces only an illusion of simplicity. If customers have flexibility in the choice of generation, spot purchases, bilateral transactions, and so on--then prices matter and competitive prices should reflect marginal costs. In large part, control of operating decisions is moving from engineers motivated by principles of technical efficiency, to market participants motivated by prices and profits. This is a major purpose of electricity restructuring--to change the locus of such key decisions. If we want the market to be guided by prices, and we expect and intend for people to take these prices seriously, it becomes important to follow the usual advice to "get the prices right." The first month with a consistent market pricing system in PJM underscores the point and provides empirical heat to help dispel the fog of confusion covering one of the central problems in electricity markets: pricing to allocate use of scarce transmission capacity.

In the United States, the move to a competitive electricity market with a consistent pricing system for allocating scarce transmission capacity entered a new phase in April 1998. This completed the first full month of operation of spot market locational pricing in the Pennsylvania-New Jersey-Maryland Interconnection (PJM). The new system includes a spot market coordinated by the Independent System Operator (ISO). The ISO accepts both bilateral schedules and voluntary bids of the market participants. Using these schedules and bids, the ISO finds an economic, security-constrained dispatch for power flows and the associated locational marginal cost prices. Sales through the spot market are at the locational prices. The transmission usage charge for bilateral transactions is the difference in the locational prices between origin and destination. An accompanying system of Fixed Transmission Rights (FTR) provides financial hedges between locations. These FTRs are the equivalent of perfectly tradeable firm transmission rights.²

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² William W. Hogan, "Independent System Operator: Pricing and Flexibility in a Competitive Electricity Market," Center for Business and Government, Harvard University, February 1998.

The new PJM pricing system was embraced after an experiment during 1997 with an alternative zonal pricing approach that proved to be fundamentally inconsistent with a competitive market and user flexibility.³ The experiment made the point in a dramatic way.⁴ The important issue is not the total cost of transmission congestion, which may be small on average and is often mistakenly dismissed as irrelevant. Rather, the point is the incentives at the margin when the system is constrained. In designing the rules for transmission pricing and access for a competitive market, it matters little how the rules perform when the system is unconstrained. The important question is how the rules deal with the market when the system is constrained. The zonal pricing system allowed market participants the flexibility to choose between bilateral transactions and spot purchases, but did not simultaneously present them with the costs of their choices. The circumstances created a false and artificial impression that savings of \$10 per MWh or more could be achieved simply by converting a spot transaction into a bilateral schedule. Faced with this perverse pricing incentive, market participants responded naturally by scheduling more bilateral transactions than the transmission system could accommodate. Inevitably, the ISO had to intervene by restricting the market and constraining choice to preserve reliability. The PJM ISO was fully aware of the perverse incentives of zonal congestion pricing and the problems they created. But without the authority to change the pricing rules, the ISO had no alternative but to restrict the market.

Even if the total cost of congestion might be modest over a year, a gap of \$10 per MWh between the true costs of transmission usage and what participants pay is more than sufficient to get the attention of market participants at the time when it matters most, when the system is constrained. Given the margins in this business, market participants will change their behavior for \$1. And the changes in behavior can substantially affect system operations; in fact, the whole point of electricity restructuring is that changes in behavior can affect system operations and lead to different patterns of electricity use and investment.

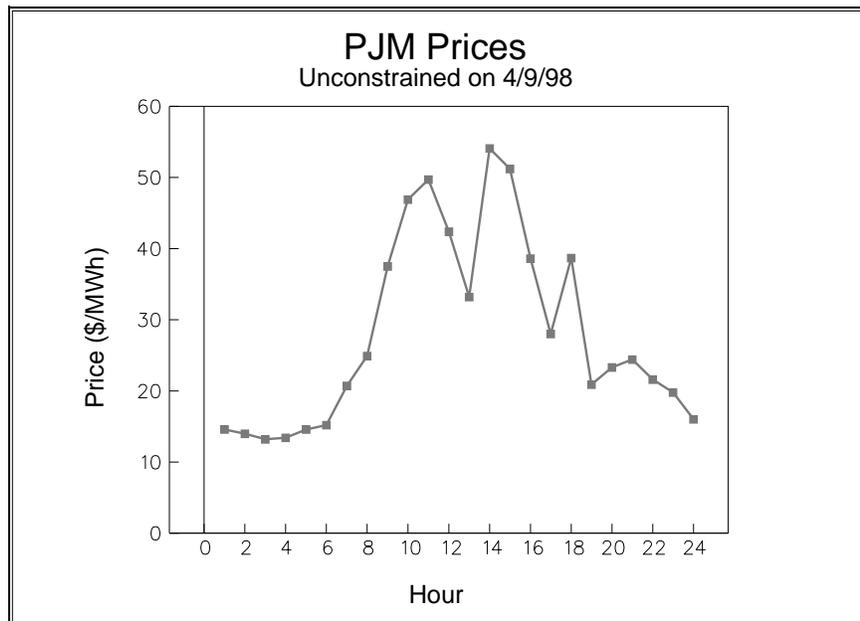
By contrast, the locational pricing system avoids this perverse incentive. By construction, the locational prices equal system marginal costs. Every generator would be producing at its short-run profit maximizing output, given the prices. The market equilibrium would support the necessary dispatch in the presence of the transmission constraints. Spot-market transactions and bilateral schedules would be compatible. Flexibility would be allowed and reliability maintained consistent with the choices of the market participants.

Faced with this reality, the Federal Energy Regulatory Commission acted to approve the locational pricing system that became operational in PJM at the beginning of April of 1998. The developing experience with this full locational pricing of the use of scarce transmission capacity deserves close study by the Commission and all system operators.

³ Here the issue is pricing for transmission congestion. The recovery of embedded costs of transmission investment through access charges is a separate matter that is amenable to zonal approach.

⁴ For details, see William W. Hogan, "FERC Policy on Independent System Operators: Supplemental Comments," Federal Energy Regulatory Commission, Docket No. PL98-5-000, Washington DC, May 1, 1998.

To put the problem in context, note that market clearing prices can vary substantially, even without transmission constraints.⁵ The accompanying figure shows the prices in PJM over the day of April 9, 1998. This was not the most volatile day, and there were no transmission constraints during the day. However, the market clearing price varied from a low of \$13 MWh to a high of \$54. Clearly market participants must deal with substantial changes in prices, even without transmission congestion.



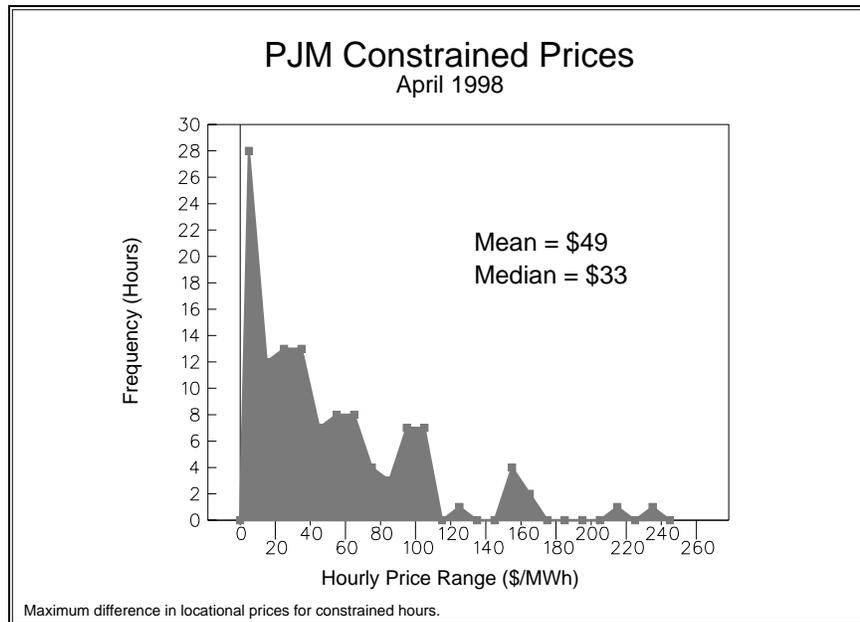
Although these are the early days, the new locational pricing mechanism is working as anticipated by the ISO and the supporters of the approach, but apparently not as anticipated by many who dismissed the importance of this issue. The month of April is not typically a highly constrained period in PJM, and it would not have been impossible for the first days of locational pricing to have been boring. With no constraints, the locational prices, ignoring losses, would be identical at all locations. The cost of transmission between points--the difference in the locational prices--would have been zero. Nothing much might have happened until we approached the summer, when congestion would be more likely, as for the previous year.

In the event, the results were not boring. The system experienced transmission constraints, locational prices separated, and the opportunity cost of transmission was quite large. The lowest locational prices were sometimes negative, reflecting the value of counterflow in the system where it would be cheaper to pay participants to take power at some locations and so relieve transmission constraints. The highest locational prices were very large, much larger than the marginal cost of the most expensive plant, reflecting the need to simultaneously increase output from expensive plants and decrease output from cheap plants, just to meet an increment of load at a constrained location. Over all hours, the low price was -\$45 at 1500 hours on April 18 at "JACK PS," and the highest price was \$232 at 1100 hours on April 16 at "SADDLEBR," both locations being in the Public Service territory. As large a range as this is, it is smaller than the range in marginal costs that occurred before the prices were charged, when users could ignore

⁵ The data used here were taken from the PJM web site at www.pjm.com for April 1998.

the cost of congestion.⁶

The contemporaneous difference in locational prices, which is the price of transmission, has been large as well. If we take the \$1 per MWh standard as an arbitrary threshold, the range of highest to lowest price across locations exceeded the threshold for 119 hours, or approximately 17% of the time. As shown in the accompanying figure, the frequency distribution of the price range in constrained hours is skewed, with a median



hourly price range at \$33 and a mean of \$49. When the system is constrained and the market incentives matter the most, the marginal costs of transmission can be large indeed.

The evidence shows many things. For example, calculating and reporting the locational prices for each point on the grid are not especially complex tasks, at least for the system operator who has the necessary information available. The prices can be available every five minutes on the Internet. Faced with these prices, the market participants adjust their behavior, just as intended. The transition was not painless, especially for those who ignored many warnings and entered into "seller's choice" contracts that gave the seller the maximum theoretical financial advantage for relieving congestion. Presumably, this form of contract will disappear, or be properly priced in the future, and market participants will become more attuned to the use of fixed transmission rights to hedge much of the cost of congestion. But market participants who rely on the spot market, and are not prepared to pay for congestion hedges, will see price signals that align their incentives with the reality of system operations.

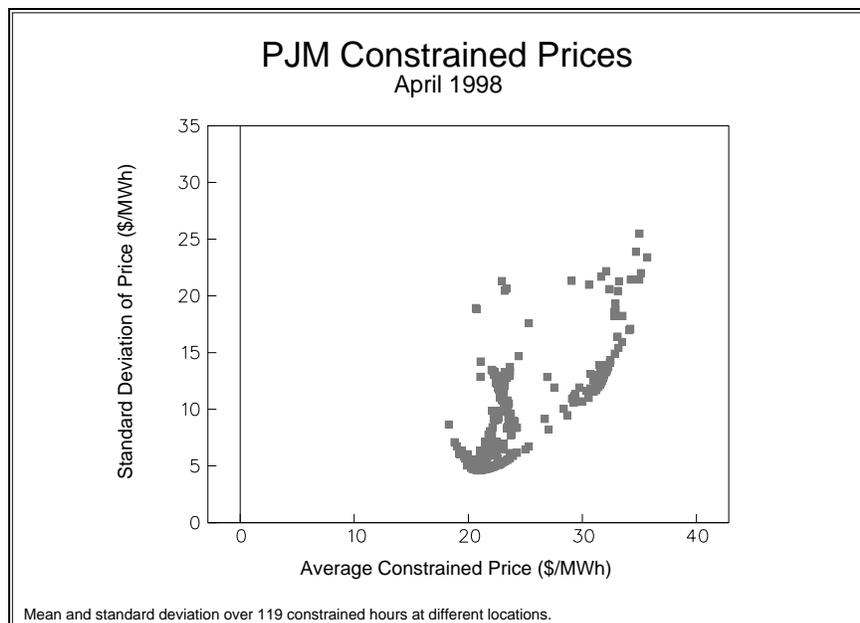
What about aggregating PJM into a few zones, if not just one? The PJM ISO is reporting prices for approximately 2000 locations. This is a convenient way to represent the information, because it is how the data are organized for actual system operations. However, some of these locations are really just multiple units at the same point on the grid, and would necessarily have the same prices in most circumstances. For other points on the grid, the zonal argument is that the locational differences would be minor, and could be represented by a

⁶ On March 26, 1998, at 2200 hours, the difference between the highest to the lowest marginal cost was almost \$400.

relatively few zones. This view has been subjected to a test over the first month of operation.

April could have been a relatively unconstrained month, presenting a low hurdle for the zonal approach. The choice of the appropriate zones would not be an easy matter, and there is some ambiguity in clustering criteria. However, one simple way to summarize the data would be to examine the average and the variation of prices at different locations during constrained hours. If two locations always have the same prices, then the two average prices would be the same and the two standard deviations of the prices would be the same. These conditions would be necessary, but not sufficient, for the prices to be the same at the two locations. Hence, this straightforward calculation gives a lower bound on the number of different locations with sometimes unique prices.

The accompanying figure plots the data on average price and standard deviation of price across 119 constrained hours in April for all the locations reported by the PJM ISO. There are 2000 points in the graph, one for each location. Were it true that there were only a few zones, the graph would show a few clusters of locations where the average prices were the same and the standard deviations were the same. In fact,



there is substantial dispersion. After the first month of operation, there were 766 locations within PJM where the price points did not overlap and were different by this lower bound test. Presumably as more experience develops and different constraints appear, this number will grow. Recall that in a sufficiently interconnected network, a single thermal limit on a transmission line could create different prices at every location, sometimes very different prices. This is contrary to the intuition that arises from the misleading analogy to a simple radial transmission connection without any network interactions, where a single constraint results in only two prices. But the network interactions and the many different prices are quite real and no surprise to the system operators.

The standard of no difference in prices may be too strict, and we might be willing to declare two locations as the same if they are close enough. Defining the standard for close enough would be contentious, but it may be moot. If we accept the \$1 per MWh threshold above and ask how many separate zones would be necessary to cover all the points in the figure, the

answer is 94 zones, so far.⁷ This is far more than the few zones predicted, and there is no reason to believe that we are finished adding to the list. Furthermore, as is obvious, the effect of locational pricing for "natural" zones is to produce the same price for all such locations. Hence, aggregating to zones where prices are almost the same still results in many zones and no apparent simplification with any meaning. We might as well do the simpler thing of using the locational prices at each location. Aggregating across the many real locations to a few zones, by contrast, necessarily means combining like with unlike, thereby recreating in microcosm the perverse incentives of the failed experiment with a single zone, leading to a breakdown of the non-discriminatory market and administrative restrictions on choice.

The interaction between reliability (with its inescapable physical realities) and economics will limit the acceptable ISO access and pricing rules for allocating scarce transmission capacity. It would be desirable to offer market participants flexibility in their own decisions. A great deal of flexibility in combining a range of bilateral schedules and spot transactions would be possible. However, the more varied and flexible the options for the market participants, the more important it will be to get the prices right, meaning consistent with the marginal impacts on the system. The whole point of the turn to greater reliance on competition is that the market participants will respond to incentives. As we have seen, if prices don't provide the right incentives, consistent with the impacts on the system, the participants will respond in their own interests without concern for the system effects, and the ISO will be driven inexorably to intervene in the market and restrict choice. With locational pricing, participant incentives are aligned. Buyers and sellers can buy and sell as they choose through the spot market at the locational prices. Or they can schedule bilateral transactions and pay the difference in locational prices as the charge for transmission usage. The result is flexible, non-discriminatory, and compatible with the mandates of reliability.

The experience of the first month in PJM illustrates the importance of using, or at least reporting the real locational marginal costs. The network effects can be surprising for virtually everyone other than experienced system operators. Our intuition about these impacts and their market implications is poorly informed and often wrong. Much of the policy argument on this point is misinformed. However, only the ISO would have the information needed to calculate and post real locational prices, as in PJM. The computations are easy for a given dispatch, but only the ISO has all the information about the dispatch. Given the striking gap between the previous claims that congestion is insignificant and the observed reality of true locational pricing in the first real implementation in the United States, the Federal Energy Regulatory Commission should have a strong interest in prescribing that the real locational marginal costs--considering the real network interactions, and not just simplified zonal aggregations--be made available on a regular basis.

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⁷ Starting with separate zones for the ten service territories and sorting on the average and then the standard deviation. If we do not require the individual service territories to be separate zones, the number of distinct price zones is 60, so far. The corresponding figures for a \$5 per MWh threshold would be 28 and 10 zones, with and without separating service territories.