

Restructuring Roundtable 9/21/12 - “Perspectives on Better Aligning Capacity Markets to Ensure Resource Adequacy while Meeting Other Policy/Planning Objectives”
Pete Fuller Remarks/Outline

I want to take a step back and reflect on where we’ve been with competitive wholesale markets over the past 15 years, and how we got to today. And I want to consider whether we should continue to follow the trajectory we’ve been on, or whether we can start making better choices about market design policy. Better choices that will allow real sustainable wholesale markets to develop and be sustained. If we can do that, markets can deliver on the promise of more efficient and lower cost outcomes for consumers while maintaining reliability and meeting environmental goals.

Basic policy objective, in federal and state legislative and regulatory forums, was (and is) to use competitive markets to reveal the most efficient allocation of electric infrastructure capital, as a superior alternative to comprehensive economic/rate regulation.

Does anyone remember ‘light-handed regulation?’

Where we went astray was when the then-new wholesale markets revealed that there was, in fact, congestion on the New England system, and load pockets in the system that were supported by local generation to ensure reliability. That was a crossroads. And I believe we took the wrong road with a number of our choices.

The market-based approach would have been to find a way for the markets to reveal the locational constraints and the relative scarcity of supply in some areas. On that front, we pursued and ultimately implemented locational energy pricing. Chalk one up on the good side of the ledger.

At the same time, however, energy market bidding became subject to tighter mitigation scrutiny, effectively requiring that everyone that was not, in actual fact, subject to intense competitive pressures had to behave as though they were. On top of that, many generating units were run out of merit and were, and still are, unable to be the marginal price-setting unit in those locations. In

fact, the use of more expensive generation to meet reliability needs had (and continues to have) the effect of lowering the apparent price seen in the market. That's two marks against.

To be clear, I'm not arguing for no mitigation on sellers or for allowing unfettered market power abuse. On the other hand, we as a region or as an industry and a regulatory community have never had a serious discussion about how to balance the objectives of limiting the exercise of market power while still allowing the interplay of supply and demand to establish market prices. I find this conversation easier to visualize and engage in in the context of capacity markets and in the comparison of 'market resource alternatives' with transmission, but the concepts are the same across all facets of the wholesale markets.

So, to deal with the fact that energy market prices failed to indicate much locational differentiation, and that capacity markets were not locational and were not sufficient to support continued operation of generators needed for reliability, we entered into a large number of reliability must run agreements. Nobody liked those agreements. Buyers because they felt the cost was too high, sellers because these agreements came with rate cases, cost-based negotiations and regulatory oversight that was a vestige of the regulated utility world and anathema to the business models of these new energy entrepreneurs. Everyone else lost out too: there was no visible market signal, so new competitors saw no opportunity to invest, and competitive load-servers faced unhedgable non-market costs. On my scorecard, choosing RMRs as opposed to moving swiftly to a locational capacity market is another mark against.

On the topic of a locational capacity market. Here we are, 9 years after the original Devon Power orders in which the FERC said:

“we will ... direct ISO-NE to modify its market power mitigation mechanism to permit selected high cost but seldom run units in DCAs to raise their bids so as to recover their fixed and variable costs through the market (a Peaking Unit Safe Harbor Bid).” (P. 32)

and

“we find that the Market Rule shall provide that the energy bids of peaking units are eligible to determine LMP. As a result, when a peaking unit is called, all sellers will be able to receive a high market price and recover fixed costs. This feature will encourage entry by new generators.” (P. 35)

and, finally

“we will direct ISO-NE to file no later than March 1, 2004 for implementation no later than June 1, 2004, a mechanism that implements location or deliverability requirements in the ICAP or resource adequacy market as discussed in [our previous] Order so that capacity within DCAs may be appropriately compensated for reliability.” (P. 37)

Wow. April 25, 2003 and we had a blueprint for some of the key elements for workable markets – energy markets with the marginal reliability unit setting price, capacity markets with locational differentiation, and mitigation policy that enabled at least some units to include fixed-cost recovery in their energy offers. And yet here we are, 9½ years later. We continue to have units needed for reliability dispatch and block-loaded peaking resources not only not setting energy price, but actually suppressing it. FCA8 was slated to have eight hard-wired capacity zones, but ISO now says that only four will be implemented and the long-run outlook is for fewer, not more, zones, and less, not more, locational differentiation. And mitigation policy continues to insist that prices be determined not by long-run unit costs disciplined by the **actual** level of competition in the markets but by an unrealistic standard that only allows short-run avoidable costs. To understand the short-run marginal cost concept: When you leave here today and get into a cab, tell the driver you’re not going to pay his posted fare, but you’ll reimburse him (or her) for the actual cost of the gas used to get to your destination. See how far you get. And the next time you check into a hotel, offer to pay them the cost of that little bar of soap, since it’s the only avoidable cash cost they’re going to incur by having you stay in the room. Good luck. Even Shatner can’t get that deal.

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So the panel here is to talk about aligning capacity markets with public policy objectives. I guess my message is this: the public policy objective that was laid out in all those legislative and regulatory arenas when we embarked on restructuring of the wholesale electric industry was to use competitive markets and allow private investors to determine the most efficient mix of resources and infrastructure to provide the reliability, affordability and environmental performance that customers want and need. And on that set of policy objectives, we have a long way to go.

In today's world, "public policy objectives" are generally interpreted to be the desire to add more renewable energy to the system mix. That's a fine objective, one that I personally want to see happen, and one that my company is obviously very supportive of. And we're seeing the cost of wind and especially solar coming way down, to the point where we are seriously talking about grid parity. Nonetheless, given the structural flaws in the New England wholesale markets (and, with some variation on the details, in every organized market area across the country), the markets themselves are not looking like a viable basis for investing and financing new resources, whether traditional generation technology or renewables. We believe that to really support both the underlying public policy objective of competitive markets as the drivers for investment, as well as the goal of moving to a lower-emitting, lower carbon-intensity portfolio, the most important focus needs to be the market structures themselves, and their ability to support investment.

So, what should we be doing as our highest priorities:

In our energy markets, ensure that the highest-priced resource dispatched on the system to meet the demand for energy plus reserves is setting the price at all times. This will support better signals for the value of energy when it gets scarce, create more value for renewables, demand response and energy efficiency, and decrease the importance of the capacity market. Relatedly, the ISO's project to enable all resources to have different energy price offers in each hour of the day, and to update those offers during the day as conditions and fuel availability change, is an important step in the right direction, but not the whole solution.

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In the capacity market, we need to re-think the purpose of sell-side mitigation, and revise the approach so that existing resources have the opportunity to bid in a way that would recover their long-run fixed costs if they are the marginal unit. Obviously, if someone bids their full fixed costs and there's another resource out there with a better cost structure or a higher risk tolerance, the market will dictate which one survives, and that's how markets are supposed to work.

On the buy side, we do need to implement strict rules to ensure that the full economic costs of new resources coming into the market are reflected in their offers and ultimately in market prices. If we allow units with long-term contracts or other discriminatory non-market revenues or subsidies to suppress prices, it will have both near-term and long-run ramifications on the ability of the market to ever earn the confidence of private investors. Minimally, if we allow uneconomic new resources to enter the market, we need to ensure that the prices seen by all other resources still reflect the long-run costs of the marginal resource.

My third Rx is to move quickly on one of ISO's Strategic Initiatives, aligning planning and markets. While we often talk about this as a means for 'market resource alternatives' to compete with backstop transmission projects, the real holy grail on this one is applying the same reliability standards and analytical methods used in long-range reliability planning to the determination of the market's capacity requirements. If we can do that and eliminate the need for out-of-market reliability reviews of delist bids and bilateral transactions, the market will be substantially more transparent and investors will have substantially more confidence in it.

If we address the original and fundamental public policy objective for sustainable competitive wholesale markets, any other public policy objectives will be far less daunting and difficult to achieve. I look forward to working with all of you on the challenge.