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MEMORANDUM | The FERC Order on Proposed Changes to ISO-NE's Forward Capacity Market

The Federal Energy Regulatory Commission's April 13, 2011 Order is a culmination of the paper hearing on proposed changes to ISO-NE's Forward Capacity Market (FCM).

In this Order, the Commission:

(1) Rejects the Alternative Capacity Price Rule (APR) that was filed as part of the Joint Filing;
(2) Rejects the modeling of capacity zones and related mitigation of the Joint Filing;
(3) Accepts ISO-NE's July 1 Proposal with regard to zonal modeling;
(4) Accepts ISO-NE's July 1 Proposal to eliminate Cost of New Entry (CONE);
(5) Accepts the Joint Filing's proposal to retain the price floor through the sixth FCA subject to extension as necessary;
(6) Requires ISO-NE to make a compliance filing within 30 days, which should include a timeframe for consideration of the two issues that we are requiring ISO-NE to examine with stakeholders—the development of market rules to implement an offer-floor mitigation construct, and the proper offer floor price for long-lead-time resources.

I. Background

In 2004, ISO-NE proposed to divide New England into multiple capacity regions, each with its own capacity requirement and capacity auction (LICAP Proposal). After several years of litigation, hearings before the FERC, and settlement discussions amongst 115 parties, the FERC replaced the LICAP Proposal with the FCM. The FCM created the Forward Capacity Auction (FCA), an annual auction to procure the amount of capacity equal to the ICR. If a provider's capacity is taken in the FCA, it has a Capacity Supply Obligation (CSO) which it must fulfill three years. The FCM settlement also established an APR mechanism to deter market participants from artificially lowering prices.

On February 22, 2010, ISO-NE and NEPOOL (the Filing Parties) filed changes jointly (Joint Filing) to the FCM Market Rules.[1] On April 23, 2010, the FERC approved certain aspects of the Joint Filing it found to be just and reasonable; they were accepted without suspension. The FERC stated that after a preliminary analysis, the remainder of the Joint Filing was not demonstrated to be just and reasonable and that it may be unjust, unreasonable, unduly discriminatory or preferential, or otherwise unlawful. The FERC set these aspects for paper hearing and provided sixty days for the parties to submit their first briefs.

ISO-NE addressed the FERC's concerns resulting from the April 23rd Order in its July 1 Proposal. Several other parties submitted proposals as well. The July 1 Proposal is used as the base of discussion in

[1] April 23 Order, 131 FERC ¶ 61,065.

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the FERC Order because it addresses all of the issues raised in the April 23 Order. In addition, most of the other parties' briefings respond to ISO-NE's July 1 Proposal.

II. Context of the Order

Since the FCM was initiated in the ISO-NE energy market, every FCA has had more capacity than is needed.[2] State-funded initiatives have created a substantial amount of new capacity. Since these capacity resources receive revenues outside of ISO-NE markets, they bid into the FCM at below-market rates, suppressing the clearing price below competitive levels. Such resources, called "out-of-market" (OOM) offers, are permitted to clear the FCM and obtain CSO.[3] Since the inception of the FCM in ISO-NE, an Alternative Price Rule (APR) has been in place. An APR is a market power mitigation rule intended to prevent and discourage buyers, who have the incentive and ability, to suppress market clearing prices below a competitive level.[4] Conceptually, the APR identifies and mitigates OOM capacity. However, the APR has never been triggered, so OOM offers have never been mitigated.

A. Out-of-Market Capacity

OOM capacity is capacity that is offered below its "true" cost (i.e., below its long-run average cost net of non-FCA market revenues).[5] An example of OOM capacity is a resource that has a long-term capacity contract which covers all of its total costs; thus, it does not need to reflect those costs in its offer into the FCA.[6] While in-market resources offer prices in the FCA based on their costs and expectations of future market revenues, OOM capacity resources are able to rely on their contractual or non-market revenues.[7] Consequently, OOM resources can offer capacity at below-market costs. It is important that the FCA price reflects new entry costs in order to maintain the long-run efficiency of the FCA. New entrants to the FCA typically require a higher price when they enter the market because they need to cover their costs.[8]

As ISO-NE explained in its July 1 Proposal,

> OOM resources typically hold contracts that ensure full payment for the resource or otherwise receive particularized subsidies regardless of the capacity price that they could receive through their participation in the FCA. Because OOM resources receive "out-of-market" revenue, these resources can be offered into the FCA at very low prices that do not reflect a market-based or competitive cost of entry. OOM resources

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[2] April 23 Order, 131 FERC ¶ 61,065 at p. 8
[3] *Id.* p. 9 (compared to PJM and NYISO which employ offer-floors that are intended to preclude OOM offers).
[4] April 23 Order, 131 FERC ¶ 61,065 at p. 69.
[5] April 23 Order, 131 FERC ¶ 61,065 at p. 9, FN.19.
[6] Testimony of Robert Ethier, ISO-NE at p. 3.
[7] *Id.*
[8] *Id.* at p. 4.

> clear in the FCA on the basis of these low offers, and in so doing take the place of new or existing resources that offer in the FCA at competitive but higher prices. As a result, the FCA clears at a price (the "Capacity Clearing Price") that is too low to retain or attract the displaced new or existing resources.[9]

In the Joint Filing, ISO-NE and NEPOOL proposed an Alternative Capacity Price Rule to adjust the Forward Capacity Auction price to offset the effect of OOM resources. The Alternative Capacity Price Rule is intended to reduce the risk in the FCA, and consequently, lower the capacity costs paid by consumers.[10] In the July 1 Proposal, ISO-NE indicates that the APR is only needed when there is a presence of OOM resources in the FCA.

III. Discussion

A. APR & Buyer-Side Market Power Mitigation

The FERC rejects ISO-NE's APR proposal in the July 1 Proposal.[11] ISO-NE's proposal included a two-tiered pricing model. Under this model, if an OOM resource clears the auction, two clearing prices result: (1) a Capacity Clearing Price; and (2) an Alternative Capacity Price. The Capacity Clearing Price is based on the parties' actual offers. All new resources receive this price. The Alternative Capacity Price is determined by benchmark pricing. ISO-NE will procure any additional capacity that bids below the Alternative Capacity Price, which in effect, procures capacity in excess of the ICR. If no OOM resources clear the auction, the APR is not triggered.

Although the FERC agrees with the general principles of baseline pricing in the July 1 APR proposal, it orders ISO-NE to work with stakeholders and develop an offer-floor mitigation construct, similar to the ones in PJM and NYISO. The FERC finds that ISO-NE's July 1 Proposal does not "appropriately balance the competing interests at issue," particularly, the goal of limiting capacity purchases to meet the ICR.[12] The FERC does not see how it is just and reasonable to require customers to pay unnecessary costs in order to purchase more capacity than is needed for reliability.

a. APR and Renewable Energy, Energy Efficiency and Demand Response Resources

In a joint filing with New England public utility commissioners, consumer counsels, utilities, and others, the Massachusetts' Attorney General (the "Parties") support the Joint Filing's proposed definition of an OOM resource, as long as it was understood that the APR would be invoked only in specified

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[9] July 1 Proposal at p. 10.
[10] *Id*.
[11] Note that ISO-NE's July 1 Proposal differs significantly than the design proposed in the Joint Filing.
[12] July 1 Proposal at p. 10.

circumstances. Particularly, the Parties want to ensure that the APR would only be triggered by OOM resources which intend to suppress FCA prices.

The Parties note that each New England state has statutory or administrative requirements which mandate the addition of renewable resources in the states' electricity portfolios. Most often, in order to enter the FCA, these renewable resources will require the execution of at least a 20-year bilateral contract to pay the resource based on its costs, not the expected in-market revenues. Therefore, because these resources have contracts which pay based on the resources' costs, not the expected in-market revenues, these resources will likely be characterized as OOM resources. (*See* above OOM definition.) The Parties assert that an APR should not be triggered upon conditions which will impede state initiatives to build generation facilities, encourage demand response, or promote beneficial state policy objectives. Under the Federal Power Act § 201(b)(1), states have a plenary authority "over facilities used for the generation of electric energy."[13] Accordingly, the states have an uncontested authority to approve bilateral contracts that will achieve legitimate state policy objectives. The Parties argue that the definition of an OOM resource in the Joint Filing is overbroad and does not properly differentiate between legitimate and illegitimate OOM capacity. Under the definition, every resource which receives state-sponsored bilateral contracts or subsidies—which are often implemented to further energy reliability or environmental objectives—will be characterized as an OOM resource. For example, if a resource receives funds from a System Benefit Charge, which subsidize energy efficiency and demand response initiatives, the resource will be considered an OOM resource. Thus, this resource's offers will be mitigated as an OOM when they are in fact receiving state subsidies to further environmental goals, not to affect the FCA clearing price. Accordingly, the Parties argue that an APR should not be triggered when an OOM does not have a price-suppression purpose. Furthermore, the Parties argue that the FERC should require a "bright-line" test to differentiate offers which seek to distort the FCA clearing price and should be mitigated, and those which are implementing legitimate state policy initiatives and should not be mitigated.

The Parties propose three criteria for triggering the APR. The Parties "propose three independently applied criteria for determining when resources with offers below a specified threshold should be mitigated and should trigger the APR:

(1) no resource's offers should be mitigated if the resource is not owned by or contracted to a net capacity buyer or an agency of a state government;
(2) unless the IMMU finds evidence of an intention to suppress the FCA clearing price, it will presume that resources procured or subsidized pursuant to a state program specifically authorizing or requiring the program were intended to further legitimate state policies and should not be mitigated; or
(3) if the offering price in the FCA is at or above the resource's net going-forward or opportunity costs associated with accepting a capacity supply obligation after crediting any revenues received pursuant to a state program specifically authorizing or requiring the program that were intended to further legitimate state policies, it should not be

[13] 16 U.S.C. § 824(b)(1) (2006).

mitigated. If a resource satisfies any of these three tests – regardless of whether it has been denominated as OOM – it should not be mitigated."[14]

With its proposed criteria, the Parties are effectively trying to protect state-supported or mandated energy efficiency, demand response, and renewable energy resources from mitigation in the FCA. In the April 13 Order concurrence, Commissioners LaFleur and Wellinghoff recognized the Parties arguments and stated that the Commission would be willing to consider requests to exempt certain entities from mitigation in an effort to satisfy states' renewable portfolio obligations. In *NYISO,* the Commission similarly recognized the need to exempt resources which further renewable energy policy objectives.[15] Moreover, the Commission permitted PJM to exempt certain types of generation resources from mitigation. Commissioners LaFleur and Wellinghoff recommended that ISO-NE and its stakeholders consider whether similar exemptions would be appropriate in New England.

b. PJM and NYISO Offer-Floor Mitigation

In the Order, the FERC directs ISO-NE to work with stakeholders to develop an offer-floor mitigation construct similar to the ones in PJM and NYISO.

PJM's Tariff contains several provisions to prevent the exercise of market power by capacity suppliers. The PJM Tariff aims to prevent market power by preventing economic and physical withholdings. Economic withholding is prevented by specific rules for substituting a predetermined default competitive bid for offers under specified noncompetitive conditions. Physical withholding is prevented by specifying that all available capacity must be offered in the Base Residual Auction and incremental auctions to receive a capacity payment or satisfy a capacity obligation. Section 6.5(a)(ii) of the PJM Tariff provides conditions and procedures for the Market Monitor to reject a non-competitive offers to be bid into the market.[16]

NYISO's supply-side mitigation structure applies only to: (1) capacity bid into the New York City capacity zone; and (2) to those who own or control more than 500 MW of Unforced Capacity.[17] Supplier mitigation only applies to market participants with more than 500 MW of capacity because those with less would not have sufficient market power to profit from a withholding strategy because of the NYC ICAP Demand Curve.[18] NYISO requires that pivotal suppliers have a must-offer requirement and offer cap. The must-offer requirement requires suppliers to offer any capacity not sold in six-month auctions, monthly auctions, or certified against a load serving entity's requirement, in the spot auction. Under this mechanism, suppliers will not be able to avoid mitigation by withholding resources. The offer cap is the higher of: "(1) the price on the in-City market Demand Curve if all qualified UCAP clears the

[14] The Joint Filing Supporters' First Brief, July 1, 2010, at p. 28–29.
[15] *See* 124 FERC ¶ 61,301 at p. 38 (2008).
[16] *See* PJM Interconnection, LLC, 117 FERC ¶ 61,331 (2006) (Dec. 22, 2006 Order).
[17] UCAP is a converted Installed Capacity Requirement (ICAP) based on a unit's generation performance data and its equivalent forced outage rate. The ICAP is NYISO's energy market.
[18] NYISO employs a Demand Curve structure which sends price signals for capacity development.

market, that is, the price resulting from all capacity being offered as price takers (the default mitigation reference level); or (2) a market-clearing price that covers the net going forward costs of the marginal unit, that is, the costs it could avoid by being mothballed rather than staying in the market to provide capacity."[19] NYISO sets the default mitigation reference level at the expected ICAP Demand Curve clearing price which is calculated based on the assumption that all qualified UCAP in the NYC market were sold.

B. Historical OOM

The FERC accepts the July 1 proposal that OOM resources which cleared in the first three FCAs should not trigger the APR. The purpose of buyer-side mitigation is to prevent uneconomic entry. Thus, allowing historical OOMs to trigger the APR would not accomplish this goal, because the uneconomical resources have already entered the market.[20]

C. Price Floor

The FERC requires ISO-NE to implement offer-floor mitigation. The FERC accepts the Joint Filing proposal to extend the price floor through the sixth FCA and until revisions to current APR are implemented. However, the FERC finds the Joint Filing proposal to limit number of years in which OOM can be carried forward from previous auctions to six to be unjust and unreasonable.

D. Treatment of Imports

The FERC requires the same price to apply to all resources in a given zone and in a given auction, including imports. The Commission concludes that it is reasonable to treat most imports like existing internal resources for mitigation purposes and thus, an offer floor is not required for most imports.

E. Zonal Modeling and Supply-Side Market Power Mitigation

The FERC accepts the July 1 Proposal to "model all zones all the time." The Proposal notes that use of large zones makes it difficult to properly reflect electrical constraints, resulting in the need to reject de-list bids and pay those resources its offer price, which is higher than the pool-wide price. More zones—a proposed eight energy load zones—will increase the likelihood that FCM pricing will reflect local constraints and reduce the need for ISO-NE to rely on OOM solutions to address reliability needs. The FERC accepts ISO-NE's proposal to develop future zones through the stakeholder process.

The FERC also accepts a mitigation regime which involves a revised threshold for IMM review of de-list bids that will result in the IMM reviewing requests by sellers to exit the market beginning at a

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[19] New York Independent System Operator, Inc., 122 FERC 61, 211 at p. 5 (2008) (Mar. 7, 2008 Order).
[20] The FERC reached a similar conclusion when adopting NYISO's market rules addressing OOM capacity. April 23 Order, 131 FERC ¶ 61,065, p. 75, FN. 146.

relatively lower price. The revised $1.00/kW-month threshold is reasonable as it represents a price that will not attract market power, while allowing resources to offer de-list bids above the threshold.[21]

The FERC also accepts revisions to the calculation of acceptable static and permanent de-list bids to reflect the fact that capacity resources typically participate in energy and ancillary services markets in addition to the FCM.

F. Demand Response Comparability in OOM Determination[22]

The FERC will not require any Tariff modifications in response to NEPGA and Boston Gen's allegations that demand response resources have improperly entered the FCM in significant quantities without being determined to be an OOM.

G. Cost of New Entry (CONE)

The FERC finds that elimination of the uses of CONE to be just and reasonable. In light of the FERC's requirement to implement offer-floor mitigation, the CONE issue is moot; it will be essentially written out of the FCM market rules.[23]

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[21] From the IMM proposal. *See* April 23 Order at p. 12.
[22] April 23 Order at p. 88.
[23] However, ISO-NE will remain to rely on the CONE parameter for the appropriate price floor until the revised APR rules are implemented.

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