UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

ISO New England Inc. and New England Power Pool	)	Docket No. ER10-787-000
New England Power Generators Association, Inc.	)	
	)	
v.	)	Docket No. EL10-50-000
	)	
ISO New England Inc.	)	
PSEG Energy Resources & Trade LLC, *et al.*	)	
	)	
v.	)	Docket No. EL10-57-000
	)	
ISO New England Inc.	)	

SECOND BRIEF OF THE NEW ENGLAND POWER GENERATORS ASSOCIATION, INC.

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SECOND BRIEF OF THE NEW ENGLAND POWER GENERATORS ASSOCIATION

The Commission has before it two sharply different visions of the future of the New England power markets. On one side, we, along with ISO-NE, propose to continue the core principles underlying good capacity market design—for example, the goal of designing the market so that all in-merit capacity resources have the opportunity to recover the cost of new entry, on average and over time. That is how all sustainable markets work. And that is how the FCM was intended to work.

On the other side, loads champions a very different vision of the future—one perverted by the ongoing unmitigated exercise of buyer market power. According to load, it should have the right to procure new "OOM" capacity resources at above-market prices, then offer those resources into the FCM on terms that artificially suppress auction prices. New resources thus receive an above-market price, while existing resources are paid much less. And as load sees it, so long as existing resources earn their going-forward costs, they have no fair complaint. In load's long-run vision, existing resources are left to tread water forever, earning little or no contribution to margin while effectively providing critical reliability support for free.

We respectfully submit that there is no serious debate about the right answer in this case. Certainly the opening briefs leave no doubt. There we fully supported the justness and reasonableness of the APR that we and ISO-NE have proposed, with detailed and thorough testimony from Dr. Shanker, Mr. Stoddard and Professor McAdams. Load, for its part, meekly advocated returning to ISO-NE's discredited "February APR." In support, load offered OOM testimony from two witnesses, Mr. Wilson and Dr. Wilson.

The fatal flaws in this testimony are so readily apparent that we could simply point them out on brief. But it is, in our view, critical to underscore the correctness of our position, and the vacuity of load's, by offering a spectrum of opinion from experts of the highest caliber. Hence, we once again offer testimony from Dr. Shanker, Mr. Stoddard and Professor McAdams, who collectively eviscerate load's weak effort to defend the February APR. In addition, we now offer testimony from Professor Paul Milgrom from Stanford, probably the world's leading expert on the economics of auction market design, and the 2008 recipient of the Erwin Plein Nemmers Prize in Economics for work of lasting significance in the field (while awarded biannually just since 1994, this honor already has seen a third of its recipients go on to win the Nobel Prize). We also offer testimony from Professor Joseph Kalt from Harvard's Kennedy School, one of the nation's leading economists specializing in antitrust, energy and regulation.

Each of these five witnesses has a somewhat different perspective on the fatal flaws in load's effort to defend its ability to exercise buyer market power. But their conclusions are remarkably uniform: a future where load retains the ability to exercise buyer market power is a future of market failure, causing higher costs to consumers and expropriating the sunk investment of existing capacity resources.

In short, we purposely sought a diversity of opinion, and have seen it unified in the conclusions presented here. Professors Milgrom and McAdams bring a rigorous academic perspective on the role of auctions in the economy. Professor Kalt has deep expertise not only in electric and natural resource markets, but with the macro- and micro-economic impacts associated with the design and regulation of such markets. Dr. Shanker and Mr. Stoddard together have approximately 50 years of expert experience in electric markets and market design, and are both nationally recognized experts in this area with on-the-ground experience in RTO market design.

The complimentary views of Professors Kalt and Milgrom are particularly noteworthy. Each has spent decades at the highest rungs of academic and consulting work in economics. And each explains the urgent need to fully mitigate buyer market power, including so-called "Innocent OOM" and "Historic OOM."

For example, Professor Kalt expresses the following opinion about the need to mitigate "Innocent OOM":

> Nothing in what I have said regarding the undesirable consequences of monopsonistic manipulation of FCM prices implies that state authorities should be precluded from pursuing benefits for their citizens that can arise from investments in environmental protection, power system reliability, and the like. Instead, the implication is that the social benefits that justify such investments in the cost-benefit considerations of state policymakers do not and should not include the "benefits" to load of having incumbent capacity sellers effectively pay for such investments via monopsonistic price suppression in capacity markets. The latter "benefits" are not net social benefits; they are transfers from one private interest (sellers of capacity) to another (buyers of capacity).

Kalt Test. at 22:11–19.

Professor Milgrom mines this same vein. As he explains, "OOM contracting can contribute to efficient decisions whenever the buyer has reason to care about the technology used in supplying capacity." Milgrom Test. at 10:3–4. In that event, "[b]uying such a favored

resource is efficient if either the resource is less expensive than in-market capacity or *if the extra public or private benefits it conveys outweigh its additional cost*." *Id.* at 10:6–8 (emphasis added).

As Professor Milgrom goes on to explain, however, full buyer market power mitigation is a necessary condition for out-of-market contracting to produce efficient results that benefit consumers:

> What standard economic analysis teaches us is that the outcome of the benefit-cost calculation using proper market prices leads to an efficient choice by aligning the buyer's decision with what I'll call the "efficiency objective" of maximizing the total net benefits enjoyed by all market participants. But that alignment is achieved only if the buyer uses unmanipulated market prices for evaluating its alternatives. In particular, its decision will be inefficient if it is changed by attributing any benefit to the effect that its OOM contract has on the market price.
>
> That is why participants in *competitive* markets, who cannot influence price, find their incentives well-aligned with the efficiency objective and why participants with market power find their incentives to be misaligned. Buyers with market power are encouraged to twist their decisions in order to reduce market prices, even when the result is a less efficient resource allocation. In this case, the particular distortion is to engage in too much OOM contracting, relative to the efficient standard.

Milgrom Test. at 10:12–11:2. Full and effective mitigation of OOM entry therefore *promotes*, rather than *undercuts*, efficient state resource planning decisions.

Professor Milgrom also trenchantly explains the urgent need to mitigate Historic OOM, testifying as follows:

> 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.

Milgrom Test. at 13:4–17. He thus supports the position set forth in our opening brief (at 2), that the Commission cannot allow Historic OOM to be "the gift that keeps on giving." The Commission should, instead, fully mitigate the future price-suppression effects of Historic OOM.

It bears emphasis, however, that this is "mitigation" only in an unusual sense. OOM resources arguably have a legitimate interest in clearing the market and thus qualifying as capacity resources. And for that purpose, their offers will be used exactly as submitted. Mitigation plays no role whatsoever in the process for determining which resources clear in the auction. The *only* effect of mitigation is to correct for the price-suppression effect that OOM otherwise would have on the auction clearing price paid to non-OOM capacity resources. For *this* purpose, and this purpose alone, the ISO-NE market monitor "corrects" the offer to reflect the benchmark cost of the OOM resource. And as Mr. Stoddard explains, "the [OOM] resource supplier is, or should be, indifferent to the level of its mitigated offer." Stoddard Supp. Test. at 12:24–13:2. The *only* thing this mitigation does is prevent collateral price suppression. And that is just as it should be.

This mitigation regime thus is precisely targeted in a way that is beyond fair challenge. For OOM resources to exist, load has to "systematically fail to procure the least-cost resources," insisting on buying more expensive new resources when cheaper existing resources are available in the market. McAdams Test. at 24:8–9. Load also has to intentionally procure more capacity than is needed to meet the reliability target (after fighting bitterly against the need to make such additional purchases in the LICAP litigation). It is far from clear why, aside from collateral price suppression, load would take these steps. But it has taken them, and threatens to continue doing

so. The mitigation we propose leaves these actions entirely unimpeded. All it does is to ensure that the decisions load makes are not warped by the misplaced incentive to seek the short-term "benefits" of artificial price suppression.

We respectfully submit that the collective evidentiary weight of our expert presentations—both the obviously high caliber of the experts and the absolute quality of their opinions—creates overwhelming support for approval of our APR proposal, and for fully correcting the price-suppressing effect of both Innocent and Historic OOM. In contrast, load has never offered any cogent, well-reasoned or well-supported defense of its position, notwithstanding numerous chances (responding to our Protest, responding to our Complaint, and now via First Briefs). And we highly doubt that things will be different in the second round of load briefs.

The reason is simple. There *is* no valid defense for the continued exercise of buyer market power, regardless of its form. That is why load has never offered any even-remotely colorable argument in support of its position, and why it never will.

Finally, we continue to support ISO-NE's proposal to model additional zones, with one modification. ISO-NE's new mitigation proposal, however, we oppose in full. It *over*-mitigates, contrary to court and Commission precedent. We also address issues related to CONE and the process going forward.

ARGUMENT

I. THE OOM PROBLEM CAN ONLY BE RESOLVED BY A ROBUST APR

The core problem of the present hearing is how to address the participation of Out-of-Market ("OOM") capacity—resources that have been subsidized outside of the market to enable them to participate in the capacity market at prices below their economic costs. *See* Opening Brief of the New England Power Association, Inc. at Section II (July 1, 2010) ("NEPGA First

Brief"). Given the extreme sensitivity of the FCM clearing price, induced by its vertical demand curve, even relatively small amounts of OOM capacity can crash the FCM clearing price. *See id.* at 64–68. This renders OOM capacity an extremely potent tool for artificial price suppression by myopic capacity buyers and interests aligned with them, including New England state entities. *See id.* at 26 (quoting NEPGA First Brief, NEPGA Exhibit 2, Testimony of Robert B. Stoddard on Behalf of New England Power Generators Association at 41:3–14 ("Stoddard Testimony")). As the Commission has found a capacity market tainted by such tactics is simply not sustainable over the long run. The FCM thus has from the beginning included an Alternative Price Rule ("APR") that was designed with the intent of curbing the effects of OOM capacity. *ISO New England Inc.*, Docket No. ER10-787-000, Various Revisions to FCM Rules Related to FCM Redesign at 3–4 (Feb. 22, 2010) ("FCM Revision").

A. Recap of the APR Progression

Because earlier versions of the APR proved ineffective, ISO-NE has gone through several iterations:

Historic APR. This was the APR in effect from the beginning of the FCM and under which the first three FCAs were conducted. ISO-NE Tariff at 2nd Revised Sheet No. 7314T (issued Apr. 15, 2009), Original Sheet No. 7314U (issued Feb. 15, 2007), 1st Revised Sheet No. 7314V (Issued Nov. 9, 2007), Original Sheet No. 7314W (issued Feb. 15, 2007), Original Sheet No. 7314X (issued Feb. 22, 2010). Its defects have been detailed in previous filings. *See, e.g.*, NEPGA First Brief at 19–35; Motion to Intervene and Protest of the New England Power Generators Association at 22–30 (Mar. 15, 2010).

February APR. Recognizing the ineffectiveness of the Historic APR, ISO-NE filed a tariff revision with a replacement APR on February 22. FCM Revision, Proposed Tariff Sheets § III.13.2.7.8; *see also* FCM Revision, Filing Letter at 3–4, 13–19. But this February APR was

designed by interests aligned with the buyer side (that is, the parties whose conduct an effective APR would be designed to restrain), and took only minimal steps towards effectively preventing the exercise of buyer-side market power. *See* NEPGA First Brief at 38, 20–25. And it was approved by ISO-NE's stakeholder committees over the opposition of independent generators (the entities an effective APR would protect from predation by load). The Commission found the February APR to be a marginal improvement over the Historic APR, *ISO New England Inc.*, 131 FERC ¶ 61,065 at P 72 ("Hearing Order"), *order on reh'g and clarification*, 132 FERC ¶ 61,122 (2010) ("Rehearing Order"). While allowing it to be used for FCA #4, the Commission noted numerous potential defects and set the hearing to develop an effective APR. Hearing Order at P 71.

June APR. In response to the Commission's findings on the APR, Hearing Order at PP 75–87, ISO-NE went back to the drawing board and developed a substantially more sophisticated APR. The principal elements of the June APR and how they correspond to the Commission's requirements were set forth in an ISO-NE presentation of June 15. Bob Ethier *et al.*, Draft Response to FERC Order of April 23, 2010 at 27–42 (June 15, 2010), http://www.iso-ne.com/pubs/pubcomm/pres_spchs/2010/final_prop_fcm_rev6_15_10.pdf. Multiple parties, including NEPGA, addressed this conceptual June APR in the first briefs filed on July 1.

July APR. In its own July 1 filing, ISO-NE set forth a further refined version of the June APR. First Brief of ISO New England Inc. at 8–38 (July 1, 2010) ("ISO-NE First Brief"). This July APR so closely resembles the June APR that our earlier comments, NEPGA First Brief at 58–64, carry forward except as otherwise noted. *See Supplementary Testimony of Robert B. Stoddard on Behalf of New England Power Generators Association*, attached as NEPGA Exhibit

9 ("Stoddard Supplementary Testimony") at 7:4–22. Nevertheless, in order to avoid ambiguity, this refined APR will herein be referred to as the July APR.

The parties before the Commission at this point are divided into two sides. One side seeks to retain the February APR with little or no modification. *See, e.g.*, The Joint Filing Supporters' First Brief at 20 (July 1, 2010) ("Supporters First Brief"); First Brief of Eastern Massachusetts Consumer-Owned Systems at 2 (July 1, 2010) ("EMCOS First Brief"); First Brief of the Connecticut Municipal Electric Energy Cooperative, Massachusetts Municipal Wholesale Electric Company, and New Hampshire Electric Cooperative, Inc. at 22 (July 1, 2010) ("Public Systems First Brief"); First Brief of the New England Power Pool Participants Committee at 12 (July 1, 2010) ("NEPOOL First Brief"). The other side urges adoption of the July APR with or without certain additional improvements. *See, e.g.*, ISO-NE Brief at 8–38 (proposing revisions to February APR); NEPGA First Brief at 11–12; Comments of Potomac Economics, Ltd. for the Commission's Paper Hearing on Revisions to the New England Forward Capacity Market Rules at 4–6 (July 1,2010) ("Potomac Economics Comments"). We emphatically adopt the latter position, with one specific vital modification, *see infra* Section II.D. Below we further demonstrate the faults of the February APR compared to the July APR.

B. The FCM, More Than Other Markets, Requires Effective Buyer Market Power Mitigation

Load continues to assert that there is nothing wrong with either the current FCM design or the massive amounts of OOM entry flooding the markets. While markets generally can be vulnerable to market manipulation and the exercise of market power, Professor Milgrom summarizes the fundamental reasons why the FCM is so uncommonly vulnerable to the exercise of buyer market power:

First, before capacity suppliers can enter the market, they must sink capital that become substantially unrecoverable. They will only do so if it appears that these costs can be justified on the basis of future revenues. Once these costs are sunk, however, suppliers are subject to predation by load:

> [I]f OOM supply is unmitigated, then the use of vertical demand curves in the FCM market can make prices especially sensitive to even small changes in new OOM capacity. An extra unit of OOM capacity can change the marginal unit in the Forward Capacity Auction ("FCA") from a unit of new capacity to a unit of existing capacity that may offer supply at a much lower price. If OOM capacity is allowed to affect prices in that way, load would find manipulation to be very profitable and would be encouraged to do it.

Testimony of Paul R. Milgrom, Ph.D., on Behalf of New England Power Generators Association, attached as NEPGA Exhibit 5 ("Milgrom Testimony") at 5:11–17.

In combination, these factors make the FCM almost uniquely manipulable:

> [T]he decisions by participants in the FCM are long-term decisions. Suppliers of new capacity expect to receive a stream of payments over the life of the capacity to recover the cost of and earn a return on their investments. Even without the exercise of market power by load in a current FCM, if there are no explicit mitigation measures, suppliers must plan for the possibility of future manipulations of FCM prices.

Milgrom Test. at 4:21–5:2. "[E]xisting capacity resources are effectively stranded in the face of such exactions because they cannot be simply moved to other geographic locations. Indeed, if incumbents' capital were not sunk, the competitive discipline arising from the threat that attempted monopsonization would be met with incumbents' simply leaving the market would make strategies of monopsonization fruitless." *Testimony of Joseph P. Kalt, Ph.D. on Behalf of New England Power Generators Association*, attached as NEPGA Exhibit 6 ("Kalt Testimony") at 24:17–21. *See also id.* at 24:9–12.

> Failing to prevent manipulations of *future* capacity prices makes long-term revenues less reliable and discourages low-cost offers into the *current* FCM.

> This problem of anticipation threatens a vicious cycle that can damage or destroy the effectiveness of the FCM. Suppliers, fearing future manipulations, would naturally seek higher margins in the current auction, which provides an additional reason for load to seek out-of-market ("OOM") supply, which further feeds supplier concerns. That is why the promise to protect tomorrow's capacity market from buyer-side market power is necessary to encourage robust participation in the FCM today.

Milgrom Test. at 5:2–10. Kalt Test. at 24:17–21.

Second, the vertical demand curve eases the exercise of market power and magnifies its effect:

> *Manipulability* of FCM prices is quite different from *uncertainty* about those prices, and far more problematic. There is no uncertainty about the effects of buyer-side manipulation: such manipulations by load lead to year-by-year FCM prices that are predictably lower than they would otherwise be, discouraging new capacity from bidding in the FCM and creating inefficient incentives for early exit by existing capacity. It is the threat of price manipulation, *not* price uncertainty, that undermines the effectiveness of the FCM and promotes multi-year bilateral contracting for new capacity.
>
> A supplier that invests in new or expanded capacity in the face of manipulable future capacity markets is encouraged to seek a long-term contract to protect its future revenues. The threat of manipulation in the FCM leaves a supplier without a long-term contract vulnerable, regardless of its ability to manage uncertainty, for even if its capacity proves to be efficient and much needed, it may still be unable to recover its investment with a reasonable return.

Id. at 7:4–16.

Professor Kalt's testimony demonstrates that these are far from hypothetical problems. *See* Kalt Test. at 17:8–22:5. For example, because the FCM, at load's insistence, has a vertical demand curve, "[s]mall changes in quantity in the FCM change can lead to large changes in price." *Id.* at 17:12–13. In Professor Kalt's illustrations, as little as 500 MWs of OOM capacity (compared to 39,800 MWs of ICR) could cause prices to drop by more than 20%, corresponding to over $600 million of annual profits from exercise of buyer market power. *See id.* at 17:18–19:10 & Figure 1 (Impact of Supply Changes on FCM Auction Results).

These effects are highly predictable and well known to state authorities. *See id.* at 18:3–19:2. Hence it should not be surprising that we see successful attempts to exploit buyer market power by states. For example, in 2007 and 2008, "Connecticut state authorities initiated and oversaw the execution of various long-term contracts under which Connecticut utilities were required to be counterparties with new generation suppliers." *Id.* at 20:4–6 (footnote omitted). To ensure that these projects would suppress capacity prices to the maximum extent possible, "Connecticut has required owners of the capacity being built as a result of these contracts to make supply offers into the FCM at prices low enough to ensure that the capacity clears in the FCM auctions," requiring bidding at effectively a zero price. *Id.* at 20:12–14. Connecticut offered subsidies sufficient to ensure the viability of the contracts for the project owners, but not the general market. *Id.* at 21:5–22:5. Although ISO-NE deemed the supplies obtained under these contracts to be OOM, *id.* at 20:7–9, under the ineffective Historic APR, this was little more than a speed bump in the price suppression scheme.

As Professor Milgrom concludes, "[t]he right economic solution to the problem of manipulability is mitigation of buyer-side market power to end the manipulation." Milgrom Test. at 7:17–18. An effective APR is the only means available for such correction.

C. OOM Capacity Continues to Crash the FCM Capacity Markets

The continuing dysfunction of the FCM demonstrates the seriousness of the OOM issue and the corresponding necessity of taking *effective* measures to address it. As we have explained in prior filings, *see, e.g.*, NEPGA First Brief at 25–28, the lack of an effective APR marred the first three FCAs. Each of these FCAs was subjected to a flood of subsidized capacity resources. *Id.* In each case, the consequence was that the clearing price was crashed far below the most conservative estimates of CONE, the average level of revenue required to justify participation by competitive generation resources. *Id.* at 27–28. In each FCA, the price slide towards zero net

compensation was stopped by the FCM's price floor. *Id.* at 4. Because the Commission expects this price floor to be eliminated, Hearing Order at P 97, it is unclear how much farther capacity prices could drop unless the OOM problem is comprehensively addressed.[1]

This pattern was repeated again in FCA #4, which was conducted in August of this year, after the first round of briefs here. Stoddard Supp. Test. at 4:6–7. The descent of the clearing price to zero was once again stopped by the price floor at $2.95/kW-month. *Id.* at 4:13–14. Nevertheless, capacity continued to flood in, including nearly 400 MW of new Demand Response, resulting in an increase of cleared capacity of over 300 MW. *Id.* at 4:14–16. At the end of FCA #4, total excess supply at the price floor was 5,374 MW, an increase from the already enormous 5,061 MW excess in the previous FCA. *Id.* at 5:3–4. One striking new pattern in FCA #4 was the explosive growth of self-supply. *See infra* at 46 (quoting Stoddard Supp. Test.). In sum, as Mr. Stoddard testifies, unless current generation resources are forced into retirement, it would take approximately 19 years, at an average load growth of 290 MW per year, to absorb this excess. *Id.* at 5:4–5.

D. The February APR Is Inadequate to Address the OOM Problem

We established the principal faults of the February APR in detail in our first brief (at 19–35). Because none of our opponents has made any serious attempt to demonstrate that the February APR already met the standards set forth by the Commission in the Hearing Order two months after the February APR was submitted to the Commission, our earlier points essentially stand unrebutted. To summarize these points briefly (and supplement them with additional critiques by Profs. Milgrom and Kalt):

[1] Without a price floor, sellers would likely price the future obligation to pay capacity buyers Peak Energy Rent dividends at a level reflecting its expected value. The problem nonetheless remains the same. The incremental revenue opportunity in the capacity market would be zero.

First, the February APR does not fully correct for the price-suppression effects of OOM:

> The February APR is only triggered when there is need for new capacity, after subtracting (i) OOM resources that entered in the current or previous six FCAs and (ii) resources whose de-list bids were rejected for reliability reasons. Such a formulation leaves two significant gaps. *First*, the presence of OOM can suppress the auction price when there is no need for new capacity, but this price-suppression is uncorrected by the February APR. *Second*, again under the February APR, OOM resources lose their OOM status after seven years and are counted among the "in-merit" resources that determine whether or not the APR is triggered. This "seven-year loophole" creates an opportunity for load to suppress the auction price both permanently and dramatically.

Supplementary Testimony of David L. McAdams Ph.D. on Behalf of New England Power Generators Association, attached as NEPGA Exhibit 7 ("McAdams Supplementary Testimony") at 22:12–20. If load "sponsors a stream of enough OOM so as to have excess capacity sufficient to cover seven years of load growth and retirements[, it] would avoid triggering the APR now or anytime in the future, guaranteeing very low auction prices now and forever." *Id.* at 22:21–23:1.

Second, as a consequence, the February APR sows the seeds of a vicious cycle that could undermine the basic functioning of the FCM:

> If the auction price paid to reserve capacity is consistently suppressed by load's OOM sponsorship, the auction will not provide sufficient incentive for the lowest-cost merchant resources to enter when new entry is needed. Indeed, a new entrant's only option to cover its costs of new entry will be to approach load in hopes of securing a long-term contract. Load has a strong incentive to sign enough such contracts so that the Net ICR remains satisfied—if the FCM were to require merchant new entry, then the price that load pays in the FCA on all of its net demand would increase to reflect the cost of new entry. So, it is reasonable to expect that the Net ICR will typically be met (with a surplus) under such a "load as gatekeeper" model.

Id. at 23:7–15. This would fatally undermine the intended, competitive, market-based mechanism of encouraging appropriate, cost-effective entry and exit of capacity resources. *Id.* at 24:1–5.

Third, as a consequence of this load-centered and controlled process, the ISO-NE capacity requirement will consistently fail to be met with efficient and cost-effective resources.

Load entities "systematically fail to procure the least-cost resources" for two principal reasons: "inefficient price discrimination" and "inefficient vertical integration." *Id.* at 24:8–10. The former is a direct consequence of the unjustified non-uniformity in capacity pricing under opaque bilateral contracts. *See id.* at 24:11–25:14. The latter is a consequence of load entities' "incentive to favor self-supply over more efficient resources that are not self-supplied." *See id.* at 25:15–26:3.

Finally, while all of these inefficiencies and distortions might simply have to be borne if they were inevitable, they are not. A superior APR built on the principles of the July APR can readily avoid or alleviate all of the above, while at the same time protecting the legitimate interests of states and others in fostering renewable resources, the desire of some market participants to hedge through self-supply, and setting the correct incentives for new entry. *See id.* at 27:19–34:10.

E. The July APR Can Solve the OOM Problem

The July 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 and existing OOM suppliers, and the principles of economics. It reflects 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; NEPGA First Brief, NEPGA Exhibit 1, Testimony of Roy J. Shanker Ph.D. on Behalf of New England Power Generators Association at 13:4–14:9 ("Shanker Test."); NEPGA First Brief, NEPGA Exhibit 4, Testimony of David L. McAdams Ph.D. on Behalf of New England Power Generators Association at 20:6–10; McAdams Supp. Test. at 27:19–34:10.

First, the July APR is triggered whenever OOM capacity is included in the auction. Unless the Commission wishes to permit OOM capacity to be used to manipulate capacity price outcomes at least some of the time, there is no alternative to this triggering condition. Nor is the trigger overly broad. Triggering the APR does not require any effect on clearing prices. For example, if all OOM offered into the market is economically efficient—that is, would have been committed even if offered at competitive prices reflecting economic cost—the APR will technically be in effect, but the ultimate price outcomes and assignments of capacity obligations will be the same as if the APR had not been triggered at all. In the presence of potentially market-distorting OOM, however, it is necessary to use the APR mechanism to determine competitive outcomes. Declining even to examine bids would be to grant downward manipulation *carte blanche*.

Second, when the APR is triggered, two parallel auctions establish two parallel prices. In the FCA auction, when setting the FCA price, *only* seller-side mitigation is applied—that is, offers are subject to caps that prevent them from reaching uneconomically high levels. *See* NEPGA First Brief at 13–15 (offering a more detailed discussion of the various De-List bid caps). When the APR price is set as we propose, in addition to seller-side mitigation, OOM offers are also subject to buyer-side mitigation. All supplier prices are prevented from being uneconomically high *and* all OOM prices are prevented from being uneconomically low. Because the effective offer prices in the APR auction are no lower than the effective offer prices in the FCA auction, but can be higher, the APR price necessarily is at least as high as the FCA price.

However, even if offers in the APR auction are mitigated upward, this does not necessarily cause the APR price to exceed the FCA price. For example, if an uneconomically

low OOM offer in the FCA auction is mitigated upward to competitive levels in the APR auction, but still falls below the APR clearing price, it will nevertheless be accepted in the APR auction, and the APR clearing price will be the same as if the resource had not been deemed OOM. *See* McAdams Supp. Test. at 21:9–13; *id.* at 22:1–9. By the same token, an OOM offer above the APR clearing price, even if corrected upward to a higher competitive level in the APR auction, will not be accepted in either the FCA or the APR auction. Its correction therefore will have no effect. Only an un-competitively low OOM offer that clears in the FCA auction, but does not clear in the APR auction (when priced competitively at its corrected level), will cause the FCA and APR prices to separate.

Third, after the two auction prices are set, Tier 1 resources—whose effective APR offer was beneath the APR price—receive a capacity obligation at the APR price, which is insulated from artificial price suppression caused by OOM resources. Tier 2 resources (meaning all resources that are not Tier 1)—whose effective FCA offer was beneath the FCA price—receive a capacity obligation at the FCA price, which may be lower than the APR price because it is subject to artificial downward pressure from OOM resources. As long as we are going to allow OOM to clear (unlike NYISO and PJM), such dual clearing prices cannot be avoided.

Existing in-market resources by necessity are and must be assigned to Tier 1. Their past and future investments were and are predicated on the reasonable opportunity to receive the competitive market price achieved by balancing supply and demand. Tier 1 resources thus are protected from artificial price suppression caused by OOM resources. 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. 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; *Supplementary Testimony of Roy J. Shanker Ph.D. on Behalf of New England Power Generators Association*, attached as NEPGA Exhibit 8 ("Shanker Testimony") at 34:13–35:3; Stoddard Test. at 5:15–6:15; Stoddard Supp. Test. at 9:11–10:12. Therefore, if competitive capacity markets are to survive, Tier 1 treatment for existing in-market resources is essential.

New and carried-forward OOM resources should be and are assigned to Tier 2, at least until they establish that they are competitive by clearing at their proxy price in the FCA. Permitting such resources to earn the potentially higher APR price would, in effect, subsidize new OOM entry by socializing its costs across the entire market, rather than leaving them to be borne by the sponsor. As load freely admits, Supporters First Brief at 25–26, OOM resources did not enter on the basis of an expectation of a reasonable opportunity to recover their investments through the competitive market clearing price. Paying these OOM resources the lower FCA price greatly diminishes their incentives to distort capacity markets, *see* McAdams Supp. Test. at 30:3–13. And these resources cannot fairly complain about being paid the lower price that results from their own price-suppressing offers into the auction.

At the same time, as Professor McAdams demonstrates, assigning such resources to Tier 2 is no impediment to *efficient* bilateral contracting:

> [S]uppose that bilateral contracting were generally more efficient than contracting through the auction, so that most (or all) new entry were sponsored by load. Under the July APR, sponsoring OOM only suppresses the auction price paid to new resources and hence provides no price-suppression benefit to load. On the other hand, load must pay these resources at least the *maximum* of (i) the expected value of the FCA clearing price that they could get in the auction and (ii) their cost of new entry, in order to induce them to agree to an out-of-market contract.
>
> For low-cost OOM resources that would have won in the auction anyway, load has to pay just the FCA clearing price, which it would have paid anyway if it had allowed those resources to bid in the auction as merchant resources. On the other hand, for high-cost resources that would not have been selected to enter by the auction, load must pay those resources' cost, which exceeds the FCA clearing

> price. Without any price-suppression benefit, load only gets a short-term benefit from such OOM sponsorship if it genuinely prefers for that resource to enter the market over an alternative, merchant entrant. In particular, load will have a short-term incentive to sponsor high-cost OOM resources only if load enjoys some benefit from such high-cost resources that exceeds the premium (cost – FCA clearing price) that it must pay to induce them to enter. In other words, load has an incentive to induce high-cost resources to enter as OOM exactly when such entry can be justified on efficiency grounds.

Id. at 30:19–31:14. "There is no simple answer" as to whether bilateral contracts or market exchange are always preferable and the answer can change over time. *Id.* at 19:21–20:7. For example, if a national carbon tax (or equivalent cap-and-trade scheme) were imposed, states might "prefer to let the auction do its work of determining the least-cost way to satisfy the Net ICR, taking the carbon tax into account" rather than sponsoring green OOM resources bilaterally. *Id.* at 20:3–7. That makes it all the more advisable to design a capacity market which can adjust its mix between market and bilateral resources as circumstances evolve, rather than effectively prejudging the issue through a preference for bilaterals.

The APR also assigns new in-market resources to Tier 2 as a necessary trade-off between equity and efficiency. Such resources, funded purely through in-market revenues, cannot be used for the purpose of artificially suppressing prices and therefore arguably should be permitted into Tier 1. However, assigning them to Tier 1 would encourage more new, competitive entry, even while OOM resources with potentially lower economic benchmark prices are not being committed in the capacity market. Such an outcome, while arguably the most equitable, could result in excessive and economically inefficient new entry and construction for an indefinite period. As a concession to the realities on the ground in New England, and to advance the most efficient market outcomes, we are willing to endorse assignment to Tier 2 for new in-market resources. (New resources, in-market or OOM, which can establish that they would be

economical by clearing in the FCA, would of course continue to enter, regardless of which Tier they are assigned to.)

The remaining category is currently-existing OOM resources. While paying such resources the higher APR price would allow their sponsors to benefit, despite their price-suppression effects, the decision whether to pay those resources the APR price or the FCA price ultimately affects only the distribution of revenues between (1) load parties that sponsored OOM and (2) those that did not. This distributional issue is of interest only to the load parties. We thus take no position on it. *See* Shanker Supp. Test. at 10:9–10; *id.* at 12:15–17 n.5.

II. AN EFFECTIVE APR REQUIRES A COMPREHENSIVE DEFINITION OF OOM

Load interests, while arguing that the February APR is sufficient and should be left undisturbed, *see, e.g.*, Supporters First Brief at 20, further contend that, if the Commission nevertheless approves ISO-NE's current July APR, it should dramatically narrow the definition of OOM capacity. *See id.* at 6. In particular, load interests demand exemptions for OOM resources (1) that are sponsored by states, *see, e.g.*, *id.* at 23–26, (2) for which intent to suppress capacity cannot be proven, *see, e.g.*, *id.* at 26–30, (3) that are used for self-supply, *see, e.g.*, EMCOS First Brief at 11, or (4) that already exist, *see, e.g.*, Supporters First Brief at 32–24. None of these proposed exemptions has any sound basis in law or economics. And granting any one of them would create loopholes in the APR massive enough to render any effort to save the FCM futile.

A. There Is No Justification to Exempt State-Sponsored OOM

Perhaps the boldest and broadest exemption from OOM designation demanded by load is an exemption for all projects and contracts blessed as "legitimate" by the states. *See, e.g.*, Supporters First Brief at 23–26. According to this view, if a state or its agencies creates or blesses OOM resources on the basis of claimed "public policy interests," the Commission is

required to ignore the resource's OOM status, and to allow it to artificially depress future capacity prices forever. *See id.* at 25–26.

To restate this claim is to refute it. The states are not neutral and independent arbiters regulating wholesale power markets for the public good. They are, instead, obvious and admitted interests engaged on the buyer side of the capacity market. *See id.* at 21 (referring to "load interests [as] including the states themselves"); NEPGA First Brief at 28–35 (discussing states' admitted policy of using and justifying programs on the basis that it will drive down capacity clearing prices or DRIPE); *infra* at 32–34 (amplifying and supplementing discussion of state's DRIPE and related programs). Granting such a financially interested party the privilege to artificially suppress wholesale electric prices would be like giving a fox keys to the henhouse in return for the fox's promise to only use them for "legitimate reasons"—with "legitimate reasons" defined solely by the fox. The farmer would hardly rest easy under such an arrangement, and neither should the Commission. Unsurprisingly, we are unaware of the Commission ever having granted such an extraordinary privilege to an interested party. It should not start now.

1. A State-Sponsored Exemption Is Contrary to the ISO-NE ICR Case

Load's legal arguments in favor of such a privilege are no more sound than its policy arguments. It is true, as load argues, that the Federal Power Act ("FPA") "fully protects the states' choice to award bilateral contracts to address their identified needs and to further their policy goals," and that the FPA "'prohibit[s] the Commission from directly regulating generating facilities.'" Supporters First Brief at 23–24 (quoting *Conn. Dep't of Pub. Util. Control v. FERC*, 569 F.3d 477, 481 (D.C. Cir. 2009) ("*CT DPUC v. FERC*"), *cert. denied*, 130 S. Ct. 1051 (2010)). States therefore do "retain the right to forbid new entrants from providing new capacity, to require retirement of existing generators, to limit new construction to more expensive,

environmentally-friendly units, or to take any other action in their role as regulators of generation facilities without direct interference from the Commission." *Id.* (quoting *CT DPUC v. FERC*, 569 F.3d at 481).

This authority does not, however, include the power to override Commission decisions setting wholesale capacity prices. Wholesale capacity prices are undisputedly within the Commission's exclusive jurisdiction. *See CT DPUC v. FERC*, 569 F.3d at 481. And wholesale capacity prices are the *only* thing in any way affected by the APR—it is, after all, called the Alternative *Price* Rule. The APR thus falls squarely within the Commission's exclusive jurisdiction over wholesale rates.

The Supporters' contrary argument is entirely indistinguishable from the same argument some of them raised in the ISO-NE ICR case, which the Commission and the D.C. Circuit rejected. In the ISO-NE ICR case, the states claimed that the FPA gives them the privilege to set one FCM parameter affecting only capacity prices—ICR—regardless of the determinations of the Commission. *See ISO New England Inc.*, 111 FERC ¶ 61,185, *order on reh'g and clarification*, 112 FERC ¶ 61,254 (2005), *petition for review granted, Conn. Dep't of Pub. Util. Control v. FERC*, 484 F.3d 558 (D.C. Cir. 2007), *order on remand*, *ISO New England Inc.*, 122 FERC ¶ 61,144, *reh'g denied*, 123 FERC ¶ 61,036 (2008), *petition for review denied*, *CT DPUC v. FERC*, 569 F.3d 477. Here the states argue that the same provisions of the FPA give them the privilege of determining another FCM parameter affecting only capacity prices—OOM status—regardless of the determinations of the Commission. Supporters First Brief at 23–24. In the prior ICR litigation, this argument was resoundingly rejected. *See CT DPUC v. FERC*, 569 F.3d at 483–85. It borders on the frivolous for load to repeat this same already-rejected argument

without even attempting to distinguish *CT DPUC* (particularly since they already cite the case, *see* Supporters First Brief at 23–24).

It is, moreover, black-letter law that although Commission wholesale ratemaking may influence a state's exercise of its sovereign powers reserved under the FPA, that does not remove such actions from the Commission's exclusive jurisdiction. *See Me. Pub. Utils. Comm'n v. FERC*, 520 F.3d 464, 479–80 (D.C. Cir. 2008), *rev'd in part on other grounds sub nom., NRG Power Mktg. v. Me. Pub. Utils. Comm'n*, 130 S. Ct. 693 (2010). And the states have conceded that this is not even an issue here. The Supporters freely admit that states will not be deterred by mitigation and will sponsor OOM projects "*without regard to the FCM.*" Supporters First Brief at 25–26 (emphasis added). The states' admission that they can and will pursue their preferred policies within their domain regardless of mitigation is difficult to reconcile with their position that an effective APR would encroach upon or even interfere with their prerogatives.

2. The State Action Doctrine Does Not Apply

Load does raise one novel, though ill-conceived, argument for a state-sponsorship exemption to the APR. Specifically, load contends that "the states are protected by the well-established 'state action' doctrine from any allegations that their bilateral contracting or capacity resource subsidies constitute an exercise of buyer monopsony power." Supporters First Brief at 24 (citing *Parker v. Brown*, 317 U.S. 341, 351 (1943), and *Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105 (1980)). While the state action doctrine may indeed be venerable, load vastly overstates and misstates its content. That doctrine does not apply here for multiple independent reasons:

First, the state action doctrine is not, as load would have it, a general free-floating ban on anybody ever, in any context under any legal regime, even alleging that states may have exercised market power. It is, instead, a judicial ruling that Congress did not intend to make

states liable under the Sherman Act. In establishing this exemption, the Supreme Court assumed "that Congress could, in the exercise of its commerce power," have subjected states to liability under the Sherman Act, but that Congress chose not to do so, given that the "Sherman Act makes no mention of the state as such, and gives no hint that it was intended to restrain state action or official action directed by a state." *Parker*, 317 U.S. at 350, 351. The Court confirmed this conclusion through the legislative history of the Sherman Act. *See id.* at 351; *see also Cal. Retail*, 445 U.S. at 104 (basing conclusion on the fact that *Sherman Act* was "directed against individual, and not state, action") (internal quotations omitted).

This examination of the state action doctrine might at least offer a starting point—albeit an unpersuasive one—for arguing that a doctrine parallel to the Sherman Act's state-action doctrine should be imputed to the Federal Power Act. But the Supporters make no such argument. They merely refer to the state-action doctrine as "well-established" and proceed to act as if it arose out of the Federal Power Act. They make no attempt to argue that the language and history of Federal Power Act have the same implications as the language and history of the Sherman Act. They cite not a single case in which a court has applied the state action doctrine as applicable to the Federal Power Act, or indeed *any* act except the Sherman Act.

Nor would there be any basis for such an argument. As explained above, the states cannot trump the Commission's ratemaking authority. In addition, in 2005, when Congress added Section 222 of the Federal Power Act prohibiting energy market manipulation, it specifically "included … entit[ies] describe[d] in section 824(f)." 16 U.S.C. § 824v. Among these entities are "State[s] or any political subdivision of a State, [and] or any agency, authority, or instrumentality" thereof. FPA § 201(f), 16 U.S.C. § 824(f). Thus, unlike the Sherman Act,

Congress specifically intended the Commission to have the right to oversee state actions in the energy markets.

Second, the Commission has already considered and rejected the state action doctrine in the wholesale rate context. *See S. Cal. Edison Co.*, 51 FERC ¶ 61,284 at 61,892 (1990) ("conclude[ing] that differences between ratemaking policies do not excuse the price discrimination found to exist in this proceeding" and "that the so-called 'state action doctrine,' …. has no bearing on regulatory price squeeze proceedings before this Commission."), *rev'd in part on other grounds, City of Anaheim v. FERC*, 941 F.2d 1234 (D.C. Cir. 1991); *S. Cal. Edison Co.*, 40 FERC ¶ 61,371 at 62,177 (1987) (finding "that the state action doctrine has no bearing on regulatory price squeeze proceedings before this Commission and … does not preclude a finding that the proven price squeeze in this case constitutes undue discrimination requiring a remedy"), *rev'd in part on other grounds*, *City of Anaheim*, 941 F.2d 1234.

Finally, even if the state action doctrine *was* applicable in its entirety to the Federal Power Act, it would not further the Supporters' position. The state action doctrine confers immunity against suit under the Sherman Act to states and certain private parties acting at the behest and supervision of states. *See Parker*, 317 U.S. at 351–52. But this case does not involve a suit under the Sherman Act against any state or a supervised party. Regardless of how the issues are resolved, the outcome will be a new tariff for ISO-NE. And nothing in that tariff creates liability under the Sherman or Federal Power Act for states or state-sponsored parties. No state or state-sponsored party could be sued and be made subject to liability under the Federal Power Act as a consequence. States can do as they wish within their own jurisdiction, while the Commission sets rates within *its* jurisdiction. Any immunity from suit that states may enjoy in other contexts is entirely irrelevant to this proceeding.

3. Granting States Free Rein to Artificially Suppress Capacity Markets Will Fatally Undermine Them and Ultimately Harm All *Participants*

It has long been the policy of the United States to endorse reliance on competitive markets for the provision of wholesale electricity supply. *See* Kalt Test. at 5:14–16. For its part, the Commission has established a regulatory framework that supports wholesale competition in organized markets wherever practical. See *id.* at 5:16–19.

In the New England capacity markets, the greatest threats to competitive markets are state- or load-sponsored actions. While "[n]o individual ratepayer making up but a small fraction of overall market demand would realistically find it to be in its unilateral self-interest to procure uneconomic OOM in such quantity as to materially affect market-clearing prices in the FCM, … [t]hese large buyers and/or the state authorities that condition these buyers' conduct can find—and have found—the exercise of buyer market power attractive (at least in the short-run)." *Id*. at 16:20–17:7.

> [S]tate authorities can have *de facto* control over their jurisdictional ratepayers, effectively negotiating on their behalf, procuring their power needs through RFPs, and utilizing the *de facto* captivity of state consumers to back up guarantees needed to attract suppliers. With well-meaning (albeit, perhaps myopic) intentions, such authorities may attempt to act, effectively, as unified buying agents via mandated procurement policies and state-sanctioned RFPs that are the *economic* equivalent of a buyers' cartel.

Id. at 8:4–10.

Such agglomeration of buyer-side market-power, however state-sanctioned, poses severe "risk from the perspective of the health of the nation's electric capacity markets [because] state authorities may see the exercise of monopsony in their interest at the expense of the overall national interest in competitive wholesale electricity markets." *Id.* at 8:10–13.

> [I]nvestors in third-party supply who have not yet sunk their capital into the region can avoid the threat of expropriation by allocating their investments to other regions. With the "demonstration project" of monopsonistic state-sponsored procurement as a legacy, allowing the unmitigated, uncorrected exercise of buyer

> market power today can readily create the expectation that such conduct may be allowed—even touted by state policymakers—in the future. This prospect yields "once burned, twice shy" responses in which investors reduce their supply of capacity to the region or, if they are to be induced to continue to supply their capital to the region, they will expect premiums to cover the perceived risks of ongoing and/or future downward price suppression in the name of benefits for load interests. With such expectations, lenders and equity investors will demand higher returns from developers of new generation to account for the risk of future monopsonistic conduct in the FCM on the part of state-controlled load. Thus, the unmitigated exercise of buyer market power will raise the cost of new entry into the FCM going forward.

Id. at 25:7–20.

Empirical research has confirmed the adverse effects created by the threat of this type of state-sponsored economic predation. *See id.* at 25:21–26:13. As Professor Kalt explains:

> While there is understandable myopia on the part of state officials (who can reasonably expect terms of office which are considerably shorter than the lives of electric power capacity investments), the longer run consequences of short-term strategies of state-controlled monopsonistic FCM price suppression portend only additional and unnecessary costs to state-controlled load. In fact, the state-sanctioned price suppression at issue here is familiar as a source of economic *underdevelopment* brought on by governments who, in the name of helping the people and pursuing sovereignty, utilize their *de facto* control over their jurisdictions' economies to promise short-term benefits from burdens placed on the backs of already-sunk investment. The long-run results, however, are inevitably increasingly difficult access to capital and discouragement of the very investment on which an economy's health, growth, and development depend. The public of the states that make up the nation will be better served by promoting viable *and competitive* electric power markets.

Id. at 4:20–5:9. We all have read about countries like Ecuador or Bolivia expropriating private investment in the name of pursuing sovereignty and seeking to benefit their citizens. And few, if any, in this country, at least, would doubt Professor Kalt's explanation of the counterproductive effects of such actions:

> The unhappy lesson of many societies is that pursuing short run payoffs (in the electric sector or beyond) by manipulating markets and burdening investors who have already been induced to sink their capital into affected markets ultimately drives investors and their capital away. Over the long run, this is a recipe for economic underdevelopment. It does not serve the sustained interests of the very citizens it purports to support.

Id. at 29:4–9 (citations and footnotes omitted). The Commission should not allow load in New England to continue veering down that same counterproductive path, effectively expropriating the sunk investment of existing capacity suppliers, in violation (at a minimum) of the Federal Power Act.

Nor is it a defense to point out that states exercise market power on behalf of buyers rather than sellers. *Id.* at 8:14–10:6. "The very same precepts that undergird the public's interest in protecting against seller-side monopoly market power apply to the need to protect against buyer market power. Ultimately, seller market power contravenes the overall public's interest in a healthy economy by distorting the relationship between prices and costs." *Id.* at 8:16–19. And buyer market power has equally distorting effects:

> In the case of monopsony, the buyer (or a group of colluding buyers acting in concert) with market power strategically withhold *demand* from the market in order to push prices of what is purchased downward. As efficient suppliers shrink in response to the lower prices ("move down their supply curves"), the economy forgoes a range of incremental supply of the monopsonized product that could be had at lower cost than the incremental value generated for consumers. The overall economy shrinks as a result. In addition, if monopsony is exercised (as is the concern here) against efficient suppliers by buyers subsidizing otherwise higher cost, inefficient supply sources of their own, the overall economy is distorted: Any given level of supply to consumers does not come from the lowest cost mix of supply sources. Resources are wasted, resources that could be used to produce further output for consumers across the economy.

Id. at 9:7–17. Just like monopolistic pricing, "[m]onopsonistic price manipulation by the buyer or buyers of a particular product is contrary to the overall public's interest in a healthy and efficient economy that serves all consumers and their needs." *Id.* at 10:4–6.

This conclusion, while perhaps coming as a surprise to beginning students of economics or antitrust law, *see id.* at 10:9–11, is well recognized by federal antitrust enforcers as well as the Commission:

> Tellingly, the recently revised Horizontal Merger Guidelines issued by the United States Department of Justice and the Federal Trade Commission make it explicit

> that "[e]nhancement of market power by buyers, sometimes called 'monopsony power,' has adverse effects comparable to enhancement of market power by sellers." Similarly, the Obama Administration's Antitrust Division has targeted monopsony for investigation, and made it clear that monopsony is no less objectionable than monopoly market power. Joint Department of Justice/USDA workshops, for example, have recently begun to address the "dynamics of competition in agriculture markets including, among other issues, buyer power (also known as monopsony) and vertical integration." The Commission's aforementioned admonition that the exercise of market power by both sellers and buyers must be mitigated to ensure that prices are neither artificially inflated nor artificially suppressed is thus wholly in keeping with sound economics and overall federal concerns regarding monopsony market power.

Id. at 10:17–11:7 (internal footnotes, citations omitted). The Commission has expressed its agreement with these sound precepts. *See* NEPGA First Brief at 5–8; Kalt Test. at 11:8–12:2.

B. Examinations of Alleged Intent Do Not Belong in the Definition of OOM

A second major loophole in the definition of OOM capacity demanded by load interests is an exemption for all OOM resources "unless the IMMU finds evidence of an intention to suppress the FCA clearing price." Supporters First Brief at 28; *see also* EMCOS First Brief at 11. The Commission should reject proposals to import of such an intent requirement into the APR for the following reasons:

(1) The Commission only recently rejected such a requirement in the NYISO ICAP case, for good reason.

(2) The intent requirement would be enormously burdensome to administratively impossible to implement on a case-by-case basis.

(3) It is also unnecessary as in many cases the sponsors of OOM resources have amply demonstrated and publicly professed their desire to artificially suppress capacity prices.

(4) Finally, to the extent that the sponsors of OOM resources truly do not intend to artificially suppress prices, they should have no objection to the appropriate correction of such price suppression effects which occur regardless of intent.

We explain each point in detail below.

1. The Commission Rejected Intent Requirements in the NYISO ICAP Case

The Commission, in its original order approving the buyer market power mitigation in the NYISO in-city ICAP market, had required that only net buyers of capacity be made subject to mitigation. *See N.Y. Indep. Sys. Operator, Inc.*, 122 FERC ¶ 61,211 at P 100, *order on reh'g*, 124 FERC ¶ 61,301 (2008), *order on reh'g and clarification*, 131 FERC ¶ 61,170 (2010) ("*NYISO*"). In response to the objections of NYISO and others, *NYISO*, 124 FERC ¶ 61,301 at P 28, the Commission reconsidered and reversed the net-buyer requirement:

> NYISO will not be required to modify its proposed market power mitigation rules for uneconomic entry so that they only apply to net buyers. *We find that all uneconomic entry has the effect of depressing prices below the competitive level and that this is the key element that mitigation of uneconomic entry should address.* Parties requesting rehearing have convinced us that defining net buyers raises significant complications and provides undesirable incentives for parties to evade mitigation measures. Accordingly, we grant rehearing on this issue[.]

Id. at P 29 (emphasis added).

The Commission's ultimate decision in the NYISO ICAP case compels rejection of the similar net-buyer requirement proposed by load interests here, *see, e.g.*, Supporters First Brief at 28 ("[N]o resource's offers should be mitigated if the resource is not owned by or contracted to a net capacity buyer or an agency of a state government."); EMCOS First Brief at 5–6. In rejecting the net-buyer requirement in NYISO, the Commission also rightly noted that "all uneconomic entry has the effect of depressing prices below the competitive level." *NYISO*, 124 FERC ¶ 61,301 at P 29. As it is the depression of prices—not the mental state of any particular market participant, which may not be discernable in many cases, and will become far less discernable if it became outcome-determinative—that "is the key element that mitigation of uneconomic entry should address." *Id.* Mitigation is called for whenever uneconomic entry occurs, regardless of intent. *Id.*

2. An Intent Requirement Would Be Extremely Burdensome to Implement on a Case-by-Case Basis

In addition, the burden arguments raised there by NYISO and others, and found persuasive by the Commission, apply equally here:

> [They] all request that the Commission grant rehearing and not limit market power mitigation measures to net-buyers only. Essentially these parties note that the limitation is impractical to implement and would achieve little positive result. They argue that the limitation would give parties an incentive to create companies solely for the purpose of subsidizing uneconomic entry, or that governmental bodies could subsidize uneconomic entry under a public policy rationale. NYISO, in particular, emphasizes that limiting uneconomic entry mitigation measures to net buyers could undermine enforcement because buyers may behave strategically to avoid categorization as net buyers. NYISO also points out that the process for identifying net buyers is unclear and that this could also result in evasion of the mitigation measures. NYISO notes that "net buyer" could be defined a number of different ways, for example, as a single entity or as an entity including all affiliates that serve load. Such a definition would not consider generation affiliates that could construct uneconomic generation and escape mitigation. NYISO also explains that contractual relationships could be undertaken to circumvent mitigation of uneconomic entry and that these would be extremely difficult to identify. For example, it asserts, a "contract for difference" might allow a buyer to subsidize uneconomic entry in a way that would not be apparent to NYISO. NYISO further emphasizes that if the Commission's view that only "net buyers" have the incentive to engage in uneconomic entry is correct, the "net buyer" condition would be unnecessary since there would be no other sources of uneconomic entry.

NYISO, 124 FERC ¶ 61,301 at P 28. *See also* Shanker Supp. Test. at 3:19–4:4 (further discussing the reason for the Commission's reversal).

Load claims that an intent test could be implemented as a simple "bright-line test that differentiates between offers from resources that seek to distort the FCA clearing price and should be corrected and offers from resources that are either owned by those with no incentive to suppress prices or are implementing legitimate state policy initiatives and should not be mitigated." Supporters First Brief at 28. NYISO's and Dr. Shanker's arguments cited above—and the Commission's prior determinations in this regard—belie the idea that an intent test could ever be a simple bright-line test.

Interestingly, so does the Supporters' own expert, Mr. Wilson. He notes that:

> To ensure that this part of the test does not inappropriately exclude from possible MOOM classification resources whose offers may reflect an attempt to suppress prices, *the test should recognize that under some circumstances an entity may not be a net buyer, but may essentially be acting as a net buyer,* due, for instance, to a regulatory of [sic] legislative action applicable to the entity. For example, if state legislation required a load-serving entity to contract for resources and offer them into FCM in order to suppress the clearing prices, the resulting resources should be classified MOOM even if the entity happens to not be a net buyer of capacity.

Supporters First Brief, Exhibit DPUC-3, Direct Testimony of James F. Wilson in Support of First Brief of Joint Filing Supporters at 11:6–13 ("James Wilson Testimony"). But this contradicts the Supporters' proposed simplistic test, under which "no resource's offers should be mitigated if the resource is not owned by or contracted to a net capacity buyer or an agency of a state government." Supporters First Brief at 28.

In any event, Mr. Wilson's testimony never goes into further detail, beyond the example he gives, to describe exactly how the ISO-NE's IMM is supposed to determine whether any particular OOM resource in any particular auction may or may not be acting essentially (or not) as a net buyer. The only certainty about whatever test is used to implement such a loose standard is that it will *not* be a bright-line test. The only bright-line test consistent with the Supporters' position is one that is so superficial as to render evasion trivial.

For the FCM to clear at a true market-based level—and therefore to function at all—it is critical that the price-distorting effects of OOM be addressed irrespective of the intent of the OOM sponsor. Nonetheless, it is instructive to recognize those instances where the OOM sponsor's intent was clearly, and unabashedly, to suppress capacity market prices. These instances highlight the effect that unmitigated OOM will have on the market. We described at length, and with the support of a wide variety of public reports sponsored by the states and other load interests, efforts to justify demand-response programs in substantial part through their

ability to artificially suppress capacity prices. *See* NEPGA First Brief at 28–35 (discussing states' admitted policy of using and justifying programs on the basis that it will drive down capacity clearing prices). Clearly states are aware that sponsoring demand-response programs tends to drive down capacity prices. And their own calculations demonstrate that the "Demand Response Induced Price Effect" is a key economic justification for these programs. *See id.* at 29–35; *see* Stoddard Supp. Test. at 20:9–12 & nn.28–29; Shanker Supp. Test. at 4:5–5:5.

Another particularly striking example of states consciously justifying OOM capacity on the basis of its price-suppression effect can be found in a recent report prepared for the Maryland Public Service Commission by, among others, lead counsel for the Supporters. Levitan & Assocs. & Kaye Scholer LLP, Analysis of Resource and Policy Options for Maryland's Energy Future (Dec. 1, 2008), *available at* http://webapp.psc.state.md.us/Intranet/sitesearch/whats_new/Levitan%20&%20Associates_Final%20Report_Analysis%20of%20Resource%20and%20Policy%20Options%20for%20Maryland's%20Energy%20Future%20for%20the%20MD%20PSC.pdf. This report considers various options for the state to expand capacity, including at least one scenario to suppress energy and capacity prices by overbuilding uneconomic resources:

> In the Overbuild Case we evaluate the addition of 1,080 MW under long-term PPAs with the IOUs in accord with the Contract CC Case. In order to sustain the overhang in Maryland, thereby reducing energy and capacity prices in SWMAAC, in particular, we assume Maryland's IOUs will enter into additional long-term contracts over the study horizon to maintain a surplus in SWMAAC, thereby supplanting new merchant generation otherwise built elsewhere in Maryland or PJM.

Id. at 4. The purpose of this overbuilding of capacity is openly conceded to be market-wide price suppression:

> Ratepayer-backed capacity reasonably assures the timely addition of new capacity, thereby meeting PJM reliability requirements. Reliance on market signals to support merchant entry is much less likely to support this objective. *Ratepayer-backed capacity can result in a short-lived or long-lived capacity surplus, yielding portfolio benefits to load.* To maintain long-lived capacity surplus to

> support portfolio benefits, Maryland's IOUs would likely need to continue purchasing new capacity under long-term agreement, or otherwise build it.

Id. at 114 (emphasis added). It is also worth noting that the Levitan/Kaye Scholer report expressly states that future and continuing OOM entry will end "[r]eliance on market signals to support merchant entry." *Id.* It thus concurs with the key conclusion of all of NEPGA's experts.

As Prof. Kalt rightly notes with respect to similar conduct by Connecticut, "[t]his is the reasoning of a monopsonist, treating suppression of the price it pays across its purchases as a benefit to be weighed against the costs incurred to suppress market-clearing prices." Kalt Test. at 15:2–4.

3. Even OOM Resources That Are Not Intended to Artificially Suppress Capacity Prices Should Not Be Exempt

Even if load interests could point to sponsored OOM resources that were not at least in part intended to artificially suppress capacity prices, they offer no reason why the bids of such resources in the APR auction should escape mitigation. If, as load interests claim, price suppression was not the intended effect of OOM sponsorship, no reasonable expectation of the sponsor is thwarted. While the new OOM resource will receive the lower FCA price, rather than the higher APR price, this is no different from what the resource would have received absent any APR. If, as proposed in some variations of the June and July APRs, OOM resources at some point become eligible to receive the higher APR price, then sponsored OOM resource will *benefit*, not suffer, from an effective APR. *If* and *only if* suppression of the price paid to other resources was the purpose of the OOM sponsorship, will OOM sponsors have anything to fear from an effective APR. But in that case—fervently denied by OOM sponsors—mitigation would be entirely appropriate even by their own standards. *See* Supporters First Brief at 26 ("OOM offers in the FCA that seek to 'inappropriately suppress' the clearing price … should be mitigated.").

More generally, as the Commission recognized in the *NYISO* case, the relevant question is not intent, but effect. *See NYISO*, 124 FERC ¶ 61,301 at P 29. *All* OOM resources that are committed because they offered capacity at prices below their economic benchmark will artificially suppress capacity clearing prices below competitive levels. This is so regardless whether that was the intent or an entirely unexpected and innocent side effect. Therefore, in order to protect the integrity of the capacity markets and competitive prices, such offers must be mitigated regardless of intent.

Professor McAdams lucidly explains why even hypothetical OOM resources that *are* "justified on the basis of a valid policy or business objective" ought nevertheless to be entered into the APR auction at competitive proxy prices:

> [While] load should be *allowed to sponsor* OOM, by signing long-term contracts before the auction with resources for which it is willing to pay a premium. However, as far as I am aware, no party to this proceeding is suggesting that states or other load interests not be allowed to sponsor OOM to achieve their own policy objectives. (Indeed, as far as I am aware, no party is proposing *any* restrictions on OOM sponsorship, despite its potential to disrupt the proper functioning of the FCM.)
>
> The debate here is merely about what should happen if load decides to bypass the market so as to induce entry by resources that are not among the lowest-cost resources available to satisfy the Net ICR. Should such entry be permitted to undercut the long-term sustainability of the market by artificially lowering the price paid to other resources? Or should load bear the incremental cost associated with procuring a resource that is more costly than others that would have been available to satisfy the Net ICR?
>
> The answer is clear, if what one cares about is the efficiency of the FCM. Load should bear the incremental cost associated with out-of-market procurement of high-cost resources since, when it bears this extra cost, load has an economic incentive to sponsor such resources only when such resources provide enough extra benefits to load to be efficient despite their higher cost.

McAdams Supp. Test. at 15:3–20; *see also id.* at 16:1–10.

As Professor Kalt explains, this compromise—permitting states to freely sponsor OOM capacity, while barring them from using these sponsored resources to artificially suppress capacity prices—is socially optimal:

> Nothing in what I have said regarding the undesirable consequences of monopsonistic manipulation of FCM prices implies that state authorities should be precluded from pursuing benefits for their citizens that can arise from investments in environmental protection, power system reliability, and the like. Instead, the implication is that the social benefits that justify such investments in the cost-benefit considerations of state policymakers do not and should not include the "benefits" to load of having incumbent capacity sellers effectively pay for such investments via monopsonistic price suppression in capacity markets. The latter "benefits" are not net social benefits; they are transfers from one private interest (sellers of capacity) to another (buyers of capacity). As Professor McAdams points out in his companion testimony, the benefits to the public as a whole that the market may not fully account for and that can justify government intervention are such attributes as greenness and reliability, not monopsonistic price suppression.
>
> In short, a state should not be precluded from pursuing objectives such as supporting alternative power sources or ensuring supply adequacy. Indeed, attendant benefits of environmental protection or system reliability should be taken into account in a proper cost-benefit analysis of capacity procurement, and such benefits might well justify procurement of otherwise high-cost, uneconomic capacity. Moreover, to the extent that excess costs do need to be covered in order to bring ratepayers or taxpayers the benefits of conservation, improved system reliability and the like, it is not a net burden on ratepayers or taxpayers to bear such costs when and if the subject investments are *efficient* (i.e., when their public benefits exceed their costs). Enabling authorities to go beyond these basic economics of the public interest such that they use "benefits" of monopsony to justify incurring of higher cost alternatives can readily lead to excess investment of the type at issue here. Blocking such outcomes entails "mitigation" which puts a floor under FCM prices at the level of competitively justified offers so that OOM payments, efficient or otherwise, do not alter prices.

Kalt Test. at 22:11–23:14.

4. Exempting the Buyer Side from Mitigation, While Harshly Mitigating the Seller Side, Will Not Achieve Competitive Outcomes

In opposition to mitigating buyer-side market power, load interests have taken up cudgels against the evils of "administered prices." *See, e.g.*, Supporters First Brief at 21 (warning against "transform[ing] the FCM from an auction that sets the market-clearing price for new and existing

resources into a regime that sets the price administratively"); *id.* at 26 (advocating limits to "ensure that the APR does not supplant market forces with administratively set prices"); *id.* at 34; EMCOS First Brief at 9 ("[R]e-pricing Self-Supply inevitably results in an artificial increase of the FCA clearing price, based solely on the market administrator's estimate of what the auction clearing price 'should' have been. The effort to substitute an administered price for a market price thus represents simply another form of price distortion."); *id.* at 7; *Id.*, Affidavit of John W. Wilson ¶ 7 ("John Wilson Affidavit") (criticizing "radical proposals that have been advanced by some of the parties to these proceedings in the name of curbing purposeful price suppression actually move still further toward administered pricing."); *id.* ¶ 8 ("EMCOS have no confidence in the ability of administered prices … to achieve a reasonable, just and economically efficient market pricing structure for electricity generation in New England.")..

Historically, and currently, *seller*-side market power mitigation caps *all* offers from existing resources for purposes of setting *both* the FCA price *and* the APR price. *See* NEPGA First Brief at 13–15. Any offer above 0.8 CONE—that is, any such offer that would be expected to set the clearing price in a balanced market, which would be expected to clear at prices near CONE—is subject to individualized scrutiny and review by the Internal Market Monitor ("INTMMU") and will only be permitted if found to be cost-justified. *Id.*

The proposed mitigation of *buyer*-side market power under the July APR is much gentler. It applies only to resources supported by out-of-market payments, rather than all resources. It applies only with respect to the APR price, not the FCA price. It applies only to resource bidding below a class-specific benchmark. And it will never prevent a resource from receiving a capacity commitment in the FCA auction.

Given this comparison, it is difficult to reconcile (1) load's arguments against interference with the free market through buyer-side mitigation with (2) its continued advocacy for maintaining and strengthening the already vastly more comprehensive seller-side mitigation scheme. If load sincerely regards even the relatively gentle buyer-side mitigation as an intolerable interference with market price-setting, we await its endorsement of the abolition of the much harsher regime for seller-side mitigation.

By the same token, load's newfound skepticism with respect to the INTMMU's ability to accurately estimate costs should be taken with a grain of salt. *See* Supporters First Brief at 35, 37. It is, after all, the INTMMU who estimates costs for the purpose of seller-side mitigation. If the INTMMU is capable of adequately performing that task in order to determine if prices are un-competitively high, then surely this ability does not disappear when the INTMMU determines whether prices are un-competitively low.

At bottom, the relevant question is whether the FCA is more likely to approximate competitive outcomes when mitigation is applied to the seller side only, or when mitigation is, instead, applied to market power on both sides of the market. Given that an alternative market unencumbered by any market power mitigation, whatever its merits, is not within the scope of this hearing, these are the two options before the Commission. We submit that mitigation even-handedly applied to all market participants is more likely to approximate competitive outcomes than mitigation applied to only to sellers, leaving buyers free to manipulate the market at will. *See* Milgrom Test. at 11:3–12:2; Kalt Test. at 7:4–8:14; McAdams Supp. Test. at 35:11–36:18.

C. The OOM Benchmark Must Be Based on Fully Amortized Economic Cost

A variation on the theme of exempting state-blessed OOM from mitigation is the idea that the OOM benchmark price should be determined solely on the basis of going-forward cost after discounting all state subsidies. *See* Supporters First Brief at 29; James Wilson Test. at

14:17–22. Accepting this lowered OOM benchmark would effectively eviscerate any APR for two reasons.

First, and most straightforwardly, permitting state subsidies to be discounted against economic cost estimates would permit states to escape OOM mitigation at will. Given sufficiently large levels of state subsidies, *any* resource, no matter how uneconomic, can bid as low as the state wants it to. If these subsidies are subtracted from real economic cost levels to determine whether the resource is OOM, no resource will ever be found to be OOM.

Second, and somewhat more subtly, the proper benchmark for OOM revenue should be full economic cost, rather than merely the lower going-forward cost. As Dr. Shanker explains, net going-forward costs are not an appropriate benchmark for offers from OOM resources:

> This proposal, if adopted, would make the APR and any mitigation of uneconomic new entry meaningless. I agree that existing, competitive resource may offer at their net going forward or to-go costs (though there are some issues with ISO-NE definition of these costs, I will not belabor here). But adopting to-go costs as the benchmark for uneconomic entry renders the APR virtually meaningless, particularly if to-go costs are calculated *after* the new plant is already built and has submitted an offer. Mr. Wilson's proposal ignores the very important issue that the facility was uneconomic *when* it was built in the first place. It also ignores whether any rational determination, made at the time a commitment was entered to build the facility, would have found the facility economic in the context of the Commission's jurisdictional markets. Finally, Mr. Wilson further aggravates this problem by *deducting* market credits or subsidies from his calculation of his version of to-go costs. James Wilson Test. at 14:14-15:2.
>
> After a new unit has already been built, its to-go costs provide no useful information about whether a new resource should be classified as OOM. The correct measurement of costs in the context of entry decision-making is the long-run levelized average cost of new entry, as discussed below.
>
> An OOM offer for a new resource based on to-go costs would likely be in the same range of in-market offers, which are also based on to-go costs. Existing units may have relatively low incremental costs. If the determination of whether a new resource is OOM or not is also based on to-go costs, the entire point of the mitigation—preventing artificial price suppression—will be lost.

> I previously analogized this as tantamount to simply stating that a fired bullet follows the laws of physics, while failing to address why the trigger was pulled in the first place. Shanker Test. at 64:3-5. In this situation, we simply cannot ignore the implications of uneconomic entry by noting that, after it occurs, an associated bid that is low is rational. By that time, the harm is already done. Allowing the results of the action to go unmitigated would simply reward, rather than discourage, the anti-competitive behavior.

Shanker Supp. Test. at 10:12–11:20. *See also* Stoddard Supp. Test. at 12:1–14:5.

In other words, using only going-forward costs as the OOM benchmark would permit load to artificially suppress capacity clearing prices down to those levels. But that, of course, is all an exerciser of buyer market power would want to do in the first place. If the OOM sponsor suppressed prices further, it would find that independent resources of the same type as the OOM resource (and hence presumably with similar going-forward costs) would leave the market to avoid further avoidable losses. And if that happened, the OOM sponsor then would need to sponsor more expensive new OOM replacement capacity, offsetting any profits of the OOM price-suppression scheme.

To avoid that outcome, the intelligent OOM sponsor would treat the independent resource like the proverbial goose that lays golden eggs—squeezing incumbent units as hard as possible, but not so hard that they cannot survive. Independent market participants would be able to recover their going-forward costs, but all the capital sunk into building the resource would effectively have been taken without compensation through the state-sponsored exercise of buyer market power. Using going-forward costs as the OOM benchmark would legitimize precisely this predatory strategy. Seen this way, Mr. Wilson's advice is more of a tutorial for anti-competitive conduct than an approach for mitigating such conduct.

D. An Exemption for Existing OOM Will Unbalance the Market for Many Years

The single most significant flaw in the July APR proposed by ISO-NE is that it grants a blanket exemption for all currently existing OOM resources. Such units would not have their

uncompetitive bids substituted by competitive benchmarks even in the APR auction. This proposed exemption not only permits existing OOM resources to *receive* the higher APR price—an arguable position, *see supra* at 17-18—but also allows these OOM resources to directly *affect* the APR price, just as if they were in-market resources. Allowing the APR price to be artificially suppressed through existing OOM resources will render the APR ineffective for the foreseeable future. In that case, the FCM may not survive long enough to be rescued by an effective APR.

1. An Exemption for Existing OOM Resources Is Not Justified

Dr. Shanker refutes the justifications offered by the Supporters for exempting historic OOM from APR mitigation:

> The Supporters, Supporters First Brief at 32-34 & n.109, and Mr. Wilson, Wilson Test. at 18:8-16, argue that the mitigated offer prices of existing resources should be exempted from the process to determine the APR Tier 1 price (the so-called "Historic" OOM). In support, Supporters cite the previous Commission decision on mitigation of uneconomic entry in New York City. I participated in that proceeding and the situation here is materially different. *See* NEPGA First Brief at 51-53. *First*, there was no applicable monopsony pricing rule in effect in NYISO during the periods when the contested new entry occurred, nor was there any determination at that time of what constituted out of market entry. *Second*, and most importantly, the new mitigation scheme in New York sets a floor price on the new capacity being offered that is directly linked to the cost of new entry for the reference capacity unit (or a lesser demonstrated unit-specific cost). If the market clears below the floor, the resource does not clear and no one is able to use the associated capacity to fulfill any capacity market requirements/obligations. The new entrant is effectively removed from the market completely, unless its mitigated price clears in the single auction.

Shanker Supp. Test. at 8:10–9:3.

And as Mr. Stoddard explains, the reasons offered by ISO-NE for exempting historic OOM are no more convincing:

> ISO-NE provides two rationales for this decision, neither of which are sufficient to warrant allowing buyer behavior to artificially suppress prices in FERC-jurisdictional markets below levels that are neither consistent with competitive behavior nor sustainable over the long run.

> The first rationale is that this treatment would be "retroactive" and "create significant market uncertainty." Including Historic OOM in the Carried Forward Excess Supply would not retroactively change any rate already set through FCA #4; instead, it would prospectively address the adverse effect on prices created by uneconomic contract purchases by load and other sources of OOM surplus. ISO-NE and every other RTO frequently changes market rules that have material effects on the value of a supplier's investment—such as the imposition of energy offer caps by ISO-NE in 2000. There is always a degree of regulatory uncertainty facing investors in this industry. The "certainty" that the Commission and ISO-NE should be seeking to provide is not unchanging *rules* but a consistent adherence to markets that create just and reasonable rates, reflecting competitive supply and demand forces and relatively untainted by the exercise of market power by either sellers or buyers. Allowing a "hangover" from the binge of OOM entry indulged in by LSEs during the first three FCAs to suppress the FCM capacity prices for the foreseeable future is inconsistent with this goal, and will lead to a market structure that is not sustainable, notwithstanding the other well-designed improvements that are being developed in these proceedings. The level of excess is simply far too large and will substantially, adversely affect the capacity markets on whole for far too long.
>
> The second rationale is that Commission precedent precludes counting these resources in the Carried Forward Excess Supply. However, as NEPGA demonstrated in its First Brief, this precedent is not applicable, given that the Comprehensive APR would still allow these Historic OOM resources to clear as capacity resources.

Stoddard Supp. Test. at 23:12–24:15 (footnote omitted).

As Professor Milgrom explains, the mitigation of existing OOM is the economically sounder policy:

> 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 testifies 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 Supporters' main counterargument appears to be that they have some "reliance interest" in not having capacity prices mitigated for existing state-sponsored OOM. Supporters First Brief at 33–34. 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 Supporters claim 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—which we doubt—they certainly were not "justified." All that we propose to do is prevent Historic 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. Yet that basically is the claim here.

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.

Perhaps load might assert reliance on OOM resources being paid the higher APR price, rather than the lower FCA price. Any such argument would be hard to square with the fact that the dual clearing price auction was only first suggested by ISO-NE in June 2010. But we would not object to accommodating such a concern. It is easy to shield existing OOM resources from their own price-suppression effect by paying them the higher APR price, though it probably would add to the overall costs that load would pay. *See supra* at 20. In no event, however, can load reasonably claim any entitlement to reap the *future* portfolio benefits of artificial price suppression in *future* auctions, simply because the initial mitigation measure designed to prevent this outcome—the Historic APR—was not up to the task.

2. An Exemption for Existing OOM Resources Would Destroy the FCM for the Foreseeable Future

The amount of existing OOM resources in the FCM is sufficiently large to drive clearing prices towards zero for many years come. Mr. Stoddard's updated testimony reflecting FCA #4 estimates the amounts of OOM currently in the market could take one to two decades to absorb. *See* Stoddard Supp. Test. at 4:10–6:16. If a truly effective APR does not go into effect before FCA #6, one can expect that the amount of pre-existing OOM will once again increase in FCA #5. To grandfather, as is currently proposed, half-a-decades'-worth of OOM capacity, and to permit it to depress capacity prices going forward for many years to come, would doom even an otherwise-effective APR.

This not only means that it will take decades for the FCM to recover from its current artificially-depressed state; it also portends a further collapse. In each of the four FCAs conducted so far, the declining clock auction was stopped by the price floor. And the

Commission has ordered this price floor to be eliminated by FCA #6. Hearing Order at P 97; Rehearing Order at P 41. If all current OOM capacity is permitted to continue to participate in setting the FCA and APR clearing prices and the price floor is ultimately abolished, there is very little to stop the price from dropping close to $0 and remaining there for many years until existing OOM capacity is absorbed in the distant future. At a minimum, some transitional mechanism, such as the price floor, must continue as long as unmitigated OOM capacity continues to depress clearing prices. *See infra* Section III.C.1.

The decision to permit all existing OOM capacity to suppress not only the FCA price, but also the corrected APR price, is not a temporary or peripheral issue. Even if all other issues before the Commission were resolved in favor of competitive prices, this overhang of existing OOM would easily be sufficient to doom the future of the FCM. Competitive suppliers that have endured the bottoming out of prices, in the hope of corrective Commission action, would then face an indefinite future of capacity prices remaining artificially suppressed to unsustainable levels. And needless to say, in an environment where existing suppliers cannot expect to consistently recover even their going-forward costs—never mind a reasonable opportunity to earn a return on their investment—there is no possibility that new competitive entrants will appear. Further investment to maintain and improve the existing facilities is heavily discouraged. Instead, the power system will be forced to rely on RMR and bilateral agreements and 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.

E. An Unlimited Self-Supply Loophole Is Without Basis in Economics and Would Eviscerate the APR

One more category of OOM for which load interests seek an exemption is self-supply—resources built or contracted for by load in order to supply their own capacity requirements

rather than bought and sold in an FCA. EMCOS First Brief at 4–11. Such resources, lacking any clearly defined or observable capacity offer price, are treated as OOM under the FCM. ISO-NE Tariff § III.13.2.7.8.1(c)(iv). Facing the prospect of an effective APR, load now seeks a blanket exemption from OOM status for all self-supply resources. *See* EMCOS Brief at 11.

The Commission should reject this demand for a self-supply loophole. The arguments advanced in its favor are either economically incoherent or demonstrably false (or both). Creating such a loophole would allow virtually all artificial anti-competitive price suppression to continue unabated. Most importantly, the Commission's guidance that load should have an opportunity to hedge its exposure through self-supply can be accommodated through a more targeted remedy that would not also allow OOM resources to be used as a tool of price manipulation.

The threat posed by an unlimited self-supply exemption is not merely hypothetical. The FCM already has seen explosive growth of self-supply designation:

> [S]elf-supply rose markedly, from 1,935 MW in FCA #3 to 2,699 MW in FCA #4, an increase of 39%. This large increase in the use of this "opt-out" mechanism is not an encouraging sign, but neither is it surprising. With the substantial amount of surplus remaining at the floor price, each MW of priced capacity in the market receives a discounted price or, similarly, quantity pro rationing. Self-supplied MWs are exempt from pro-rationing, however, and so effectively are worth more in the market. This sharp increase in self-supply highlights that the self-supply option can be used not only for hedging by loads, but also to respond to incentives created by the FCA market rules.

Stoddard Supp. Test. at 5:8–15. If we add an unlimited APR exemption, then within the near future a large fraction of all capacity in ISO-NE may be allocated on the basis of bilateral contracts and other self-supply arrangements, rather than a functioning auction process.

1. Exempted Self-Supply Would Be a Powerful Tool for Market Manipulation

The basic premise underlying the demands to exempt self-supply from review and mitigation is that self-supply cannot affect the FCM clearing price and therefore cannot be a tool

of price suppression. *See, e.g.*, EMCOS First Brief at 7–8; John Wilson Aff. ¶¶ 11–13. This premise is demonstrably false.

The unstated assumption implicit in this argument is that load interests would only add or designate an additional amount of self-supply if simultaneously choosing to add the same amount of load. On this assumption, it is true that adding 100 MW of additional load, shifting the demand curve to the right by 100 MW, and adding 100 MW of self-supply priced at $0, shifting the supply curve to the right by 100 MW, will not affect the price at the intersection of supply and demand. But as Dr. Shanker explains:

> Dr. Wilson appears to be arguing that there is no net impact to self-supply because there are offsetting adjustments to supply and demand. Dr. Wilson argues that under the tariff, the level of self-supply cannot exceed a participant's requirements, thus it should not matter how this supply is procured. John Wilson Aff. ¶¶ 9-13. In turn, he argues that self-supply should be removed from both supply and demand in the FCA process. *Id.* ¶¶ 11-14. This is simply wrong. The tariff section cited by Dr. Wilson, ISO-NE Tariff, § III.13.1.6 ("Self-Supplied FCA Resources") explicitly allows self-supply to be designated for either existing *or new* resources. The same tariff provision also appropriately recognizes that new self-supply is out of market.

Shanker Supp. Test. at 32:16–33:2; *see also* Shanker Supp. Test. at 32:12–36:23; Kalt Test. at 15:7–16:6

The problem with this unstated assumption, and therefore the entire argument, is that it is without basis in the tariff or load's filings, and is contradicted by the observed facts. Nothing in the tariff requires load to add self-supply only when it chooses to increase load by the same amount. To the contrary, the history of the FCM, *see supra* Section I.C, shows a massive buildup of all types of load-sponsored capacity resources in FCM even while overall demand was flat. In fact, load entities could never commit to add self-supply exactly in step with increases in demand, because, with rare exceptions, the overall level of demand growth is not

within their discretion.[2] Consumers decide independently whether, where, and when to increase or decrease their demand, and the ISO develops an aggregate load forecast reflective of its forecast of the future year peak loads. Load then must proceed to decide how to meet that consumer-set demand:

> For any given level of demand in the system, there is a discrete decision to make regarding how that demand for capacity will be met. There is no simultaneous or instantaneous appearance of offsetting supply and demand. It makes more sense to see this decision process as sequential, with anticipated actions or alternatives available to meet the load requirements via existing or new supply. Whether for existing or new, the alternative should always be to seek the lowest cost supply.
>
> Dr. Wilson seems to suggest that as long as the self-supply procured equals or is less than demand, the fact that new resources can be used, even when there is a surplus, is irrelevant and has no impact on the rest of the market. That simply is not so. If the decision were to procure *new* uneconomic supplies bilaterally, when cheaper existing resources were available, the overall level of supply would be expanded, and prices, but for mitigation such as the proposed APR, would be artificially depressed.
>
> Inherent in Dr. Wilson's analysis is the belief that the bilateral self-supply doesn't change the level of overall supply, but this is not necessarily true, and it is precisely when this is not true that is of concern in this proceeding. If the party engaging in self-supply procures additional OOM resources, such as a request for proposal for new-only generation, regardless of the cost of existing generation via the FCAs, then the overall supply is increased, and prices suppressed. Visually, this can be seen by comparisons to the equivalent of Dr. Wilson's curves by holding demand constant and shifting supply via the artificial price taking (e.g., zero) bid of the new, uneconomical, OOM resources. *See* NEPGA Exhibit 8-A. Clearly the self-supply action in the face of excess existing resources suppresses prices.

Shanker Supp. Test. at 33:3–34:2.

Realistically, the choices available to load and their consequences are quite different than from those assumed by self-supply advocates. As far as any load party is concerned, overall levels of demand and the amount of demand it must meet are largely fixed. The only choice for

[2] Further, the market rules governing the use of self-supply designations is based on the capacity responsibility or ICAP tags of the load serving entity at the time the self-supply request is made. As a result, self-supply is made based on historic peak load responsibility of the existing customers the entity serves.

load entities is whether to meet that demand through self-supply or by procurement in the auctions. If a load entity designates 1,000 MWs as self-supply, the effect is to pre-clear that 1,000 MW, removing it from the auction and shifting the demand curve to the left by that amount. This will have *exactly* the same effect on price as if the load entity had offered that 1,000 MW into the auction at a price of $0, shifting the supply curve to the right by that amount. Just as 1,000 MW offered into the auction at $0 is an effective tool for artificial price suppression, so to is designating 1,000 MW of capacity as self-supply. The auction price impacts are indistinguishable.

If new and old self-supply is granted a blanket exemption from OOM status, the APR will become a dead letter. Load interests wishing to exercise buyer market power would effortlessly switch from (1) bidding their OOM projects into the market at anti-competitive prices to (2) designating them as self-supply. Either approach creates exactly the same price suppression effect. Seeking to defuse this obvious problem, load points to the fact that tariff permits self-supply only up to the level of load served by the entity. EMCOS First Brief at 7. But this misses the point entirely. A load entity is unlikely to spend more money to self-supply *all* of its requirements. It is, instead, likely to pursue a strategy of self-supplying only a *portion* of its requirements, up to the point that causes the price to crash sufficiently to create net benefits for the rest of its portfolio. And the load entities serving the largest amounts of demand have the most powerful incentive to artificially suppress capacity prices.[3] Hence, this limit on self-supply would not bind the very entities to whom artificial price suppression is most attractive.

[3] The fact that some LSEs contract away their load responsibility to competitive market participants is not to the contrary. This current practice, and whatever state laws underlie it, would easily be changed once self-supply becomes the most effective loophole in the APR.

2. Efficient Self-Supply Benefit from an Effective APR

An effective APR without a self-supply loophole would be a benefit, not a harm, to efficient self-supply for two reasons:

First, as Mr. Stoddard explains, Stoddard Supp. Test. at 9:3–8, a competitive, un-manipulated capacity price—such as the APR price under an effective APR—reveals useful information to all market participants. This price information is particularly valuable for market participants that, for whatever reason, prefer to fulfill their capacity obligations through self-supply or bilateral arrangements outside the FCA.

Second, contrary to the impression created by the arguments of load advocates, OOM designation does not lock it out of the market or otherwise penalize it or its sponsors. The principal effect of OOM designation on a resource is that, for purposes of setting the APR price, its offer is mitigated to a price reflecting its levelized cost of new entry. (Its offer in the FCA auction remains unaffected). For an efficient resource—one with costs below the APR clearing price—this change has no effect. It clears, regardless of whether it is offered at its cost or at $0, and the APR clearing price is the same as if the resource had not been designated as OOM. Such a resource has nothing to fear from the APR.

Inefficient new self-supply—self-supply with costs above the APR clearing price—would be affected by OOM designation. But it is unclear why load would be eager to engage in and protect inefficient new self-supply. Inefficient new self-supply, by definition, costs more than the APR price. So any entity that uses inefficient self-supply *must* incur higher costs than if it had just relied upon the market to serve its needs, even at the higher APR price (and much more so if some capacity resources are paid a lower FCA price).[4]

[4] There are only two plausible explanations for why load entities would engage in inefficient self-supply. One possibility is that these sponsors might make incorrect predictions about trends in capacity prices, purchased

3. Even Inefficient Self-Supply Can Be Accommodated Under an Effective APR

While blanket mitigation exemption for self-supply would render the APR easily avoidable and efficient self-supply has no need for an exemption, it is possible to design a limited exemption for self-supply that provides load entities with the opportunity to hedge their exposure to capacity price fluctuations using self-supply. Hearing Order at P 77. *See* Stoddard Supp. Test. at 16:1–18:23.

Dr. Shanker has offered one such proposal:

> New self-supply would also be part of the mitigation process described just above and entered into the Tier 1 APR price determination at its proxy level. Further, new self-supply should not be allowed to offset capacity requirements after the determination of the Tier 1 price (as could be allowed for existing self-supply resources) *unless* the new self-supply's proxy price would clear the market at the Tier 2 FCA price. If the new resource at its proxy price cannot clear the market at the Tier 2 FCA price, then the party procuring these resources should not be allowed to offset its capacity requirements with these resources. The purchasing party should only receive a financial credit, based on the FCA clearing price (i.e., Tier 2 FCA price), for the self-supply quantity. It should not have its capacity requirement reduced by this additional new self-supply amount. An approach such as this effectively puts a cap on self-supply at existing levels, *unless* the incremental self-supply would clear at the Tier 2 FCA price. …
>
> This would be a function of the specific bilateral contract between the party purchasing the uneconomic new entry and the seller. The market recognition of the value of the uneconomic new entry would be at the lower FCA Tier 2 price—unless the resource could clear at the FCA Tier 2 price based on its proxy value. In that case, it would be allowed to offset the capacity requirements of the party

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unneeded and overpriced capacity resources for self-supply, and are now stuck (or rather, have left their ratepayers stuck) with the costs of their miscalculation. The other possibility is that they would consciously purchase overpriced self-supply for the purpose of artificially depressing capacity prices.

While the advocates of a self-supply exception do not state which of these reasons they believe applies, they implicitly admit that their self-supply is inefficient. For example, a figure in the testimony of EMCOS's expert purports to illustrate the effects of the APR on the offer stack. John Wilson Aff. at 7 (Figure 1). According to this figure, the self-supply quantity is in the supply stack at $0 without the APR, but with the APR (and without any special exemption for self-supply) the self-supply appears nowhere in the supply stack. Because the sole effect of the APR would be to re-price the self-supply quantity at cost rather than $0, the only way to interpret that figure—unless unintentionally erroneous or deliberately misleading—is that the cost of self-supply is not only above the clearing price, but so far above the clearing price that it was pushed entirely out of the diagram. *See* Shanker Supp. Test at 32:13–34:2.

> claiming the resource as self-supply. How the parties partition the difference between the FCA Tier 2 price and the bilateral price and the overall obligations of the buyer in the capacity market would be a matter to be addressed in the contract between buyer and seller.
>
> What is important is that such contracts, whenever they are for uneconomic new entry, should not be allowed to distort the pricing for other existing resources. If the municipality wishes to enter into any such new contracts it is free to do so, but the financial consequences have to be isolated to the municipality and the seller under the contract and should not distort the overall market. Presumably, this would not be a problem if the municipality procured in a non-discriminatory fashion from all alternatives. In a market with excess supply, that would mean procuring existing resources that would receive the APR price under the proposed APR. Similarly, when there is no intent to price discriminate, there would be no reason not to enter into bilateral agreements *after* the FCA. It would actually be expected that the FCA result, absent distortion, would actually support more efficient bilateral procurement. *See* Stoddard Supp. Test. at 9:3–8.

Shanker Supp. Test. at 35:13–36:23.

Notably, this proposal permits load to retain all currently-existing capacity obligation offsets using self-supply—efficient or inefficient—it currently enjoys. Moreover, there is nothing to prevent the addition of new self-supply capacity resources. As long as these new self-supply resources are efficient (that is, less expensive than fulfilling the obligations through the auction), they will continue to fully hedge load entities against price fluctuations. Only new inefficient self-supply resources that are more expensive than the FCA Price are discouraged under the Shanker proposal. But self-suppliers seeking to fulfill their obligations in a cost-effective manner—rather than to artificially suppress capacity market prices—would not aim to construct inefficient capacity resources anyway. Therefore, load entities without improper motives have little reason to object to the Shanker proposal.

III. ALL ZONES SHOULD BE MODELED, SUBJECT TO APPROPRIATE MITIGATION

Load interests rehash their now oft-repeated arguments that zones should not be modeled because doing so may increase prices or make it more likely that market power may be unlawfully exercised. They manufacture theories that locational pricing is failing in PJM, or that

existing generators are erecting barriers to entry by controlling sites for new builds, or that generators are colluding to affect price. But there is no indication that any of this is actually the case.

We reiterate here, as we have time and time again, that market efficiency demands the modeling of all zones all the time. If there are legitimate market power concerns, the solution is to apply appropriate monitoring and mitigation. In support, we rely upon world-renowned economists. Load has no such support.

ISO-NE agrees that all zones should be modeled, but has proposed an Orwellian mitigation regime that assumes all de-list bids are an exercise of market power and essentially mitigates them out of existence. This is a fundamental change to the FCM design that ISO-NE has wholly failed to justify, or to consider its consequences, and it must be rejected.

A. ISO-NE's Proposal to Model Additional Zones Should Be Approved, With One Modification

With one exception discussed below, we continue to strongly endorse ISO-NE's proposal to model additional zones in advance of the auction, as we highlighted in our First Brief. *See* Stoddard Supp. Test. at 52:16–20; *see also* NEPGA First Brief at Section III.B. Professor Milgrom explains the benefits of this approach:

> There are two advantages.
>
> First, full modeling of zones reduces the need for guesswork about which zonal constraints will bind, requiring additional local resources to ensure the reliability of resource supply. No one can be certain before the auction whether a zonal constraint will be binding. In a standard sealed-bid auction system, zonal constraints do not affect the course of the auction and if they do not bind, they have no effect on the cleared resources or on the prices. So, the system eliminates guesswork.
>
> Second, zonal pricing has the usual advantage of a market system of generating price signals that inform other potential suppliers about opportunities to supply valuable capacity *in the right places*. It is these price signals that guide private

> sector entry and innovation and that encourage unanticipated solutions to resourcing problems.

Milgrom Test. at 17:5–15. By modeling a greater number of zones in *advance* of the auction, ISO-NE's proposal meets these objectives.

We do have one concern with ISO-NE's proposal, however. ISO-NE no longer plans to include rejected de-list bids as OOM capacity, and "consequently, such bids would no longer be allowed to set the capacity price paid to any other capacity resource." Stoddard Supp. Test. at 49:21–22. Thus, a unit that tried to de-list can be forced to stay in the market for reliability reasons and also re-priced in the capacity auction to a level that suppresses prices paid to other existing resources. ISO-NE argues in support that its plan to model smaller zones will "naturally capture the sorts of transmission constraints that currently lead to de-list bids being rejected for reliability." ISO-NE First Brief at 38. But as Mr. Stoddard testifies, this still leaves gaps in the design "that could, under some scenarios, lead ISO-NE to reject de-list bids for reliability." Stoddard Supp. Test. at 51:1–2.

A better approach is the one Mr. Stoddard proposed in his initial testimony, which is to "potentially creat[e] sub-zones when a de-list bid is rejected for reliability." *Id*. at 51:21–22. As Mr. Stoddard explains:

> Following an FCA in which a de-list bid was rejected for reliability, ISO-NE would identify the largest sub-zone possible of resources that serve a comparable reliability function. In all subsequent FCAs, this sub-zone would be modeled. In the Commitment Period covered by that FCA, however, these comparable resources would receive only their FCA clearing price, not the price of the rejected de-list bid.

Id. at 51:22–52:4. While it would be better to model every constraint in the first instance, this may not always be possible. Mr. Stoddard's proposal is a good second-best solution, as it only results in a one-year lag in modeling a binding constraint (when a de-list bid has been rejected for reliability). It is also a market-based solution to a problem that has arisen in the past (the

failure of prices to separate even as de-list bids are rejected for reliability), and could recur in the future, even under ISO-NE's proposal. This possibility is foreseeable, and should be addressed now.

B. Load's Arguments Against Modeling Zones Should Be Rejected

Load largely opposes ISO-NE's proposal to model additional zones. It is not, of course, coincidental that the load parties most adamantly opposed to locational prices are those that are located in historically constrained zones where price separation is more likely to occur—EMCOS in the Northeastern Massachusetts ("NEMA") load zone (*see* John Wilson Aff. ¶ 23), CMEEC in Connecticut, MMWEC in Massachusetts, and most of the Supporters (minus the Maine Public Utilities Commission, which abstained from NECPUC joining the filing (*see* Supporters First Brief at 1 n.2)); *see also* Shanker Supp. Test. at 17:12–15 (prices increase in unconstrained regions whenever constraints are ignored and costs are socialized across a broader region). Load in these areas has an obvious incentive to spread locational costs across New England as a whole. But that is not good market design. Regardless, load raises no issues that justify failing to model zones.

1. Market Power Concerns Do Not Mean that Zones Should Not Be Modeled

Load's primary argument against modeling zones continues to be the risk of the unlawful exercise of market power as zones become smaller. *See, e.g.*, ISO New England Inc., Docket Nos. ER10-787-000, *et al.*, Comments of National Grid USA in Support of Agreed Revisions to Forward Capacity Market at 12 (July 1, 2010) ("NGrid Comments"); Supporters First Brief at 41–42. Load's two experts, Dr. Wilson and Mr. Wilson, cite various alleged market power concerns and urge "a cautious approach" to increased modeling. *See, e.g.*, James Wilson Test. at 25:13–15.

This does not mean that all zones should not be modeled, but only that, to the extent market power arises, it should be appropriately mitigated. Every other expert in the case that addressed this issue confirms this is the correct course of action, as follows:

- *Dr. Patton, ISO-NE External Market Monitor*

Dr. Patton explains that the solution is "strengthening the market power mitigation measures" rather than failing to model zones. Potomac Economics Comments at 7.

- *Robert Stoddard*

Mr. Stoddard testifies that "the market design should not be compromised because of abstract concerns over market power. First, implement a sound market design. Second, develop market power mitigation rules that complement that market design. Any other path will guarantee that markets will fail to produce the required results." Stoddard Supp. Test. at 54:7–11.

- *Dr. Shanker*

As Dr. Shanker observes:

> In reality, [Dr. Wilson's] comments are based on nothing more than the belief that small zones may be subject to the exercise of market power. To whatever extent this is true, the solution lies in the mitigation of any such market power, not ignoring legitimate constraints reflecting the need for locational capacity resources.
>
> Indeed, if anything, the continued conflation of these two concepts suggests that the true objective *is* to maintain price discrimination and lower prices in constrained areas (even though it results in increased prices elsewhere) and to continue solving the wrong auction formulation, rather than addressing the exercise of market power.

Shanker Supp. Test. at 37:19–26.

> The general notion that a material constraint should be ignored in price formation when it binds is illogical. FCM is designed to procure capacity when and *where* it is needed. Failing to model zones defeats this locational objective. As I previously stated, there may be legitimate concerns regarding appropriate mitigation, or even the complexity associated with the proper auction price determination process (whether to use a descending clock auction or something else). But these require actions regarding market mitigation, and possibly

> increased technical sophistication in the solution "engine." Neither consideration justifies not defining the right problem and solving it. Mr. Wilson is advocating that the wrong problem (e.g., one ignoring material transmission constraints) be formulated and solved, explicitly encouraging under-pricing within constrained areas. Paradoxically his proposed approach will actually lead to *higher* prices for market participants across the entire rest of New England. That is what happens when locational constraints are ignored and locational costs are socialized across a broader region.

Id. at 17:2–15 (footnote omitted).

- *Professor Milgrom*

Professor Milgrom agrees and provides the following context:

> There are three important issues to keep in mind when evaluating the relationship between modeling of zones and market power.
>
> The first concerns the goal of promoting efficient, price-guided capacity decisions in the FCM. With that goal in mind, it makes no sense to suppress important zonal distinctions to establish a single market price. Such a price cannot guide efficient decisions, because it necessarily fails to reflect the actual situation in constrained zones. Such a price does not encourage the development of new capacity where it is most needed and it needs to be supplemented by extra rules, deviating from the single-price rule, even to avoid retirement of existing capacity that is urgently needed.
>
> I list this issue first because it is foundational: if important zonal price distinctions are suppressed, then any policy successes in mitigating market power are Pyrrhic victories. To the extent that the underlying zonal model is unrealistic, even a perfectly functioning competitive market would fall short of achieving efficient outcomes. Full modeling of relevant zones is necessary for the FCM to promote efficient outcomes.
>
> Second is the *structural* market power issue, which is entirely separate from the zonal modeling issue. If some supplier is pivotal—if its supply is needed to meet local resource requirements in a zone—then some mitigation of that market power will be needed. Without mitigation, a pivotal seller could potentially hold out for a very high price for all of its resources in that zone. This conclusion, however, holds regardless of whether zones are fully modeled and regardless of any other market rules. The market power problem cannot be avoided just by pretending that the relevant zone does not exist.
>
> The proper response to market power is to mitigate it. Attempting to combat structural market power by eliminating the modeling of zones cannot fix the problem, but it can certainly undermine the efficiency of the market outcome and make the market unsustainable over the long run. To decide correctly about the

> need for mitigation, one must assess whether a seller is pivotal after taking account of *all* the potential suppliers in the same zone. It is not correct to exclude new resources when assessing whether an unmitigated supplier can disrupt the system by withholding some of its capacity.
>
> Third is the issue of auction market design. Bad auction rules—especially ones that provide too much information—can make it easier for a seller to detect when it is pivotal and how much capacity it needs to withhold to manipulate the market. Really bad auction rules could make it easier for a group of sellers which are jointly pivotal to coordinate. It is not my objective today to advise on the best auction rules, but I do wish to point out that it is easy to avoid bad rules of the kinds just described. The most standard kinds of sealed-bid auctions largely avoid these problems because they do not provide the extra information that can enable sellers to exercise market power.

Milgrom Test. at 14:3–15:15; *see also id.* at 16:12–17:2 (if the descending clock auction causes any unneeded complexity to modeling all zones, it could easily be replaced by a sealed-bid auction without any loss of market benefits).

In short, there is no justification for failing to model zones because of market power concerns.

2. Modeling Zones Does Not Guarantee That Prices Will Separate

The Public Systems argue against "any perceived imperative to change the FCM market rules radically in an effort to *ensure* that zonal capacity prices separate." Public Systems First Brief at 22 (emphasis added). This is a warning against a threat no one has made. Modeling all zones all of the time does not "ensure" price separation. It only permits it. Prices will only separate if constraints bind. As Dr. Shanker explains in response to Dr. Wilson, EMCOS' expert, the rules should:

> Allow for zonal separation and, if Dr. Wilson is correct, it just won't occur. Thus, at worst, the zonal separation constraint in the market settlement would turn out to be superfluous. However, if separation does occur, as manifest recently by rejected de-list bids, the zonal representation is needed to provide the necessary locational capacity and pricing that truly reflects system conditions. The conclusion should be clear that you always model the zones.

Shanker Supp. Test. at 37:12–18. The current rules, on the other hand, *prohibit* price separation when constraints would otherwise be binding because zones are not modeled in the first instance.

3. There Is No Evidence That the PJM Capacity Market Is Being Systematically Gamed to Increase Locational Prices

The Supporters and their expert, Mr. James Wilson, launch a lengthy attack on the PJM locational capacity market design, arguing that the "evidence" suggests that generators are exercising market power in smaller zones and that higher prices are not attracting more capacity relative to the Rest of RTO zone. *See* Supporters First Brief at 40–41. They assert that:

> PJM's experience with separate zones has shown the fallacy of relying on mitigation to replicate a competitive market. Despite mitigating every offer in the constrained zones because they all failed the structural market power screen, suppliers were still able to withhold capacity or to increase their capacity offers and thereby to inflate the market clearing prices in the zones.

Id. at 47 (citing John Wilson Test. at 27:2–14).

If this all sounds familiar to the Commission, it should; the Commission rejected substantially similar claims made by the same expert and some of the same lawyers in a complaint brought by load parties against PJM. *See Md. Pub. Serv. Comm'n v. PJM Interconnection, L.L.C.*, 124 FERC ¶ 61,276 at P 30 (2008), *reh'g denied*, 127 FERC ¶ 61,274 at P 13 (2009); *see also Md. Pub. Serv. Comm'n v. PJM Interconnection, L.L.C.*, Docket No. EL08-67-000, Complaint of the RPM Buyers, Attachment A, Affidavit of James F. Wilson in Support of Complaint of the RPM Buyers (May 30, 2008). The Commission denied that complaint in full.

The complaint there involved the initial "transitional" auctions in PJM's capacity construct, RPM, and the allegations of a group of "RPM Buyers" that notwithstanding complete mitigation, sellers still exercised market power. The Commission rejected these claims, finding as follows:

> In fact, in the transitional auctions, every offer by generators was subject to the mitigation process established in the tariff, under which the market monitor

> approves a rate designed to represent the seller's avoidable costs, and those rates are used to establish just and reasonable offer prices. The PJM Market Monitor reviewed those offers and concluded based on his review that "[t]he data do not support the claim that suppliers could offer prices well in excess of avoidable costs." In contrast to the PJM Market Monitor's unequivocal statement, RPM Buyers have offered nothing other than suggestions and speculation that parties may have, or could have, exercised market power, despite complying fully with the tariff.

Md. Pub. Serv. Comm'n, 127 FERC ¶ 61,274 at P 13 (citations omitted).

Mr. Wilson raises essentially the same claims about PJM in his testimony in this case, but for later RPM auctions, and with the focus shifted somewhat to smaller zones instead of the PJM region as a whole. Yet nowhere in his testimony does he acknowledge the prior rejection of his very similar earlier analysis at the Commission. The Supporters who sponsored his testimony never cite it either. Apparently they consider their claims about PJM in this case—that RPM is subject to rampant market manipulation notwithstanding full mitigation and market monitor certification of the results—to be so different from the claims in the Maryland complaint proceeding—that RPM is subject to rampant market manipulation notwithstanding full mitigation and market monitor certification of the results—that there was no need to distinguish or even mention it. To be clear, the Commission rejected similar claims before, and should give them no credence now.

Even setting aside this prior history, Dr. Shanker fully repudiates Mr. Wilson's flawed analysis of the PJM market results to date. *See* Shanker Supp. Test. at 16:6–30:22. With respect to Mr. Wilson's conclusion that locational pricing in RPM has not attracted new entry, Dr. Shanker demonstrates that:

- Mr. Wilson ignores RPM's bias in favor of transmission solutions when locational constraints are binding. *Id*. at 18:11–20:14.

- Mr. Wilson only looked at relative prices between zones without taking into account the expected average net costs of new entry or the anticipated margins that a new entrant might need. *Id*. at 21:1–22:2. The fact that price separation has

occurred does not mean that prices have risen to levels sufficient to support new entry.

- Similarly, Mr. Wilson nowhere demonstrates that it would have been profitable for a new entrant to build in a constrained zone in PJM in the RPM auctions held to date. *Id.* at 22:3–23:12.

- Mr. Wilson also ignores the effect of state-sponsored OOM entry in PJM. *Id*. at 25:3–16.

Mr. Wilson's failure to recognize these points invalidates his conclusion. *Id*. at 16:9–20.

Mr. Wilson's other conclusion about RPM is that it is being systematically gamed to increase prices in smaller zones. Mr. Wilson has no evidence for this point, only rank speculation. *Id*. at 24:7–25:2. Essentially, his only support is the bald statement that "there has been little new entry; *ergo,* market manipulation." He specifically cites existing generators' control over power plant sites as one means by which generators are manipulating the markets. But he has no support whatsoever for this bare claim. He never even attempts to show how existing generators control all potential sites, and somehow are able to block all others from accessing any sites. *Id*. at 26:1–9; *see also id*. at 27:3–28:9 (demonstrating that new developers are actually quite adept at finding new sites). In fact, site control information is publicly available, as any entity with market-based rate authority is required to submit quarterly site-control filings to the Commission (*see* 18 C.F.R. § 35.42(d)), but Mr. Wilson apparently did not analyze this data.

His wholly unsupported claims should be rejected out of hand, just as his similarly unsupported claims were rejected in the Maryland complaint proceeding. *See Md. Pub. Serv. Comm'n*, 124 FERC ¶ 61,274 at P 13 ("RPM Buyers have offered nothing other than suggestions and speculation that parties may have, or could have, exercised market power, despite complying

fully with the tariff. These unsubstantiated suggestions do not meet the burden of proof that a section 206 complainant must meet.").

Unfortunately, load's tendency to assume the unlawful exercise of market power everywhere—at least on the seller side—extends to FCM as well. Dr. Blumsack, on behalf of the Supporters, argues that even *competitive* bids may be used to exercise market power. Supporters First Brief, Exhibit DPUC-23, Direct Testimony of Seth Blumsack, Ph.D on Behalf of First Brief of the Joint Filing Supporters at 7:12–16; 21:3–13 (July 1, 2010) ("Blumsack Test."). As Professor Milgrom explains:

> Dr. Blumsack's testimony about this is muddled because it has no anchor: it attempts to analyze the threat of market manipulations in the FCM without relating it to the foundational issue of how markets can promote efficient, price-guided decisions.
>
> When a competitive bid triggers a capacity zone, which means that it causes the relevant zonal price to differ from that of unconstrained zones, that is just what it should do. That trigger causes prices to be correctly aligned with the cost of supplying that zone, thereby fulfilling a key objective of markets. To characterize such a bid as a manipulation and suggest that it needs to be mitigated evidences a fundamental misunderstanding of how competitive markets are supposed to work. When the competitive supply in a zone falls short, the competitive price rises. To claim there is something improper or manipulative about that is to misread the law of supply and demand.

Milgrom Test. at 16:1–11; *see also* Stoddard Supp. Test. at 45:1–16; McAdams Supp. Test. at 39:13–41:3. Many load parties simply do not believe in markets (or do not understand them), but that ship has sailed. The Commission's longstanding policy is in favor of competitive electricity markets.

4. Modeling Zones in Advance Supports Efficient Transmission Investment

NGrid claims that increased zonal modeling "would undermine development of New England's transmission infrastructure" because capacity prices allegedly only send "market price signals to *generation* and *demand* resources." NGrid Comments at 6–7 (initial caps omitted;

italics in the original); *see also* Public Systems First Brief at 21–22 ("The region's success in planning, funding, and completing construction of new transmission facilities in recent years calls into question—or at least counsels caution with respect to—any perceived imperative to change the FCM market rules radically in an effort to ensure that zonal capacity prices separate."). EMCOS make a related assertion that "the extent (if any) to which New England any longer experiences significant transmission constraints should be open to serious question." EMCOS First Brief at 13 (citing John Wilson Test. ¶ 20.)

But as Mr. Stoddard explains, increased zonal modeling will not devalue recent transmission investment and should actually assist in regional planning and lowest-cost investment to meet reliability needs:

> [The] Public Systems correctly note that billions of dollars have recently been invested in transmission upgrades throughout New England to address reliability concerns. Good market design will reflect the additional reliability benefits of those upgrades, and indeed the Local Sourcing Requirements for each Capacity Zone are set by ISO-NE based on a detailed examination of the system. If recent transmission upgrades have eliminated constraints, ISO-NE's examination will reflect that fact. Therefore, nothing about the proposal to model all Capacity Zones, all the time, diminishes the value of the transmission investment made in the region. To the extent, though, that local reliability issues remain, it is important that capacity prices reflect the need to carry location-specific capacity to address those issues.
>
> Appropriate modeling of capacity zones is not merely reactive, however; it can aid the planning process by appropriately valuing transmission upgrades. Some reliability needs can be addressed more economically by generation than by transmission, so a policy that builds out transmission to address all local reliability needs may be unnecessarily expensive. A locational capacity market, with properly modeled zones, may avoid or defer transmission upgrades by identifying lower-cost, market-based solutions from generation or Demand Resources. On the other hand, if a transmission solution is a more efficient response, the locational capacity market is likely to prompt its construction.

Stoddard Supp. Test. at 53:6–54:3. Transmission will continue to receive the signal to be built when it is the most efficient resource to address a reliability issue.

5. The Commission Has Already Ruled That Locational Issues Are Subject to Hearing

Load also argues that the Commission has previously rejected modeling all zones in advance in New England, and that this question should not be revisited here. *See, e.g.*, Supporters First Brief at 39. But the Commission itself has already set this issue for hearing and thus indicated that it is open to reevaluation. *See* Hearing Order at P 18. The Commission's original action also was in the context of the overall FCM settlement, and experience under FCM has shown that the settlement deal for locational pricing has been a failure.

This argument thus fails, along with all of load's other attempted rationales in opposition to modeling zones in advance. The Commission should approve ISO-NE's zonal modeling proposal with the exception highlighted above regarding rejected de-list bids.

C. The Commission Should Reject ISO-NE's New Proposed Mitigation Regime

ISO-NE couples its proposal to model all zones with a pervasive new mitigation regime that has become even more broad since ISO-NE first presented its proposed market changes to stakeholders on June 15. Under this new mitigation regime, only dynamic de-list bids below $1/kW-month would bypass the exhaustive 8-month market monitor review of static and permanent de-list bids. The current standard is 0.8 times CONE (or $6/kW-month for FCA #1, held just *three* years ago). All static and permanent de-list bids above $1/kW-month would also be subject to market monitor review. The standards to measure going-forward costs also would be substantially modified. For most de-listed resources, going-forward costs would—according to ISO-NE—be close to zero. Under this proposal, there no longer would be any need for a pivotal supplier test because everyone essentially would be mitigated all of the time. *See* ISO-NE First Brief at 46–47. And these standards would apply everywhere, regardless whether a resource had any ability to exercise market power.

While we agree that modeling all zones in advance requires that market power be appropriately mitigated, ISO-NE's proposal *over*-mitigates. It would establish "competitive" bids at nearly the lowest conceivable levels, so that de-list bids no longer would be a viable market option. One of the most basic design concepts of the FCM—the right to competitively de-list—effectively would be written out of the tariff.

As discussed below, mitigation should be narrowly tailored to address structural market power where it has been found to exist. ISO-NE has made no effort to meet this test. It just states—without support—that it cannot model all zones without its new "you cannot de-list" mitigation regime. The Commission should reject this "Hotel California" approach to mitigation.[5]

1. The New $1/kW-month Threshold for Dynamic De-List Bids Should Be Rejected

ISO-NE argues that a competitive de-list bid "is one that reflects a resource's going forward or opportunity costs." ISO-NE First Brief at 50. For dynamic de-list bids—which are those submitted during the auction and which do not require prior ISO-NE approval—ISO-NE proposes a competitive proxy based on the *lowest* results of annual reconfiguration auctions held to date, which ISO-NE calculates as $1/kW-month. *Id*. at 50–52. Dynamic de-list bids thus will only be permitted if they are less than $1/kW-month.

a. The Reconfiguration Auctions Are an Inappropriate Proxy for Competitive De-List Bids

As Mr. Stoddard testifies, this approach "is flawed in both concept and its particulars." Stoddard Supp. Test. at 26:14–15. 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

[5] "You can check out anytime you like, but you can never leave." Eagles, *Hotel California*, *on* Hotel California (Asylum Records 1976).

reduced trading volume. *Id*. at 26:18–28:2. And ISO-NE has compounded the error by using the lowest possible reconfiguration auction clearing price—out of three separate reconfiguration auctions—as its starting point for a competitive offer.

As Mr. Stoddard explains, 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 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.

Much better data is readily available, including past RMR filings in New England. *Id*. 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 testifies:

> 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 ISO New England Inc.*, Docket Nos. ER10-787-000, *et al.*, Initial Brief in Paper Hearing on New England's Forward Capacity Market, Attachment A, Affidavit 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").

There may also be serious unintended consequences from setting the dynamic de-list threshold so low. It is possible, for example, that as prices fall to very low levels, an excess of resources may de-list at the $1/kW-month threshold, potentially causing a shortage with no mechanism to sort it out. It is also unclear how the $1 threshold will affect imports from NYISO. There has been no consideration of these issues, at least not in any of the First Briefs.

b. ISO-NE's New Mitigation Proposal Changes the Fundamental Purpose of Dynamic De-list Bids

In the FCM market design, dynamic de-list bids were intended to be a market mechanism to enable capacity prices to not deviate too far below the long-run average cost of new entry when surplus conditions occur. This was necessary because the FCM design eliminated a sloped demand curve.

ISO-NE's pervasive new $1 mitigation regime eliminates any ability for dynamic de-list bids to fulfill this role. As Mr. Stoddard explains:

> A more serious loss to the intended market design, though, would be the effective removal of an important price stabilization mechanism in the FCM. I discussed this point in my July testimony. 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 price in the long run. Give 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). ISO-NE states that "[a]bsent mitigation, the ability of existing resources to leave the market would enable resources that possess market power to use it and raise the price above competitive levels through de-list bids." ISO-NE First Brief at 47. But this was by 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). Mr. Stoddard explains why this was good market design, in response to testimony from the Supporters' witness, Dr. Blumsack:

> A bid does not have to be reviewed by the market monitor in order for it to be competitive. In a well-designed market, the primary "market monitoring" is the competitive dynamic of the market itself. The IMM and direct mitigation of bids should serve as a backstop, not the default.
>
> Competitive de-list bids, or de-list bids reviewed by the IMM, should be allowed to create zonal price separation. This is the standard in the energy markets, and there is no rationale for deviating from this standard in the capacity markets. Dr. Blumsack does not consider the consequences of failing to allow zonal price separation because of some real or imagined market power issue. Genuine cost difference in meeting the reliability needs of different zones cannot simply be wished away. Suppose that, as the auction price ticks down, the price falls to a point where the capacity remaining in a zone equals the LSR, but there is a surplus in the Rest of Pool region. If the auction price is allowed to tick down further in the constrained Capacity Zone, additional capacity may de-list and the LSR will not be met. Dr. Blumsack would have ISO-NE ignore this fact if the marginal de-list bid is either a Dynamic De-list Bid or a Static De-list Bid from a pivotal supplier. But what is ISO-NE supposed to do then? Presumably he would have ISO-NE reject those de-list bids for reliability reasons, pay the marginal resources their bids, and continue to tick down the auction until the Rest of Pool surplus equals zero. But this approach is exactly parallel to the pre-SMD energy market design, where NEPOOL established a single regional price and paid as-bid for congestion relief. This "pay as bid" congestion management was correctly discarded. Likewise, the Commission has already determined that a locational capacity market is required in New England. Ignoring genuine cost differences reflected in competitive or properly mitigated de-list bids is directly counter to the proper development of a locational capacity market.

Stoddard Supp. Test. at 54:12–55:18 (footnotes omitted).

If dynamic de-list bids no longer will be permitted to serve this role, then the Commission should implement a demand curve, as we have previously advocated. NEPGA First Brief at 64–68; *see also* Stoddard Supp. Test. at 3:19–4:2. As Mr. Stoddard explains:

> Although a demand curve is not strictly required in theory, it now appears that, in practice, a demand curve is the only plausible means of both moderating price volatility and ensuring just and reasonable prices in the New England capacity markets, given the other structural proposals that have been offered by ISO-NE.

Id. at 3:20–4:2.

Finally, on a related point, ISO-NE's proposal ignores the context of the current tariff. The market rules do not require ISO-NE to purchase all needed replacements for de-listed resources in the FCA, but instead it can push off a decision on what to buy in the Reconfiguration Auctions. Thus, ISO-NE's proposal gives itself unreasonable discretion.

2. Proposed Changes to the Mitigation Rules for Static and Permanent De-list Bids Should Also Be Rejected

For static and permanent de-list bids—which are both submitted far in advance of the auction—ISO-NE proposes two expansive changes: *First*, it seeks to review all bids above $1/kW-month (currently it only reviews bids above 0.8 times CONE and 1.25 times CONE, respectively). *Second*, it seeks to "recast what costs and revenues it includes in determination of a reasonable bid level." *Id.* at 37:14–15. Neither change is warranted.

ISO-NE does not explain why it now needs to review all static and permanent de-list bids above $1/kW-month. As Mr. Stoddard explains:

> I agree that the Static De-list Bid review threshold should be equal to the Dynamic De-list Bid price threshold, although I disagree that any change is needed to either one of these thresholds. . . . [T]he 1.25 times CONE review threshold for Permanent De-list Bids was a well-reasoned level, was agreed by stakeholders, and was accepted by the Commission as part of the FCM Settlement Agreement. I am not aware of any evidence that the review threshold has been abused or has been insufficient, and in light of the substantial surplus capacity and abundant offers of new capacity, I cannot construct a credible example in which a

> Permanent De-list Bid below 1.25 times CONE could be used to increase prices profitably to a supplier. I see no reason or rationale for a change in this rule.

Id. at 37:21–38:8. In fact, while the current rules provide for an ever-fluctuating range of bid prices that must be reviewed, taking into account the prior years' CONE, ISO-NE proposes a never changing threshold of $1.

Reviewing bids is one thing, but ISO-NE now also proposes a much more draconian standard of review. 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. Under the current tariff, this calculation assumes that the de-listing resource will exit the capacity and energy and ancillary services markets. ISO-NE now proposes to assume that any resource submitting a static or permanent de-list bid will remain in the energy and ancillary services markets. As a result, the resource would not be allowed to include in its de-list bid costs associated with participating in these markets that are unavoidable, such as labor and maintenance costs. This, in turn, will cause their going-forward costs to be close to zero. ISO-NE First Brief at 52–53.

As Mr. Stoddard explains, however, ISO-NE is asking 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 is attempting "to impose 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. This is a fundamental change in the mitigation regime which prevents capacity resources from

collecting "the 'missing money' between actual, out-of-pocket expenses and net revenue." *Id*. at 38:19–20.

No other RTO mitigates in this way. *Id*. at 39:10–40:19. 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 addition, this mitigation proposal would require the owner of the resource to forfeit its option value to remain in the energy market (perhaps as supplemental capacity backstop for its cleared capacity resources) and ancillary service market. If capacity market prices do not adequately value this option, the resource may wish to exit the capacity market. Under this mitigation proposal, they lose the value of that option. This result is inconsistent with a competitive market.

Market monitor review of all static and permanent de-list bids down to such severely low dollar thresholds will also increase the stakes that the market monitor must correctly account for costs. But several of the cost assumptions drive the numbers too low. For example:

- the delist rules explicitly prohibit use of company-specific risk factors;
- the market monitor has refused to include corporate overheads allocated to plants;
- offerors cannot use their own calculation of the likely PER adjustment, but must use ISO-NE's historic PER;
- it is unclear if company-specific projection of opportunity costs of selling into the New York capacity market will be allowed; and
- capital improvements that support a delist request must be amortized over a period of years determined by ISO-NE to reflect a useful economic life (*see ISO New England Inc.*, 128 FERC ¶ 61,266 (2009), *order on reh'g and clarification*, 130 FERC ¶ 61,108 (2010)). That useful life is based on ISO-NE's perspective,

> not the unit owner's perspective. Furthermore, the amortized costs are only allowed into static delist bids the first year of the amortization schedule; after that, the amortized capital costs are deemed "sunk" and not allowed in future delist bids. A unit owner is thus faced with a major risk that capital improvements cannot be recovered beyond year 1 of an amortization schedule.

The original $6 threshold (0.8 times CONE) allowed for at least some leeway to account for these variables. At $1.00, there is no such leeway, and each of these considerations is likely to drive the allowed costs to levels that are far too low.

As with its proposal for dynamic de-list bids, ISO-NE has made no showing that its proposed mitigation of static and permanent de-list bids is specifically targeted to limit the unlawful exercise of market power. It makes no showing that the existing mitigation rules have been inadequate, and in fact, "the high levels of offers from new supply sources has borne out the assumption[s]" underlying the existing mitigation rules. Stoddard Supp. Test. at 37:10–11. Nevertheless, ISO-NE proposes to review essentially all static and permanent de-list bids while severely clamping down on the costs that can be included in a "competitive" offer. Modeling all zones in advance does not require this pervasive level of mitigation.

3. ISO-NE's and Load's Proposals Fail the Fundamental Tests of Market Power Mitigation

It is unlawful to mitigate phantom market power. *Before* mitigation can be imposed, there must be an express finding that a resource has the ability to exercise structural market power. The courts have held that it is "the epitome of agency capriciousness" to impose mitigation and its "potential ill effects of forcing down prices *absent structural market distortions*." *Edison Mission Energy v. FERC*, 394 F.3d 964, 968–70 (D.C. Cir. 2005).

Once it has been established that mitigation is necessary, it must then 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 become some subset has market power.

Professor McAdams explains how this court and Commission 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. ISO-NE's proposed mitigation fails this test, as does Dr. Blumsack's "mitigate-even-the-competitive" proposal. *See id.* at 36:19–37:6.

Professor McAdams describes three types of "improper mitigation"—all of which are present in the proposals on the table 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*, unequal mitigation—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*, overly-broad mitigation—that is applied even to market participants without market power—imposes an unnecessary regulatory burden. *Third*, overly-restrictive mitigation—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 the original) (footnote omitted). "Unequal mitigation" exists because buyer market power is barely mitigated in contrast with seller market power. *See id.* at 35:11–36:18. ISO-NE's new proposal is also both "overly broad" and "overly restrictive." As Professor McAdams explains:

> 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 describes how this process will result in over-mitigation. *See id*. at 37:15–39:2. Load's proposed mitigation fares no better. *See id*. at 39:13–41:3.

The Commission is well aware 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" and allowed other *de minimis* exceptions to mitigation. *See, e.g.*, *NYISO*, 122 FERC ¶ 61,211 at PP 64–70 (limiting mitigation to only 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 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). This market already has enough problems with out-of-market entry without imposing a new over-mitigation regime. The proposals here are unlawful and should be rejected.

D. EMCOS and Dr. Wilson Profoundly Misread and Misuse the DOJ/FTC Horizontal Merger Guidelines

The Eastern Massachusetts Consumer-Owner Systems ("EMCOS") demand—in addition to implementation of a pivotal supplier test—"a concurrent, flat prohibition against zonal pricing in any Capacity Zone with a Herfindahl-Hirshman [sic] Index in excess of the 1800 'highly concentrated threshold.'" EMCOS First Brief at 13 (citing John Wilson Aff. ¶¶ 23–24). Dr. Wilson, in turn, claims the "Department of Justice-Federal Trade Commission Merger Guidelines" as an authority requiring the 1,800 Herfindahl-Hirschman Index ("HHI") threshold. John Wilson Aff. ¶ 23. This argument contains a series of errors, ranging from the elementary to the conceptual:

First, EMCOS and Dr. Wilson appear to be using an outdated version of the DOJ/FTC Horizontal Merger Guidelines. The *current* guidelines, *available at* http://www.ftc.gov/os/2010/08/100819hmg.pdf ("Guidelines"), were released in April and recently became final. Press Release, Fed. Trade Comm'n, Federal Trade Commission and U.S. Department of Justice Issue Revised Horizontal Merger Guidelines (Aug. 19, 2010), *available at* http://www.ftc.gov/opa/2010/08/hmg.shtm. The new guidelines offer not only directions for future regulatory review, but also "more accurately represent agencies' merger review process," *id.*, over the thirteen years

since the old guidelines, cited by EMCOS and Dr. Wilson, were released in 1997. According to the Guidelines, a market with an HHI of 1,800 is only "moderately concentrated," not "highly concentrated" as claimed by EMCOS and Dr. Wilson. *Compare* Guidelines at 19 *with* EMCOS First Brief at 13 and John Wilson Aff. ¶ 23. In fact, a market with an HHI of 1,800 is substantially closer to the threshold for "unconcentrated markets" (1,500) than the threshold for "highly concentrated markets" (2,500). Guidelines at 19.

Second, the guidelines, current and past, do offer a standard for determining what constitutes a separate market for purposes of legal and economic analysis, but this analysis is not based on HHI levels—which can only be determined *after* a market has already been defined. Product markets are defined by the "Hypothetical Monopolist Test." *Id.* at 9. Under this test, a group of products constitute an independently priced market if a hypothetical monopolist of all the products "likely would impose at least a small but significant and non-transitory increase in price ('SSNIP')" typically of 5%. *Id.* at 9. Under this test, any zone in which prices separate by at least 5% shows strong indications of being a separate market. Similarly, the guidelines' definition of geographic markets "often depends on transportation costs." *Id.* at 13. In locational power markets, the cost of transportation is reflected in the congestion component of the Locational Marginal Price, so any area which faces substantial congestion is likely to be deemed a separate geographical market under the guidelines. Under the guidelines' definition of either product or geographic markets, any zone suffering congestion is likely to be deemed a separate market.

Third, and most significantly, the guidelines use concentration thresholds *not* for defining markets, as EMCOS and Dr. Wilson attempt to use them, but for an entirely different purpose: to determine whether the agencies should subject a *proposed merger* in a market with *unregulated*

prices to particular scrutiny. *See id.* at 19. The considerations for zonal definition are of an entirely different kind. The first major distinction is that zonal definitions are constructs for economic analysis, not proposals for mergers the Commission may or may not approve. Refusing to recognize a constrained zone in a tariff does not prevent concentration, as denying a merger might. It merely refuses to acknowledge system constraints which already exist and thereby prevents any constructive attempt to deal with it, ultimately requiring resort to such inefficient out-of-market measures as denials of de-list bids for reliability and RMR contracts. *See* Stoddard Supp. Test. at 52:15–5:18. A better tariff recognizes the economic and physical facts of the transmission system in prices and *then* addresses any potential issue through market power mitigation.

The existence and ubiquity of seller market power mitigation in the FCM, *see* NEPGA First Brief at 12–15, is the second major distinction from the market considered in the guidelines. The guidelines address markets, like those for most goods and services, in which after a merger has been approved and consummated the participants are entirely free to set their own prices. In such markets, merger review may be the final roadblock to the creation and exercise of substantial market power. In the FCM, however, sellers remain subject to heavy cost-based price regulation which restrain or entirely prevent the exercise of market power even where it otherwise might exist. Given this drastically different purpose and context, applying the horizontal merger guidelines to the issue of zonal separation is improper.

IV. THE FUTURE OF CONE IN THE FCM

In its First Brief, ISO-NE proposed to eliminate the use of CONE as a reference point in numerous tariff provisions, but proposed no other update to CONE. ISO-NE First Brief at 58–61. ISO-NE will, however, develop a new series of technology-specific benchmarks, including one for a new peaking unit. Load parties opposed any reset to CONE while arguing about its

"relative insignificance" in the FCM. *See, e.g.*, Supporters First Brief at 48. We continue to support a reset of CONE as it will remain relevant in ISO-NE's anticipated market design. And while we do not oppose several of ISO-NE's proposed tariff changes regarding CONE, others require modification.

A. Recap of NEPGA's Position

In our First Brief, we argued that FCM's automatic updating process (based on auction results) had caused CONE to plummet to unreasonably low levels ($4.918/kW-month). *See generally* NEPGA First Brief at 87–97. This made CONE inappropriate as a foundational value for numerous tariff provisions. Stoddard Test. at 93:20–99:2. We sponsored an updated analysis of the cost of a new peaking unit to be used as the value for CONE in future auctions. NEPGA First Brief, NEPGA Exhibit 3, Testimony of Christopher D. Ungate on Behalf of New England Power Generators Association at 14:1 & Table 3 (concluding that the true "gross" cost of new entry (*i.e.*, not net of margins available from energy and ancillary service markets) is $13.72/kW-month to $15.20/kW-month, depending on whether the generation would be located in Western Massachusetts or in Boston). We further demonstrated that even if CONE were to be removed from the tariff, it would remain relevant (1) to establish a technology-specific benchmark for a peaker and (2) because "a just and reasonable and fully functioning competitive electricity market must support, on average and over time, and in addition to the expected earnings from the sale of energy and other products, the incremental capital cost of generation, *i.e.*, the cost of new entry." NEPGA First Brief at 97.

B. Many of ISO-NE's Proposed Alternatives to CONE in the Tariff Are Improvements, But Others Require Modifications

ISO-NE's First Brief proposes not to reset CONE but instead to remove it as a reference point from several provisions in the tariff. We support a reset, as discussed in the next section,

but we also do not oppose most of ISO-NE's proposed changes to the use of CONE. Some require modification:

First, ISO-NE explains that its new de-list proposal eliminates one of the key tariff provisions linked to CONE, which is that dynamic de-list bids—which are, by definition, de-list bids below 0.8 times CONE—will not be subject to market monitor review. ISO-NE proposes to delete this provision and replace it with an expansive new mitigation regime for de-list bids. For the reasons discussed *supra* Section III.C.1, we oppose this change.

Second, ISO-NE proposes to replace the price paid to existing resources in the event of Inadequate Supply or Insufficient Competition, which is currently 110% of CONE, with a new payment of 110% times the capacity clearing price from the last competitive FCA. ISO-NE First Brief at 61. As Mr. Stoddard testifies, the purpose of the payment slightly above CONE was to ensure that it would not interfere with signals for new entry. *See* Stoddard Supp. Test. at 57:2–6. This purpose is obviously frustrated when CONE is below reasonable levels. *Id.* at 57:7–15. However, a payment slightly above the clearing price, as ISO-NE proposes, may also fail to provide incentives for new entry. Such prices may have reflected overall conditions of surplus, for example, and would be inconsistent with conditions of Inadequate Supply or Insufficient Competition, when new entry is required. A better solution is to pay slightly above the benchmark cost of a peaker, which ISO-NE will calculate as part of its new APR proposal. *See id*. at 57:16–58:4.

We do not oppose ISO-NE's remaining changes to the CONE-based provisions in the tariff. One of the most significant of these changes is to the threshold to determine whether a resource is out-of-market (any bid below 0.75 times CONE). This threshold has been eliminated. ISO-NE First Brief at 59. Instead, ISO-NE will use technology-specific benchmarks. While we

support this change in principle (*see* Stoddard Supp. Test. at 13:13–14:5), its justness and reasonableness entirely depends upon the benchmarks ultimately chosen. We highlighted these concerns in our First Brief. NEPGA First Brief at 93–96.

We also support elimination of the Quantity Rule, as ISO-NE has proposed. ISO-NE First Brief at 54–56. As Mr. Stoddard previously testified, the rule has never been invoked "because there have been no high-priced Static or Permanent De-List bids." Stoddard Test. at 98:12–13. It "unduly complicates the FCA design and suppresses efficient pricing" while also "increas[ing] reliability risks through reducing the new capacity development timeline." *Id*. at 98:11, 13–14. It should be eliminated, as ISO-NE proposes.

C. CONE Should Still Be Reset

We disagree with the conclusion of ISO-NE and load that CONE does not need to be reset. ISO-NE's view is that they are proposing to eliminate all of the tariff provisions that rely upon CONE so it no longer serves any purpose. Load's view is that the current undervalued CONE is consistent with actual prices in New England and that it is an unimportant variable in the FCM design, and increasingly so as tariff provisions are decoupled from CONE.

As we have previously demonstrated, however, the cost of new entry of a peaking unit will remain an important calculation even if CONE is entirely removed from the tariff. *First*, one of the principal technologies for which ISO-NE will have to calculate a benchmark is that of a peaking unit, which is the lowest cost new generating capacity resource to construct without being significantly dependent upon infra-marginal revenues from the energy and ancillary services markets. Other benchmarks will also need to be calculated, but the cost of a new peaking unit is perhaps the most important of them all.

Second, to be sustainable, the bulk power markets must produce revenues from all energy products sufficient to sustain the incremental cost of generation. Otherwise, the markets will fail.

The cost of new entry of a peaking unit thus will always be relevant because those are the costs that—on average and over time—the electricity markets must sustain.

Several load parties dispute this fundamental point. *See, e.g.*, Supporters First Brief at 6, 34, 36, 49; James Wilson Test. at 24:6–10; Supporters First Brief, Exhibit DPUC-22, James F. Wilson, Forward Capacity Market CONEfusion at 10–11 (June 2010). They claim that CONE means something different in ISO-NE than it does in NYISO or PJM because ISO-NE has no demand curve. These claims are wrong. It is a fundamental truth that the bulk power system ultimately relies upon *power generators*. Without power generators, there would be no electricity. *See* Stoddard Test. at 85:9–16. As Mr. Stoddard testifies:

> While some may argue that Demand Resources are the most economical means of meeting capacity requirements today, they generally reflect an agreement to release generator and import capacity sources for use by others, not a source of system accessible energy to service load's needs. As prices increase, more customers may be willing to forego the firm service and defer their demand. You can't go out and build new Demand Resources when and where they are needed, however; by contrast, a peaker can be added relatively quickly as needed. For some purposes, therefore, CONE should reflect the cost of building a peaker.

Stoddard Supp. Test. at 56:8–15. Thus while demand response and unit upgrades can provide some reduction in electricity use or some additional power, but they simply cannot sustain the system over the long term.

Ultimately the markets must support new generation entry, and if they do, they will also support existing resources that remain needed and economic (while those that become uneconomic will shut down). And this is true regardless of the particulars of the capacity market design.

There can be no dispute, moreover, that revenues from FCM and energy and ancillary service markets have fallen far short of this objective to date. Mr. Stoddard has analyzed public reliability must-run data to establish a baseline of generator costs. *See* Stoddard Supp. Test. at

31:1–14. He has also calculated approximate energy and ancillary services revenues for the period covered by the first four auctions. *Id*. Based on actual capacity clearing prices, Mr. Stoddard calculates "[t]he gap between the Fixed O&M costs approved in RMR rates and the forecast of total margin from sale of energy, ancillary services, and uplift ranges from $0.96/kW-month to $7.45/kW-month.". *Id*. at 31:7–10. In short, FCM is falling far short of providing sufficient revenues for existing resources.

This has been load's express objective. They want to price discriminate and only pay new resources the prices necessary to sustain new entry. They have sponsored a massive influx of OOM and other subsidized entry. If this huge overbuild is not mitigated in future years, prices will remain significantly undervalued for years to come. FCM is thus failing its core objectives. It is not attracting new entry (out-of-market payments and other subsidies are doing that), and it will not sustain existing needed resources over the longer term. Stoddard Supp. Test. at 2:1–7. FCM is thus unjust and unreasonable.

The cost of new entry of a peaking unit is the correct measure of the total revenues that the markets must ultimately support. We have provided evidence of current costs. Even if CONE were fully eliminated as a reference point from the tariff, this value will remain relevant not only for that purpose, but also as a technology-specific benchmark.

V. THE COMMISSION SHOULD PROCEED WITH ITS PLANS TO IMPLEMENT REFORMS FOR FCA #5

In establishing this paper hearing, the Commission stated that "[i]t is our intention that, if practicable, we will issue an order terminating the transitional market rules and *accepting longer-term market rules* before March 1, 2011." Hearing Order at P 23 (emphasis added); *see also id*. at P 21(c) ("The Commission anticipates issuing an order in sufficient time to allow all parties to *implement* our findings *prior to FCA #5*.") (emphasis added). The Commission also denied ISO-

NE's request for clarification that market rules would be "implemented no earlier than FCA #6." Rehearing Order at P 35; *see also id*. at PP 36–37 (reiterating "intent if practicable to issue an order terminating the transitional market rules and accepting revised market rules before March 1, 2011").

In their First Briefs, however, many parties sought to transfer this paper *hearing* into something more like a technical conference—to do nothing more than "to gain insight and provide guidance to the region on further refinements for consideration [by stakeholders] in later FCAs." NEPOOL First Brief at 2.

The Commission should reject efforts to bypass or minimize its hearing proceedings, or to punt issues back to stakeholders or to otherwise delay relief. Just as in any regular hearing, the Commission should weigh all of the evidence in the record before it and *resolve* the issues in favor of the party that carries its burden of proof. And the Commission should continue to ensure that all reasonable steps are taken so that reforms can be implemented in time for FCA #5, if possible. We suggest a potential process that fits within the Commission's timeframe below.

A. The Commission Should Retain the Process that It Set Out in its Hearing Order

1. The Commission Seeks Resolution by March 1, 2011

From the outset of this proceeding, NEPGA sought a remedy for the massive amounts of OOM entry coming into the market in time for FCA #4 (held in August, 2010). The Commission, however, permitted the February APR to go into effect for FCA #4, but stated its intention to implement reforms from this proceeding without any further delay—"prior to FCA #5." Hearing Order at P 21(c). To meet this objective, the Commission explained that it:

> has "broad discretion in determining how best to handle related, yet discrete, issues in terms of procedures" (*Louisiana Public Service Comm. v. FERC*, 482 F.3d 510, 524 (D.C. Cir. 2007), *citing Mobil Oil Exploration & Producing S.E., Inc. v. United Distrib. Cos.*, 498 U.S. 211, 230 (1991) and "[t]he agency abuses that discretion only when its manner of proceeding significantly prejudices a party

> or unreasonably delays a resolution," *GTE Serv. Corp. v. FCC*, []782 F.2d 263, 274 (D.C. Cir. 1986).

Hearing Order at P 20 n.14. To meet its implementation objectives here, the Commission established a detailed paper hearing process, including an expedited schedule for First and Second Briefs. *Id.* at PP 20–23. Again, it targeted "issu[ing] an order terminating the transitional market rules [the February APR] and accepting longer-term market rules before March 1, 2011." *Id*. at P 23. This expedited hearing process was necessary to ensure that parties opposed to reform could not "unreasonably delay[] a resolution." *Id*. at P 20 n.14 (citing *GTE Serv. Corp. v. FCC*¸ 782 F.2d at 274). No party can argue that it can be prejudiced by this process, as stakeholders have had several bites at the apple to reach a resolution in this case.

The Commission also carefully clarified the evidentiary burdens of proof that would apply in the hearing to parties supporting the transitional market rules, as well as to parties challenging those rules or proposing any alternatives. *Id.* at P 22. It "require[d] the parties to address [their] concerns *in [the] paper hearing*." *Id*. at P 20 (emphasis added).

Finally, the Commission expressly rejected a proposal by ISO-NE and NEPOOL to require additional stakeholder processes "to address remaining concerns" to "continue to improve the FCM." *See id*. at P 170 (describing ISO-NE and NEPOOL proposal for additional stakeholder processes). The Commission reasoned that since "extensive stakeholder proceedings up to this point have not fully resolved these heavily-contested issues, we will not require ISO-NE or NEPOOL to continue with stakeholder processes." *Id.* at P 183. Instead, the Commission set "many of the questions that the parties raise here for *paper hearing*." *Id*. The Commission did state that stakeholders could continue to deliberate if they so chose, but that the paper hearing would proceed as scheduled. *Id*. at P 183.

2. The Commission Should Reject Any Attempt to Delay Resolution Beyond March 1, 2011

Several parties either disagree with the Commission's decision to implement reforms by FCA #5 or want to let stakeholders have another chance to address the issues. NEPOOL—speaking on behalf of the super-majority of net-buyer interests that it represents in this case[6]—wants the Commission to use the paper hearing merely as an information-gathering exercise to inform future stakeholder processes. *See* NEPOOL First Brief at 2. NEPOOL asks the Commission to "finally approve" the February APR and provide whatever "guidance" the Commission deems "appropriate," and then to permit *stakeholders* "to continue working through further refinements and improvements in the FCM design." *Id.* at 4–5.

Clearly such a process would not be completed by FCA #5, and likely not by FCA #6 (or even FCA #7). Such an "unreasonably delayed resolution" would benefit all those reaping the rewards from massive amounts of unmitigated OOM entry. It would also be directly contrary to the Hearing Order, which already rejected exactly this sort of prolonged stakeholder process. *See* Hearing Order at P 183. (NEPOOL did not seek rehearing of this issue.)

Unlike NEPOOL and load, ISO-NE no longer supports the February APR. It filed the July APR in its First Brief, but without any affidavits or testimony (although *NEPGA* did offer extensive expert testimony in support of the July APR, and does so again in this Second Brief). ISO-NE argued that the Commission should "approve the fundamental design principles offered in [its First Brief], and permit the ISO to follow the process" that ISO-NE had previously outlined in prior filings. ISO-NE First Brief at 62. ISO-NE had called for an additional year's

[6] Approximately 70% of the NEPOOL membership are net capacity purchasers, meaning that they buy more capacity than they sell and thus prefer low short term capacity prices.

delay in implementing reforms, citing implementation concerns—essentially stating that any significant reforms would be too difficult or otherwise take too long to implement by FCA #5.

While we generally are very supportive of the July APR, we were very concerned about undue delay in ISO-NE's proposed process. In its Rehearing Order, however, the Commission rejected ISO-NE's request for clarification that no market rule changes would be implemented any earlier than FCA #6. *See* Rehearing Order at PP 35–37.

We fully support the Commission's action, but one lingering concern is that ISO-NE's First Brief essentially assumed that the Commission would accede to ISO-NE's process. It included a significantly revamped APR and proposed to work out specific tariff language in future processes, with apparently heavy stakeholder involvement. While ISO-NE's proposed process was unworkable and has now been rejected by the Rehearing Order, its new July APR is a giant leap forward to finally remedy the serious OOM problems in the FCM. The Commission should approve it as part of this paper hearing and require ISO-NE and the parties to make every reasonable effort to implement it by FCA #5, just as the Commission intended. We next suggest a process for how this can happen within the Commission's timeline.

B. How to Get There From Here

1. The Commission Should Weigh All of the Evidence and Resolve Issues in Favor of the Parties that Meet Their Burden of Proof

As an initial matter, there should be no doubt that the Commission has substantial record evidence to find that the Historic and February APRs are unjust and unreasonable, and that the July APR—with the modifications discussed herein—is just and unreasonable. The Commission clarified the burdens of proof in this paper hearing (*see* Hearing Order at P 22) and reaffirmed them on rehearing (*see* Rehearing Order at PP 28–30), and we have met our burdens while others have not.

Specifically, the Commission clarified the burden of proof that applied to the "Filing Parties," meaning ISO-NE and NEPOOL:

> the Filing Parties have the burden under section 205 of proving that their proposed Rule Changes [the February APR] are just and reasonable. To the extent that the complainants in Docket Nos. EL10-50-000 and EL10-57-000 are asserting that the proposed Rule Changes are not just and reasonable, the burden will be on the Filing Parties to support their proposals.

Hearing Order at P 22; *see also* Rehearing Order at P 29 (same). ISO-NE has abandoned the Historic and February APRs, and NEPOOL has offered very little defense of the February APR.

Several load parties continue to support the February APR, but what little evidence they muster has been definitively refuted and overwhelmed by the evidence and credentials of NEPGA's experts. Indeed, load's primary defense of the current rules is that the entire transitional rules filing is a stakeholder-approved package and that any modification to it will upset some delicate balance. But the Commission has already rejected this line of argument on rehearing. *See* Rehearing Order at P 23. As the Commission stated, it has the duty to ensure just and reasonable rates (*id*. at P 24), and cannot "defenestrate" that duty under any circumstances (*see id*. at P 22), even when—and perhaps most particularly when—a super-majority of like-minded stakeholders have agreed to a one-sided package wholly in their favor. Load's primary defense thus eviscerated, they have remarkably little case left. The Filing Parties—and their supporters, load—have failed to carry their burden.

The Commission also clarified the burden of proof that would apply to those challenging the Historic or February APRs (or any of the Transitional Market Rules), and to those offering alternatives to these rules:

> Under section 206, however, the burden is on the complainants in Docket Nos. EL10-50-000 and EL10-57-000 [including NEPGA] to support any challenges to tariff provisions which have previously been found just and reasonable and any alternative that they propose to such provisions.

Hearing Order at P 22 (footnote omitted); *see also* Rehearing Order at P 30. We have met our burden with extensive expert testimony to show that both the Historic APR and the February APR fail to adequately mitigate OOM entry, and as such, are unjust and unreasonable. We have also adopted ISO-NE's July APR—with relatively minor modifications—as our own alternative to these prior tariff provisions. We have supported the July APR with extensive expert witness testimony, including from some of the world's leading market and auction economists. ISO-NE has not provided testimony of its own, but we have—fully supporting the economic soundness of the July APR.

In sum, we have met our burdens of proof, and the Filing Parties and load have not met theirs. The Commission has more than substantial evidence to approve the July APR in this hearing, with the modifications that we call for herein. The record fully supports this relief without the need for any additional litigation.

2. The Commission Should Issue an Initial Order and Take Other Intermediate Steps Before March 1, 2011

Regardless when the Commission issues a final order on the merits, it is imperative for it to issue early orders to let the parties know how to proceed for FCA #5. As a first priority, the Commission should issue an order by September 30, 2010, to suspend the Existing Resource Qualification deadline for FCA #5, which is on October 1, 2010. This is the earliest deadline in the build-up to FCA #5, and as we have previously explained, there is precedent for this deadline being delayed until much closer to the auction. *See ISO New England Inc.*, Docket Nos. ER10-787-000, *et al.*, Request For Clarification or, in the Alternative, Rehearing of the New England Power Generators Association at 8 (May 24, 2010). This is a preliminary step that the Commission should take regardless of its ultimate decision on the merits—otherwise the clock may run out on implementing reforms in time for FCA #5 before the Commission has even

considered the merits. The deadline should be extended to 30 days after the Commission issues an initial order accepting reforms in this paper hearing.

Next, the Commission should issue an order on the merits—accepting ISO-NE's July APR with the modifications that we advocate herein. The Commission would issue this order as soon as possible, ideally by November 1. We disagree with NEPOOL and ISO-NE, however, about how detailed this order should be. In our view the order should largely resolve the issues in this case and only leave the task of drafting precise tariff language in strict compliance with the Commission's order. It should *not* be a "high-level" order that merely accepts a conceptual framework or provides general "guidance" and leaves it to stakeholders to develop new rules.

In that same order, the Commission should establish a timeline for the compliance process of developing and filing the precise tariff language on an expedited basis. ISO-NE should of course consult with stakeholders in developing the rules, but stakeholders should not vote to *approve* the rules. At this stage of this long proceeding, ISO-NE should simply be carrying out the compliance task of implementing the Commission's order. We discuss the stakeholders' proper role at this stage of the proceeding below. To implement these rules by FCA #5, ISO-NE would need to file the rules *and* an implementation schedule early enough to give the Commission time to still issue an order approving final rules by March 1, 2011.

This is the sort of schedule that the Commission would have to follow to meet its objective of implementing reforms in time for FCA #5. We support this objective, and reiterate that every reasonable effort should be made to implement new rules in this time frame.

But under any schedule, the Commission should provide clear guidance before October 1, 2010—the Existing Resource Qualification Deadline for FCA #5—so that parties have this information going into the next auction, particularly if any changes are made to seller-side

mitigation thresholds. To the extent that the Commission does not suspend the Existing Capacity Qualification Deadline and the final rules approved by the Commission differ from the rules in place when Existing Capacity was required to qualify their bids, then the Commission must permit existing capacity a means to modify and qualify their bids in accordance with the new rules.

3. The Commission Should Eliminate Any Decisional Role for Stakeholders in Any Process Going Forward

We underscore here that there should be very little future role in this proceeding—including in any compliance process—for stakeholders. ISO-NE should consult with stakeholders in developing tariff language in response to the Commission's order on the paper hearing, but that is all.

The practical reality is that 70 percent of all stakeholders are net capacity purchasers. If past is prologue, these entities will not willingly agree to any process, proposal, rule, tariff provision or implementation schedule that may even potentially cause or lead to higher capacity prices. The *sole* exception to this is when these stakeholders determine that change is inevitable, but even then they will only agree to the barest minimum of changes to forestall more sweeping reform (*e.g.*, see the February APR).

Net purchasers of capacity benefit from prolonging the current rules or delaying full reform for even one more auction. While the rules go unfixed, unmitigated OOM entry will continue to flood the market. The Commission would never tolerate a moment's delay if rules inadequately mitigated *seller* market power, nor should it when they inadequately mitigate *buyer* market power.

The Commission has already found in this proceeding that stakeholders have reached an impasse and will no longer be relied upon to move the ball forward. *See* Hearing Order at P 183.

That is, in fact, why the Commission established a paper hearing. It would only cause unreasonable delay to punt *any* decisions—on process, proposals, rules, tariff provisions or implementation schedules—back to stakeholders. The time for that has passed.

Some stakeholders and NEPOOL will likely respond that stakeholders must retain their traditional role to vote on tariff language. To that we respond that we fully agree that stakeholders should almost always play a significant role in any proposed rule changes, *but stakeholders already had their say in this matter*. Stakeholders have had multiple rounds to try to resolve these issues, and have failed every time. Giving them yet another chance at the same issues will only lead to watered down rules and delay.

There is, moreover, no reason why stakeholders need anything more than a consultative role in ISO-NE's compliance task of drafting implementing tariff language after the Commission issues its order on the paper hearing. In the RPM settlement, PJM developed tariff language during the settlement process and filed it *with* the settlement proposal. *See PJM Interconnection, L.L.C.*, 117 FERC ¶ 61,331 (2006) (approving tariff rules developed in RPM filing as revised during settlement); *see also PJM Interconnection, L.L.C.*, Docket Nos. ER05-1410-000, *et al.*, Settlement Agreement and Explanatory Statement of the Settling Parties Resolving All Issues at 1 (Sept. 29, 2006) (requesting "that the Commission approve the Settlement Agreement, including the enclosed revised sheets of the [OATT, the Operating Agreement and the RPM}, as set forth in [attachments] to the Settlement Agreement"). There was no need for a separate stakeholder process to develop tariff language to implement the order, which would have simply given stakeholders another shot at watering down the rules.

And that is exactly what happens when stakeholders are given the role of "developing" rules in response to a "high-level" Commission order that provides "guidance" but not concrete

and specific directions. Stakeholders do not suddenly abandon long-held litigation positions. They simply redirect them to angle for watered-down rules with numerous loopholes.

In short, stakeholders should have no decisional role in *any* compliance efforts that result from the hearing order.

4. The Commission Must Take Some Transitional Action in the Markets if Reforms Are Delayed Beyond FCA #5

Finally, in the event that it turns out to be impossible to implement reforms in time for FCA #5—despite the Commission's and ISO-NE's best efforts after taking every reasonable step—then some transitional mechanism will be necessary. The Commission has already clarified that the removal of the price floor will be simultaneous (and not prior to) the implementation of a new APR. *See* Rehearing Order at P 41. We address the price floor earlier in this brief in our discussion of historic OOM, and in short, our view is that some transitional mechanism will be necessary until the current over-supply is exhausted or *all OOM*, including historic and current, is fully and completely accounted for in the APR. The Commission should also ensure that any additional OOM entry from later auctions (from FCA #4 and beyond) is not given a free pass to be treated as existing and to undercut price. That would simply reward those parties that have taken advantage of the loopholes in the current rules with additional ill-gotten gains.

CONCLUSION

At this point, NEPGA[7] has made its case. Our opponents have not—a circumstance that will not change with either the second or third round of briefing. We respectfully request that the Commission act promptly and fully to remedy the unjust and unreasonable rules afflicting the FCM. We have been struggling for ten long years to develop a sustainable capacity market in New England. An effective solution for the issues in this case is now at hand. The Commission should approve it without delay.

Respectfully submitted,

/s/

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September 1, 2010

[7] NEPGA is a private, non-profit entity that advocates for the business interests of non-utility electric power generators in New England. NEPGA's member companies represent approximately 28,000 megawatts of electrical generating capacity throughout the New England region. 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.

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

ISO New England Inc. and New England Power Pool	)	Docket No. ER10-787-000
New England Power Generators Association, Inc.	)	
	)	
v.	)	Docket No. EL10-50-000
	)	
ISO New England Inc.	)	
PSEG Energy Resources & Trade LLC, *et al.*	)	
	)	
v.	)	Docket No. EL10-57-000
	)	
ISO New England Inc.	)	

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 1st day of September 2010.

/s/ Carl Edman

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