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**VIA ELECTRONIC FILING**

The Honorable Kimberly D. Bose, Secretary  
The Honorable Nathaniel J. Davis, Sr., Deputy Secretary  
Federal Energy Regulatory Commission  
888 First Street, N.E.  
Washington, D.C. 20426

**Re: ISO New England Inc., Docket No. ER10-787-000**

Dear Secretary Bose and Deputy Secretary Davis:

Attached for electronic filing in the above-referenced docket is the *Motion for Leave to File Answer and Answer of the Internal Market Monitor for ISO New England Inc.* A copy of the foregoing has been served upon all parties included in the Commission's service list.

If you have any questions or concerns regarding this filing, please feel free to contact me. Thank you for your assistance in this matter.

Respectfully submitted,

/s/ Sherry A. Quirk  
Sherry A. Quirk, Esq.

Counsel for ISO New England Inc.

Attachment

cc: Official Service List



Market Monitor responds to comments submitted by the External Market Monitor, Dr. David B. Patton of Potomac Economics, Ltd., and arguments advanced by protestors.

## **I. MOTION FOR LEAVE TO FILE ANSWER**

Pursuant to Rule 213 of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.213 (2009), the Internal Market Monitor requests leave to file this answer to the comments and protests submitted in this proceeding. The Internal Market Monitor requests waiver of Rule 213(a)(2) (18 C.F.R. § 385.213(a)(2)) to permit it to answer the protests. Good cause for this waiver exists here because the answer will aid the Commission in understanding the issues in the proceeding, provide additional information to assist the Commission in the decision-making process, and help to ensure a complete and accurate record in this case.<sup>5</sup>

## **II. ANSWER**

### **A. Modeling Capacity Zones All the Time Requires Comprehensive Mitigation Measures for All Supply Offers or De-List Bids**

In his comments, the External Market Monitor states that the ISO’s proposal to allow certain bids to be considered in the modeling of Capacity Zones<sup>6</sup> “increases the harmonization between the capacity market and the reliability requirements and, therefore, is in accord with the objective [he] propose[s] above – that the FCM market requirements reflect the system’s reliability requirements.”<sup>7</sup> However, the External Market Monitor also states that while the ISO’s amendments improve the Forward

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<sup>5</sup> See, e.g., *Entergy Services, Inc.*, 116 FERC ¶ 61,286 at P 6 (2006); *Midwest Independent Transmission System Operator, Inc.*, 116 FERC ¶ 61,124 at P 11 (2006); *High Island Offshore System, L.L.C.*, 113 FERC ¶ 61,202 at P 8 (2005); *Entergy Services, Inc.*, 101 FERC ¶ 61,289, at 62,163 (2002); *Duke Energy Corp.*, 100 FERC ¶ 61,251 at 61,886 (2002); *Delmarva Power & Light Co.*, 93 FERC ¶ 61,098 at 61,259 (2000).

<sup>6</sup> Capitalized terms used but not otherwise defined in this filing have the meanings ascribed thereto in the ISO’s Transmission, Markets and Services Tariff (FERC Electric Tariff No. 3) (the “Tariff”). Section III of the Tariff is Market Rule 1.

<sup>7</sup> External Market Monitor Comments at 18.

Capacity Market (“FCM”) design, more is needed to allow the prices in Capacity Zones to more fully reflect the system’s capacity needs.<sup>8</sup> Specifically, the External Market Monitor states that the objective to have the FCM requirements reflect system reliability requirements “would be satisfied if the zones were always modeled (*i.e.*, the triggers were eliminated).”<sup>9</sup> The External Market Monitor cautions that always modeling the zones could:

raise market power concerns *that are not fully addressed by the current mitigation measures*. However, we would generally recommend improving the mitigation measures as necessary, rather than mitigating market power by adjusting the market design (*i.e.*, by not always modeling the zones).<sup>10</sup>

NEPGA and other generator parties argue that the FCM rules should be changed immediately to permit all zones to be modeled all of the time because: (a) all permanent and static bids are mitigated by the Internal Market Monitor; (b) such bids therefore, are competitive; and (c) there is no need to mitigate Dynamic De-List Bid levels due to the fact that the FCM Settlement provided 0.8 times CONE as a safe harbor for de-list bids.<sup>11</sup>

The Internal Market Monitor agrees with the views of the External Market Monitor that modeling zones all of the time is the preferred approach, so long as there is comprehensive and effective mitigation of all de-list bids. The Internal Market Monitor also agrees with the generator parties that the rejection of the Salem Harbor de-list bid in the third Forward Capacity Auction (“FCA”) illustrates that the zonal creation and pricing aspect of the FCM design needs to be examined and improved. However, the

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<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at 18-19.

<sup>10</sup> *Id.* at 19 (emphasis added).

<sup>11</sup> *See, e.g.*, NEPGA Protest at 11, 63-67; and Joint Protestors Protest at 3, 8, 14-23.

Internal Market Monitor strongly disagrees with the conclusion of the generator parties that the existing mitigation scheme is comprehensive and effective enough to permit all of the zones to be modeled all of the time.

In reviewing the results of the first two FCAs and the design elements of the FCAs (*see Internal Market Monitoring Unit Review of the Forward Capacity Market Auction Results and Design Elements*, ISO New England Inc. Market Monitoring Unit, June 5, 2009 (“FCM Report”)),<sup>12</sup> the Internal Market Monitor stated that in the absence of market power, the ideal would be for all zones to be included in the auction. The Internal Market Monitor also indicated that market power concerns outweigh the potential efficiencies of this ideal approach, particularly in concentrated, constrained zones.<sup>13</sup> To move closer to the ideal, the Internal Market Monitor recommended in the FCM Report that Permanent De-List Bids be included in zonal modeling and pricing.<sup>14</sup> The proposed changes in the FCM Redesign Filing move even closer to the ideal by including Static De-List Bids from non-pivotal suppliers in zonal modeling and pricing.<sup>15</sup> However, modeling all zones all of the time requires a comprehensive mitigation approach for all de-list bids because it enables all bids to affect zonal pricing. A comprehensive mitigation approach is one that would assure that all de-list bids are competitive. A de-list bid is competitive if it reflects the marginal cost of remaining in the capacity market. There are currently several categories of de-list bids. A comprehensive approach to mitigation should review the mitigation rules governing all

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<sup>12</sup> The FCM Report can be found at: [www.iso-ne.com/markets/mktmonmit/rpts/other/fcm\\_report\\_final.pdf](http://www.iso-ne.com/markets/mktmonmit/rpts/other/fcm_report_final.pdf).

<sup>13</sup> FCM Report at 5, 42.

<sup>14</sup> *Id.* at 5, 43.

<sup>15</sup> *See* FCM Redesign Filing, Transmittal Letter at 28-33.

types of de-list bids to determine if they are competitive. In particular, Dynamic De-List Bids currently receive no review for competitiveness and are not mitigated. If all bids are to be considered in creating and pricing zones, then the Internal Market Monitor recommends that the appropriate treatment of Dynamic De-List Bids should be included in a comprehensive review of mitigation measures.

In addition, there is one issue regarding the net risk-adjusted going-forward cost of a resource that must be considered for any mitigation rules to be considered comprehensive. In general, there are two broad categories of net risk-adjusted going-forward costs to be considered. The first category involves the operating and maintenance (“O&M”) costs associated with being in the capacity market. The second category involves the opportunity costs of selling capacity to adjacent markets, primarily in New York. This issue is related to the first category. Under the existing rules governing the calculation of Static and Permanent De-List Bids in the FCM, a de-list bid is intended to reflect the net risk-adjusted going-forward cost of the resource. However, the current rules do not distinguish between the going-forward costs of resources *wanting to exit the energy market* and those resources *wanting to remain in the energy market*. As a practical matter, the going-forward costs for a resource that wants to remain in the energy market will be much lower than costs for those that want to leave the energy market because a resource remaining in the energy market does not avoid the costs (*e.g.*, labor, fixed O&M) of operating the unit. Consequently, Static De-List Bid levels for resources wanting to leave the capacity market but remain in the energy market are likely to be much lower than the level for Dynamic De-List Bids.

In summary, a comprehensive review of mitigation measures should consider all types of de-list bids, determine whether or not the current mitigation rules provide for mitigation to competitive levels and, if not, propose new mitigation rules that do.

**B. The Forward Capacity Market Price Floor Is Not Too Low and Should Not Be Based on the Fixed O&M Costs of Generating Resources**

With regard to the three-year extension to the price floor proposed by the ISO in the FCM Redesign Filing, NEPGA states that it supports the extension.<sup>16</sup> The price floor is set at 0.6 times CONE and currently is \$2.95/kW-month. However, citing to witness Stoddard’s affidavit, NEPGA also states that a “floor price higher than \$2.95/kW-month is easily justified.”<sup>17</sup> Mr. Stoddard states that:

The level of the price floor proposed by ISO-NE is so low that, based on public data on resource costs, it risks under-compensating many baseload and intermediate resources for the direct O&M costs they require. I have examined the RMR filings made by New England generators from 2006 to 2009, and assembled the fixed O&M items for those resources in Exhibit RBS-6. The plants show a wide range of technologies and age, and so they serve as a reasonable cross-section of the New England fossil-fueled fleet. As the table and chart in that exhibit show, the fixed O&M costs of these 11 plants ranged from \$3.16 to \$7.45/kW-month, with a median of \$3.85/kW-month and a capacity-weighted average of \$4.11/kW-month. These costs exclude not only all debt coverage and equity return, but also excludes taxes, insurance, and other non-discretionary operating items that are not available in public data. Moreover, many of these resources have historically operated with modest energy earnings (particularly with the low gas prices seen recently and expected going forward). Based on these data, a price floor much higher than \$2.95/kW-month is easily justified. If anything, at that level it seems likely that many resources will not be able to support their cash costs of operating and may be deactivated.<sup>18</sup>

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<sup>16</sup> NEPGA Protest at 77.

<sup>17</sup> *Id.*

<sup>18</sup> NEPGA Protest, Stoddard Affidavit at P 112.

Mr. Stoddard's assertion that the floor price is too low because it does not cover fixed O&M costs of a resource is completely unsupported by economic theory. There is no practical or theoretical nexus between a price floor and recovery of fixed O&M costs. There are at least two flaws with this assertion: it ignores net energy market revenues, which help to cover fixed O&M costs, and more broadly, there should not be a general right to recover costs in the market as long as resources are allowed to voluntarily leave the market. Nothing in FERC's market based rate policies or in economic theory supports the notion that certain price levels or cost recovery should be guaranteed.

The assertion that the price floor is too low also is contradicted by auction results. The total amount of generating resources that have de-listed in the first three auctions is 1,516 MW, not including 330 MWs in FCA #1 and 581 MWs in FCA #3 that sought to de-list but that were prevented from doing so for reliability reasons. This indicates that de-listing is available and being used by resource owners. However, over 32,000 MWs of generation remain in the market. If Mr. Stoddard's assertion that the floor price was too low was in fact correct, then many more resources would have de-listed and the FCA would have been cleared somewhere between the floor price and 0.8 times CONE, the level at which Dynamic De-List Bids are de-listed. The fact that resources wished to remain in the auction when they could have left at a higher price indicates that the floor is not too low. Further evidence that the price floor is not too low is seen by the fact that in the first annual reconfiguration auction roughly 200 MW took on a Capacity Supply Obligation at a price of \$1.50/kW-mo, which is about 50% lower than the price floor.

In short, the abundant surplus of capacity in the presence of a floor price is consistent with economic theory that in a competitive market there should be no price

floor. In general, a floor price creates excess capacity and interferes with efficient retirement decisions, which is consistent with what has occurred in the first three FCAs.

### III. CONCLUSION

For the foregoing reasons, the Internal Market Monitor respectfully requests that the Commission grant its Motion for Leave to File Answer and accept these comments.

Respectfully submitted,

Internal Market Monitor of  
ISO NEW ENGLAND INC.

By: /s/ Ray W. Hepper

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Dated: March 30, 2010

## **CERTIFICATE OF SERVICE**

I hereby certify that I have this day served the foregoing document upon the parties designated on the official service list for the above-captioned docket in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure. 18 C.F.R. § 385.2010 (2009).

Dated at Washington, D.C. on this the 30<sup>th</sup> day of March 2010.

/s/ E-filed \_\_\_\_\_  
Sherry A. Quirk  
Attorney for ISO New England Inc.