

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

**Revisions to ISO New England Transmission,
Markets and Services Tariff Related to
Competitive Auctions with Sponsored
Policy Resources**)
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Docket No. ER18-619-000

**MOTION FOR LEAVE TO ANSWER OF THE ISO-NEW ENGLAND
EXTERNAL MARKET MONITOR**

In accordance with Rules 212 and 213 of the Commission’s Rules of Practice and Procedure,¹ Potomac Economics,² respectfully requests leave to answer, and answers, the answer filed by ISO-New England (“ISO-NE”) February 13, 2018 in this docket (“ISO-NE’s Answer”). Our answer responds to arguments advanced by ISO-NE regarding a critical design flaw in its proposed Forward Capacity Market (“FCM”) reforms known as the Competitive Auctions for Sponsored Resources (“CASPR”). This flaw biases the auction significantly in favor of new conventional resources and is likely to result in such new resources clearing the FCM when they are not needed or economic.

Potomac Economics raises these limited points in an effort to clarify the record, and to enable the Commission to make a more informed decision.

¹ 18 C.F.R. §§ 385.212, 385.213 (2011).

² Potomac Economics serves as the External Market Monitor (“EMM”) for ISO-NE.

I. MOTION FOR LEAVE TO ANSWER

Rule 213 authorizes Potomac Economics to answer ISO-NE's answer. The Commission also has discretion³ to accept answers not otherwise permitted by right, and has done so when they help to clarify complex issues, provide additional information, or are otherwise helpful in the Commission's decision-making process.⁴ Potomac Economics respectfully submits that its answer in this proceeding will aid the Commission's decision-making process. It will do so by clarifying inaccuracies or exaggerations in ISO-NE's answer, and by providing additional information relevant to the evaluation of the justness and reasonableness of the likely outcomes under the CASPR reforms.

For these reasons, we submit that this answer satisfies the Commission's standards for discretionary answers, and respectfully request that the Commission allow this answer to be considered as part of the record in this proceeding. The fact that Potomac Economics has limited the scope of this answer to the most serious defects in the ISO-NE's filings should not be construed as agreement with, or acquiescence to, any other argument made by those pleadings.

II. ANSWER OF THE ISO-NE EMM

Our protest filed in this proceeding focused entirely on a serious design flaw in the CASPR proposal that will undermine the performance of the forward capacity market. The flaw is that new conventional resources that are not needed to meet planning requirements may clear in

³ See 18 C.F.R. § 385.213(a)(2).

⁴ See *Black Oak Energy, L.L.C. v. PJM Interconnection, L.L.C.*, 125 FERC ¶ 61,042 at P 14 (2008) (accepting answer to rehearing request because the Commission determined that it has "assisted us in our decision-making process."); *FPL Energy Marcus Hook, L.P. v. PJM Interconnection, L.L.C.*, 123 FERC ¶ 61,289 at P 12 (2008) (accepting "PJM's and FPL's answers [to rehearing requests], because they have provided information that assisted us in our decision-making process"); *New York Independent System Operator, Inc.*, 123 FERC ¶ 61,044 at P 39 (2008) (accepting answers to answers because they provided information that aided the Commission's decision-making process); *Morgan Stanley Capital Group, Inc. v. New York Independent System Operator, Inc.*, 93 FERC ¶ 61,017 at 61,036 (2000) (accepting an answer that was "helpful in the development of the record. . .").

Pass 1 of the FCA (the primary auction) when there is a capacity surplus due to sponsored resources being mitigated under the MOPR. ISO-NE proposal would guarantee these conventional resources a capacity obligation by excluding them from the substitution auction. If these resources were not excluded, the substitution auction would allow the sponsored resources that are entering to efficiently displace the unnecessary conventional resources. By not allowing the substitution of these new conventional resources in the in Pass 2 substitution auction, the FCA will likely result in overbuilding of high-cost new resources that are not needed. ISO-NE conceded this concern in its Filing Letter:

...there are circumstances where the ISO's proposal could lead FCM to procure competitive new resources in the FCA instead of acquiring capacity from new sponsored policy resources that will be built to meet legislative mandates. While this could result in excess resources on the system, this overbuild potential is minimal at present given the long-market capacity conditions and low prices.⁵

Notwithstanding this concession, ISO-NE asserts that eliminating this flaw as we proposed in our protest would create more serious concerns than the overbuilding concern. As we address in the following subsections, ISO-NE advanced three arguments in its answer in response to our protest. ISO-NE claimed that our approach to correcting the design flaw would:

- Require provisions that are “complex, unfair and ineffective”;
- Change the “meaning of the primary auction price” and investors’ ability or willingness to enter based on it; and
- Potentially result in substantial cost increases.

A. Remediating the CASPR design is not complex, unfair, or ineffective

The ISO-NE creates the illusion that remediating the design flaw is complex by posing multiple “problems” together with the necessary fix for each problems. First, ISO-NE describes a “fictitious entry” problem that would be created by making a severance payment to a new

⁵ Filing Letter at 21.

(Continued...)

conventional resource that first clears the primary FCA auction and then are substituted out in the substitution auction. Second, they describe a “price blowout” problem that could result if new investment is deterred.⁶

ISO-NE argues that because of these problems, the EMM has proposed a “multi-layered” solution that is complex, unfair, and ineffective. In reality, the solution is none of these things – it is simple, fair, and effective. The only reason the solution appears to be “multi-layered” is that ISO-NE hypothesizes a flawed starting point. For example, ISO-NE starts with an assumption that the new resource is entitled to the result of the primary auction and, therefore, would receive a severance payment if it is substituted out in the substitution auction. There is no basis to grant the new resource this entitlement and, thus, no basis for the assumed severance payment that creates the fictitious entry problem. In fact, this was ISO-NE’s original proposal. Although ISO-NE later abandoned this position, there is no evidence it was abandoned due to complexity.

Second, the “price blowout” concern described by ISO-NE in its answer is *not* caused by subjecting new resources to the substitution auction as asserted by the ISO, it is caused by a flaw in the MOPR rules that would over-mitigate sponsored policy resources and prevent them from entering at prices that reflect the net CONE of a conventional resource. This is an existing flaw that could cause prices to clear inefficiently high even under the current FCM without the CASPR provisions. Importantly, ISO-NE offered no disagreement in its answer to our argument that the current MOPR rules are flawed and will tend to over-mitigate the sponsored resources by not allowing them to enter at prices that signal the need for new resources.

Instead, ISO-NE introduced a design flaw that they concede can lead to overbuilding, in part as a means to address the pricing concern caused by the MOPR flaw. In market design, it is generally not optimal to offset one flaw by introducing a countervailing flaw (i.e., two

⁶ ISO-NE Answer at p. 23.

wrongs do not make a right). There is no need to balance the overbuilding concern with the pricing concern because proposing a good market design will address both concerns.

B. ISO-NE's concerns about changing the meaning of the primary auction clearing price are misplaced

The second argument advanced by ISO-NE is that our proposed revisions to CASPR to include new conventional resources in the substitution auction would “alter the meaning of [the primary auction] clearing prices” and “...change the commercial investor’s willingness to develop projects in New England based on the primary auction price”.⁷

This argument illustrates precisely ISO-NE’s misconception that led to its flawed market design choice. The new supplier is not entitled to the primary auction clearing price and this price should not govern their entry decision. The price that governs entry and exit under the CASPR reforms is *the substitution auction price*. The primary auction price does not include all of the supply and demand in the New England market because the MOPR is applied to the sponsored resources, effectively removing them from the supply stack. Therefore, it can never accurately indicate the need for a new conventional resource and should not be the basis for the decision of the new resource to enter. This is precisely why the CASPR design will lead to overbuilding.

Instead, the price in the substitution auction does reflect the true value of new investment. If the substitution auction clears at \$6 per kW-month, this means that the sponsored policy resources will pay all of the existing resources to retire that have going-forward costs (substitution auction bids) that exceed \$6 per kW-month. If a new conventional resource can enter at a cost of less than \$6 per kW-month, it will receive a capacity obligation and enter. This outcome is efficient because it represents the true supply in the capacity market.

⁷ Id. at p. 23.

C. ISO-NE's cost concerns are not valid

In its answer, ISO-NE constructs an example that it claims shows that remedying the flaw as we propose could cost customers one billion dollars. It then compares this value to an example in our protest that illustrates the excess costs that could be caused by the design flaw in the CASPR proposal. The purpose of this comparison is to indicate that our solution is more costly than the flawed CASPR design.

Before addressing the merits of ISO-NE example, the cost comparison itself is not valid. It is an apples to oranges comparison because the example we presented in our protest was limited to the additional costs incurred by the sponsored resources in the form of lost capacity revenues (i.e., the “to-go” payment made to the retiring resources). In contrast, the ISO's cost is a maximum consumer cost estimate assuming all capacity is procured through the FCA, calculated by multiplying the estimated price change times the entire capacity demand in New England. This is not comparable to the costs we illustrate in our protest.

Further, while the cost increase calculated by ISO-NE may sound compelling, it is entirely based on the same flawed assumption that caused it to change the market design in the first place; namely, the assumption that investors are incapable of weighing the risks and expected outcomes when deciding whether to offer in the forward capacity market. ISO-NE implies that investors will only offer new resources if they are highly confident that they will clear. Therefore, ISO-NE is concerned that if investors believe sponsored resources will enter and displace them in the substitution auction, they will not offer their new resources in the FCM. This is simply not true in theory nor in reality.

The economic theory underlying forward capacity markets is that investors will submit offers in competition with other new resources and existing resources, and rely on the auction to coordinate the ultimate entry. If investors were only to offer when they are confident they will be selected, the FCA would provide little value. In this view of the world, investors are essentially

deciding in advance of the auction whether to enter based on their individual expectations. However, this would generally not be rational behavior by an investor in a new resource. Unless the costs to qualify for the auction are a substantial share of the total project costs, it is economically rational for new suppliers to offer new resources even if the probability of clearing is relatively low. In other words, the expected profits of the new resource if it clears would simply need to exceed the costs incurred to qualify to offer.

ISO-NE has provided no data or other evidence to suggest that new suppliers would not have the economic incentive to offer in the FCA even if they believe the probability of clearing is low. It has simply asserted that the new resources will be deterred if they are not confident that they will clear. Based on this assumption, ISO-NE constructs a hypothetical case in which neither new conventional resources nor sponsored resources are offered. Not surprisingly, this leads to substantial price effects.

In any market, it is a straightforward exercise to calculate large price increases and consumer cost increases if one assumes supply reductions. However, these cost increases are not meaningful unless the assumed supply reductions have an economic basis. In this context, a supply reduction from new suppliers would be a justifiable assumption if one could demonstrate that the new suppliers would no longer have the incentive to offer. ISO-NE has made no such demonstration and their assumption is inconsistent with actual behavior by new suppliers in the FCM.

Historical results from the FCM are instructive on this point. New conventional resources have been offered in *every* FCA, and a large quantity of them has failed to clear in most of them. This includes two most recent FCAs, FCA 11 conducted in February 2017 and FCA 12 conducted this month. In FCA 11, more than 1850 MW of new conventional resources were offered and only roughly 250 MW cleared at a price of \$5.30 per kW-month. This price is well below the estimated net CONE of approximately \$8 per kW-month. Likewise, in FCA 12 conducted this

month, almost 800 MW of new conventional resources were offered and the price cleared at \$4.63 per kW-month, only slightly above half of the estimated net CONE.

These prices reflect the prevailing surplus in New England, which makes it very unlikely that a material quantity of new conventional resources will clear (not unlike how the presence of sponsored resources reduces the probability that the new resources will clear). Nonetheless, large quantities of new conventional resources continue to be offered because it is economically rational to qualify and offer in the FCA as long as the probability of clearing is not close to zero. This demonstrates that investors in New England do, in fact, rationally offer new resources when the probability of clearing is low, likely because the expected profits of clearing the FCA will exceed the costs of qualifying to offer.

The ISO has offered no evidence that the sponsored resources will change this investment incentive in any way. In other words, as long as there is some possibility that the sponsored resources will be delayed or canceled, there is no reasonable basis to assume that new resources will not be offered in future FCAs.

It is also important to point out that the ISO-NE illustration relies on two things occurring simultaneously: i) new conventional entrants shunning the auction altogether; and ii) no sponsored policy resources in the auction. Based on available evidence, the chances that both of these would occur simultaneously is vanishingly small. This further underscores the unreasonableness of introducing an intentional bias in favor of new conventional resources, which the ISO has conceded may lead to overbuilding.

Hence, neither the ISO-NE's initial filing, nor its answer provides evidence or a reasoned basis for excluding new conventional resources from the substitution auction and we renew or recommendation that the Commission find that the CASPR reforms unjust and unreasonable on this basis.

III. CONCLUSION

WHEREFORE, for the foregoing reasons, Potomac Economics, Ltd. respectfully requests that the Commission accept this answer, and renews its request that the Commission grant the relief requested in its Protest.

Respectfully submitted,

/s/ David B. Patton

David Patton
President
Potomac Economics, Ltd.

February 19, 2018

CERTIFICATE OF SERVICE

I hereby certify that I have this day e-served a copy of this document upon all parties listed on the official service list compiled by the Secretary in the above-captioned proceeding, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated this 19th day of February, 2018 in Fairfax, VA.

/s/ David B. Patton
