M E M O R A N D U M

TO: NEPOOL Participants Committee Members and Alternates

FROM: NEPOOL Counsel

DATE: May 31, 2014

RE: Summary of FERC Order in Performance Incentives "Jump Ball" Proceeding (Docket Nos. ER14-1050-000 and -001, EL14-52)

This memorandum provides a brief summary of a 50-page order issued by the FERC on May 30, 2014 with respect to ISO-NE and NEPOOL's "jump ball" filing of alternative versions of Market Rule changes to increase incentives for resources to perform during times of operating reserve shortages (the *PI Order*).[1] We have previously summarized for you the numerous pleadings submitted and arguments made by various parties in response to that filing that can be reviewed if desired at: http://www.nepool.com/ER14-1050.php.

The *PI Order* and any NEPOOL proposed actions in response will be discussed at the June 6, 2014 Participants Committee meeting. NEPOOL Counsel will circulate additional background materials in advance of the meeting.

Please let us know if you have any questions related to the *PI Order* or would like to discuss your thoughts on any NEPOOL actions in response to the *Order*.

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Overview

The *PI Order* addresses a January 17, 2014 filing by ISO-NE and NEPOOL of alternative versions of Market Rule changes intended to improve the operating performance of resources in New England -- the "ISO-NE Proposal" and the "NEPOOL Proposal".

Under the ISO-NE Proposal, beginning with the Capacity Commitment Period associated with the ninth Forward Capacity Auction (FCA9), capacity payments to resources would be changed from the existing Forward Capacity Market (FCM) structure so that resources with a Capacity Supply Obligation would be paid an amount comprised of (1) a base capacity payment that would be determined in the Forward Capacity Auction and (2) a performance payment or charge[2]. Under the alternative NEPOOL Proposal, additional performance incentives would be provided more immediately by increasing the current system-wide Reserve Constraint Penalty Factor (RCPF) values on and after June 1, 2014. The RCPF value for Thirty-Minute Operating Reserves would increase from $500/MWh to $1,000/MWh and the RCPF value for Ten-Minute Non-Spinning Reserves would increase from $850/MWh to $1,500/MWh. In addition, beginning with the Capacity Commitment Period associated with FCA9, the current FCM

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[1] *ISO New England Inc. and New England Power Pool*, 147 FERC ¶ 61,172 (May 30, 2014) (*PI Order*).

[2] The second settlement of the ISO-NE Proposal entails a Capacity Performance Payment, determined for each resource by measuring its performance against its forward position (i.e., its share of the system's requirements at the time of each Capacity Scarcity Condition).

incentive mechanism that penalizes resources solely for failing to perform during Shortage Events would be replaced with capacity payment adjustments based on each resource's availability during times of highest demand for resources, which is referred to as the resource's EFORp.

As an initial matter, citing its authority under Section 206 of the Federal Power Act,[3] the FERC concluded in the *PI Order* that ISO-NE's existing Tariff, specifically the current FCM payment design, "is unjust and unreasonable, because it fails to provide adequate incentives for resource performance, thereby threatening reliable operation of the system and forcing consumers to pay for capacity without receiving commensurate reliability benefits." (23)[4] It goes on to conclude that neither the ISO-NE Proposal nor the NEPOOL Proposal, standing alone, had been shown to be just and reasonable. Drawing features from each Proposal, the *PI Order* concludes that the Tariff with a modified version of the ISO-NE Proposal, together with increases to the RCPF values proposed in the NEPOOL Proposal, would "provide a just and reasonable incentive structure that will help ensure reliability." (25)

Accordingly, the FERC initiates a new proceeding (EL14-52) and requires ISO-NE to submit a compliance filing in that proceeding within 45 days of the date of the *PI Order* (or by July 14, 2014) making the following two sets of revisions to the Tariff: (1) changes to implement ISO-NE's proposed two-settlement capacity market design with certain modifications that are described and discussed below, and (2) changes to increase the RCPF values for 30-minute operating reserves to \$1,000/MWh and for 10-minute non-spinning reserves to \$1,500/MWh. The FERC also established a refund effective date of the date on which notice of the Commission's Section 206 proceeding (EL14-52) is published in the *Federal Register*.

ISO-NE Proposal

The *PI Order* concludes that the ISO-NE Proposal has not been shown to be just and reasonable and must be changed. The *Order* adopts many features of the ISO-NE Proposal but changes must be made to that proposal because it unduly discriminates against energy efficiency resources and potentially sends improper price signals in the event of an intra-zonal transmission constraint. Further, the proposal does not address resource performance issues with the requisite speed.[5] (23)

<u>Capacity Resource Performance Measurement – The Two-Settlement Capacity Market Design is Acceptable</u>

The *PI Order* concludes that ISO-NE's proposal to modify the FCM to incorporate a two-settlement capacity market design that measures the performance of capacity resources during

[3] Under this authority, the FERC instituted a Section 206 proceeding in Docket No. EL14-52.

[4] Parenthetical citations refer to the corresponding paragraph(s) in the *PI Order*.

[5] The FERC expressed concern that ISO-NE's proposed performance incentive mechanism won't be in effect until June 1, 2018 at the earliest, which is the Capacity Commitment Period associated with FCA 9.

Capacity Scarcity Conditions[6] "represents a just and reasonable approach to addressing resource performance concerns in the New England region."[7] (36) The FERC disagreed with arguments made by NEPOOL and others that the ISO-NE Proposal is "fundamentally at odds with the existing FCM construct," (37) concluding instead that, "under the existing FCM, capacity revenues are already linked to real-time performance":

> ISO-NE's proposal fortifies that existing link by not only providing for penalties, but also compensating capacity resources based on their real-time performance. This change, while significant, is not fundamentally at odds with the existing FCM construct. (39)

<u>Exemptions for Non-Performance – Changes or Further Explanation is Needed for Export Constrained Resources During Capacity Scarcity Conditions</u>

The ISO-NE Proposal contains no exemptions for non-performance. The *PI Order* rejected calls by many for certain exemptions for non-performance, and largely although not completely accepts ISO-NE's no-exemptions principle. Specifically, it finds that ISO-NE's proposed Tariff revisions reflecting multiple mechanisms intended to help mitigate the risk to suppliers are just and reasonable, including: (1) a monthly and annual stop-loss mechanism,[8] (2) Capacity Performance Bilaterals,[9] and (3) the phase-in of the Capacity Performance Payment Rate[10].

The *PI Order* concludes, however, that ISO-NE's proposal to apply Capacity Performance Payments to resources on the export side of an *intra*-zonal transmission constraint would send an improper price signal. "[R]esources on the export side would be incented to maximize their provision of energy or reserves in order to maximize their Capacity Performance Payments for the duration of the Capacity Scarcity Condition, even though that additional energy

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[6] Under the ISO-NE Proposal, a "Capacity Scarcity Condition" is measured in 5-minute intervals and exists in a Capacity Zone whenever the real-time energy price includes a Reserve Constraint Penalty Factor triggered by (1) the system minimum 30-minute reserve requirement, (2) the system 10-minute reserve requirement, or (3) the zonal 30-minute reserve requirements.

[7] The FERC remarked: "We conclude that ISO-NE has persuasively demonstrated that revising its FCM market design to more closely link capacity revenues to real-time performance will address this concern by providing better incentives for investment decisions appropriate for the New England region. ISO-NE's proposed approach to the problem of resource performance is also consistent with the overall purpose of the FCM: to help ensure reliability through resource adequacy." (36)

[8] ISO-NE's Proposal contains a "stop-loss" mechanism that is intended to limit—on both a monthly and annual basis—the amount of money a resource can lose as a result of its performance.

[9] Under the ISO-NE Proposal, a Capacity Performance Bilateral allows a resource with a Capacity Performance Score greater than zero during a particular five-minute interval of a Capacity Scarcity Condition to transfer some or all of its Capacity Performance Score to another resource for that same five-minute interval, but only if both resources were subject to the same Capacity Scarcity Condition.

[10] ISO-NE proposes to phase-in the Capacity Performance Payment Rate as follows: $2,000/MWh for the period June 1, 2018 through May 31, 2021; $3,500/MWh for the period June 1, 2021 through May 31, 2024; and $5,455/MWh for the open-ended period starting June 1, 2024.

production would not be useful or efficient because it cannot reach the import-side of the constraint." (66) Because the ISO-NE Proposal "does not address this inefficient incentive", the FERC directs ISO-NE either to submit Tariff revisions to exempt all resources within a zone experiencing a Capacity Scarcity Condition and which are located on the export side of the binding transmission constraint" or to explain further why such an exemption is unnecessary. (67)

Treatment of Certain Classes of Resources – Capacity Performance Payments for Energy Efficiency Resources Must Be Changed

The *PI Order* accepts in part ISO-NE's assertion that its proposal is resource neutral and will pay capacity suppliers providing the same service the same compensation, regardless of technology. Rejecting arguments of undue discrimination by some, the *PI Order* concludes that ISO-NE's proposed treatment of resources ***does not*** unduly discriminate against intermittent resources, "mid-range resources without quick-start capabilities", import resources, or demand response resources. (86-88)

The *Order* goes on however to conclude that ISO-NE's proposal ***does*** unduly discriminate against energy efficiency resources. The FERC explained that energy efficiency resources are "not similarly situated to other capacity resources because they do not actively perform in real-time" and thus are not able to respond to ISO-NE's proposed performance incentive. (89) The *PI Order* therefore directs ISO-NE to submit Tariff revisions as part of its compliance filing to ensure that energy efficiency resources' Capacity Performance Payments are only calculated during hours in which the demand reduction values are calculated under the existing Tariff for that particular type of resource. (89)

Bidding/Market Monitoring Rules -- Accepted as Proposed by ISO-NE

The *PI Order* concluded that ISO-NE's proposed bidding rules and market monitoring provisions are a just and reasonable component of the two-settlement capacity market design. The FERC stated that ISO-NE's proposal "allows suppliers to include in their bids '[a]ny risk that can be quantified and analytically supported and that is not already reflected in the formula for net going forward costs.'" (96) Consistent with other provisions found to be just and reasonable, the FERC directs ISO-NE to submit those proposed bidding and market monitoring rules as part of the compliance filing required within 45 days of the date of the *PI Order*.

NEPOOL Proposal

The *PI Order* finds that NEPOOL's Proposal has not been shown to be just and reasonable and is deficient because: (1) while the RCPF changes are a step in the right direction, they alone do not provide a sufficient incentive to fully address the region's resource performance problems and they do not correct the fundamental flaws in the FCM design; and (2) NEPOOL's proposed EFORp metric is flawed. (24)

Reserve Constraint Penalty Factor Changes – Accepted as Proposed by NEPOOL

The *PI Order* accepts the NEPOOL Proposal to increase the current, system-wide RCPF values for Thirty-Minute Operating Reserves from \$500/MWh to \$1,000/MWh and for Ten-

Minute Non-Spinning Reserves from $850/MWh to $1,500/MWh. The *Order* finds that NEPOOL's proposed increases to these RCPF values, in combination with the ISO-NE Proposal with FERC's required modifications discussed above, "represent a just and reasonable solution to the region's resource performance problems." (107) Explaining that the RCPF changes will enhance performance incentives in the near-term before ISO-NE's modified proposal can be implemented, the *PI Order* directs ISO-NE to implement both the RCPF changes and ISO-NE's two-settlement FCM design. (108)

The *PI Order* recognizes that the increased RCPF values may impact certain elements of the ISO-NE Proposal, and accordingly directs ISO-NE to submit as part of its compliance filing either: (1) Tariff revisions reflecting any adjustments to its proposal that may be necessary in light of the Commission's decision to accept the RCPF changes; or (2) an explanation as to why no such adjustments are needed. (110)

<u>EFORp Metric – Rejected in its Entirety</u>

The *PI Order* concludes that the EFORp metric is flawed for a variety of reasons.

> By measuring a resource's performance only against its own historical performance, NEPOOL's proposed EFORp metric may inappropriately reward poorly-performing resources and penalize highly-performing resources, which could further erode reliability in the region.[11] Further, NEPOOL's proposal to calculate charges and credits for each resource at 150 percent of the FCA clearing price, subject to annual caps, based on how each resource's availability in that Capacity Commitment Period compared to its five-year historical availability, could provide an incentive for a capacity resource to reduce its measured performance over the next four years to lower the five-year historical EFORp Hour Availability Score against which its performance would be measured starting in the 2018-2019 Capacity Commitment Period. (24)

The *PI Order* goes on to explain that, while it is clear that certain revisions could be made to improve the proposed EFORp metric, even with such changes the EFORp metric "would still be flawed because it would measure performance in terms of 'availability,' would do so only in certain peak hours of the year, and would maintain numerous exemptions for non-performance." (24, footnote #22)

[11] The *PI Order* concluded further: "In addition, the EFORp mechanism, when measured using a resource's own historical performance, may not provide a performance incentive over the long-term. While reduced performance in one year relative to a resource's historical average performance will result in a penalty, this reduced performance will also lower that resource's historical average performance (the 5-year average EFORp) which could then lead to increased payments in future years if the resource's performance returns to its historical average level." (24, footnote #21)

Conclusion and Orders

The *PI Order* concludes with the following five separate findings and orders:

1. Both the ISO-NE Proposal and the NEPOOL Proposal are rejected as unjust and unreasonable;

2. A new proceeding is ordered (EL14-52) pursuant to the Commission's authority under Section 206 of the Federal Power Act;

3. ISO-NE must submit a compliance filing within 45 days of the *Order* (on or before July 14, 2014), consistent with the *Order*;

4. The FERC Secretary is directed promptly to publish notice of the new proceeding in the *Federal Register*; and

5. The refund effective date for any changes ordered in Docket No. EL14-52 will be the date that the notice is published in the *Federal Register*.