UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

ISO New England Inc. and New England Power Pool Participants Committee	))	Docket No. ER10-787-___
New England Power Generators Association Inc. v. ISO New England Inc.	)))	Docket No. EL10-50-___
PSEG Energy Resources & Trade LLC, *et al.* v. ISO New England Inc.	)))	Docket No. EL10-57-___

REQUEST FOR REHEARING AND CLARIFICATION

The New England Power Generators Association ("NEPGA") and NextEra Energy Resources, LLC, hereby request rehearing and clarification of the Commission's April 13, 2011 order in these cases. *ISO New England Inc.*, 135 FERC ¶ 61,029 (2011) ("Order").

SUMMARY

The Order properly seeks to achieve effective rules for mitigating buyer market power. We firmly support that goal, as does ISO-NE. On a number of key issues, however, we respectfully submit that the Commission has erred. Unless fixed, these errors unfortunately will leave the ISO-NE capacity markets in distress for many years to come.

First, the Commission should clarify the type of mitigation that will apply to out-of-market, or "OOM" entry that occurred, or will occur, in Forward Capacity Auctions (or "FCAs") 4, 5, 6 and possibly 7 (if the new mitigation regime is not yet implemented). We address this issue first here in the Summary because it is relevant to the next several auctions, which will occur *before* the fatal flaws in the current tariff are fixed.

Load, we are told, contends that the Order *intentionally leaves the New England markets entirely defenseless* against the entry of *additional uneconomic OOM entry*, until the

Commission, at some point in the future, approves a full and effective buyer-side market power mitigation regime for the ISO-NE market. To the contrary, the Commission's orders here require that additional out-of-market entry be mitigated. The only open question is *how* these resources will be mitigated.

In its April 23, 2010 Order setting these cases for paper hearing, *ISO New England Inc.*, 131 FERC ¶ 61,065 at P 83 (2010), and in its more recent Order, the Commission ruled that "Historical OOM"—specifically defined as out-of-market entry occurring in the first three FCAs, meaning those held on or before October 2009—will be exempt from mitigation in future auctions. As we explain below, that decision is not well founded. Importantly, however, in so ruling, the Commission expressly confirmed that resources entering in subsequent auctions, from FCA 4 onward—what we might call "Interim OOM"—were subject to mitigation. This is consistent with the fact that the current tariff requires ISO-NE, beginning with FCA 4, to identify OOM—even if it is not mitigated under the current rules—and carry it forward to be addressed in subsequent auctions.

This leaves open, however, the question of how Interim OOM will be mitigated when the new mitigation regime begins. In the Order, the Commission requires ISO-NE to develop an offer floor mitigation approach. We submit that the right—and most straightforward—answer is to apply that same offer floor mitigation regime to Interim OOM. This will mean that Interim OOM will need to be treated as new resources in FCA 7 (or FCA 8, depending on when the new rules are implemented). These resources thus will be repriced to competitive levels under the offer floor mitigation regime. Only when they demonstrate that they are economic on a market basis, by clearing in the auction at their benchmark offer levels, will they exit the mitigation process. As we discuss below, the Commission alternatively might choose to impose some other form of mitigation, but the key is that the chosen mitigation measure needs to fully and effectively mitigate the price-suppression effects of Interim OOM, in all auctions after the new mitigation regime is put into effect, until those resources prove that they are economic by clearing on a market basis.

Any resources that entered on an out-of-market, uneconomic basis *after* the Commission's April 23, 2010 Hearing Order obviously were seeking to escape mitigation before the tariff was strengthened. The Commission cannot lawfully or fairly reward such strategic behavior. We argue below that all OOM, including Historical OOM, should be fully and effectively mitigated. But the case for full and effective mitigation is undeniably overwhelming where Interim OOM is concerned.

Second, the Commission erred in rejecting ISO-NE's proposal to adopt a two-tier auction-clearing process as its new APR. In brief, as Commissioner Spitzer explained in his dissent on this issue, the two-tier APR structure is more appropriate for New England than a PJM-style structure at this point in time. The supply and demand of capacity is more in balance in PJM than in ISO-NE, reflecting the fact that ISO-NE has a large amount of uneconomic out-of-market capacity. And PJM has a demand curve, while ISO-NE does not. The two-tier APR would allow existing out-of-market resources in New England, along with future resources that may be uneconomic—such as renewable resources—to clear and qualify as capacity resources, while paying them precisely the price that results from their entry (with no mitigation at all). At the same time, the two-tier APR approach protects incumbent resources from the artificial price-suppression effects of out-of-market actions.

The Commission gave only one reason for rejecting this approach: the fact that it will result in the procurement of additional capacity above the Installed Capacity Requirement. But this is not an inviolate design feature, particularly when the reason that surplus capacity is procured through the forward capacity auctions is that load itself decided to subsidize the entry of uneconomic resources into the New England capacity market. By giving dispositive weight to the *quantity* of capacity procured, the Commission arbitrarily overlooked other more important advantages to the two-tier APR approach, including the Commission's statutory mandate to ensure that wholesale capacity *rates* are just, reasonable and not unduly discriminatory. And the advantages of a two-tier approach are particularly important where Historical OOM is concerned, which we next address.

Third, the Commission erred in declining to mitigate Historical OOM. Once again, the Commission gave only one reason for its decision. Relying on a prior order involving the NYISO markets, the Commission ruled that there was no reason to apply mitigation to capacity resources that had already entered the market because the purpose of mitigation is to prevent uneconomic entry. This reasoning does not hold water.

The core purpose of market power mitigation is to ensure that wholesale rates are just, reasonable and not unduly discriminatory. In this case, the central goal, imposed by statute, is to prevent the continuing artificial suppression of capacity prices, which unjustly and unreasonably harms the market and all incumbent suppliers, including demand response and existing competitive resources. We agree that well-constructed mitigation rules help to accomplish this goal by discouraging uneconomic entry. But the Commission conflates the end with the means by holding that the purpose of mitigation is confined to deterring uneconomic entry. It is irrational and unlawful for the Commission to abandon the ultimate end of mitigation rules—preventing the artificial suppression of market prices by uneconomic resources—whenever those rules fail to achieve the subordinate objective of preventing uneconomic entry in the first instance.

The Commission also ignored the highly counterproductive incentive its decision sends over the longer term. As Professors Milgrom and Kalt explained, declining to mitigate Historical OOM improperly incentivizes the future exercise of market power by signaling that the Commission will allow the rewards of that exercise to be reaped for many years to come. In contrast, mitigating Historical OOM properly disincentivizes the future exercise of market power by prospectively removing those rewards. The Commission acted arbitrarily and capriciously by declining to give any substantive attention to this important evidence and underlying policy concern.

In any event, the Commission erred by not mitigating Historical OOM until the entire oversupply is absorbed by load growth and retirements. The mitigation that the Commission did impose—a brief extension of the existing price floor until new rules become effective—is manifestly insufficient, arbitrary and capricious. There are various mitigation approaches the Commission could use. It could apply the mitigation ultimately approved in the compliance phase of this proceeding. It also could employ the two-tier APR at least on a narrow, tailored basis as a mitigation measure for Historical OOM. Failing either of these two approaches, it could make necessary additions to, and then extend, the price floor (at a level consistent with the clearing price that would have occurred but for uneconomic entry). Or it could implement transition payments. Under any approach, however, the mitigation should extend until the entire oversupply caused by Historical OOM is exhausted. This is necessary to ensure just, reasonable and not unduly discriminatory price outcomes, both in the near term and in the long term.

Fourth, the Commission erred in reducing the dynamic de-list bid threshold from 0.8 times the cost of new entry to a fixed $1/kW-month. This lower threshold over-mitigates capacity suppliers. In addition, the Dynamic De-List Bid process was a core price-stabilizing feature of the market design. By essentially eliminating it, the Commission has returned the Forward Capacity Market to a vertical demand curve and an extremely volatile pricing regime. When auction results indicate an oversupply of capacity, such as we have now, reflecting substantial uneconomic out-of-market entry, the clearing price will, absent a higher price floor, essentially be capped at $1/kW-month. If supplies eventually tighten (assuming out-of-market activity is fully mitigated), prices will spike. The Forward Capacity Market thus will have lost the price stability that the Commission originally sought to create when it ordered modifications to the earlier ICAP market.

Fifth, one justification the Commission gave for adopting the $1/kW-month figure is that Static De-List Bids still are available. But as we explained in our briefs, that purported option is, in reality, an empty one. The reason is that ISO-NE has adopted a patently erroneous and idiosyncratic approach to calculating going-forward costs in the context of reviewing Static and Permanent De-List Bids. Both PJM and NYISO calculate going-forward costs as the costs avoided by mothballing a unit. In contrast, ISO-NE—and ISO-NE alone—will calculate going-forward costs based on the assumption that the unit in question continues to participate in the energy and ancillary services markets, and will disallow any costs associated with participation in those markets. This is wrong, as we establish below. As a result, the Static De-List Bid process has been rendered a nullity. It will no longer provide any meaningful alternative to Dynamic De-List Bids—an assumption upon which the Commission incorrectly relied. For this reason, too, the Commission's decision on Dynamic De-List Bids does not survive scrutiny.

Sixth, the Commission erred in excluding De-List Bids rejected for reliability reasons from the price formation process. This artificially lowers clearing prices in constrained zones, discouraging rather than encouraging infrastructure development, and results in unjust, unreasonable, and unduly discriminatory auction outcomes for resources in such zones.

Seventh, the Order might be read to preclude any review of offer benchmarks for demand response resources. The Commission should clarify that this issue is open for consideration in the stakeholder process, along with the other issues being addressed in that process. Alternatively, we seek rehearing. Demand response should be subject to the same type of offer floor mitigation that the Order imposes on generation. Anything else contradicts comparable treatment, and is unjust, unreasonable and unduly discriminatory.

BACKGROUND

In early 2010, ISO-NE and the New England Power Pool Participants Committee jointly filed substantial revisions to the rules governing New England's Forward Capacity Market ("FCM") in order to address several significant flaws identified during the first three Forward Capacity Auctions ("FCAs") that ISO-NE conducted in 2008 and 2009. Various Revisions to FCM Rules Related to FCM Redesign, Docket No. ER10-787-000 (Feb. 22, 2010) ("FCM Revision"). NEPGA protested that rate filing, Motion to Intervene and Protest of the New England Power Generators Association, Docket No. ER10-787-000 (Mar. 15, 2010) ("NEPGA Protest"), and also filed a complaint regarding essentially the same issues, Complaint Requesting Fast Track Processing, Docket No. EL10-50-000 (Mar. 23, 2010) ("NEPGA Complaint"). A separate complaint raising discrete issues was filed by a smaller group of NEPGA members, the Joint Complainants, in Docket Nos. EL10-57, *et al.*

In an order issued April 23, 2010, the Commission found certain aspects of the Joint Filing to be just and reasonable, and accepted those provisions for filing. *See ISO New England*

Inc., 131 FERC ¶ 61,065 at P 16 ("Hearing Order"), *order on reh'g and clarification*, 132 FERC ¶ 61,122 (2010) ("Rehearing Order"). However, the Commission preliminarily found that the remaining rule changes proposed in the Joint Filing had not been adequately shown to be just and reasonable. *Id.* at P 15. It thus suspended those rule changes for a nominal period, making them effective on April 23, 2010, and set them for paper hearing in this consolidated proceeding alongside the alternative proposed by NEPGA and the Joint Complainants. *Id.*

ISO-NE responded to the issues identified in the Hearing Order by filing an extensive revision to its initial rate proposal with a redesigned two-tiered APR featuring separate clearing prices for competitive and out-of-market capacity. First Brief of ISO New England Inc., Docket Nos. ER10-787-000, *et al.* (July 1, 2010) ("ISO-NE First Brief"). We filed three sets of briefs and accompanying expert testimony largely in support of ISO-NE's revised two-tiered APR proposal, but noted several remaining flaws. Opening Brief of the New England Power Generators Association, Docket Nos. EL10-50-000, *et al.* (July 1, 2010) ("NEPGA First Brief"), accompanied by expert testimony from Dr. Roy Shanker, NEPGA Exhibit 1 ("Shanker Test."), Robert Stoddard, NEPGA Exhibit 2 ("Stoddard Test."), Christopher Ungate, NEPGA Exhibit 3 ("Ungate Test."), and Prof. David McAdams, NEPGA Exhibit 4 ("McAdams Test."); Second Brief of the New England Power Generators Association, Docket Nos. EL10-50-000, *et al.* (Sept. 1, 2010) ("NEPGA Second Brief"), accompanied by further expert testimony from Prof. Paul Milgrom, NEPGA Exhibit 5 ("Milgrom Test."), Prof. Joseph Kalt, NEPGA Exhibit 6 ("Kalt Test."), Prof. McAdams, NEPGA Exhibit 7 ("McAdams Supp. Test."), Dr. Shanker, NEPGA Exhibit 8 ("Shanker Supp. Test."), and Mr. Stoddard, NEPGA Exhibit 9 ("Stoddard Supp. Test."); NEPGA's Third Brief, Docket Nos. EL10-50-000, *et al.* (Sept. 29, 2010) ("NEPGA Third Brief"), accompanied by further expert testimony from Prof. McAdams, NEPGA Exhibit

10 ("McAdams 2d Supp."). Several other parties, including load interests favoring ISO-NE's original proposal, also filed numerous briefs.

In its Order, the Commission stood by its earlier findings that there are significant dangers posed by unrestrained exercise of buyer-side market power in the ISO-NE capacity markets. *See, e.g.*, Order at PP 17-19, 158. However, the Commission declined to adopt ISO-NE's two-tier pricing proposal or to correct many of the other flaws and loopholes that we and others pointed out. Commissioner Spitzer dissented in part from the Order, arguing that the two-tier pricing structure proposed by ISO-NE is both just and reasonable and particularly suited to the unique circumstances faced by the ISO-NE capacity markets. Partial Dissent by Commissioner Spitzer, Docket Nos. ER10-787-000, *et al*. (Apr. 18, 2011) ("Spitzer Dissent").

SPECIFICATION OF ERRORS AND STATEMENT OF ISSUES

The Order erred on the following points:

1. The Commission erred, Order at PP 19, 165, 189, in rejecting ISO-NE's proposed two-tier APR. *See infra* at 11–19. Under the two-tier APR, all parties—both competitive and load-subsidized—would have been able to clear and receive the capacity clearing price that corresponds to their legitimate expectations and economic requirements: (i) a competitive price, based on competitive offers and proxies for competitive resources (where offered below competitive levels) and (ii) a potentially lower price determined by the quantity of uneconomic resources pushed into the market for those who sponsor them. The two-tier solution was supported by substantial expert evidence and an emphatic and clear dissenting opinion by Commissioner Spitzer. Rejecting this just and reasonable tariff revision violated section 205 of the Federal Power Act ("FPA"), 16 U.S.C. § 824d.

2. The Commission further erred, Order at P 169, by completely delegating the design of a just and reasonable replacement for the rejected two-tier APR to the stakeholder process. *See infra* at 18–19. The near-impossibility of a stakeholder process dominated by load interests designing an effective mitigation of the exercise of load-side market power is what led ISO-NE, after many years of process, to the present point. Consigning its capacity markets to another lengthy extension of unjust and unreasonable rates violates the present-tense command of FPA section 205(a) ("All rates and charges [for] sale of electric energy … shall *be* just and reasonable . . . .") (emphasis added), 16 U.S.C. § 824d(a).

3. The Commission erred, Order at PP 213-20, in limiting the mitigation that will be applied to out-of-market entry from the first three FCAs to include only a temporary extension of

the price floor in future auctions. *See infra* at 19–32. These resources will indisputably cause capacity clearing prices to deviate substantially below just and reasonable levels for at a minimum 5 years. Moreover, the price suppression is exacerbated because the price floor is set at levels substantially below competitive levels. In both respects of dealing with Historical OOM capacity, the Commission failed to fulfill its mandate, FPA sections 205 and 206, 16 U.S.C. §§ 824d, 824e, not merely to protect against uncompetitive behavior but to ensure that *prices* are just and reasonable.

4. The Commission ruled at the outset of this proceeding that Historical OOM is limited to the first three FCAs. *See* Hearing Order at P 83. The instant Order directs that the capacity auction floor price will continue to apply until new market mitigation rules are in effect, Order at P 216, but does not describe what mitigation will be applied to Interim OOM. The Commission should clarify the mitigation that will be applied to Interim OOM for the period when the new mitigation rules go into effect.

5. The Commission erred, Order at PP 313-15, in reducing the Dynamic De-List Bid threshold from 0.8 CONE to a fixed $1/kW-month. *See infra* at 36–54. Dynamic De-List Bids at levels approaching the competitive equilibrium (*i.e.*, CONE), were an essential component to the FCM Settlement designed to dampen and compensate for price swings due to other components of the settlement, such as the vertical demand curve. Removing this essential component, under the guise of merely considering its own isolated merits, violates FPA section 205 by resulting in unjust and unreasonable *rates*.

6. The Commission erred, Order at PP 313-315, by failing to support adoption of the new $1/kW-month threshold by any, much less substantial, evidence in violation of FPA section 313(b), 16 U.S.C. § 825*l*(b), and section 10(e)(2)(E) of the Administrative Procedure Act ("APA"), 5 U.S.C. § 706(2)(E), and by mitigating offers without the narrow tailoring required by precedent. *See Edison Mission Energy, Inc. v. FERC*, 394 F.3d 964, 968-70 (D.C. Cir. 2005); *see also Wisc. Pub. Power Inc. v. FERC*, 493 F.3d 239, 264 (D.C. Cir. 2007). *See also infra* at 44–51.

7. The Commission erred, Order at PP 316-317, 322-23, in revising the threshold for Static and Permanent De-List Bids to "near zero" by excluding from the determination of Net Risk-Adjusted Going Forward Costs required to participate in the energy and ancillary services markets and without regard to any decision that the resource will in fact participate in those markets during future periods. *See infra* at 51–54. This decision will result in unjust and unreasonable rates in violation of FPA section 205, as resources will be committed to the capacity market at confiscatory rates. The Commission's ruling is in direct contradiction to the measures sanctioned by the Commission in other organized markets. *See, e.g.*, *New York Indep. Sys. Operator, Inc.*, 122 FERC ¶ 61,211 at P 21, *order on reh'g*, 124 FERC ¶ 61,301 (2008),[1] *order on reh'g and clarification*, 131 FERC ¶ 61,170 (2010) ("*NYISO*").

[1] A petition for judicial review of parts of this order is currently pending before the D.C. Circuit. *Pub. Serv. Comm'n of N.Y. v. FERC*, Case No. 08-1366 (D.C. Cir. Nov. 18).

8. The Commission erred, Order at P 63, in denying De-List Bids rejected for reliability reasons any competitive role in setting auction clearing prices, by instead effectively re-pricing such bids to zero. *See infra* at 54–58. This results in artificially low capacity prices in shortage areas and—contrary to all economic logic—discourages rather than encourages investment in these regions. Acceptance of the resulting unjust and unreasonable rates violates FPA section 205.

9. The Commission appears to exclude, Order at P 246, review of the proper price benchmark for demand response resources. *See infra* at 59–62. However, the correct offer benchmarks, and if necessary mitigation, for demand response resources are as vital to the creation and preservation of just and reasonable rates as the equivalent benchmarks and mitigation for other types of resources. If the Commission intended to commit this issue, along with the other appropriate benchmarks, to the stakeholder process, it should clarify the Order accordingly. If the Commission intended to exclude demand response benchmarks from further review, it enabled unjust and unreasonable rates and violated FPA section 205.

REQUESTS FOR REHEARING AND CLARIFICATION

I. THE COMMISSION ERRED IN REJECTING THE APR SOLUTION

The Commission ruled that OOM entry should be mitigated, but it rejected ISO-NE's specific reforms to the APR. *See* Order at P 165. In the paper hearing, ISO-NE proposed a "two-tier" APR mechanism. That mechanism would have permitted all OOM resources to clear, but would have paid them a price based on running the auction with their actual bids. At the same time, all existing competitive resources potentially would have been paid a mitigated, higher price: the clearing price that would have occurred had the OOM bid at asset-class-specific benchmarks. Numerous experts testifying in the paper hearing, including ISO-NE's external market monitor, either independently arrived at the same conclusion or supported it.

The Commission rejected ISO-NE's two-tiered APR proposal because it could procure capacity in excess of ICR. The Commission ordered stakeholders to develop an offer floor mitigation regime—similar to those in PJM and NYISO—that would not procure more capacity than ICR.

Commissioner Spitzer filed a dissent solely on this issue, arguing that ISO-NE's proposal was just and reasonable and the most appropriate solution for the ISO-NE market. *See generally* Spitzer Dissent. We agree with Commissioner Spitzer's dissent. The Commission erred in rejecting ISO-NE's proposed two-tier mitigation regime.[2] While it ultimately would be appropriate to improve ISO-NE's proposal to reflect recent Commission rulings, such as the adoption, in PJM, of a 90% benchmark approach (or higher), rather than the lower percentages used under ISO-NE's proposal, the overall APR construct represents the best fit for the ISO-NE markets.

A. The APR Solution Was Supported by Substantial Record Evidence and Should Have Been Approved

We support the Commission's decision to mitigate OOM entry (*see, e.g.*, Order at P 165), but the Commission should have adopted a two-tier APR mechanism like that proposed by ISO-NE and advocated by NEPGA. The two-tiered APR is the most elegant and economically sophisticated solution yet proposed to reconcile the divergent requirements imposed on FCM pricing by the Commission's orders, the demands of load, the Historical OOM capacity overhang, and the principles of economics.

The Commission summarized how two-tier pricing works:

> ISO-NE's July 1 Proposal would remove the financial incentive to exercise buyer market power because it would raise the price paid for existing capacity back to the level that would have occurred if the new OOM capacity had offered into the auction at a competitive price reflecting its cost of entry, that is, at its benchmark price. Under the July 1 proposal, anytime an OOM resource clears the auction, two clearing prices result. All new resources, whether OOM or in-market, that offer below the Capacity Clearing Price would receive the Capacity Clearing Price, which is based on parties' actual offers. On the other hand, ISO-NE also

[2] The D.C. Circuit has recently emphasized that the Commission's obligation to engage "facially reasonable alternatives" in its orders is particularly acute where those alternatives are supported by a dissenting Commissioner. *Am. Gas Ass'n v. FERC*, 593 F.3d 14 (D.C. Cir. 2010) (quoting *Laclede Gas Co. v. FERC*, 873 F.2d 1494, 1498 (D.C. Cir. 1989); *see id.* at 20 (citing *Chamber of Commerce v. SEC*, 412 F.3d 133, 137-38 (D.C. Cir. 2005)). In our view, the Order may fall short of that standard.

> procures all existing resources that bid below the comparatively higher Alternative Capacity Price (and pays these resources the Alternative Capacity Price), which is arrived at through the use of benchmark pricing. This mechanism would reduce or remove the incentive for buyer-side entities to subsidize uneconomic entry. However, since ISO-NE procures all existing capacity that bid below the Alternative Capacity Price as well as all capacity that bids below the Capacity Clearing Price, the mechanism results in ISO-NE procuring capacity in excess of ICR.

Order at P 159. In sum, the two-tier mitigation proposal permits OOM resources to clear and pays them a price based on their bids. They are free to bid as low as they want, and the low bids only affect themselves. The market will clear at a price that includes all of the below-cost bids of OOM supply. Existing in-merit resources are paid a second, mitigated price that re-prices OOM bids based on an asset-class-specific benchmark. Prices paid to existing in-merit resources thus are not affected by OOM entry. In the event that there is OOM entry, the overall level of capacity procured is increased to account for that OOM entry.

The two-tier APR received overwhelming record support. It reflected the conclusions reached by ISO-NE, *see* ISO-NE First Brief at 10–12, its external market monitor, *see* Potomac Economics Comments at 3, and independently by NEPGA's experts, *see* Stoddard Test. at 19:1–9; Stoddard Supp. Test. at 8:2–5; Shanker Test. at 13:4–14:9; McAdams Test. at 20:6–10; McAdams Supp. Test. at 27:19–34:10. Commissioner Spitzer succinctly summarized its benefits:

> The two-tiered pricing proposal recognizes the potential for "excessive" capacity purchases, but limits compensation to new resources by paying the lower Capacity Clearing Price (rather than the higher Alternative Capacity Price). Paying a potential *new* entrant the relatively lower Capacity Clearing Price provides it with a price signal that properly reflects the supply and demand balance in the market; paying such a resource a higher price than it had indicated by its offer that it was willing to accept would only result in additional market entry. However, paying an *existing* resource the relatively higher Alternative Capacity Price is proper because existing resources are uniquely harmed by the presence of out-of-market (OOM) resources – these existing resources established their entry prices without being able to foresee the price suppressing effect of OOM capacity.

Spitzer Dissent at 3 (footnote omitted).

The Commission erred in rejecting this proposal. Two-tier pricing eliminates the price-suppressing effect of uneconomic entry while still allowing uneconomic entry to be built (if that is what its sponsors want). Given the unique characteristics of the New England market, it is a superior mechanism for ISO-NE to those in PJM and NYISO. Finally, the stakeholder process that the Commission ordered to develop an alternative mitigation regime will inevitably lead to controversy and delay. We address each of these issues below.

B. The APR Solution Eliminates Price Suppression Caused by OOM Entry

Two-tier pricing would eliminate the price-suppressing effects of uneconomic entry. Existing in-merit resources would be paid a clearing price that assumes that all uneconomic entry is competitively priced. If uneconomic entry is going to be permitted into the market, two-tier pricing is the only buyer market power mitigation regime that can achieve those objectives.

One of the key issues with buyer-side market power mitigation is what to do when a state or other entity has its own reasons for sponsoring a resource that is uneconomic. The market does not support the new resource, but the state or sponsor wants it nevertheless. In a regime without two-tier pricing, the critical issue becomes whether the new resource will be granted an exception to mitigation. The Commission has ruled that exceptions can be sought pursuant to section 206. *See* Order at PP 20, 168. It is unclear how many exceptions will be granted, but it is not difficult to imagine a host of resources seeking exceptions (and, perhaps, every new resource). The states in their pleadings filed today already have unmistakably signaled that they will seek exceptions for nearly every possible resource. There will be tremendous pressure to grant many of these exceptions in order to permit states to fulfill their other policy objectives (renewables, for example).

If each exception also is permitted to bid into the market as a price taker (at zero) to ensure that it clears, as happens today, each granted exception will artificially suppress prices.

The decision whether to grant an exception thus is of the utmost importance. We can expect extensive litigation over these determinations, each and every time.

Two-tier pricing eliminates this issue. Two-tier pricing re-prices the uneconomic entry, based on its actual bid. Uneconomic entry automatically clears and is paid a bid-based clearing price. There is no question about how to re-price uneconomic entry.

Most importantly, under two-tier pricing there is no artificial price suppression for existing in-market resources. These resources' past and future investments were and are predicated on the reasonable opportunity to receive the competitive market price achieved by balancing supply and demand. Failure to protect existing in-market resources from artificial price suppression would leave such resources vulnerable to OOM predation after they have sunk their fixed costs. *See* Spitzer Dissent at 3 ("existing resources established their entry prices without being able to foresee the price suppressing effect of OOM capacity"). Such after-the-fact predation would heavily discourage or even completely prevent any further competitive entry into the capacity market. *See* Milgrom Test. at 7:1–20; Kalt Test. at 7:4–10:6, 23:15–27:2; McAdams Supp. Test. at 21:3–26:19; Shanker Test. at 34:13–35:3; Stoddard Test. at 5:15–6:15, 9:11–10:12. Therefore, if competitive capacity markets are to survive, prices paid to existing in-market resources cannot be artificially suppressed.

The two-tier APR mechanism also would have elegantly solved the problem of how to mitigate Historical OOM. (Historical OOM is discussed in detail in the next section.) In brief, Historical OOM would have been allowed to clear without suppressing prices paid to existing in-merit resources. Similarly, two-tier pricing would also be an effective remedy to resolve the same issues with respect to Interim OOM.

Without the two-tier APR mechanism, each grandfathered OOM resource or exception granted in a section 206 case becomes another blow to the capacity markets. The Commission should adopt two-tier pricing to eliminate this possibility. Failing that, the Commission should at the very least require stakeholders to adopt some alternative mechanism that eliminates the price-suppressing effects of each resource excepted from the minimum offer price mitigation.

C. The Only Capacity in Excess of ICR that Would Be Procured Under Two-Tier Pricing Is the Uneconomic Capacity that Its Sponsors Want

The Commission's primary concern with the two-tier APR is that it may procure more capacity than ICR. *See* Order at PP 159-60, 162, 167. As Commissioner Spitzer highlights, however:

> [T]he total amount of capacity purchased would only exceed the ICR if OOM capacity clears. If no OOM capacity is offered into the auction (a probable result in the absence of state-funded capacity), the FCM will clear at the Capacity Clearing Price and all capacity would receive that same price.

Spitzer Dissent at 4 (footnote omitted). The only scenario where excess capacity would clear is when the sponsors of uneconomic capacity—which is capacity that by definition was not needed by the market—insist upon building it anyway and the proxy price for that capacity resource was above the APR clearing price. In such circumstances, it is only fair that the unneeded capacity be procured on top of ICR.

The Commission highlighted "three competing objectives" used by ISO-NE in developing the two-tier pricing mechanism: "(1) allowing new OOM capacity to clear and obtain a capacity supply obligation; (2) preventing new OOM capacity from distorting the market for existing capacity; and (3) ensuring that total purchases do not exceed the ICR." Order at P 161. The Commission's order gives the third element complete supremacy, sacrificing the first and second elements. *See* Spitzer Dissent at 4. Under the Commission's order, ICR is not exceeded (element three), but OOM capacity does not clear and it appears that any exceptions will be permitted to suppress price (elements one and two, respectively). It is unreasonable to give the objective of not exceeding ICR this exalted role.[3] That is particularly true here, where the only capacity that will ever exceed ICR is uneconomic capacity that its sponsors decided to build anyway.

Finally, the Commission argues that in PJM and NYISO—which each have sloped, administrative demand curves—it is possible to purchase more *or less* than ICR. *See* Order at P 164. Under the two-tier APR, in contrast, it would be possible only to purchase an amount of capacity equal to or greater than ICR. *See id*. Purchasing less than ICR, however, is unprecedented under modern capacity market design and is unlikely to occur going forward.[4]

D. *The APR Solution Addressed Unique ISO-NE Market Characteristics Not Present in PJM or NYISO*

Commissioner Spitzer highlighted another key consideration in support of adopting two-tier pricing in ISO-NE:

> I disagree with the majority that the Commission should require ISO-NE to institute a MOPR. A MOPR is certainly one way to deter the exercise of buyer-side market power. *However, based on the extensive record in this proceeding, I have no basis to conclude it is appropriate for the ISO-NE region.* Despite the thousands of pages of arguments in this proceeding, no party advocated for a MOPR. In fact, there is barely any mention of a MOPR in the record.
>
> In the absence of any record evidence in support of a MOPR, the majority's rationale for imposing a MOPR seems to amount to little more than that MOPRs have been adopted in the other eastern RTO/ISO markets. I do not find that basis persuasive to satisfy our obligation under section 206.

Spitzer Dissent at 1-2 (emphasis added) (footnotes omitted). We agree.

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[3] In any event, the Commission's prior decisions contradict the notion that ICR is inviolate. After the first FCA in 2008, the Commission determined that ICR may be exceeded when an analysis of transmission constraints indicates that particular generation resources may not be allowed to exit the market for reliability reasons. *See, e.g.*, *ISO New England Inc.*, 123 FERC ¶ 61,290 (2008), *reh'g denied*, 130 FERC ¶ 61,235 (2010).

[4] In fact, the NYISO includes an excess capacity risk factor when it calculates the proxy unit Net CONE in the Demand Curve reset process to adjust for the fact that the markets will never be allowed to have shortages that offset surplus conditions. *See New York Indep. Sys. Operator, Inc.*, 134 FERC ¶ 61,058 at PP 114-29 (2011).

ISO-NE has unique characteristics that make it far more susceptible to even the slightest amounts of additional price suppression. *First*, ISO-NE uniquely has a large OOM oversupply. *Second*, unlike PJM and NYISO, ISO-NE has no sloped administrative demand curve. Rather than a sloped administrative demand curve, ISO-NE's FCM has a vertical demand curve. This means that even a tiny increase in uneconomic bid quantities can have a profound effect on clearing prices.[5] There are other differences, but either one of these two fully justify a different rule in ISO-NE.

The Commission routinely has permitted and even advocated regional differences in market design where appropriate. *See Midwest Indep. Transmission Sys. Operator, Inc.*, 116 FERC ¶ 61,292 at P 53 (2006) ("We have consistently allowed for regional differences in the RTO context and have never mandated a one-size-fits-all approach for dealing with resource adequacy."); *id.* at n.50 (citing *Long-Term Firm Transmission Rights in Organized Elec. Mkts.*, FERC Stats. & Regs. ¶ 31,226 at P 100 (2006) (adopting an "allowance for regional flexibility" that "will appropriately recognize regional differences in market design") and other cases). The Commission erred by precluding that outcome here.

E. A MOPR-Like Remedy Is Likely to Engender Significant Controversy and Delay

Finally, the Commission should not have sent the design of yet another mitigation regime back to stakeholders for development. *See* Order at P 169. No matter how clear the Commission's direction, the net buyers of capacity who dominate the ISO-NE stakeholder

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5 Indeed, that phenomenon is essential to the price suppression strategy known as Demand Response Induced Price Effect ("DRIPE"), which has been embraced by state regulatory authorities in New England. *See* NEPGA First Brief at 29-34; *see also* Rick Hornby *et al*., Avoided Energy Supply Costs in New England: 2007 Final Report, at 1-1 (Jan. 3, 2008), http://www.synapse-energy.com/Downloads/SynapseReport.2007-08.AESC.Avoided-Energy-Supply-Costs-2007.07-019.pdf; http://www.nationalgridus.com/non_html/eer/ne/2007_NE_AESC_Report.pdf ("2007 Report"); Rick Hornby *et al.*, Avoided Energy Supply Costs in New England: 2009 Report, at 1-1 (Oct. 23, 2009), http://www.synapse-energy.com/Downloads/SynapseReport.2009-10.AESC.AESC-Study-2009.09-020.pdf ("2009 Report"). Although exposing DRIPE was a significant component of our complaint, the Order does not address it all.

process fundamentally oppose effective buyer-side market power mitigation. Controversy and delay are inevitable. ISO-NE, in fact, already has proposed a schedule that would not result in new buyer-side mitigation rules until FCA 8, which is four years after the auction by which our complaint requested relief. Under this schedule, rule changes addressing uneconomic entry that came into the market beginning with the FCA 4 auction would not be implemented until the delivery year that begins on June 1, 2017.

We again agree with Commissioner Spitzer. "While [we] generally support the stakeholder process, the balance here seems to weigh in favor of greater certainty and a more timely remedy to the flaws in the capacity market, rather than further stakeholder discussions." Spitzer Dissent at 2. These issues should not be delegated to stakeholders for yet another bite at the apple. A more expedited and efficient process is required.

II. THE COMMISSION UNLAWFULLY ENABLES SUPPRESSION OF CAPACITY PRICES BY GRANTING HISTORICAL OOM A PERPETUAL EXEMPTION FROM MITIGATION IN FUTURE AUCTIONS BASED ON THE IRRATIONAL NOTION THAT MITIGATION SERVES ONLY TO PREVENT UNECONOMIC ENTRY IN THE FIRST INSTANCE

In its Order, the Commission agreed "that the amount of historical OOM resources in the market has significantly contributed to a large capacity surplus in New England that is likely to last for many years," Order at P 214, and "that the pre-existing APR rules did not effectively address the entry of OOM capacity into the FCM." *Id.* at P 218. Nevertheless, the Commission rejected any reexamination of Historical OOM resources, effectively granting them a perpetual exemption from mitigation and permitting them to artificially suppress capacity prices for many years or even decades to come. *See id.* at PP 213-220.

The Commission's lone rationale for this holding is that:

> [T]he investment in OOM capacity has already occurred. As noted previously, we believe that the purpose of buyer-side mitigation is to prevent uneconomic entry. But subjecting historical OOM resources to mitigation would not prevent the entry of these uneconomic historical OOM resources.

Order at P 214; *see also id.* at P 215 ("Whether or not there was a buyer-side mitigation measure in effect at the time of the historical OOM investment, no mitigation can deter its entry into the market in either ISO, since such investment has already been made."). That contention is unsustainably flawed and the Commission's holding contradicts its statutory mandate.

As a matter of law, the FPA requires the Commission to enforce just and reasonable *rates*. And "it is the result reached, not the method employed, which is controlling." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602) (1944); *accord, e.g.*, *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1177 (D.C. Cir. 1987) ("[A] court cannot affirm simply because each of the component decisions of [an] order, taken in isolation, was permissible; it must be the case 'that they do not *together* produce arbitrary or unreasonable *consequences*.'") (quoting, with emphasis, *Permian Basin Area Rate Cases*, 390 U.S. 747, 800 (1968)); *id.* at 1177-78 ("In reviewing a rate order courts must determine whether or not the end result of that order constitutes a reasonable balancing . . . . [A]n order cannot be justified simply by a showing that each of the choices underlying it was reasonable; those choices must still add up to a reasonable result.")). No rate can be just and reasonable when it continues to be artificially suppressed by the uneconomic offers of thousands of megawatts of OOM capacity. The Commission concedes the problem exists, and it had several workable remedies before it. By refusing to adopt any of those remedies, the Commission committed reversible error.

Moreover, the Commission's insistence that the sole purpose of mitigation is to deter uneconomic entry into the market is wrong. That position mistakenly conflates the *purpose* of mitigation—which is to ensure just, reasonable, and non-discriminatory capacity prices—with only one of several *means* through which mitigation can achieve that purpose (deterring uneconomic entry into the capacity market). The Commission's contrary decision here thus conflicts, without rational explanation, with the Commission's orders on review in *Connecticut Department of Public Utility Control v. FERC*, 569 F.3d 477 (D.C. Cir. 2009). In that case, the Commission held, and the Court agreed, that the New England capacity market did not mandate, or preclude, the construction of generation. The point instead is to set just and reasonable capacity rates. Id. at 483-85. That is the correct, statutorily-consistent point of view. The Commission thus misses the point, and contradicts its prior holdings, when it claims that the whole point of buyer-side market power mitigation is to prevent entry when it is uneconomic.

Where, as here, the Commission agrees that ISO-NE's market mitigation rules failed to achieve their purported sole objective of deterring uneconomic entry at the outset of the forward capacity market, the Commission cannot rationally or lawfully decide to allow that failure to indefinitely continue injuring the market and a vulnerable subset of its participants. This would be akin to firemen declining to extinguish a fire, even though they have been called to the scene while it still is raging, because the fire alarm failed to go off. While the first line of defense—deterring uneconomic entry—has failed to work because the tariff was fatally flawed, the core mission—preventing unjust, unreasonable and unduly discriminatory rate outcomes—still can be achieved, at least on a going-forward basis. While past harm cannot be addressed, that is no basis for declining to remedy future harm.

A. Historical OOM Should Be Fully Mitigated in Future Auctions

1. Mitigation Is Used to Ensure Just and Reasonable Non-Confiscatory Rates, Not Merely to Deter Uncompetitive Entry

The Commission bases its decision not to mitigate Historical OOM on its holding in *NYISO* that grandfathered two Historical OOM resources. But *NYISO* is distinguishable, and even if it is not, it should not be followed here given the facts of the ISO-NE market. In *NYSIO*, the Commission exempted two new OOM units from mitigation in future auctions because applying a new mitigation rule "to units that already exist in the market misses the point of this prospective rule, *which is to affect future*" *auctions*. *NYISO*, 122 FERC ¶ 61,211 at P 118 (emphasis added). However, while Historical OOM, just like those two resources, can no longer be deterred from entering the market, *id.*, it *can* be prevented from affecting future auctions, *see id.*, by imposing robust mitigation in future auctions.

The mitigation of Historical OOM has a much larger role than merely deterring the entry of OOM supply. It is true that the costs for OOM that entered in FCAs 1, 2 and 3 are already "sunk" and their decision to build can no longer be affected. *See* Stoddard Test. at 34:11-16. But that is not, and has never been, the main purpose of mitigation. The main purpose of mitigation is to ensure just and reasonable rates in both current and future auctions. *See, e.g.*, *Wisc. Pub. Power, Inc.*, 493 F.3d at 256–63 (affirming Commission's approval of mitigation measures as "just and reasonable"); *NSTAR Elec. & Gas Corp. v. FERC*, 481 F.3d 794, 802–04 (D.C. Cir. 2007) (remanding mitigation agreements due to "critical gap" in Commission's analysis of whether the rates set in mitigation agreements were "just and reasonable"); *PJM Interconnection, L.L.C.*, 135 FERC ¶ 61,022 at P 17 (2011) ("MOPR Order") (explaining that the Commission's task was to determine whether PJM's Minimum Offer Price Rule proposal—which, like ISO-NE's proposal, was designed to mitigate buyer market power in the capacity market—was just and reasonable), *reh'g pending*.

The Commission's contrary holding in this case does not survive scrutiny. It appears that the Commission is drawing some distinction because it is *buyer* market power at issue in this case. If so, there is no support for that distinction. *See, e.g.*, *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.*, 549 U.S. 312, 321–22 (2007) ("The kinship between monopoly and monopsony suggests that similar legal standards should apply to claims of monopolization and to claims of monopsonization.”). There is nothing unique about buyer market power mitigation that eliminates the statutory requirement to ensure just and reasonable rates. That is a requirement of the FPA. It cannot be waived solely because here it is buyers—rather than sellers—that are exercising the market power. In scores of cases, the Commission has mitigated seller market power from existing resources to prospectively ensure just and reasonable rates. Failing to apply the same mitigation standards to buyers is unduly discriminatory. We respectfully submit that the Commission’s different treatment of buyer mitigation is in error and unlikely to withstand judicial review.

The record evidence indisputably establishes these facts. World-renowned economists testified that the exercise of market power through Historical OOM needs to be mitigated in future auctions to produce just and reasonable rates. As Professor Milgrom explained, the mitigation of existing OOM is economically justified to ensure just and reasonable future rates, regardless of its deterrence value:

> For a regulator with a goal of promoting competitive markets, mitigations should aim to restore future market prices to competitive levels—ones unaffected by any attempt to exercise market power. A policy that promotes a delayed response to exercises of market power—restoring market prices to competitive levels only with a lag—is hardly ideal, but it is more effective than a policy of making no mitigation for past manipulations. By following a predictable policy of mitigating market power as quickly and completely as reasonably possible, the regulator can achieve two kinds of benefits. First, it both corrects the market prices today to competitive levels and promotes a belief among market participants that future prices will be more nearly-free from manipulations. Competitive prices and the belief in future unmanipulated prices promotes the usual advantages of competitive markets, which I have already discussed. Second, maintaining such a policy promotes the expectation that the ill-gotten gains from market manipulations will be small, because the benefits of long-term market manipulations will be cut short.
>
> These advantages of mitigating historical manipulations are particularly important in markets like the FCM, where interest group politics make it difficult for a regulator to respond quickly to changing circumstances and where an unmitigated manipulator’s damaging behavior can sometimes lock in a long stream of ill-

> gotten benefits. Good policy should combat that outcome by restoring prices to competitive levels as quickly as the process allows.

Milgrom Test. at 13:4–23. Professor Kalt testified in a similar vein:

> Nothing in what might realistically be accomplished with the Commission's design of the FCM is going to alter the fact that state authorities are in *de facto* control of large blocks of load. Thus, the underlying source of buyer market power will remain intact. Understandably, state authorities will, themselves, face incentives to exercise that power via whatever outlets might be available. Providing appropriate going-forward mitigation for monopsonistic manipulation of the FCM through OOM procurement without also limiting the flows of monopsonistic "benefits" attributable to prior manipulative conduct would inappropriately incentivize large buyers (including state-controlled load) to search for yet other means of artificially depressing FCM prices through anticompetitive practices.

Kalt Test. at 30:10–19. The Commission gave no substantive attention to these highly qualified opinions. That is not reasoned decision-making, and the resulting policy choices are ill-informed.

2. *The Reasoning Underlying the MOPR Order, Based on NYISO, Does Not Apply to the FCM*

There are several other significant differences between this case and *NYISO*. *See* Shanker Test. at 60:7-20 (distinguishing *NYISO* from ISO-NE's proposal). The mitigation contemplated in *NYISO* may have prevented the two new units in question from clearing in future capacity auctions. They thus would have been deprived of capacity revenues. *See id.* at 60:9-14 ("For NYISO, the proposed mitigation would have resulted in the mitigated units potentially not clearing at all should their 'true' price exceed the market-clearing price. It was in this context that the Commission ruled that it was inappropriate to apply such exclusory mitigation on units that were built and operating …."). In this case, ISO-NE's two-tier pricing proposal could have been applied to Historical OOM to permit it to continue to clear. That remedy still is available and could be adopted, for the reasons set forth *supra* at 11–19.

Another distinction is that in *NYISO*, there was no equivalent to the APR at the time the two new In-City units were built. These two units could at least argue that they had no notice that bids below cost would be mitigated. That is not true here. All buyers were on notice that bids below cost were improper and would have to be fully justified. It turned out, however, that the initial APR was so full of loopholes that it failed to trigger in any of the first three auctions. While the Historic APR was ineffective, its existence should have put OOM entrants on notice that their offers were subject to mitigation and should not be allowed to artificially reduce capacity market clearing prices. Dr. Shanker also refuted these justifications offered by the Supporters for exempting Historical OOM from APR mitigation. *See* Shanker Supp. Test. at 8:10–9:3.

Yet another distinction is in the market design itself. As set forth *infra* at 25, NYISO has an administrative, sloped demand curve. ISO-NE has a vertical demand curve. Because of the sloped demand curve, capacity in excess of the minimum requirement in NYISO does not create the same degree of capacity price suppression that it does in ISO-NE.[6] The impact of uneconomic entry thus is magnified in ISO-NE.

In sum, *NYISO* does not stand for the proposition that mitigation rules in all instances cannot be changed and applied to existing resources in future auctions because conduct cannot be retroactively deterred. Even if it did, we have shown why our case is distinguishable. And if the Commission for some reason (wrongly) does not find that case distinguishable, or otherwise fact-bound, it should reverse the outcome here. In the specific context of this case, there is no rational basis for allowing the prior exercise of market power in the form of OOM entry to artificially suppress future auction prices.

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[6] Indeed, the Commission cited the price stabilizing benefits inherent in the NYISO ICAP Demand Curve structure as one of the primary bases for approving it. *See New York. Indep. Sys. Operator, Inc.*, 103 FERC ¶ 61,201 at P 31 (2003) (a capacity "Demand Curve will help stabilize these prices and send better price signals to encourage the construction of generation before a shortage occurs").

3. *Mitigation Is Routinely Imposed Only* After *a Market Power Issue Emerges*

The Commission has long rejected claims that a party should be excused from mitigation forever because there were no bid caps when they first entered the market—an exact corollary to load's position here. Past auction results are protected, but *future* bids and their market impacts are not. *See New York Indep. Sys. Operator, Inc.*, 92 FERC ¶ 61,073 (2000) (accepting prospective bid cap proposal over objection that it interfered with existing contractual arrangements and expectations), *order on reh'g and clarification,* 97 FERC ¶ 61,154 (2001).

In this same vein, the Commission routinely applies new mitigation rules to existing resources. For example, the Commission earlier ruled that generation built after a certain date would be exempt from all market power mitigation, but later reversed course and *imposed* mitigation. *Md. Pub. Serv. Comm'n v. PJM Interconnection, L.L.C.*, 123 FERC ¶ 61,169 at PP 40-45, *order on reh'g*, 125 FERC ¶ 61,340 (2008). In addition, the Commission recently rejected supplier arguments that it would be unjust and unreasonable to change the thresholds for Net Commitment Period Compensation payments without having a phased-in transition mechanism, because earlier bids into the capacity market might have relied on an assumption that the then-current mitigation would continue into the future. *ISO New England Inc*., 129 FERC ¶ 61,008 at P 20 (2009). As the Commission concluded, "[w]e will not allow market participants to continue to exercise market power during a transition period just because the first and second [FCAs] have already taken place." *Id*. at P 24.

These prior cases directly support applying new mitigation rules to existing OOM resources here. The Commission utterly failed to recognize these earlier contrary rulings. It thus has failed to engage in reasoned decision-making, irrationally departing from prior precedent without rational explanation.

Load's main counterargument—nowhere endorsed in the Order—appears to be that there is some "reliance interest" in not having capacity prices mitigated for existing state-sponsored OOM. The Joint Supporters' First Brief, Docket Nos. ER10-787 *et al.* at 33–34 (July 1, 2010) ("Supporters' First Brief"). As noted above, the Historic APR, originally proposed in the FCM Settlement Agreement, mitigated the effects of OOM offers only for the very first FCA in which that OOM resource participated. *See* NEPGA First Brief at 22. Based on this, the load claims that they had "justifiable expectations" that their offers would never be subject to effective mitigation and sponsored OOM entry accordingly. *See* Supporters' First Brief at 33–34.

If any such expectations ever existed, they certainly were not "justified." All we propose to do here is to prevent Historical OOM from artificially suppressing future auction prices. It is facially absurd for load to argue that it has some defensible reliance interest in continued price suppression in future auctions. There is no basis for the Commission to find any such reliance to be worthy of protection—certainly no basis that would withstand judicial review.

If any reliance interest were justified, it would only be the interest of the sponsors of OOM entry to be able to rely on that capacity to help meet their capacity obligations—*not* to be able to rely on OOM capacity to suppress prices. And the obvious remedy for any such reliance interest would be to permit the resource to clear in future auctions, while precluding it from suppressing price outcomes. As Commissioner Spitzer correctly recognized, the two-tier APR would provide this exact remedy.

B. The Commission's Limited Extension of the Price Floor Is Not an Effective Remedy for Historical OOM

The Commission extended the price floor until the replacement mitigation rules are implemented. *See* Order at PP 216-18. That is the totality of the Commission's effort to remedy the significant and lingering problems caused by Historical OOM. While this countermeasure is certainly better than nothing, the price floor is set too low and expires too soon to remedy the price suppression caused by the large volume of Historical OOM in the market. The remedy also is arbitrary because it is divorced from any connection at all with actual capacity market requirements. Instead, the Commission permits the duration of the price floor to hinge solely on the period of time that it takes ISO-NE stakeholders to develop rules based on construct akin to PJM's Minimum Offer Price Rule. Some additional remedy is essential until the overbuild is exhausted.

1. The Price Floor Is Too Low To Sustain A Healthy Market

A capacity price floor, while preferable to a market consistently clearing near $0/kW-Month, is an inadequate substitute for mitigation of current, future, and Historical OOM resources. The price floor is set at 0.6 CONE, or 40% below the level the capacity market needs to average in order to induce and sustain competitive new entry. CONE itself is artificially low because its value has been depressed by low clearing prices. While less ruinous to current competitive capacity suppliers, including demand response, than doing nothing, 0.6% CONE is insufficient to sustain a healthy market over the long term.

2. The Duration of the Price Floor Is Too Short; It Should Remain In Effect Until All Historical OOM Is Absorbed by the Market Through Load Growth or Retirements

The rules defining OOM entry were extremely lax under the Historic APR: Self-supply resources and resources bidding up to 25% below CONE (regardless of actual cost) were excused from mitigation, and mitigation was only applied for a single year. For purposes of economic effect, however, a OOM resource is any resource "bidding at a level below its all-in costs, including appropriate risk premium, ignoring subsidies or above-market contractual payments, but net of expected earning from the market-priced sale of its output." Stoddard at 27:1-4. These "all-in costs … include[e] engineering, procurement and construction costs, along with financing costs. . . ." *Id.* at 26:23-24. OOM resources, by definition, include "[s]elf-supplied new capacity resources [that] are intrinsically out-of-market [because] their offer price … is effectively zero," which is below any rational measure of all-in cost for any resource. *Id.* at 27:6-8.

The lax Historic APR also allowed vast quantities of new supply to be bid in below cost into the capacity auctions without being classified as OOM or, even if classified as OOM, to be mitigated only for a single year, with no impact on auction clearing prices. We continue to challenge that decision (but need not address it here because the Order denied our prior request for rehearing).

As a result of these factors, in the first three FCAs, during which this Historical OOM entry occurred, the price floor—to which the clearing price fell every time—progressively dropped from $4.50/kW-month to $3.60/kW-month to $2.95/kW-month. Stoddard, NEPGA Exhibit 2-H at 1. Even at this price, excess supply reached 5,061 MW in FCA 3 (and, in FCA 4, *increased* to 5,374 MW, with the same price floor and clearing price as in FCA 3). Stoddard Supp. Test. at 5:3-4. An excess of this magnitude, absent plant retirements, will require many years to absorb. *Id.* at 5:4-5.

The exact share of excess supply that constitutes OOM cannot precisely be determined from publicly available information. But several indications are that a substantial amount of the capacity overhang constitutes uneconomic OOM:

(1) Resources deemed to be OOM by the IMM, even under the excessive lax standard described above, total 1,450 MW. *Id.* at 19:12 & n.24.

(2) Many additional resources must be presumed to have taken advantage of old tariff's permission of bidding up to 25% under CONE, regardless of actual cost, to escape OOM designation.

(3) Resources new to FCA 1, but which under the then-effective tariff escaped any examination for whether they were OOM, total 586 MW. *Id.* at 19:13 & n.25.

(4) Demand response resources not deemed "OOM because of inappropriate benefits measures by the IMM" total 2,554 MW. *Id.* at 19:16-17 & n.26.

Another component could be self-supply, which is effectively bid at $0/kW-month and therefore is economically OOM, "rose markedly, from 1,935 MW in FCA 3 to 2,699 MW in FCA 4, an increase of 39%." Stoddard Supp. Test. at 5:8-9. Much of this, however, is offered by existing resources and thus probably is not properly classified as OOM.

Even under the most conservative measure—counting only OOM so designated by the IMM under the over-narrow standard—at least five additional years of demand growth will be needed to absorb OOM capacity. Adding new resources which escaped any OOM review in FCA 1 and all self-supply increases this to at least ten years.

If Historical OOM is not reflected in future auctions at mitigated prices, the clearing price not only will immediately drop to very low levels—or to the Commission-imposed floor— but it will remain suppressed for many years until Historical OOM has been absorbed by the market. Stoddard Test. at 35:2-36:13. These artificially low prices will be the direct result of OOM supply, exacerbated by ISO-NE's vertical demand curve (*see infra* at 43–44). They will lead to premature retirement of existing resources that would otherwise be economic but that cannot compete against subsidized new resources. This will increase the overall cost of capacity over time.

The duration of prices at artificially low levels or a price floor depends critically on how much of the Historical OOM is mitigated. The Commission has contemplated a brief extension of the price floor beyond the sixth FCA—until the new mitigation rules are implemented. Order at P 218. The Historical OOM surplus, however, will last much longer. At a minimum, some transitional mechanism must continue as long as unmitigated OOM capacity continues to depress clearing prices.

The decision to permit Historical OOM from the first three capacity auctions to suppress capacity prices is not a temporary or peripheral issue. Even if the Commission had resolved all other issues in favor of competitive prices, the lagging effects of Historical OOM still would cripple New England's capacity market. Competitive suppliers that have endured the bottoming out of prices in the hope of corrective Commission action will now face an indefinite future of artificially suppressed capacity prices. Further investment to maintain and improve the existing facilities will be heavily discouraged. Instead, the power system will be confronted with the premature retirement of otherwise economic resources. ISO-NE will more likely be forced to rely upon reliability must-run ("RMR") agreements to maintain reliability, and to forgo the efficiencies of competitive markets. *See* Milgrom Test. at 8:1–9:22; Kalt Test. 13:3–15:6; McAdams Supp. Test at 11:16–13:13, 19:19–20:17, 21:14–21, 27:19–34:10. This is precisely what drove the Commission to initiate the capacity market review in New England in the *Devon* cases in the first place. *See Devon Power LLC*, 103 FERC ¶ 61,082 at P 37, *order on reh'g*, 104 FERC ¶ 61,123 (2003); *Devon Power LLC*, 110 FERC ¶ 61,315 at P 45 (2005).

3. The Commission Should Grant Rehearing to Extend Mitigation of Historical OOM

As demonstrated above, a capacity price floor—while not a sufficient remedy against the deleterious effects of Historical OOM—is a minimal safety net while Historical OOM continues to affect capacity clearing prices. But while Historical OOM will continue to influence capacity price for many years, the Commission noted the possibility of removing the safety net in less than *two* years.[7] The duration of the threat and this weak remedy do not match. Unless the Commission decides to mitigate Historical OOM prospectively—as we urge it to do—the minimum necessary to keep the FCM alive is to extend the price floor—set at a reasonable level consistent with the clearing price that would have occurred but for uneconomic entry—for as long as Historical OOM continues to exercise its influence.

There are alternatives to an extended price floor. Above we advocate applying two-tier pricing to Historical OOM. Another option would be to apply the offer floor mitigation regime or whatever other mitigation the Commission ultimately approves to Historical OOM. Yet another option is lump-sum transitional payments. Another possibility could be a hybrid that includes a single adjusted price under the APR and pro-rating of payments to respect the constraint of purchasing no more than ICR. The floor itself could be modified.

In the final analysis, the particular mitigation mechanism to apply is a secondary consideration; the more important thing is that the Commission decide that effective mitigation will continue until Historical OOM is absorbed by load growth and retirements. The two- or three-year price floor extension provides some minimal relief, but the Commission erred by not requiring mitigation in future auctions to reflect Historical OOM.

III. THE COMMISSION SHOULD CLARIFY THE MITIGATION THAT WILL BE APPLIED TO INTERIM OOM WHEN THE NEW MITIGATION REGIME BEGINS

The Commission has been explicit that the grandfathered Historical OOM category is limited to OOM Entry from the first three auctions, and has expressly distinguished any "Interim

[7] The Commission's decision to temporarily extend the price floor defeats any argument that Historical OOM may make in the future that it was not on notice that it would be subject to prospective mitigation.

OOM" entry that occurs thereafter. We seek clarification of what specific type of mitigation will apply to Interim OOM after the compliance phase of this proceeding.

In the order establishing the paper hearing, the Commission discussed whether to mitigate Historical OOM resources, setting the issue for briefing. After discussing Historical OOM, the Commission stated as follows:

> *Different considerations apply* regarding the treatment of OOM resources that clear after the third FCA (*i.e.*, FCAs held after the issuance of this order). A primary objective of APR mitigation is to address the suppression of market clearing prices due to OOM capacity. This is a principal reason for accepting the Filing Parties' proposal to consider the effect of OOM resources built after the issuance of this order that affect the capacity price in multiple years.

Hearing Order at P 83 (emphasis added). In the current Order, the Commission ruled that "OOM Resources that cleared in the first three FCAs (so-called 'historical OOM') should not trigger the APR." Order at P 21.

In sum, the Commission chose to grandfather Historical OOM from the first three auctions, but not any OOM thereafter. All OOM after FCA 3 has been on notice that it will be mitigated—*before* the auctions cleared or any investments were made. *See* Order at P 21.

The Commission has not, however, addressed the specific form of mitigation that it will prospectively apply to Interim OOM entry that occurs in FCAs 4, 5, and 6 (and potentially 7), after the new mitigation regime is implemented.[8] Mitigation in the interim period has been settled—the Commission extended the price floor and left in place the "APR-1" and "APR-2" mechanisms proposed by ISO in its Feb 6 filing. *See* Order at P 218 (extending the price floor "through the sixth FCA (and potentially longer depending on the timing of the offer-floor

[8] To be clear, any OOM that enters in the period before the final mitigation rules are implemented, should be subject to mitigation. This is true whether the interim period extends through FCA-6, or FCA-7 or even longer.

mitigation stakeholder process)"); *see also id*. at P 213 (same).[9] APR-2 requires that OOM be identified beginning with FCA 4 and carried forward even if APR-2 is not triggered.

But the mitigation to be applied to Interim OOM entry in future auctions—after this interim period, and after the new mitigation regime is put into effect—is unclear. Load, predictably, already has signaled its view in stakeholder meetings that Interim OOM should not be subject to any mitigation in future auctions, which, if correct, would lead them to flood the market with even more OOM entry during this interim period.

Unless the Commission grants rehearing, the mitigation that the Commission approves presumably will be a type of offer-floor mitigation. Special arrangements will be necessary, however for Interim OOM. Offer floor mitigation usually includes a rule providing that after a resource clears some number of times, it will no longer be subject to mitigation. But here, given the toothless mitigation rules now in effect, and despite the notice the Commission gave when it set these cases for paper hearing, a large amount of OOM has cleared FCA 4, and may clear in future interim auctions. This means that targeted additional requirements need to be imposed.

The solution is simple. All Interim OOM should be treated as new resources in the first year that an offer floor-based mitigation regime is implemented. All OOM resources that enter the market in FCAs 4, 5, 6 and possibly 7 should be treated as new resources when the auction is run under the Commission-approved mitigation in FCA 7 or 8. Their offers should be compared to a resource-specific benchmark and mitigated up to that level, if necessary. Any resources that do not clear will not qualify as capacity resources. And mitigation should continue for as long as provided for in the new offer-floor-based regime.

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9 We are not seeking rehearing of the Commission's decision to extend the price floor during the compliance phase of this case. We are seeking rehearing, instead, of the Commission's ruling that this limited extension of the price floor alone is a sufficient remedy for the OOM oversupply. *See supra* at 19–32.

While it is essential to mitigate Interim OOM in future auctions, it is *not* essential to use an offer floor-based mechanism for these resources. For the same reasons that we outlined above (*see supra* at 11–19), two-tier pricing is a superior form of mitigation for the ISO-NE region. And that approach would work well for Interim OOM. There is no cause for sympathy about the prospect of Interim OOM failing to clear in future auctions, and thus failing to qualify as capacity resources, because the sponsors of these resources already were on notice of this possibility, and built Interim OOM during the compliance phase of this proceeding at their own peril. But if there were any concern about this possibility, the answer would be simply to alter the mitigation—*not* to permit Interim OOM to escape mitigation in future auctions. And a two-tier APR approach would achieve that, permitting Interim OOM to clear without affecting prices paid to existing in-market resources. Two-tier pricing could be limited solely to Interim OOM (and Historical OOM, if the Commission grants rehearing), while all future resources could be subject to an offer floor-based mitigation.

If these approaches are deemed unacceptable for Interim OOM, another possible alternative mitigation would be to extend a price floor, although the level of the price floor must be higher. The Commission could also require transition payments. In the final analysis, however, we submit that the simplest solution is to apply the mitigation ultimately approved in this case to Interim OOM when that mitigation is implemented. Interim OOM resources would be treated as new resources in the first year that the offer floor-based mitigation is applied. This should deter future OOM entry, while achieving the statutorily predominant goal of preventing price outcomes from being suppressed downward in unjust, unreasonable, and unduly discriminatory ways.

IV. THE COMMISSION ERRED IN REDUCING THE DYNAMIC DE-LIST BID THRESHOLD

The Commission also erred in reducing the threshold for reviewing Dynamic De-List Bids to \$1/kW-month. The current threshold is 0.8 times the CONE, which translated into \$6/kW-month in the first auction held only a few years ago. The Commission holds that its new, much lower standard is justified because generators can submit bids above \$1/kW-month to the market monitor for review, and that a higher threshold "could provide an opportunity to exercise market power." Order at P 313. As we explain below, unless altered or reversed, this decision, on a stand-alone basis—and particularly in light of the decision not to mitigate Historical OOM—will effectively create a \$1/kW-month ceiling on FCM prices for years to come. And this, in turn, will require a return to the RMR regime, the elimination of which was one of the Commission's prime motivations for adopting the FCM design in the first place.

This new mitigation regime effectively eliminates the Dynamic De-List bidding option during an auction. Given the current surplus caused by OOM entry, it also imposes an effective capacity price cap at \$1 for years to come, beginning as soon as the price floor is removed. Furthermore, the \$1/kW-month threshold itself bears almost no relation to competitive pricing in the capacity auctions. In sum, the new mitigation regime over-mitigates without cause, contrary to precedent. It is unjust and unreasonable.

The ability for bidders to go to the market monitor to demonstrate actual costs does not remedy this over-mitigation. *First*, this cannot be done in an auction, but must happen eight months in advance, which eliminates the benefits of Dynamic De-List bidding. *Second*, in the particular context of estimating going-forward costs for existing units, demonstrating such costs to the market monitor imposes its own significant burdens, costs and uncertainties.

A. The New Mitigation Regime Effectively Eliminates Dynamic De-List Bidding

The new $1/kW-month Dynamic De-List Bid mitigation threshold essentially eliminates the ability to competitively de-list after an auction has started. This had been one of the key price-formation components of the FCM design. Its elimination fundamentally changes the capacity market.

Under the original FCM design, generators could submit Permanent De-List bids (used to permanently remove a unit form the capacity market) or de-list bids that took a resource out of the capacity market for a single year. A resource may want to de-list for a single year in various circumstances, including, for example, if it projected that clearing prices would not cover operating costs for the year but it had reasonable expectations that prices would rebound in future years, or if it believed it could sell its capacity in another capacity market at a higher price.

For single-year de-listing, the FCM settling parties established a minimum threshold to determine whether cost-justification to the market monitor would be required. Bids above 0.8 times the CONE, called "Static" de-list bids, had to be cost-justified in advance, in a process that takes eight months. Bids below 0.8 times CONE, called "Dynamic" De-List Bids, could be "entered during the course of the descending clock auction." Stoddard Supp. Test. at 25:24. Since clearing prices must, by design, on average and over time equal the actual cost of new entry for the market to be sustainable, bids at levels below 0.8 times CONE were assumed to be free from the exercise of market power. *See ISO New England*, 125 FERC ¶ 61,102 at PP 9, 37-40 (2008), *order on reh'g*, 130 FERC ¶ 61,089 (2010); *Devon Power*, 115 FERC ¶ 61,340 at PP 28, 146-47; *see also* Stoddard Test. at 77:18-78:20 (explaining economic rationale for dynamic de-list bid threshold at 0.8 times CONE). The Commission later explained the logic of not requiring such bids to submit costs:

> [W]e think that a dynamic de-list bid establishes a reasonable default level of compensation for units needed for reliability. A dynamic de-list bid must be at least 20 percent below CONE, and is only entered into the auction in an auction round where the clearing price is at or below that level. Over the long run, the average price for capacity should reflect CONE, in order to attract new entry needed for reliability. The costs of an existing unit would ordinarily be below the entry cost of a new unit, and we conclude that a default level for existing resources that is at least 20 percent below the cost of a new entrant (and at least 20 percent below the likely average price of capacity over time) is reasonable.

ISO New England Inc., 125 FERC ¶ 61,102 at P 77.[10]

CONE initially was $7.50/kW-month. As a result of poorly structured rules and the resulting massive out-of-market entry in the capacity auctions held to date, CONE fell to about 2/3 of its initial level—$4.918/kW-month—after just two auctions under the tariff's flawed automatic updating mechanism. For FCA 5, CONE has been adjusted for inflation under the tariff to $5.349/kW-month. Thus, initially, the 0.8 times CONE threshold was $6/kW-month but for FCA 5 will be $4.28/kW-month.

The Commission now orders what it calls the "relatively stricter" threshold of $1/kW-month. *See* Order at P 290. This is not, we respectfully submit, an accurate description of what the Commission has done here. The new $1/kW-month threshold is *six times lower* than the initial threshold, and *over four times lower* than the current threshold. There has not been any showing that this substantially tighter threshold is needed to address the exercise of market power or that the 0.8 times CONE threshold had in any way failed to prevent the exercise of market power.

The original $6/kW-month value appropriately served its purpose as a cut-off threshold below which bids were assumed not to be an exercise of market power. Such bids were, after all,

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10 *See also id*. at PP 78-79 (describing considerations of administrative convenience for bids at this level and concluding that "[i]f it is just and reasonable to allow a de-list bid below the threshold level to establish the market price for all capacity without market monitor review, then a lower bid (based on market monitor review) should not be required to establish the compensation of only the single resource needed for reliability, as this practice would be unduly discriminatory.").

below a *fraction* of the estimated cost of new entry and the anticipated level of the long-run clearing price in the auctions. As CONE fell under the automatic updating process, however, the lower and lower thresholds increasingly reduced the role of Dynamic De-List bidding in the auctions. The Commission's decision to change the threshold from 0.8 times CONE to $1/kW-month now essentially eliminates Dynamic De-Listing. Any bid over $1/kW-month is now a Static De-List Bid that must be fully cost-justified several months in advance of auction. And in the specific context of the FCM design, this rule is not just and reasonable.

The ability to submit Dynamic De-List Bids provided significant value and flexibility to capacity suppliers and substantial benefits to the market. The decision whether to de-list could be made at the time of the auction, rather than many months in advance. With Static De-List Bids, capacity suppliers have to guess eight months earlier about whether they think the resource will be available and profitable in the delivery year. Moreover, the decision to submit a Static or Permanent De-List bid based on that guess is binding at the time of submittal—eight months before the start of the auction

Costs and circumstances of course change over time. The further in advance the decision whether to de-list is made, the more it is subject to uncertainty. Environmental regulations, in particular, frequently change on relatively short notice. Regulations currently under consideration, for example, could significantly increase costs for coal and oil resources, and others that use "once-through" cooling.

As Professor McAdams testified, "[t]he [static de-list] process is cumbersome and requires bidders to commit to a Static De-List Bid months before the auction, foreclosing bidders' flexibility to modify their bid to reflect changing costs or new opportunities that may arise in the months preceding the auction." McAdams Supp. Test. at 37:17-20. As Mr. Stoddard testified, the Static De-List approval process “locks the supplier down months in advance of the auction to a particular bid price.” Stoddard Supp. Test. at 33:10-11. Some resources may de-list in circumstances where—had they had more time and better information—they could have stayed in service. Far from being “relatively stricter” (*see* Order at P 290), the $1/kW-month threshold has the effect of virtually eliminating Dynamic De-List Bids from the market. And to the extent that a unit seeks to dynamically de-list and is prevented from doing so for reliability reasons, it will be limited to its Dynamic De-List Bid of under $1.00/kW-month.

B. The Commission Erred in Ruling That Dynamic De-List Construct Was Not a Key Part of the Original Design

The right to competitively de-list was a basic design element of the FCM. The $1/kW-month threshold effectively writes it out of the tariff. In so doing, the Commission did not give proper weight to substantial record evidence about the purpose and need for Dynamic De-List Bids in the overall ISO-NE market construct, including in particular, their price stabilizing role. The Commission instead finds—without any basis in the record—that the “[a] resource’s de-list bid is not intended to serve as a price stabilizer.” Order at P 315. This was an error.

To understand the intended role of Dynamic De-List bidding, two characteristics of capacity markets and the FCM market must be kept in mind: *First*, for any capacity market to be sustainable over the long-term, it must permit the recovery of the CONE on average and over time. *See ISO New England Inc.*, 125 FERC ¶ 61,102 at P 43; *Blumenthal v. ISO New England Inc.*, 117 FERC ¶ 61,038 at PP 82-87 (2006), *order on reh’g,* 118 FERC ¶ 61,205 (2007), *petition for review denied*, *Blumenthal v. FERC,* 552 F.3d 875 (D.C. Cir. 2009); *Devon Power*, 115 FERC ¶ 61,340 at P 114. In a construct like the FCM that has a vertical demand curve, in times of surplus, prices are likely to fall far below this level. Conversely, in times of shortage, prices would need to rise to many multiples above this level. The FCM included an explicit price cap of two times the CONE level, and had further limitations on purchase quantities at prices above CONE. Symmetry demands a comparable set of bounds on the lower side of CONE. Otherwise, prices can never equal CONE on average and over time.

Second, under the FCM tariff, the quantity of capacity purchased essentially is fixed at the Installed Capacity Requirement, regardless of the prices and quantities of capacity offered. This is the economic equivalent of a vertical—or infinitely steep—demand curve. The Commission recognized the existence of a vertical demand curve in the Order. *See* Order at PP 195, 235-236.

These two factors combine to create circumstances where prices are likely to fall far below CONE during times of surplus—and to stay there for very long periods of time—without any similar periods of time where prices are above CONE. Without correction, the market is headed to significant price volatility and failure.

These problems are not unique to ISO-NE. In large part to combat these very issues, PJM and NYISO have adopted administrative "sloped" demand curves—which smooth out the demand for power over time, reducing price volatility while still ensuring that sufficient capacity is available.

But the ISO-NE capacity market has no administrative demand curve. In the FCM market design, dynamic de-list bids were intended to be a market mechanism to stabilize prices. They would enable capacity prices to not deviate too far below the long-run average cost of new entry for too long during surplus conditions.

The Commission did not respond to record evidence that this was the purpose of dynamic de-list bidding. *See* Order at P 290. As Mr. Stoddard testified:

> With no demand curve to add price stability to the FCA, the relatively looser review standards for supply priced below an agreed level—0.8 times CONE—

> was designed as the stabilizer on the low side. (New entry into a readily contestable market is the stabilizer on the high side.)

Stoddard Test. at 78:6-9. Thus "[t]he Dynamic De-List Bid threshold at 0.8 times CONE was not justified because it represented the one-year going-forward cost of capacity, but instead because the FCM price should equal, on average over time, the long-run average cost of capacity (net of market earnings for energy and other products)." *Id*. at 77:20-78:2.

Mr. Stoddard further explained that:

> If mitigation rules allow few or no de-list bids priced above $1 in the FCA as ISO proposes, any surplus supply is likely to crash the market down to $1. How, then, can the FCM return an *average* price equal to the cost required by new entry? Each low-priced year would need to be offset by at least one high-priced year when prices range well above the (true) CONE value. That is a very unlikely result. While the 5-year price lock option for new resources somewhat insulates them from volatility in the early years, it does nothing to protect these new resources against non-compensatory prices in the long run. Given that investors look at a twenty-year (or longer) investment horizon, the threat of over-mitigation in future years makes new resources less likely to enter the market. Further, if low-priced years occur fairly often, say three years out of five, then the cap of 2 times CONE prevents the high prices from ever offsetting the low prices.

Stoddard Supp. Test. at 32:14–33:5 (footnote omitted). Thus, in the original FCM design, parties were expressly permitted to submit bids up to a level where everyone agreed that they were presumed to be competitive (0.8 times CONE). Any argument seeking to evaluate dynamic de-list bids based on the one-year going-forward cost of capacity fundamentally misapprehends what dynamic de-lists bids are.

Dynamic de-list bids at levels up to 0.8 times CONE were intended to help stabilize prices by creating—in effect—a proxy supply curve to compensate for the absence of a sloped demand curve. By resetting the threshold to $1/kW-month, the Commission has eliminated this price stabilizing role—which it incorrectly claims never existed. This is contrary to the record evidence. Moreover, nothing has changed in the overall ISO-NE market design to eliminate the need for a price stabilizing mechanism such as dynamic de-list bidding. In fact, given the

Commission's determinations to date on the treatment of Historical OOM, a properly structured dynamic delist bid component in this market structure is now more critical than ever before.

C. Given the OOM Overhang and a Vertical Demand Curve at ICR, the $1/kW-Month Threshold Likely Will Act As a Cap on Capacity Prices

As noted, the current FCM market design has a vertical demand curve which fixes capacity procured at ICR. As originally designed, dynamic de-list bids permitted market conditions to be reflected in the capacity prices. Collectively, dynamic de-list bids reflect the various costs and future expectations of individual market participants, effectively creating a sloped *supply* curve. As long as there was a sloped supply curve, capacity prices could vary and send price signals to current and potential future market participants, even in the presence of a vertical demand curve. At the same time, under the 80% cap, no dynamic de-list bid ever could drive prices above (or even within 20% of) CONE, the expected long-run equilibrium capacity price which represents cost recovery in a competitive market. Basically, under this approach, capacity prices will remain at a small fraction of CONE, unless new, competitive capacity is needed. And given the Commission's rulings elsewhere, that will not happen for many years.

The Commission's depression of the dynamic de-list cap from 80% CONE to $1/kW-month, while retaining the vertical demand curve, destroys any vestige of a fragile equilibrium in the existing capacity market design. As long as there is a capacity overhang—projected to continue for as many as 19 years, *see supra* at 29—the relevant part of the supply curve will be exclusively determined by existing capacity. Because of the burdens and uncertainties associated with submitting Static De-List bids to the IMM, and the IMM's stated expectation and intent that the permissible costs for most units are "near zero" (*see infra* at 44–51), much of this capacity likely will be offered at or below the new $1/kW-month threshold.

Once the Commission eliminates the capacity market floor, as it has stated it will, *e.g.*, Order at PP 22, 213, 216, the FCM will be in a unique condition: It will combine a vertical demand curve (at ICR) with a *de facto* horizontal supply curve (at $1/kW-month). Regardless of what other events may occur in the world of ISO-NE power markets, this combination can have only one result: purchase of a fixed quantity, ICR, at a fixed price, $1/kW-month or less.

Given this, existing generators will not be able to make anything more than the most trivial new investments. And a number of resources will have no reasonable choice but to file for RMR agreements.

D. The Commission Erred in Accepting the $1/kW-Month Value

The $1/kW-month value itself bears no relation to competitive prices in the FCA. The logic behind the choice of this threshold does not withstand scrutiny. It appears that the number just as easily could have been 17¢, or $2, or any other random value proposed by ISO-NE. A higher value should be adopted.

The $1/kW-month threshold is based on the *lowest* results of annual reconfiguration auctions held to date. *See* Order at P 314. The Commission failed to give appropriate weight to record evidence demonstrating that the lowest reconfiguration auction results are an inappropriate proxy for competitive prices in the FCA. As Mr. Stoddard testified, this approach "is flawed in both concept and its particulars." Stoddard Supp. Test. at 26:14–15.

First, reconfiguration auctions are ill-suited to serve as a proxy for competitive prices, as they have a shorter forward procurement period than the FCA and a vastly reduced trading volume. *Id*. at 26:18–28:2. As a group of load parties argued in its brief at hearing:

> ISO-NE also has offered no rationale for or evidence to support using recent results in annual reconfiguration auctions as a basis for setting the thresholds for permitting unrestricted Dynamic De-List Bids. The reconfiguration auctions have included only a small fraction of the non-ISO-NE supply, have cleared very little capacity, and may clear at prices that reflect a short-term problem so that they

> may not be representative of competitive results in New England. ISO-NE has offered no justification for using those results, and it represented to stakeholders on July 22, 2010, that it does not intend to use the results of future reconfiguration auctions to set the threshold.

The Joint Filing Supporters Second Brief, Docket Nos. ER10-787 *et al.* at 58 (Sept. 1, 2010) ("Supporters' Second Brief") (footnotes omitted). We agree. The seemingly random choice of the reconfiguration auctions as a proxy does not withstand scrutiny.

Second, the error is compounded by using the lowest possible reconfiguration auction clearing price—out of the first three annual reconfiguration auctions—as the starting point for a competitive offer. As Mr. Stoddard explained, there are two facts to keep in mind about the $1/kW-month cap on dynamic de-list bids:

> Most obviously, it is the *lowest* of the clearing prices in the three [reconfiguration] auctions; turning this *lowest* of clearing prices into the *highest* allowable offer is bizarre. Moreover, even though the auction cleared at $1, we cannot infer that that is a representative offer price. To the contrary, the $1 price reflects the offer price of the *lowest-priced* 188 MW from a total supply stack (of demand bids) of 7,617 MW—just 2% of the total supply, implying that 98% of the offered, available resources required *more* than $1/kW-month to take on a capacity supply obligation. The same story plays out in the other two Reconfiguration Auctions: the clearing price is set by a tiny fraction of the total supply at a price lower than the vast majority of the remaining supply was willing to accept

Stoddard Supp. Test. at 28:4–13. The clearing price in a reconfiguration auction thus represents "a very thin fringe" of the lowest-cost capacity without a Capacity Supply Obligation that cannot provide any useful information about competitive offers for a de-listing resource. *Id*. at 28:14–30:2.

The Commission ignored this evidence. It agreed with ISO-NE that bids below $1/kW-month will be competitive, but it made no finding that $1/kW-month was the least restrictive mitigation threshold. *See* Order at P 290. But the threshold is likely to become the clearing price during times of surplus, it must be chosen with much more care.

There has been no showing, for example, that a $1/kW-month threshold takes into account the risks that a capacity resource takes on by submitting a de-list bid. This includes political and regulatory risks that rules and regulations may change, or that permissible costs may change, or that environmental requirements may change, or that fuel costs may change, or that the business climate may change. A de-listing resource faces all of these and many more risks when it submits a de-list bid. There are, again, *more than three years* between the time a dynamic de-list bid is submitted and delivery. Static De-List Bids add eight months on top of that. The $1/kW-month threshold completely ignores these risks, instead assuming a static world where nothing changes in three years and eight months. That is not reality.

Mr. Stoddard also demonstrated to the Commission that much better competitive price data is readily available to use as a basis for a mitigation threshold, including in past RMR filings in New England. Stoddard Supp. Test. at 30:3–31:14. This data demonstrates that ISO-NE's $1/kW-month threshold for a competitive offer has no basis in reality. As Mr. Stoddard testified:

> Based on these data from RMR filings, a dynamic delist bid price threshold much higher than $1/kW-month is clearly required. At a $1 price, it seems likely that many resources will not be able to support their cash costs of operating at that level and would choose to deactivate at higher prices. ISO's proposed changes to mitigation of de-list bids, however, would effectively preclude existing suppliers from reflecting these demonstrable out-of-pocket operating costs in their FCA bids.

Id. at 31:16–21; *see also* Initial Brief in Paper Hearing on New England's Forward Capacity Market, Docket Nos. ER10-787-000, *et al.*, Attach. A, Aff. of Miles O. Bidwell, Ph.D at 3–8 (July 1, 2010) (cost analysis showing that an investor that built a generation plant in the last 10 years "has a vanishingly small probability of ever recovering the original investment").

Rather than adopting the lowest conceivable mitigation threshold, the Commission should have examined this record evidence and required a higher competitive proxy. Instead, it takes a huge step back towards the days of the 17¢ deficiency charge. *See, e.g., Cent. Me. Power*

Co. v. FERC, 252 F.3d 34, 46 (1st Cir. 2001) (discussing the Commission's "well justified" rejection of a "plainly non-complying" $0.17 ICAP deficiency charge that had been supported by load parties). In those days, capacity suppliers successfully refuted arguments that an existing resource's marginal cost of providing capacity were near-zero and thus that capacity prices should likewise be near zero. In fact, it was exactly this situation and the common interest in establishing a market construct in which long-term costs could be reflected in sellers' prices that produced the current proceeding. Yet here we are again essentially arguing the same points.

E. The Commission Erred by not Narrowly Tailoring the Mitigation

The Commission's adoption of the $1/kW-month threshold also errs because it is not narrowly tailored. Mitigation must be targeted to mitigate only where structural market power exists:

> The Commission will approve only mitigation measures that address well-defined structural problems in the market. . . . The ISO's request for mitigation authority in unconstrained areas referred to pivotal suppliers that have market power at certain times. However, the ISO did not identify these suppliers or the number of hours in which each individual supplier is pivotal. Nor did the ISO explain how the proposed mitigation targets this structural problem, that is, how the proposal would mitigate only the individual suppliers that are pivotal without targeting other suppliers that are not pivotal. Therefore, we reject this proposal. . . .

New England Power Pool, 101 FERC ¶ 61,344 at P 28 (2002). It is unlawful to mitigate *everyone* as if they have market power just because some subset might have market power.

Professor McAdams explained how this precedent is supported by economics: "Proper mitigation of market power seeks to stop those with market power from exercising that power so as to create inefficiencies in the market, while *at the same time* seeking to minimize the inefficiencies created by market mitigation itself." McAdams Supp. Test. at 34:14–17. The Commission's new mitigation threshold fails this test.

Professor McAdams described three types of "improper mitigation"—all of which are present here:

> *Proper* market power mitigation seeks to maximize the *net* economic benefit of such restrictions, bearing in mind their economic costs. The economic benefit of market power mitigation is that all those with market power who are subject to mitigation will have less ability and/or incentive to distort market outcomes. The economic costs of market power mitigation, by contrast, can come in various forms. *First*, <u>unequal mitigation</u>—that is not equally applied to all market participants having market power—can potentially induce more inefficient market outcomes than if there were no mitigation at all. *Second*, <u>overly-broad mitigation</u>—that is applied even to market participants without market power—imposes an unnecessary regulatory burden. *Third*, <u>overly-restrictive mitigation</u>—that stops (or disincentivizes) market participants from behaving as they would in a competitive market—needlessly creates inefficiencies in market outcomes.

McAdams Supp. Test. at 34:23–35:10 (emphasis in original) (footnote omitted). "Unequal mitigation" has existed to date because buyer market power is barely mitigated in contrast with seller market power. *See id*. at 35:11–36:18. The new mitigation on sellers also is both "overly broad" and "overly restrictive." As Professor McAdams explained:

> Under [ISO-NE's] proposal, any resource interested in delisting at a price greater than $1/KW-month must submit to a Static De-List Bid review. In his testimony, Mr. Stoddard has provided evidence that this threshold is likely to be binding on a number of existing resources, whose true stand-alone economic cost is greater than $1/KW-month. Furthermore, as I understand it, ISO-NE's proposal *includes no safe harbors* to protect bidders who lack market power from the burdens associated with this regulatory review.

See id. at 37:9–14 (citation omitted). Professor McAdams described how this process will result in over-mitigation. *See id*. at 37:15–39:2.

Commission precedent confirms that a proper balance between "under-mitigation" and "over-mitigation" must be struck, precisely because of the pernicious effects of over-mitigation:

> [T]he difficulty in mitigating bids is to find the appropriate balance between under-mitigation and over-mitigation, because each has its costs. While under-mitigation may result in some exercise of market power that is not mitigated, over-mitigation means more frequent intervention in the market, and some competitive market results will be mitigated. Mitigation is counterproductive to the extent [that] it penalizes suppliers trying to resolve constraints, and when their

> higher offers reflect higher costs, not manipulation. Over-mitigation also can inadvertently lead to decreased confidence in the market and cause reliability problems to the extent that it keeps capacity out of the market over the long term."

Midwest Indep. Transmission Sys. Operator, Inc., 115 FERC ¶ 61,158 at P 12 (2006); *see also id*. at P 24 (rejecting mitigation proposal where the "ISO has not shown that . . . [it] is necessary to address market power abuse"). It is for these reasons that the Commission has, among other things, limited mitigation to only suppliers that have been shown to be "pivotal," has allowed other *de minimis* exceptions to mitigation and has eliminated mitigation measures when they are deemed to be no longer required.[11] *See, e.g.*, *NYISO*, 122 FERC ¶ 61,211 at PP 64–70 (limiting mitigation only to pivotal suppliers with control of more than 500 MW). Indeed, the Commission has also found that in a larger area where suppliers "must compete to sell capacity," competition subject to market monitoring is sufficient, without any additional mitigation measures. *Midwest Indep. Transmission Sys. Operator, Inc.*, 125 FERC ¶ 61,060 at PP 151–52 (2008) (rejecting as unnecessary market power study where "resource adequacy program [was] characterized by many suppliers competing to participate as resources.")

The Commission has also found that to unnecessarily mitigate a workably competitive market is to "suppress prices and deter *market* entry." *Midwest Indep. Transmission Sys. Operator, Inc.*, 111 FERC ¶ 61,043 at P 78 (2005) (emphasis added), *order on reh'g*, 112 FERC ¶ 61,086 (2006).

In this case, the Commission has made no finding that any market power has been exercised through de-list bids at the 0.8 times CONE threshold. The Commission nevertheless ignores all of this precedent and imposes a pervasive new mitigation regime, without making any finding that the mitigation it imposes is the least restrictive mitigation necessary. In the name of

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[11] *See, e.g.*, *New York Indep. Sys. Operator*, 99 FERC ¶ 61,246 at 62,041-43 (2002) (eliminating fixed price caps for non-synchronous reserves in favor of conduct and impact test).

permitting more locational markets, the Commission's new mitigation regime essentially eliminates market pricing in the capacity auctions. This is over-mitigation. The Commission should reverse itself, and either retain the 0.8 times CONE threshold (with CONE appropriately updated) or adopt an alternative mechanism or threshold to protect the viability of the FCM.

F. The Ability to Justify Costs Above $1/kW-Month Does Not Remedy the Unjustness and Unreasonableness of the Threshold

The Commission holds that the $1/kW-month threshold is "simply a boundary," Order at P 313, and that any bid above this boundary "must simply be submitted" to IMM review. *Id*. To the contrary, "[t]here is nothing simple about the Static De-list Bid approval process." Stoddard Supp. Test. at 33:8.

As Professor McAdams testified, "If bid review were perfect, costless and quick, such mitigation would impose little regulatory burden on bidders. Unfortunately, Static De-List Bid review is neither perfect nor costless nor quick." McAdams Supp. Test. at 37:15-17. Professor McAdams then explained several of the problems associated with IMM review, including:

- "The process is cumbersome and requires bidders to commit to a Static De-List Bid months before the auction, foreclosing bidders' flexibility to modify their bid to reflect changing costs or new opportunities that may arise in the months preceding the auction." *Id*. at 37:17-20.

- "[T]he market monitor conducting a Static De-List Bid review does not have all relevant information about bidders' economic costs and, especially, about the alternative opportunities available to each resource." *Id*. at 37:20–38:1.

- There is a likelihood that the IMM will either over-estimate or under-estimate actual costs. "Since over-estimates have no impact on market outcomes, while under-estimates force the bidder to remain in the market even when exit is efficient, <u>mitigating bidders who lack market power needlessly and unquestionably creates inefficiencies</u>." *Id*. at 38:15-18 (emphasis in original).

Mr. Stoddard further warned that:

> Given the high costs of preparing such a bid, there is a significant danger that many suppliers, especially those with relatively small portfolios, will assume that other, similar suppliers will set a sufficiently high clearing price in the FCA for

> them to cover their costs, and not participate in the static de-list bid process themselves. If enough suppliers behave this way, however, there won't be enough Static De-list Bids to equilibrate supply and demand in the market, and the FCA will tick down quickly to the price threshold of $1.

Stoddard Supp. Test. at 33:11-17.

Permitting market participants to prove higher costs will offer little relief as long as permissible costs are as restricted as they are today. There are several disputed cost categories. Bids cannot include a risk premium reflecting the fact that the bid is being placed 3 to 4 years in advance of delivery. Experience has shown that the IMM's calculation of costs typically is far more conservative than actual costs. The safety valve of IMM review thus provides little comfort, and comes at high cost.

To be clear, we are not here challenging the IMM review process itself and all of the various cost review aspects of that process, , with one exception, raised immediately below, that was specifically addressed in the Order. Our point here is that the availability of the IMM review process does not remedy the unjust and unreasonable over-mitigation caused by the $1/kW-month threshold.

G. The Commission Erred In Revising the Calculation of Static and Permanent De-list Bids to Assume that All Costs Associated With Participating in the Energy Market Should Be Excluded

The new much-lower mitigation threshold will require most de-list bids to be reviewed by the IMM (in the parlance of the ISO-NE Tariff, most De-List Bids will become "Static" De-List Bids). Other changes to the costs allowed to justify a static or Permanent De-List bid make that review much more likely to reject most de-list bids. *See* Order PP 316-17; *id*. at PP 322-23 (accepting same). Thus, under the rules approved by the Commission, nearly every de-list bid is subject to IMM review, and the IMM review, in turn, imposes a cost test that no one can pass.

The result essentially is automatic mitigation of all de-list bids, even if the costs associated with a de-list bid would be fully justified under a normal set of assumptions.

Under the tariff, de-list bids must reflect a resource's net risk-adjusted going forward cost and opportunity cost. ISO-NE Tariff §§ III.13.1.2.3.2.1.1, III.13.1.2.3.2.1.2.[12] The current tariff assumes that the de-listing resource will exit the capacity and energy and ancillary services markets. As part of its new mitigation rules, ISO-NE proposed to revise the calculation of net risk-adjusted going forward and opportunity costs that could be included in static or Permanent De-List bids. The changes exclude all costs that would be spent by a resource continuing to participate in the energy and ancillary services markets regardless of whether the resource will in fact participate in those markets during future capacity supply obligation periods. *See* Order at P 316.

> As a result, ISO-NE states that it is expected that most acceptable static or permanent de-list bids under this revision will be *nearly zero* since a resource providing energy and ancillary services would incur few or no additional costs in order to provide capacity.

Order at P 316 (emphasis added).

This test is too stringent. The de-listing resource cannot include in its de-list offer any unavoidable costs associated with participating in the energy and ancillary services markets, such as labor and maintenance costs. If labor costs *could* be spent for the resource to participate in the energy market, for example, it is simply assumed that they *will* be spent and therefore required to be excluded from the determination of Net Risk-Adjusted Going Forward Costs regardless whether the resource will in fact participate in the energy and ancillary services markets three to four

[12] We reiterate here that capacity sellers almost unanimously have opposed this as the correct calculation of costs, but that issue is not in dispute in this case, nor are we seeking to reopen it here.

years out in the future. When all such costs are excluded, the result is total capacity costs of "nearly zero."

Left unexplained is why anyone would have bothered creating a de-list bid mechanism if most de-list bids would be expected to be "nearly zero." Mr. Stoddard discussed the error in this logic. In sum, ISO-NE's proposed test asks the wrong question with regard to the costs to de-list from the capacity market:

> The standard as currently written is intended to answer the question: "If you are a capacity resource, what is the lowest capacity price that you need to cover your expected out-of-pocket costs, net of expected earnings from the sale of energy and ancillary services?" ISO-NE now proposes to turn this question around, asking instead: "Given that you're already here, what costs could you save if you didn't take on a capacity supply obligation?"

Stoddard Supp. Test. at 38:12–17. ISO-NE's test now assumes that the unit will remain in the energy market, though it has no commitment to do so. On that basis, ISO-NE's test rejects labor, maintenance, and other costs as unavoidable. Thus, ISO-NE's test "impose[s] the lowest possible level of bid on each resource, rather than a bid that is directly linked to a conservatively low measure of the actual total costs of maintaining a resource so that it can operate reliably." *Id*. at 41:26–42:2. Mr. Stoddard further testified that this would be a fundamental change in the mitigation regime which would prevent capacity resources from collecting "the 'missing money' between actual, out-of-pocket expenses and net revenue." *Id*. at 38:19–20.

We previously demonstrated to the Commission that no other RTO mitigates in this way. *Id*. at 39:10–40:19 (Reviewing mitigation rules in PJM, CAISO and NYISO). ISO-NE's proposal is, for example, very different from how mitigation works in NYISO. Instead of ISO-NE's very limited definition of going-forward costs, NYISO defines them as "the costs [a unit] could avoid by being mothballed rather than staying in the market to provide capacity." *NYISO*, 122 FERC ¶ 61,211 at P 21.

In accepting this proposal, the Commission failed to engage in reasoned decision making. There is no point to a de-list mechanism if no costs are allowed to be included in a de-list bid. This rule change, combined with the changes to the dynamic de-list threshold, has the effect of writing the de-list mechanism out of the tariff. This was unjust and unreasonable.

Again, for clarity, we are not here seeking rehearing on any of the other cost review components of the IMM's review of Static De-List bids, or of the net risk-adjusted going forward cost mitigation approach as a whole. That does not mean that we agree with these mechanisms, but we consider them beyond the scope of this case. Here we only are seeking rehearing of the Commission's decision in the Order to assume continued participation in the energy and ancillary services markets by a de-listed unit, and the rejection of certain costs as unavoidable based on this assumption of continued participation. We argued above that the availability of the IMM review process does not remedy the unjust and unreasonable over-mitigation caused by the $1/kW-month threshold. This is particularly so now that the Commission has ruled that no costs associated with participating in the energy and ancillary services markets can be included in a de-list bid.

V. THE COMMISSION ERRED IN REJECTING ANY PRICE ADJUSTMENT FOR DE-LIST BIDS REJECTED FOR RELIABILITY REASONS

Sometimes a resource cannot de-list because it is needed for reliability. The region needs the resource, but the resource itself cannot financially justify continued operations. Meanwhile, the reliability need has not been revealed in the formation of Capacity Zones. The Commission rejected a proposal to consider de-list bids that are rejected for reliability reasons in setting clearing prices in the same auction. *See* Order at P 63. This will unjustly and unreasonably suppress prices, and was in error. It also perpetuates a problem that the Commission has long recognized, and that it first attempted to remedy in time for FCA 2. *See ISO New England Inc.*, 120 FERC ¶ 61,190 at PP 11-12 (2007) ("It is therefore critical that ISO-NE meet the May 15, 2008 deadline" to remedy the pricing problems caused by de-list bids rejected for reliability.)

ISO-NE had proposed a re-pricing mechanism for de-list bids rejected for reliability, which it called "APR-3." As explained by the Commission, "APR-3 employs a re-pricing mechanism in which the ISO determines the FCA price that would have resulted if de-list bids had not been rejected for reliability." Order at P 52. The rejected de-list bid itself does not automatically set the price, but the clearing price is adjusted by adding the quantity of rejected megawatts back into the supply stack. ISO-NE's re-pricing proposal included an unnecessary triggering mechanism (*see id*. at P 52 n.52; Shanker Test. at 12:17-19), but it would have allowed re-pricing of at least some rejected de-list bids, and thus would have addressed at least in part the price suppressing effects of rejected de-list bids.

The Commission rejected this proposal. It ruled that "it is not appropriate to attempt to use the APR to correct for the potentially price-suppressing effect of rejected de-list bids." *Id*. The Commission was concerned that this might "re-price an entire zone," or "[i]n the absence of zonal modeling, … the entire New England market" "on the basis [of] a single bid." *Id*. at P 63 & n.70. It ruled that any constraints causing the reliability issue should be considered for modeling in *subsequent* auctions. *Id*. at PP 63, 292. In so holding, the Commission committed reversible error.

Modeling the constraint in the next auction is an essential step (which we support), but this alone is insufficient. The Commission also should have remedied the "price-suppressing effect of rejected de-list bids" (*see* Order at P 63) in the same auction in which the de-list bids are rejected.

First, rejected de-list bids suppress capacity prices. In the existing tariff, rejected de-list bids are automatically included as capacity resources. *See* ISO-NE Tariff, Section III.13.2.5.2.5 (in ISO-NE parlance, these de-list bids "will not clear in the Forward Capacity Auction," but the resources are assumed to be part of the supply stack). The Order retains this treatment. The effect is the same as if rejected de-list bids were automatically re-priced at zero. A market already saturated with OOM simply cannot afford another tranche of unpriced capacity.

Second, it is particularly damaging to the market to fail to price *these* megawatts. capacity that has been forbidden from leaving the market because reliability would be jeopardized without it. It thus has above-average locational value, but is treated as if it has no value at all.

This defeats one of the Commission's fundamental tenets of capacity markets. As Dr. Shanker testified earlier in this case, "capacity markets must include locational and reliability price signals to reflect the fact that capacity in certain congested areas has potentially greater value than capacity located elsewhere." Shanker Test. at 7:3-5 (citing *PJM Interconnection, L.L.C.*, 119 FERC ¶ 61,318 at P 76; *Devon Power LLC*, 103 FERC ¶ 61,082 at P 37). Capacity with "attributes that provide for a differential reliability benefit … should be recognized in the market design and compensated accordingly." Shanker Test. at 7:12-14. This minimizes or eliminates the "need for out-of-market contracts such as [Reliability-Must-Run] agreements." *Id.* at 7:15-16.

Failing to price this capacity defeats these objectives. Rather than revealing critical locational pricing information to the market, rejected de-list bids become just another category of zero-priced capacity. The result is that no market signal is sent to solve the reliability issue, and in fact, the rejected de-list resource may actually suppress clearing prices further below what they would have been. This is exactly backwards. Prices are not just suppressed in the zone but region-wide, as setting the de-list resource's price to zero is equivalent to decreasing ICR by the amount of megawatts of the resource.

Third, market power concerns should not be an excuse to permit price suppression. The answer is to screen the de-list bids or to otherwise ensure that they do not reflect an exercise of market power, not to automatically assume that they do.

We argued previously that the $1/kW-month threshold for reviewing de-list bids is too low. *See supra* at 44–51. But whatever threshold the Commission ultimately settles upon, all bids below the threshold will have been assumed by the Commission to not reflect an exercise of market power. All bids above it will have to be cost-justified to the IMM. In either case, the bids should be considered in setting price. No supplier will ever be in a position to simply "name its price"—even if it is the only resource that can solve a reliability issue.

On this score, the Commission seems unduly concerned that a "single bid" may set the clearing price for "an entire zone," or if there is no zonal price separation, for "the entire New England market." Order at P 63. That is, however, another basic feature of locational marginal pricing: the marginal resource sets the locational price. It always is only a single resource, by definition. The last resource needed sets the price for all other resources. It was never the case under ISO-NE's proposal, however, that a rejected de-list bid would automatically set the price. The rejected megawatts would be added back into the supply stack, where they may or may not set the price. The addition of these rejected megawatts would appropriately shift the supply stack.

If the exercise of market power is the concern, the answer again is to ensure that the marginal bid does not reflect the exercise of market power, not to prohibit it from setting price.

There already is a comprehensive structure by which the IMM reviews delist bids above 0.8 times CONE to ensure that such bids are "consistent with the [unit's] net risk-adjusted going forward costs." ISO-NE Tariff § III.13.1.2.3.2.1 It is hard to imagine what market power could be reflected, or what adverse outcome might ensue, from a bid so constructed and reviewed setting a locational price if the resource is needed to maintain the reliability of its zone. And it is harder still to reconcile the Commission's refusal, on the one hand, to rely on IMM review of delist bids for resources required for reliability, and its insistence, on the other hand, that IMM review of Static De-List bids will appropriately allow generators to recover legitimate costs.

While ISO-NE's proposal itself had flaws, the Commission erred in rejecting it without at the very least permitting some alternative mechanism to permit rejected de-list bids to be re-priced in the same auction in which the bids are rejected. There are many ways that this could be done. We have advocated that rejected de-list bids that have passed market monitor review should simply be considered in setting price. This would remedy the price-suppression problem caused by their current treatment. Failing this, the Commission should establish procedures for ISO-NE to submit a new proposal as part of its already-required compliance filing.[13] Locational pricing will largely remain elusive if bids rejected for reliability are not allowed to be priced in a way that permits their stated bid costs, as reviewed and mitigated, to potentially affect zonal clearing prices.

[13] We note that this is not a new issue. The current tariff has a provision that required ISO-NE to work with stakeholders to consider "any potential rule changes relating to the treatment of de-list bids rejected for reliability reasons." Tariff, Section III.13.2.5.2.5(f). ISO-NE made a proposal, but given the Commission's order, a replacement mechanism is required.

VI. THE COMMISSION ERRED IN FAILING TO REQUIRE STAKEHOLDER REVIEW OF THE OPPORTUNITY COSTS TO INCLUDE IN THE CALCULATION OF THE DEMAND RESPONSE BENCHMARK

We proposed and still recommend asset-class-specific benchmark offer floors as an appropriate tool to determine when to mitigate. *See* Order at P 17. The Commission agreed and directed stakeholders to develop the asset-class-specific benchmarks, providing some guidance to help in the process. *Id*. at PP 165, 173-79. It did not otherwise rule on benchmarking issues raised with respect to generation resources. *See id*. at P 172, n.120. With respect to demand response, however, it appears that the Commission ruled that the costs to include in their benchmarks had already been settled and were not open to further consideration. The Commission rejected "any Tariff modifications" related to "demand response resources' costs." *Id*. at P 246.

These demand response-related rulings could be interpreted to foreclose stakeholder consideration of opportunity and other costs to include in the demand response benchmark. Thus, at a minimum, we seek clarification that this issue will be included in the stakeholders' development of asset-class-specific benchmarks. However, if the Commission intended to foreclose consideration of these costs, we submit that this was error. The Commission should require stakeholder review of the demand response benchmark in the same process where stakeholders consider all other asset-class-specific benchmarks.

The appropriate costs to include in a demand response benchmark were never fully at issue in the paper hearing below. Additional consideration is needed. During the paper hearing, parties raised arguments that demand resources had not been labeled OOM when they should have been, in part because opportunity costs may not have been appropriately accounted for. *See* Order at P 240. The IMM responded to these arguments, asserting that its demand resource calculations fully accounted for all costs, including opportunity costs. *See id*. at PP 241-42.

There was no response to these points in the record, largely because capacity suppliers and other participants have no access to demand response providers' cost data, and thus have limited empirical data.

It is premature, however, to foreclose prospective review of this issue. Demand response plays an increasingly crucial role in the capacity markets. Everyone agrees that calculating the opportunity costs associated with demand response at the very least involves unique considerations. By way of comparison, for generation resources, all or almost all costs affecting the benchmark offer costs will be actual expenditures anticipated for such traditional items as real estate, construction, operations, maintenance, and fuel. A generation resource must be built and will in most cases consume fuel. As such costs are likely to be the same or similar within each type of generation resource, it is possible to establish price benchmarks for each type against which the bids of individual resources can be measured. Moreover, because these costs represent estimates of actual expenditures, each individual resource will by necessity create an objective audit record which the IMM can obtain and use to determine whether bids outside the benchmark ranges are justified.

Neither of these conditions obtain for demand response resources. Such resources will generally only have relatively small fixed and virtually no variable costs reflected in actual expenditures. A demand response resource requires only a one-time investment in metering and perhaps control equipment and, whenever the resource is dispatched, the cessation of power consumption which involves no expenditure at all (unless it is really a generator located behind the meter for which costs can be determined with reference to actual expenditures).[14] Rather, the

[14] This discussion treats the actually curtailed consumer as the "demand responder." That in practice there may be an intermediary or aggregator which collects the demand response payments from the capacity market and then distributes some of them to the curtailed consumer adds another layer of detail to the discussion, but does not change

principal costs of almost all demand response resources are opportunity costs (*i.e.*, the revenues and profits foregone by the demand responder due to the curtailment). *See, e.g.*, ISO-NE Tariff §§ III.13.1.2.3.2.1.1, III.13.1.2.3.2.1.3 (properly recognizing that the relevant costs include opportunity costs). Foregone revenues, however, vary vastly even between superficially similar demand responders.

Moreover, foregone profits or opportunity costs, in contrast to actual expenditures, leave no audit record, making case-by-case determination by the IMM that much more difficult. In combination, these problems mean that for the IMM to find that a given demand response resource is offered below a proper measure of cost, it must account for the resource's foregone, undisclosed, additional profit opportunity if dispatched. This task is difficult, but necessary.

We respectfully submit that it is essential for the opportunity costs of demand response resources to be appropriately considered in setting the benchmark. The Commission ruled in the Order that the IMM should assume that *generators* will be participating in the energy and ancillary services markets for purposes of calculating their own net, risk-adjusted going forward costs. Order at P 322. In other words, the opportunity costs of participating in Energy and Ancillary Service markets are included in establishing net generator costs. Demand response and generation resources should be treated in a comparable manner.

While the IMM stated in the paper hearing that it accounts for opportunity costs when reviewing demand response bids, there has been no transparency to these determinations. The fact is that a very large amount of demand response has entered the market with very little of it being classified as OOM. In many cases, the new capacity qualification package for Demand

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the basic economics. The principal part of the economic cost of the curtailment remains the opportunity cost of the curtailed entity.

Resources is nothing more than a DR developer's marketing plan, with no commitment by any end user to provide the promised load interruption service at the time of the FCA.

Given this fact, the calculation of opportunity costs and whether they are being fully and appropriately taken into account is ripe for review in an open process. Stakeholders should consider the appropriate inputs into the asset-class-specific benchmark for demand response at the same time that they consider benchmarks for other resource types. There is no reason to carve out demand response from this stakeholder process.

This is not an attack on demand response. NEPGA has long supported demand response, with properly structured rules, as a component of the supply portfolio. This is a matter of non-discriminatory pricing. All costs associated with being a generator will be taken into account to establish a generator's asset-class-specific benchmark, including revenues from other markets. So too all costs associated with demand response must also be taken into account for a demand response resource's benchmark, including foregone opportunities by not consuming power.

CONCLUSION

For the foregoing reasons, NEPGA[15] requests that the Commission grant rehearing and clarification of the Hearing Order.

Respectfully submitted,

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15 The comments contained in this filing represent the position of NEPGA as an organization, but not necessarily the position of any particular member with respect to any statement, concept, issue or position expressed herein.

* NEPGA requests that all further correspondence, communications and other documents relating to these dockets be served upon these individuals electronically at aoconnor@nepga.org and Paul.Wight@skadden.com.

CERTIFICATE OF SERVICE

I hereby certify that I have this day caused to be served copies of the foregoing document upon each person designated on the official service list as compiled by the Office of the Secretary in the captioned proceedings, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and procedure, 18 C.F.R. § 385.2010.

Dated at Washington, D.C., this 13th day of May, 2011.

/s/ Carl Edman

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