

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

State Policies and Wholesale Markets)
Operated by ISO New England Inc., New York) Docket No. AD17-11-000
Independent System Operator, Inc., and)
PJM Interconnection, L.L.C.)

ISO NEW ENGLAND INC. PRE-TECHNICAL CONFERENCE STATEMENT

ISO New England Inc. (ISO-NE) submits the following statement on the topics of long-term expectations regarding resource adequacy, and better coordinating competitive wholesale markets with state policies. Matthew White, ISO-NE's Chief Economist, will be participating in the Technical Conference on Panel 2.

I. Roles of the New England States and ISO-NE Regarding Resource Adequacy

We believe that resource adequacy requires a single point of responsibility and accountability. ISO-NE currently bears this responsibility. Another option is for the states to take on this role through local utilities; to date, however, the New England states have not expressed interest in assuming this role. Therefore, in response to the Commission's inquiry, we do not foresee a diminished role for ISO-NE in ensuring resource adequacy in the region.

States influence resource adequacy through the execution of their responsibilities to site, permit, and oversee utilities' procurement of generation. In this role, the states affect resources' entry and exit decisions. For example, siting decisions that deny a needed new resource a construction permit could, in principle, adversely affect resource adequacy until replacement resources are procured. Such actions could result in unintended cost increases, since the New England competitive markets will ultimately procure replacement resources needed to maintain resource adequacy at a price that sends an appropriate signal about the need for and difficulty of permitting such resources.

II. Impact of States' Out of Market Procurements

In recent years, as state-level environmental requirements have grown more stringent, the states have sought to meet those requirements by requiring local utilities to procure renewable resources in increasing quantities. Without protection from the price-suppressive effects of this subsidized entry on New England's Forward Capacity Market (FCM), these out-of-market procurements could undermine cost-effective price formation, in turn impacting both FCM's ability to attract unsubsidized new investment cost-effectively and investors' willingness to maintain existing supply resources.

The reasoning is simple: if current investors, after incurring the sunk costs of entry, face state-subsidized competition that depresses their capacity market revenue, then future

investors (in unsubsidized resources) may logically hesitate to develop new capacity, require greater risk premiums, or only offer to develop new capacity at such a high price as to recover their total costs and return on equity within a short, initial capacity price lock period. This risk could raise the net cost of new entry substantially over time, and inefficiently undermine the cost-effectiveness of competitive markets to the detriment of society overall.

Currently, ISO-NE protects price formation in the FCM through the Minimum Offer Price Rule (MOPR), which scrutinizes and adjusts the prices of subsidized new entry. The MOPR has its own consequences, however, as it can result in substantial regional over-supply when the FCM acquires resources to meet the region's needs and the subsidized resources that have been re-priced out of the market are nonetheless built. The states have expressed concerns about this outcome, as consumers ultimately pay for the unnecessary over-supply.

III. Alternatives to Achieve or Accommodate State Policies

In New England (to a much greater extent than in many other regions), the states are focused on subsidizing new renewables given stringent environmental goals. Given the consequences of this procurement (discussed in the previous section), the region has been assessing potential market responses. In so doing, ISO-NE and stakeholders have distinguished between solutions that help the states “achieve” these goals and those that “accommodate” them. In either case, as the New England states’ objectives vary from those in other regions, the solution for New England may not be the same as that of any other region.

To date, stakeholders and ISO-NE have only identified one solution that would help the states “achieve” their goals while simultaneously preserving the benefits of competitive markets – a carbon cap and trade system. Carbon pricing would work by efficiently pricing the attributes sought by the states within a market framework that selects resources based on the least cost. It could reduce regional emissions, build on existing initiatives (such as the Regional Greenhouse Gas Initiative), and enjoy the same success as emissions pricing programs for sulfur dioxide and nitrogen oxide.¹ That said, there are significant jurisdictional and political issues regarding the implementation of such a carbon pricing mechanism.

Moreover, a carbon pricing mechanism does not give the states the ability to control the type and location of the procured resource. As those objectives are not easily reconciled with the competitive markets’ objectives to be technology neutral and meet the power system’s needs at least cost, ISO-NE has focused on “accommodating” the states’ goals, rather than seeking to achieve them. Specifically, following stakeholder discussions, ISO-NE agreed to develop a proposal to address both investors’ and states’ concerns about subsidized new resources’ participation in the FCM.

¹ See ISO-NE’s discussion of the carbon pricing model at http://nepool.com/uploads/IMAPP_20170125_ISO-NE_Discussion_Paper_Rev.pdf, pp. 2-4.

IV. ISO-NE's Proposed Market Design Solution – Competitive Auctions with Subsidized Policy Resources (CASPR)

In developing a market design to accommodate state goals, ISO-NE first articulated the specific objectives and principles to be met. The four key objectives are to: maintain competitively-based capacity auction prices by minimizing the price-suppressive effect of out-of-market subsidies on competitive (i.e., unsubsidized) resources in the auction; accommodate the entry of subsidized new resources into the FCM over time and minimize the potential for New England to develop far more resources on the power system than are required to reliably operate it; minimize the potential for one state's consumers to bear the costs of other states' subsidies; and seek a practical, transparent, market-based approach that extends, rather than upends, the region's existing capacity market framework.

Conceptually, ISO-NE's approach meets these objectives by closely coordinating the entry of (subsidized) new resources with the exit of (unsubsidized) existing capacity resources.² By doing so, the FCM can accommodate the entry of significant subsidized resources over time while maintaining competitively-based capacity prices for non-subsidized resources.

Specifically, the CASPR proposal provides financial incentives for existing, high-cost capacity resources to transfer their capacity obligations to subsidized new resources and to permanently exit the capacity market. This exchange of obligations is coordinated by conducting the annual Forward Capacity Auction using a two-stage, two-settlement process. In the first stage, ISO-NE clears the auction as it does today, including application of the MOPR to new capacity offers.

In a new second stage, called a *substitution auction*, existing capacity resources with retirement bids that retained capacity obligations in the primary auction transfer their obligations to subsidized new resources that did not clear in the first stage due to the application of the MOPR. The retiring capacity resources participate on the demand side of the auction, and the new subsidized resources constitute the supply side.

The MOPR is not applied in the substitution auction, and, as a result, new subsidized resources offer at a lower price than in the primary auction. Therefore, the substitution auction will generally produce a different (lower) clearing price than the primary auction, enabling existing capacity resources that retained capacity obligations in the primary auction to shed (or 'buy out') their obligations for a lower cost. The transferring resources must pay the subsidized new resources at the substitution auction's clearing price for accepting the capacity obligations, and the transferring existing resources must then permanently retire from the FCM. In effect, existing resources that transfer their obligations in the substitution auction end up with a net payment for voluntarily retiring – akin to a 'severance payment.'

Through this exchange of obligations, subsidized new resources obtain capacity supply obligations, accommodating the states' (and ISO-NE's) objective that new state-

² The proposal is fully described in ISO-NE's April 2017 Discussion Paper, *Competitive Auctions with Subsidized Policy Resources*, available at https://www.iso-ne.com/static-assets/documents/2017/04/caspr_discussion_paper_april_14_2017.pdf.

mandated resources contribute toward the region's resource adequacy requirements. As the quantity of subsidized new resources that enter (acquire obligations) through the substitution auction must be aligned with the quantity that exit (after transferring their obligations), system reliability is preserved and consumers are not adversely impacted. The substitution auction's outcomes therefore do not affect the capacity payments to other existing resources that obtained capacity obligations, as their payment rate continues to be determined by the competitive capacity clearing price established in the primary auction. As set out in ISO-NE's objectives, this proposal thereby preserves competitively-based capacity prices for new and existing competitive resources that acquire capacity obligations in the capacity market.

With reference to ISO-NE's second objective of accommodating the entry of subsidized resources into the FCM, the substitution auction approach replaces the existing Renewable Technology Resource (RTR) administrative exemption from the MOPR. The substitution auction accommodates a broader range of new technology resources than are allowed under the current RTR exemption and the potential entry of more new subsidized resources than the existing RTR exemption. The design will be further enhanced if the states provide accurate forward-looking estimates of the timing and amount of new subsidized resources that will seek to acquire capacity obligations. While that decision is at the discretion of the states, it would facilitate existing resource owners' evaluations of whether (and at what price) they would be willing to transfer their obligations and permanently exit, thereby accommodating the new subsidized supply.

To further facilitate the entry of new subsidized supply, the substitution auction rules can be extended to enable new competitive resources to participate alongside retiring resources as demand in the substitution auction. On the supply side, the substitution auction proposal may also help market participants that self-supply if they were to subsidize new resources that do not clear due to the MOPR.

Finally, from a practical standpoint, this design is feasible for ISO-NE to implement before the thirteenth capacity auction in February 2019, and in particular before the retirement window opens for that auction in March 2018. This timing is important given the anticipated schedule for substantial new state-sponsored resources to enter service in 2022. (As a three-year forward market, the capacity auction in 2019 will have a delivery year commencing in 2022.)

V. Conclusion

ISO-NE, the New England states and stakeholders have invested considerable time and effort pursuing solutions to the challenges at issue in this Technical Conference. ISO-NE appreciates the Commission's leadership on these topics, and hopes its comments and participation prove useful.