"BUYER-SIDE" MITIGATION IN ORGANIZED CAPACITY MARKETS: TIME FOR A CHANGE?

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Synopsis: This article presents an analysis of the current status of buyer-side mitigation in wholesale competitive capacity markets. Buyer-side mitigation, which takes the form of a potential minimum offer floor for all new generation entrants, has been implemented by the Federal Energy Regulatory Commission (FERC) to deter the subsidization of new entry that could unduly depress capacity market prices. In addition to reviewing the reasons for and current status of buyer-side mitigation, this article takes the position that the FERC has been overly broad in its implementation of buyer-side mitigation rules by requiring every new entrant to prove that its facility is economic or be subject to an offer floor. The authors believe that there is room for the FERC to modify its rules and create safe harbors for certain new entrants while, at the same time, maintaining its ability to supervise competitive wholesale capacity markets such that they are not subject to undue interference and result in just and reasonable rates.

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I. INTRODUCTION

Over the last twenty years, the electric industry has see-sawed as regulators seek to strike the right balance between using competitive forces and regulation to establish just and reasonable rates. Nowhere is this tension more evident than in regulation of capacity[1] markets in organized wholesale markets administered by Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs). Indeed, the degree of litigation that has taken place at the Federal Energy Regulatory Commission (FERC) over the administration of capacity markets has served to impede the smooth functioning of those markets. This litigation has involved many aspects of the capacity markets. One issue that has been particularly contentious recently involves buyer-side mitigation. Buyer-side mitigation refers to offer floors that have been put in place by the FERC to deter large net buyers[2] and local governments from subsidizing new entry and artificially depressing capacity market prices.

This is a legal article written by lawyers. Economists have offered and will continue to offer opinions on what makes economic sense in terms of buyer-side mitigation. This article will explore the extent to which the FERC is properly approving buyer-side mitigation proposals from ISOs and RTOs in terms of its statutory authority to determine just and reasonable rates and to use competitive market forces to substitute for cost-of-service rates. This article proposes that even though RTO/ISO capacity markets are not markets in the traditional sense, they are still markets where the final price is a function of supply and demand. Therefore, the FERC should analyze buyer-side mitigation within the context of its decisions such that competitive market forces determine the price of capacity. This article further proposes that the FERC should not intervene in capacity markets in order to establish what it believes to be a just and reasonable rate that will prevent the market price from being "too low," regardless of whether price depression is the result of market manipulation or market power abuse. Because the FERC has adopted this approach, it now subjects all new entry to a test to determine whether it will unduly depress market prices unless it can show it is economic new entry. If the new entry is deemed "uneconomic," it is subjected to a minimum offer floor that could prevent the new entry resource from clearing in the capacity market auction. In contrast, this article proposes that the FERC should not subject new entry to buyer-side mitigation in the

1. A capacity payment can be viewed as a type of reservation payment or call option on energy. Typically, a generator that receives a capacity payment is required to bid every hour into the relevant ISO or RTO day-ahead energy markets and to provide energy on an emergency basis in the real-time market if the generator was not selected in the day-ahead market. NRG Power Mktg. v. Maine Pub. Utils. Comm'n, 558 U.S. 165, 130 S. Ct. 693, 697 (2010).

2. The FERC originally defined "a net buyer of a capacity" as "a market participant whose capacity purchase obligation as an LSE [load serving entity] outweighs the amount of capacity supply it owns or controls." *New York Indep. Sys. Operator, Inc.*, 122 F.E.R.C. ¶ 61,211 at n.5 (Mar. 7, 2008) [hereinafter NYISO]. An LSE refers to any entity that purchases supply on behalf of its customers and is therefore obligated to purchase capacity to meet that supply obligation. *See generally* NERC, GLOSSARY OF TERMS USED IN RELIABILITY STANDARDS 10 (2008), *available at* http://www.nerc.com/files/Glossary_12Feb08.pdf.

absence of market power or a finding that there has been a specific intent to manipulate the markets.

At the same time, this article also considers the degree to which the FERC should let states and local governments pursue public policy goals even when they interfere with capacity markets. Now is the perfect time to re-consider the current state of buyer-side mitigation rules given that the FERC has stated that ISOs and RTOs should be allowed to consider and authorize cost allocation for transmission built for public policy reasons. This raises the question of whether transmission and generation built for public policy reasons are being treated on an equal footing given the FERC's stated policy that they should be treated comparably.[3]

This article will focus on how the FERC has treated the potential for buyer-side manipulation of the capacity markets under the Federal Power Act (FPA) and not whether state intervention in capacity markets may violate the Commerce Clause of the United States Constitution. Accordingly, the litigation currently pending over state intervention in wholesale electricity markets will not be discussed.[4] In terms of discussing the FERC's decisions on buyer-side mitigation, this article will first review the statutory requirement of just and reasonable rates and the degree to which regulation may be supplanted by competition in the determination of such rates, and the FERC's rules governing market power and market manipulation. This article will also briefly discuss the FERC's recent issuance of Order 1000[5] and its requirement for the consideration of public policy in transmission planning and cost allocation. In Part III, this article will briefly discuss electric restructuring and some of the state actions to foster new generation that prompted the FERC to implement measures that seek to deter such actions. In Part IV, this article will discuss the FERC's seminal decisions adopting buyer-side mitigation and discuss in some detail the buyer mitigation measures that have been implemented or considered in the New York, PJM and New England markets. Part V concludes with proposals for modifying buyer mitigation rules and creating "safe-harbor" exemptions from buyer-side mitigation for certain new entrants that would be consistent with the FERC's recent pronouncements on public policy and transmission in Order 1000.

II. LEGAL AND REGULATORY BACKGROUND

A. Rate-Making Authority Over Capacity Markets

Capacity markets are necessary in wholesale markets to help provide reliability. It has generally been politically infeasible to have competitive wholesale energy markets without price caps.[6] As a result, the concern has been

3. *See infra* note 54.

4. Currently, litigation on this issue is pending before the Federal District Court for the District of New Jersey in *PPL EnergyPlus, L.L.C. v. Lee A. Solomon*, No. 3 11-CV-00745-PGS-DEA (D.N.J. 2012). The case involves New Jersey's Long-Term Capacity Agreement Pilot Program, which is discussed in Part III. One of the claims there involves the Interstate Commerce Clause, U.S. CONST. art. 1, § 8, cl.3.

5. Order No. 1000, *Transmission Planning and Cost Allocation by Transmission Owning and Operating Pub. Utils.*, 136 F.E.R.C. ¶ 61,051, 76 Fed. Reg. 49,842 (2011) (codified at 18 C.F.R pt. 35) [hereinafter Order No. 1000].

6. Texas has recently decided to allow price caps of $4500/MWh in its energy markets, but it has been heavily contested by consumer interests. Rebecca Smith, *Texas Raises Electricity Cap*, WALL ST. J., June 29,

that there will be insufficient revenues to maintain an adequate generation supply in the absence of a capacity market that provides additional revenues for fixed cost recovery that would also provide a price signal to build new power plants or reduce demand. The FERC's traditional jurisdiction over wholesale rates thereby intersects with the traditional state concern to provide reliability by, *inter alia*, having sufficient generation resources.

Capacity markets can be viewed in several ways. First, in order to ensure that sufficient generation capacity (i.e., the ability to produce electric energy) exists within a region, LSEs are generally required to purchase enough capacity to meet their projected peak load plus a certain level of reserve. To that end, a capacity payment is viewed as a reservation payment to ensure that a generator will be available to provide energy over a specified period of time. Second, to the extent that the revenues generators receive from selling energy and ancillary services do not fully cover their fixed and variable costs, capacity revenues can be viewed as a way of providing generators with that missing money.[7] Finally, capacity payments provide an incentive for new entrants to locate in regions where there is a need for additional resources.

One way of meeting these needs is through the use of a "demand curve" capacity auction where an administratively set demand curve is established. This curve establishes the price that load serving entities will pay for various quantities of capacity, with the price of capacity increasing as the demand for such capacity increases. In general, the ultimate price that LSEs pay in this type of auction (i.e., the clearing price) is based on the price of capacity on the demand curve line that is equal to the amount of capacity offered for sale in the auction. Currently, the PJM and NYISO markets use a demand curve, while different mechanisms are used in other markets.[8]

The FERC's authority to regulate the prices paid in capacity markets was confirmed in *Connecticut Department of Public Utility Control v. FERC*,[9] where the threshold issue was whether the FERC's assertion of jurisdiction over the New England ISO's capacity market was consistent with the provisions of the FPA.[10] As the court explained, the New England capacity market was designed to provide a price signal for new supply side resources.[11] The capacity market used the capacity requirement as an estimate of capacity the system as a whole would require for reliability for three years,[12] and each retail load supplier paid a capacity price based on its share of the capacity requirement "multiplied by the clearing price."[13]

2011, at A3, *available at* http://online.wsj.com/article/SB10001424052702304830704577494931542578446.html.

7. Paul L. Joskow, *Competitive Electricity Markets and Investment in New Generating Capacity*, *in* THE NEW ENERGY PARADIGM 76 (Dieter Helm ed., 2007), *available at* http://economics.mit.edu/files/1190.

8. *ISO New England Inc*., 138 F.E.R.C. ¶ 61,027 at P 30 (2012) (noting that New York and PJM use a demand curve while New England does not). *See also supra* note 4.

9. Connecticut Dep't of Pub. Util. Control v. FERC, 569 F.3d 477 (D.C. Cir. 2009).

10. *Id.* at 478-79; 16 U.S.C. §§ 791-828c (2006).

11. *Connecticut Dep't of Pub. Util. Control*, 569 F.3d at 480.

12. *Id.* New England uses a "descending clock auction" which "stops when the quantity offered equals the ICR, and that price point becomes the [capacity] market clearing price." *Id.*

13. *Id.*

The court in *Connecticut Department of Public Utility Control* concluded that setting the capacity requirement was not the type of direct regulation over generating facilities prohibited by the FPA.[14] It found that the controversy over jurisdiction arose from a misunderstanding of the capacity requirement, which does not require anyone to install new capacity, but simply is an estimate of peak demand.[15] The court explained that state and municipalities retained 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 interference from the Commission."[16] The court added: "Of course, those choices affect the pool of bidders in the [capacity market], which in turn affects the market clearing price for capacity."[17]

As for the FERC's assertion of jurisdiction over capacity prices, the court noted that the court in *Municipalities of Groton v. FERC* upheld the FERC's jurisdiction to review deficiency charges assessed against utilities for failure to procure a sufficient level of capacity.[18] In discussing its approval of the FERC's review of the deficiency charges in *Groton*, the court noted that: "[W]e held it 'sufficient for jurisdictional purposes that the deficiency charge affects the fee that a participant pays for power and reserve service, irrespective of the objective underlying that charge.'"[19]

The court concluded, based on *Groton*'s precedent, that the FERC "may directly establish prices for capacity or . . . prices for failing to acquire enough capacity-even for the express purpose of incentivizing construction of new" supply resources.[20] This court noted that the FERC's authority over practices that affect rates had long been decided.[21] In *Groton*, the court noted further that "it [was] irrelevant that the deficiency charges were 'designed as an incentive'" to encourage construction "so long as the charges affected transmission rates otherwise within the Commission's jurisdiction."[22] Indeed, based on its analysis of *Municipalities of Groton* and *Mississippi Industries v. FERC*, the *Connecticut* court concluded that nothing in the nature of capacity places it beyond the FERC's jurisdiction:

> Thus, *Mississippi Industries*, together with *Municipalities of Groton*, teaches that there is nothing special about capacity decisions that place them beyond the Commission's jurisdiction. Where capacity decisions about an interconnected bulk power system affect FERC-jurisdictional transmission rates for that system without directly implicating generation facilities, they come within the Commission's authority.[23]

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14. *Id.* at 485.
15. *Id.* at 481.
16. *Id.*
17. *Id.*
18. *Id.* at 482 (citing Municipalities of Groton v. FERC, 587 F.2d 1296 (D.C. Cir. 1978)).
19. *Id.* (quoting *Groton*, 587 F.2d at 1302).
20. *Id.*
21. *Id.* at 483.
22. *Id.* at 484 (quoting *Groton*, 587 F.2d at 1302).
23. *Id.* (citing Mississippi Industries v. FERC, 808 F.2d 1525 (D.C. Cir. 1987) and *Groton*, 587 F.2d 1296).

B. Just and Reasonable Rates

The second principle relevant to the FERC's decisions concerning mitigation of capacity markets is that rates approved by the FERC must be "just and reasonable."[24] The FERC has traditionally determined "just and reasonable" rates using a cost of service ratemaking analysis but it has been permitted to rely on competitive markets to determine just and reasonable rates. In a watershed decision, *Farmers Union Central Exchange, Inc. v. FERC*, the U.S. Court of Appeals for the D.C. Circuit acknowledged that just and reasonable rates could be accomplished in a "light-handed" regulatory scheme that used competition to keep rates within a "zone of reasonableness." [25]

While disapproving of the regulatory scheme approved by the FERC in that case, the court laid out a path for "light handed regulation," with the proviso that the scheme accomplishes the goals and purposes of the FPA with "less regulatory oversight."[26] The court acknowledged that, while the market price could be taken into consideration in establishing a just and reasonable rate, the FERC methodology did not establish a "rational or permissible assumption . . . between 'just and reasonable' rates and the market price."[27] The court further acknowledged that non-cost factors, if part of reasoned decision-making, could be part of the regulatory scheme.[28]

As recently stated by the Ninth Circuit Court of Appeals, the Supreme Court has not yet affirmed that market-based rates for wholesale electricity transactions are valid under the FPA.[29] The court there upheld its prior decision that market based rates are permissible and stated that

> '[i]n a competitive market, where neither buyer nor seller has significant market power, it is rational to assume that the terms of their voluntary exchange are reasonable, and specifically to infer that the price is close to marginal cost, such that the seller makes only a normal return on its investment.'[30]

The Ninth Circuit rejected the petitioners' claim that the FERC has an obligation to "assess the overall competitiveness of the market," but noted at the same time that the FERC does have an obligation to screen for and prevent market power from unduly affecting the market price.[31] In other words, the FERC's statutory obligation, to the extent that it relies on competitive markets to

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24. The just and reasonable standard arises from the FPA, which provides that:

> [a]ll rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

16 U.S.C. § 824d(a) (2006).

25. Farmers Union Cent. Exch., Inc. v. FERC, 734 F.2d 1486, 1530 (D.C. Cir. 1984), *cert. denied*, 490 U.S. 1034 (1984).

26. *Id.* at 1510.

27. *Id.* at 1509.

28. *Id.* at 1502.

29. Montana Consumer Counsel v. FERC, 659 F.3d 910, 920 (9th Cir. 2011) (quoting Morgan Stanley Capital Grp. v. Pub. Util. Dist. No. 1 of Snohomish Cnty., Wash., 554 U.S. 527, 538 (2008) ("We have not hitherto approved, and express no opinion today, on the lawfulness of the market-based-tariff system"), *cert. denied sub. nom.* Public Citizen, Inc. v. FERC, No. 11-1009, 2012 WL 485716 (U.S. June 25, 2012).

30. *Id.* at 916 (citing California *ex rel.* Lockyer v. FERC, 383 F.3d 1006, 1013 (9th Cir. 2004)).

31. *Id.* at 916-17.

establish price, is to prevent market power abuse and market manipulation that would impede the proper working of a competitive market, but not necessarily to determine whether the market is working such that the price that results is the "right" price. Otherwise, the FERC would risk unduly interfering with the markets that would otherwise result in "just and reasonable" rates.

C. Market Manipulation

Prior to the enactment of EPAct 2005, and acting pursuant to its authority under section 206 of the FPA, the FERC amended all market-based rate sellers' tariffs and authorizations to include Market Behavior Rules.[32] One of the Market Behavior Rules, Rule 2, prohibited "actions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for electric energy or electricity products."[33] Section 1283 of EPAct 2005 amended the FPA by adding section 222, which states as follows:

> It shall be unlawful for any entity (including an entity described in section 824(f) of this title), directly or indirectly, to use or employ, in connection with the purchase or sale of electric energy or the purchase or sale of transmission services subject to the jurisdiction of the Commission, any manipulative or deceptive device or contrivance (as those terms are used in section 78j(b) of title 15), in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of electric ratepayers.[34]

On October 20, 2005, the FERC issued a notice of proposed rulemaking to adopt new rules to implement section 222.[35] On January 19, 2006, the FERC issued Order No. 670, adopting the new Anti-Market Manipulation Rule.[36] In light of section 222 and Order No. 670, the FERC rescinded Rule 2 of the Market Behavior Rules.[37] Critically, the FERC explained that a finding of market manipulation under EPAct 2005 requires scienter: "Congress directed that market manipulation includes the requirement of scienter, that is, intentional or reckless conduct. Therefore, [the] argument that Congress did not impose the requirement of scienter is without merit."[38]

Similarly, in Order No. 670, the FERC made clear that the new Anti-Market Manipulation Rule required the element of scienter to establish a violation:

> The Commission will act in cases where an entity: (1) uses a fraudulent device, scheme or artifice, or makes a material misrepresentation or a material omission as to which there is a duty to speak under a Commission-filed tariff, Commission order, rule or regulation or engages in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity; (2) *with the requisite*

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32. *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 105 F.E.R.C. ¶ 61,218 (2003), *reh'g denied*, 107 F.E.R.C. ¶ 61,175 (2004).

33. *Id.* at 62,170 app. A, ¶ 2.

34. 16 U.S.C. § 824v(a) (2006).

35. Notice of Proposed Rulemaking, *Prohibition of Energy Market Manipulation*, 113 F.E.R.C. ¶ 61,067 (2005).

36. Order No. 670, *Prohibition of Energy Market Manipulation*, 114 F.E.R.C. ¶ 61,047, 71 Fed. Reg. 4244 (2006) (codified at 18 C.F.R. pt. 1c) [hereinafter Order No. 670].

37. *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 114 F.E.R.C. ¶ 61,165 at PP 25, 50, 54 (2006), *reh'g denied*, 115 F.E.R.C. ¶ 61,053 (2006).

38. Order Denying Rehearing, *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 115 F.E.R.C. ¶ 61,053 at P 12 (2006).

> *scienter*; (3) in connection with the purchase or sale of natural gas or electric energy or transportation or natural gas or transmission of electric energy subject to the jurisdiction of the Commission.[39]

The FERC had an opportunity in 2011 to apply its new Anti-Market Manipulation Rule in *Brian Hunter*.[40] Hunter was a trader at Amaranth[41] who the FERC claimed "engaged in a scheme to manipulate the prices for [natural gas] [f]utures [c]ontracts on [the New York Mercantile Exchange]."[42] According to the FERC, "[t]he scheme included the accumulation of large amounts of [such contracts] that were then sold off . . . with the aim of driving down the settlement price."[43] Such price decline would "benefit the significantly larger short positions maintained by Amaranth in natural gas swaps, whose value increased as the [futures] settlement price declined."[44] The FERC upheld the Administrative Law Judge's (ALJ's) findings and, in doing so, re-affirmed that the Anti-Manipulation Rule required scienter.[45]

D. Legal Definitions of Market Power, Manipulation, and Mitigation

In order to define buyer-side mitigation, one must first define the conduct that is being mitigated. In *California ex rel. Lockyer v. Mirant Corp*, the court defined market power or monopoly power as "the power to exclude competition or control prices."[46] Buyer market power, or monopsony power, occurs when a single buyer is able to control a market by limiting its purchases to reduce market prices in order to profit from that action.[47] Whereas with seller market power, the Commission looks at the ability of a large or pivotal seller to artificially raise market prices, with buyer market power the focus is on the converse, i.e., the ability of one or more large buyers to artificially depress market prices. In the *Horizontal Merger Guidelines* (*Guidelines*) promulgated by the Department of Justice and the Federal Trade Commission, this issue is raised by an examination of the impact of "powerful buyers." While the Guidelines state that "[p]owerful buyers are often able to negotiate favorable terms with their suppliers," the Guidelines note that these favorable prices "may reflect the lower costs of serving these buyers," or "price discrimination in their

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39. Order No. 670, *supra* note 36, at P 49 (emphasis added).

40. *Brian Hunter*, 135 F.E.R.C. ¶ 61,054 (2011), *reh'g denied*, 137 F.E.R.C. ¶ 61,146 (2010), *appeal docketed*, Brian Hunter v. FERC, No. 11-1477 (D.C. Cir. Dec. 12, 2011).

41. *Id.* at P 12.

42. *Id.* at P 11.

43. *Id.*

44. *Id.*

45. *Id.* at P 118.

46. California *ex rel.* Lockyer v. Mirant Corp., 266 F. Supp. 2d 1046, 1055 (N.D. Cal. 2006).

47. United States v. Syufy Enters., 903 F.2d. 659, 663 (9th Cir. 1990). The Supreme Court has said that monopsony power can be analyzed in the same way as an exercise of monopoly power. The principle discussed in *Weyerhauser Co. v. Ross-Simmons Hardwood Lumber Co.*, however, should also apply to buyer-side mitigation – that the conduct at issue is one designed to benefit customers and that "mistaken findings of liability would 'chill the very conduct the antitrust laws are designed to protect.'" 549 U.S. 312, 320, 322 (2007) (quoting Brooke Group Ltd. v. Brown and Williamson Tobacco Corp., 509 U.S. 209, 226 (1993)). Here, the FERC asserts that it intervenes in markets to protect consumers from long-term harm even though the immediate impact will be a reduction in prices.

favor."[48] The exercise of buyer market power occurs when a buyer manipulates a market so as to artificially depress prices. Market manipulation, "broadly stated, is an intentional exaction of a price determined by forces other than supply and demand."[49]

Centralized wholesale electricity markets "require appropriate price signals to alert investors when increased entry is needed."[50] If buyers are allowed to artificially depress prices, "these necessary price signals may never be seen."[51] The FERC has thus required that centralized markets have mitigation measures in place in order "to guard against the exercise of market power by those who buy [capacity] and who thus benefit from a low price."[52] As the FERC stated, this type of mitigation measure "is commonly referred to as 'buyer side mitigation.'"[53]

E. Order 1000

Order 1000, the FERC's 2011 landmark order on transmission planning and cost allocation, has two requirements that bear on the issues addressed in this article: (1) the requirement that all transmission planning entities consider public policy for transmission planning and cost allocation; and (2) the reaffirmation of the FERC Order 890 principle that all planning entities should consider transmission, generation, and demand response equally.[54]

In Order 1000, the FERC determined that transmission planning entities should be allowed to consider public policy, and that it is permissible for the planning entity to delegate to states the responsibility for determining and implementing such public policy.[55] The FERC stated that "the transmission planning process and the resulting transmission plans *would be deficient* if they do not provide an opportunity to consider transmission needs driven by [p]ublic [p]olicy."[56] But, incremental transmission built for public policy reasons has the same potential as incremental generation to depress market prices for new electric generation built for public policy reasons. Thus, Order 1000, combined with the FERC's principles on comparability, raises the question of whether the FERC policy on transmission should be applied to generation.

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48. DEP'T OF JUSTICE AND THE FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES 27 (2010); In *R.C. Dick Geothermal Corp., v. Thermogeneics, Inc.*, the court defined buyer market power as a case where the "price is not allowed to rise and suppliers will remain unwilling to exploit those resources necessary to satisfy the unmet demand." 619 F. Supp. 411, 455 (N.D. Cal. 1985).

49. United States v. Reliant Energy Servs., Inc., 420 F. Supp. 2d 1043, 1056 (N.D. Cal. 2006).

50. NYISO, *supra* note 2, at P 103.

51. *Id.*

52. *New York Indep. Sys. Operator, Inc.*, 133 F.E.R.C. ¶ 61,178 at P 2 (2010).

53. *Id.*

54. Order No. 1000, *supra* note 5, at PP 166, 155 ("Specifically, public utility transmission providers are required to identify how they will evaluate and select from competing solutions and resources such that all types of resources are considered on a comparable basis.").

55. *Id.* at P 209.

56. Order 1000-A, *Transmission Planning and Cost Allocation by Transmission Owning and Operating Pub. Utils.*, 139 F.E.R.C. ¶ 61,132 at P 205 (2012) (emphasis added).

III. FACTUAL BACKGROUND

Electric industry restructuring began in the mid-1990's and its difficult beginning, especially in California, has been discussed extensively in prior Energy Bar Journal articles.[57] The basic components of that restructuring were: 1) Retail competition: Generation and delivery were separated and customers could now "choose among suppliers" for the generation portion of the bill; 2) Independent System Operators (ISO): Incumbent transmission utilities were required "to transfer operational control over their respective transmission systems to [an ISO], which would be responsible for assuring non-discriminatory access" to a particular region's transmission grid and system reliability; and 3) Generation divestiture: In some regions vertically integrated utilities divested themselves of their generation which then competed to sell power into centrally administered wholesale electricity markets.[58]

The policymakers who implemented competitive markets believed that merchant electric generators would respond to price signals in the wholesale markets by developing and constructing new generation to meet reliability needs. Likewise, even when there were no reliability needs, it was believed that merchant developers would build new generation that would be more efficient than the existing generation fleet, which would have the beneficial effect of lowering both prices and air emissions without the need for government intervention. But, even when the belief in competitive markets was at its highest at the outset, government was not willing to rely exclusively on competitive generators to maintain reliability.[59] This reluctance has continued.

State governments, which for the most part gave up their market control over electricity generation as a result of electricity restructuring, have continually sought to take steps to foster the development of new electric generation if necessary to meet a public interest need, such as reliability, lower prices, lower or zero emitting generation, or job creation.[60] The FERC also responded to the concern that competitive markets would not always produce new resources to meet reliability or economic needs by requiring RTOs/ISOs to develop more detailed planning rules.[61]

The first major state effort outside of California, prior to 2007, was the request for proposals (RFP) for new electric resources issued by Connecticut in 2006. This RFP stemmed from "Public Act 05-01, An Act Concerning Energy

57. Nicholas W. Fels & Frank R. Lindh, *Lessons from the California "Apocalypse:" Jurisdiction over Electric Utilities*, 22 ENERGY L.J. 1 (2001); Peter Navarro & Michael Sharnes, *Electricity Deregulation: Lessons Learned from California*, 24 ENERGY L.J. 33 (2003).

58. Fels & Lindh, *supra* note 56, at 8.

59. In New York in 2000, then Governor George Pataki ordered the New York Power Authority to build 400 megawatts of new generation in New York City to avoid the reliability and pricing problems that occurred in California. While New York did not have any of the structural restrictions that the California market had (no power exchange purchase requirement and the legal ability to pass through power supply costs), New York was not ready to trust the competitive markets exclusively to build new generation. Neela Banerjee, *Five Questions for Clarence D. Rappleyea: A Different Sort of New York Power Struggle*, N.Y. TIMES (Jan. 14, 2001), http://www.nytimes.com/2001/01/14/business/five-questions-for-clarence-d-rappleyea-different-sort-of-power-struggle.html.

60. Michael Wyman, *Capacity Value Trap: Are Merchant Power Assets Overpriced?*, PUB. UTIL. FORTNIGHTLY (1994), Dec. 2011.

61. Order No. 1000, *supra* note 5 and accompanying text.

Independence, which authorized the Connecticut Department of Public Utility Control to launch a competitive procurement process geared toward motivating new supply-side and demand-side resources in order to reduce the impact of Federally Mandated Congestion Charges (FMCCs) on Connecticut ratepayers."[62]

The pressure for states to intervene to make sure that new generation is built has only increased since the 2008 financial crisis. This is to be expected. The 2008 financial crisis overall created the impression in the minds of many that private markets cannot be trusted, especially to serve the public interest, and electricity is a product that is imbued with the public interest because it is a basic human need and can have significant environmental impacts. Post financial crisis, New Jersey adopted legislation to foster the development of new generation through its Long-Term Capacity Agreement Pilot Program (LCAPP).[63] The legislation adopted stated that PJM's capacity market had "resulted in significant capacity additions in the form of new demand response resources, new energy efficiency resources, reversals of generation unit retirements, upgrades of existing generating units and certain new peaking facilities," but it had not resulted in "large additions of peaking facilities or any additions of intermediate or base load resources."[64] The statute further provided that state action was necessary because "the construction of new, efficient generation must be fostered by State policy that ensures sufficient generation is available to the region, and thus the users in the State in a timely and orderly manner."[65] The method called for in the legislation to foster new generation is a contract for differences (CFD) entered into by the state utilities with the selected generators.[66]

Maryland followed suit issuing a "Notice of Approval of Request for Proposals for New Generation to be issued by Maryland Electric Distribution Companies" ordering Maryland's companies to issue a RFP for capacity and energy.[67] As with New Jersey, the selected bidders would enter into a contract

62. *Home*, CONNECTICUT RFP 2006, http://www.connecticut2006rfp.com/index.php (last visited Aug. 24, 2012).

63. An Act Establishing a Long-Term Capacity Agreement Pilot Program to Promote Construction of Qualified Electric Generation Facilities, Amending and Supplementing P.L.1999, c.23, 2011 N.J. Sess. Law Serv. Ch. 9 (West).

64. *Id.* § 1(b).

65. *Id.* § 1(d). The legislation noted that the FERC had rejected PJM's proposal to foster the construction of new generation through the use of persistence pricing for new entry, i.e., allowing a new generator to receive a fixed price for certain period of time through the RTO's market. *PJM Interconnection, L.L.C.*, 126 F.E.R.C. ¶ 61,275 at PP 149-50 (2009). The Legislature also noted that the FERC had rejected a PJM proposal to allow PJM to mandate that a generator remain in operation when needed for reliability reasons. *PJM Interconnection, L.L.C.*, 110 F.E.R.C. ¶ 61,053 at P 137 (2005) (stating that PJM could not "'require' generators to continue to operate for an indeterminate period"). Both of these issues are outside the scope of this paper but it is worth noting here that these policies have increased state concern that the FERC is relying too heavily on the competitive market to maintain reliability.

66. 2011 N.J. Sess. Law Serv. Ch. 9 §§ 3(b), 3(c)(4) (West). Under the CFD, a winning bidder will be paid (or required to pay) based on the difference between its bid prices for energy and capacity (as reflected in the CFD) and PJM's corresponding price for capacity. The CFD assures that the winning bidder will always be paid the greater of (1) the PJM price or (2) the bidder's winning bid price.

67. *Maryland Utilities Issue Request For Proposals For Generation Capacity Resources Under Long-Term Contract*, PEPCO (Oct. 7, 2011), *available at* http://www.pepco.com/welcome/news/releases/archives/2011/article.aspx?cid=1875.

for differences with the applicable utility company.[68] New Jersey's program resulted in three generators being awarded a contract and the Maryland program resulted in one generator being awarded a contract.[69]

IV. BUYER MITIGATION AS APPLIED BY THE FERC IN NEW YORK, NEW ENGLAND, AND PJM

Although market power mitigation measures existed for sellers of both energy and capacity for several years, market power mitigation measures for buyers are a relatively new concept that started in 2006. They initially came into existence as part of the forward capacity markets introduced in New England and PJM. But, it was in a dispute over the New York City capacity markets that the FERC first adopted its theory of buyer-side mitigation that it has now applied in most ISOs and RTOs.[70]

With respect to New York, the first major discussion over concerns regarding buyer market power began with a proceeding concerning mitigation measures for both sellers and buyers in the New York City capacity market.[71] Here, the FERC first stated that buyer mitigation measures were an element of a balanced approach to market power mitigation because seller mitigation measures were already in place.[72] The FERC had initially explained that "[l]arge net buyers may have both the incentive and the ability to depress prices through uneconomic entry."[73] A large net buyer could acquire new capacity that is not needed in the market and whose costs exceed the market price. Such an investment would be inefficient, the net buyer would lose money on the capacity, and no rational seller would knowingly make such an investment.[74] The FERC then explained that nevertheless this "investment could benefit the net buyer because the additional capacity could reduce the market price for capacity and lower the net buyer's total capacity bill."[75] Moreover,

> [i]f the newly added capacity represents only a portion of the net buyer's total capacity needs, the reduction in the buyer's total capacity bill caused by the lower prices could more than offset the loss on the newly added capacity investment. As a result, a large net buyer could have an incentive to make such an inefficient investment.[76]

The FERC found that large utility net buyers with captive ratepayers could have an incentive to undertake these types of investments because they could pass the costs of these investments on to their ratepayers.[77] The FERC ultimately found

68. *Id.*

69. *What was Impact of State-Created Plants on PJM Capacity Auction*, Restructuring Today (May 22, 2012), http://www.restructuringtoday.com/public/9090print.cfm.

70. NYISO, *supra* note 2, at P 1. There are three distinct capacity markets in the NYISO: (1) New York City; (2) Long Island; and (3) Rest of State. Both the seller and buyer capacity mitigation measures are applicable to the New York City capacity market only. This is because historically there has been a high degree of market concentration in New York City market.

71. *Id.* at P 6.

72. *Id.*

73. *Id.* at P 101.

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

that "the mitigation of net buyers' sales of capacity proposed by NYISO should help avoid this."[78] The FERC defined net buyer as "a market participant whose capacity purchase obligation as an LSE [load serving entity] outweighs the amount of capacity supply it owns or controls."[79]

The effect of large net buyers entering into contracts with new generators could be to depress prices. Moreover, if a new unit relies on out-of-market payments, it can bid its capacity into an auction at a price below its cost, which would lower the clearing price. In the initial NYISO buyer mitigation order, the FERC stated that it would not be interfering with any state policies concerning resource adequacy because it was limiting its new entry mitigation to net buyers only;[80] but then, the FERC reversed itself on rehearing and eliminated the restriction of applying buyer mitigation to net buyers only, stating "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."[81] The FERC agreed with parties requesting rehearing (including the NYISO) "that defining net buyers raises significant complications and provides undesirable incentives for parties to evade mitigation measures."[82]

Moreover, the FERC has since made it clear that it believes it has the obligation to deter all "uneconomic entry" regardless of whether there is an intent to manipulate prices. In a recent ISO-NE order the FERC stated

> [out-of-market] capacity suppresses price regardless of intent. Moreover, because other resources in the [capacity market] will be affected by such price suppression, the Commission has a duty to ensure just and reasonable rates by requiring that bids in the [capacity market] represent a resource's true cost of entry, regardless of agreements between a resource's developer and sponsor.[83]

In effect, notwithstanding its reliance on competitive markets to set price, the FERC has decided that it does not need to determine that there is either an exercise of market power or intent to depress prices in order for it to apply a buyer mitigation remedy. Instead, the FERC has determined that it is necessary to have rates that are "just and reasonable." But this is contrary to the principle that the FERC should engage in light-handed regulation when it decides to rely on markets to determine market prices.

This is one significant area where buyer mitigation differs from seller mitigation. As applied by the FERC, buyer mitigation has effectively become new entrant mitigation under which all new entrants are subject to mitigation unless otherwise exempted because they have somehow demonstrated that their new facility is not "uneconomic." As the FERC explained:

> The Commission acknowledges the rights of states to pursue policy interests within their jurisdiction. Our concern, however, is where pursuit of these policy interests allows uneconomic entry of [out-of-market] capacity into the capacity market that is subject to our jurisdiction, with the effect of suppressing capacity prices in those markets. We note that our primary concern stems not from the state policies themselves, but from the accompanying price constructs that result in offers into the

78. *Id.*

79. *Id.* at P 5 n.5.

80. *Id.* at P 112.

81. *New York Indep. Sys. Operator, Inc.*, 124 F.E.R.C. ¶ 61,301 at P 29 (2008).

82. *Id.*

83. *ISO New England, Inc.*, 138 F.E.R.C. ¶ 61,027 at P 20 (2012).

> capacity market from these resources that are not reflective of their actual costs. We agree with arguments contending that [out-of-market] capacity suppresses prices regardless of intent and that the Commission has exclusive jurisdiction on assessing whether wholesale rates are just and reasonable.[84]

The problem with this reasoning is that the FERC states that it is only acting to protect competitive markets, but it has failed to acknowledge the effect of its actions is to impede the implementation of state policies. States will not provide incentives for the development of a particular kind of generation if the result is that the generation will not clear in competitive wholesale markets.[85]

Under the FERC's current buyer mitigation policy, the offer floor can be applied to prospective new entrants only. In establishing its buyer mitigation measures in the NYISO's New York City capacity market, the FERC was careful to recognize that such mitigation "clearly applies to 'new' uneconomic entrants, not existing capacity."[86] The FERC believed that "to apply this new market rule to units that already exist in the market misses the point of this prospective rule, which is to affect future actions."[87] In a recent New England order, the FERC explained:

> We agree that it is generally reasonable to apply mitigation to sellers with market power that had not initially been mitigated. Mitigation in this context typically involves offer caps and/or must-offer requirements, which tend to lower the price of capacity, which in turn is likely to increase the amount of output that buyers are willing to purchase. This is an efficient result, because the value of the extra output to buyers (reflected by the price they are willing to pay) equals or exceeds the seller's incremental cost of producing it. But in the case of historical [out-of-market] capacity, in this proceeding, where buyer-market power is at issue, applying after the fact mitigation may result in inefficient decisions, as explained above, by encouraging less efficient resources to remain in the market rather than retire.[88]

The FERC's rationale for a broad–based approach to mitigation for new entrants is based on the need to mitigate uneconomic entry before it could occur.[89] According to the FERC, its mitigation rules "assure that uneconomic new capacity will not be allowed to distort market supply curves and inefficiently depress market clearing prices below a competitive level."[90] This enables the mitigation measures to influence whether such a new entrant actually comes into service. But, the FERC's buyer mitigation measures, as currently

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84. *ISO New England, Inc.*, 135 F.E.R.C. ¶ 61,029 at P 170 (2011).

85. In addition, because the FERC has stated that the purpose of buyer mitigation is to deter the construction of such generation, it is only before the new entrant comes into being that a market power mitigation rule can mitigate the effect that the new entrant could have on a market. Once the new entrant has arrived, whatever downward impact it could have on prices has already occurred. In rejecting a rehearing request from some New York City suppliers, the FERC affirmed that "new entry mitigation is intended to deter the construction of uneconomic capacity and such deterrence would not apply" to generation units that already exist. *New York Indep. Sys. Operator, Inc.*, 131 F.E.R.C. ¶ 61,170 at P 43 (2010). This differs from seller mitigation where a seller with market power has the ability to influence market prices every time it places a bid to sell its capacity or energy.

86. NYISO, *supra* note 2, at P 118.

87. *Id.*

88. *ISO New England, Inc.*, 138 F.E.R.C. ¶ 61,027 at P 40.

89. *New York Indep. Sys. Operator, Inc.*, 133 F.E.R.C. ¶ 61,178 at P 48.

90. *New York Indep. Sys. Operator, Inc.*, 124 F.E.R.C. ¶ 61,301 at P 27.

constructed, apply to all new entry even if there is no finding of market power and/or an intent to depress prices.

A. NYISO In-City Buyer Mitigation Rules (2006-2008)

In 2007, the NYISO filed a new comprehensive market power mitigation plan that included new seller and buyer mitigation measures for the New York City capacity market.[91] The NYISO's original proposal, along with all of the subsequent modifications accepted by the FERC, does not look at the intent of either buyers or sellers in determining whether to impose mitigation measures. On the buyer side, the new entrant is required to bid using an offer floor which is either 75% of the net Cost of New Entry (CONE) of a typical new generation resource in that region, or the specific cost of new entry of the new resource in question as measured over a specified period of time.[92] NYISO's proposal applied "to all new entry deemed 'uneconomic' in the form of an offer floor equal to [seventy-five] percent of net CONE, applicable to all new entrants for the first three years of operation."[93] A unit would be "economic" and exempt from mitigation if the "NYISO determines that a new entrant's costs are legitimately [as determined by the NYISO] less than seventy-five percent of net CONE."[94] In accepting the NYISO's proposal of an "offer floor equal to seventy-five percent of net CONE," the FERC stated that "this offer floor will deter uneconomic entry by preventing such entry from depressing the market price significantly below the net CONE."[95] The Commission accepted seventy-five percent as a "balanced" offer floor because "[i]t deters uneconomic entry but is not so high as to deter economic entry."[96]

One of the more controversial aspects of the NYISO proposal that was approved by the FERC was that it made no exception for new entry that resulted (either directly or indirectly) from a state action or requirement.[97] The New York State Public Service Commission argued that the failure to provide for this type of exemption interfered with the state's jurisdiction over reliability and resource adequacy.[98] Specifically, the New York Commission argued that the FERC "failed to recognize that the pricing regime it adopted has a direct and

91. NYISO, *supra* note 2, at P 8.

92. *Id.* at P 107. Net CONE refers to the capital cost of constructing a new generating facility (typically a combustion turbine) minus the revenues that such generator would receive from the energy and ancillary services markets. The capital cost, times a reasonable return, minus these energy and ancillary service revenues is deemed to be the amount that a plant would need to earn from the capacity markets in order to be financed and built. *Id*. at n.24.

93. NYISO, *supra* note 2, at P 87.

94. *Id.* at P 88.

95. *Id.* at P 107. As discussed above, because Net CONE is deemed to be the amount that a plant needs to earn in the capacity markets, the FERC determined that prices below that level would not be just and reasonable.

96. *Id.* The NYISO's proposal also provided that all new capacity classified as uneconomic "would not be able to directly participate in bilateral transaction, or in strip or monthly auctions." *Id*. at P 87. Thus, mitigated new entry would only be able to sell its capacity in the twice yearly demand curve auctions.

97. Request for Rehearing of the Public Service Commission of the State of New York, FERC Docket No. EL07-39, at 5 (April 7, 2008).

98. *Id.* at 1-2.

adverse impact on the way in which New York's resource adequacy requirements are met."[99]

The FERC rejected the rehearing requests of the New York Commission, stating that "resource adequacy can have a significant effect on wholesale rates and service."[100] The FERC relied on *Mississippi Industries v. FERC*, finding that "[c]apacity costs are a large component of wholesale rates."[101] The FERC provided, however, that the New York Commission could "make a filing under section 206 of the FPA to justify a mitigation exemption for entry of new capacity that is required by a state-mandated requirement that furthers a specific legitimate state objective."[102]

Con Edison and other market participants sought rehearing on the grounds that the Commission's mitigation measures would "require buyers to purchase the same quantity of capacity twice."[103] As explained:

> Under the buyer mitigation measures adopted in the March 7th Order, certain contracted-for capacity could be required to be bid into the [NYISO] spot market auction at a floor price of 75% of [Net CONE] (or lower if justified with the NYISO). If, at the time of the spot market auction, the market price of capacity is less than 75% of Net CONE, the contracted-for capacity will not clear the auction, in whole or in part. In that case the buyer would have to purchase both the contracted-for capacity and the same amount of capacity from the NYISO spot market. If this occurs, the buyer that owns the contracted for capacity and its customers would have to pay twice for the same quantity of capacity – once through the NYISO market, and again through the contract.[104]

There have been some modifications to the NYISO rules, related to such issues as the timing of the test and the length of the mitigation period,[105] but the essential shape of the mitigation has remained the same.

There has been, however, significant litigation to date over the application of the NYISO's implementation of the buyer-side mitigation measures. In 2011, the New York City generators filed a complaint with the FERC alleging that it appeared that the NYISO had improperly exempted from buyer-side mitigation exemption to two new entrant New York City generators.[106] The FERC subsequently rejected many of the assumptions used by the NYISO when it exempted these generators. The FERC required the NYISO to redo the exemption test for those generators, which will also result in the NYISO redoing the test for a controllable transmission line that is also being evaluated for an

99. *Id.* at 9.

100. *New York Indep. Sys. Operator, Inc.*, 124 F.E.R.C. ¶ 61,301 at P 35 (2008).

101. Mississippi Indus. v. FERC, 808 F.2d 1525, 1541 (D.C. Cir. 1987), *vacated in part on other grounds*, 822 F.2d 1103 (D.C. Cir. 1987).

102. *New York Indep. Sys. Operator, Inc.*, 124 F.E.R.C. ¶ 61,301 at P 38.

103. Request For Clarification Or, In The Alternative, Request For Rehearing Of Consolidated Edison Company Of New York, Inc., et al., FERC Docket No. EL07-39 at 2 (April 7, 2008). Con Edison and O&R have filed an appeal with the U.S. Court of Appeals for the D.C. Circuit of the Commission's orders approving the buyer mitigation mechanism. NYS PSC v. FERC, No. 08-1366 (D.C. Cir.) (consolidated with Docket Nos. 08-1368 (Con Edison and O&R), 08-1369, 08-1370, 08-1372).

104. *Id.*

105. *New York Indep. Sys. Operator, Inc.*, 133 F.E.R.C. ¶ 61,178 at P 47.

106. Astoria Generating Co., L.P. and TC Ravenswood, L.L.C. v. New York Indep. Sys. Operator, Inc., FERC Docket No. EL11-50, at 3 (2011). Most of the arguments and materials submitted pursuant to this complaint has been made subject to confidentiality and cannot be discussed in detail here. The complaint is still pending at the FERC.

exemption.[107] This saga will continue, but it highlights the complexity of the litigation that can result from the FERC's decision that every new provider of capacity must be tested.

B. PJM Mitigation Rules Modified in Response to New Jersey Legislation

The reaction to the New Jersey LCAPP legislation described in Section III above was immediate. Three days after it was signed, on February 1, 2011, the PJM Power Providers Group filed a complaint at the FERC requesting changes to PJM's buyer-side mitigation mechanism, which also used an offer floor.[108] PJM filed a similar request on February 11, 2011.[109] The existing mitigation had been designed in 2006, when PJM implemented a new capacity market design.[110] The theory behind PJM buyer-side mitigation was that only suppliers and their affiliates who were net short would have an incentive to suppress capacity prices.[111] Therefore, only suppliers and their affiliates who were net short were potentially subject to an offer floor. The New Jersey developers were not net short buyers (because they were generating companies), and therefore would have been exempt from the offer floor. The PJM complaint requested the elimination of the net short requirement and several other significant changes.[112]

As it had done for the New York City market, the FERC agreed to eliminate the net-short requirement.[113] The FERC recognized that the purpose of the net-short limitation was to focus buyer-side mitigation "on entities with the incentive to exercise buyer market power."[114] But, the FERC noted, it was not accurate that only these entities would have the incentive to suppress prices.[115] Although the FERC did not specifically refer to the New Jersey developers, the FERC expressed its concern that a "state-supported" seller that does not serve load could make an "uncompetitively low offer" that does not trigger the offer floor requirement because the seller is not net-short.[116] The FERC also expressed concern that if mitigation were limited to buyers who were net short, power purchase agreements could be drafted that would evade mitigation and suppress prices if a buyer, for example, committed to cover the seller's costs while directing that the seller offer the new plant's capacity at a low price.[117]

In response to an argument that elimination of the net-short requirement would result in "over mitigation," the FERC stated that it was not over-mitigating because it was approving a process by which new offers could prove that their bid price was competitive and should not be mitigated.[118] Further, the

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107. *New York Indep. Sys. Operator, Inc.*, 140 F.E.R.C. ¶ 61,189 (2012).

108. *PJM Interconnection, L.L.C. and PJM Power Providers Grp. v. PJM Interconnection, L.L.C.*, 135 F.E.R.C. ¶ 61,022 at P 2 (2011).

109. *Id.* at P 1.

110. *Id.* at P 5.

111. *Id.*

112. *Id.* at P 7.

113. *Id.* at P 86.

114. *Id.*

115. *Id.* at P 89.

116. *Id.* at P 87.

117. *Id.*

118. *Id.* at P 89.

FERC expressed concern that a blanket exemption provided entities with an opportunity to evade or game the net-short requirement:

> We are not persuaded however, that merely refining the net-short requirement, or applying it more broadly, will be an effective means of addressing PJM's legitimate concern that this provision is too easily gamed or evaded. . . .[T]he evasion of the net-short requirement can come in a variety of forms, some unforeseen, and attempting to revise this provision to account for those scenarios may simply lead to further opportunities for gaming.[119]

In addition to elimination of the net-short requirement, PJM proposed additional significant revisions.[120] The existing mitigation used both a conduct and impact screen to measure the impact of a bid on capacity auction prices.[121] Under the conduct test, a sell offer was mitigated "if it was less than eighty percent of the real levelized net CONE for the applicable asset class."[122] Other, unspecified plant types were mitigated if their sell offer was less than seventy percent of the net CONE of a combustion turbine.[123] A resource was entitled to file at the FERC to show that its entry costs were lower than the applicable thresholds.[124]

The FERC accepted PJM's proposal to raise the conduct screen to ninety percent of net CONE for natural gas plants and seventy percent for unspecified plant technologies.[125] Even though the FERC had adopted seventy-five percent in New York, it saw the ninety percent and seventy percent levels as representing a balancing of the protection against uneconomic entry, the limits of administrative estimates, and the additional burdens of the cost justification process, stating: "We find persuasive PJM's assertion that the revised ninety percent threshold strikes a reasonable balance between protecting against unreasonable exercises of market power and recognizing the imperfection of administrative estimates and the burden of the cost justification process."[126]

PJM also proposed to eliminate the impact screen.[127] Under the impact screen, if a sell offer failed the conduct screen, PJM would re-run the auction to determine the impact of the unmitigated bid price on capacity clearing prices.[128] An offer was mitigated if there was "at least a $25/MW-day or a twenty to thirty percent change in clearing price, depending on the size of the zone."[129] The FERC agreed and concluded that the impact screen allows offers that are "indisputably uneconomic" to evade mitigation.[130]

The FERC also revised the process by which a new entry resource can prove that its offer is based on competitive market factors. If a unit's sell offer is rejected as outside of the costs of its particular asset class and subject to

119. *Id.* at P 90.
120. *Id.* at P 29.
121. *Id.* at P 91.
122. *Id.* at P 52.
123. *Id.*
124. *Id.*
125. *Id.* at P 66.
126. *Id.* at P 70.
127. *Id.* at P 92.
128. *Id.* at P 91.
129. *Id*.
130. *Id.* at P 101.

mitigation, the unit's owner can nevertheless make a showing at the FERC that its sell offer is based on competitive factors.[131] In its filing, PJM proposed to clarify that such a filing would be made at the FERC under section 206 of the FPA.[132] The FERC rejected PJM's clarification and explained that a filing with the FERC[133] could result in complex and lengthy litigation that could be avoided if such determinations were made first by PJM and PJM's Market Monitor.[134] Therefore, the FERC directed that parties first submit their proposed offers with full documentation to the PJM Market Monitor for review,[135] and to PJM if the Market Monitor's decision is adverse to the party's interests.[136]

The FERC ultimately limited the application of the buyer mitigation measures agreeing with PJM that wind and solar generation should not be required to bid at a price higher than zero, and that the zero-price exemption should apply to upgrades and additions to an existing capacity resource.[137] The FERC concluded that wind and solar facilities are not likely to be used to suppress capacity prices because their energy output is intermittent.[138] The FERC also reasoned that facilities like coal and nuclear do not provide reliable reference values because not many have been placed in service, and estimates of their costs could vary widely.[139] Additionally, the FERC found that long lead time resources are less likely to be the source of price suppression because developers of such resources make investment decisions several years in advance of the first capacity auction in which they participate while developers of natural gas facilities could wait until after the auction results to develop their facilities.[140]

In a surprise, two of the three New Jersey LCAPP legislation developers, as well as a third developer in New Jersey, LS Power, were able to clear their new resources in PJM's May 2012 capacity auction despite the more stringent standards applicable to new entry.[141] The PJM mitigation rules were changed to address this legislation, but the new resources cleared in the auction nonetheless. In addition, these new units will no longer be subject to mitigation because under the new rules mitigation ends once the generator clears one auction.

This incident illustrates the administrative limitations on the accuracy of mitigation offer floors. And it also shows the risk that state interference in a market could lead to developers being overpaid for new supply which would

131. *Id*. at P 109.

132. *Id.* at P 110.

133. *Id.* at P 118. The FERC noted as an example the recent filing of West Deptford Energy L.L.C. where West Deptford Energy requested an exemption from MOPR, and interveners requested the company's confidential cost data. *West Deptford Energy, L.L.C.*, 134 F.E.R.C. ¶ 61,189 (2011).

134. 135 F.E.R.C. ¶ 61,022 at P 118.

135. *Id.* at P 119.

136. *Id.* As noted in *West Deptford Energy*, a similar procedure in New York has not helped to avoid litigation as the generators have filed complaints at the FERC contesting the exemption determinations that were made. 134 F.E.R.C. ¶ 61,189 at P 4.

137. 135 F.E.R.C. ¶ 61,022 at P 152.

138. *Id.* at P 153.

139. *Id.* at P 154.

140. *Id*. at P 155.

141. Scott DiSavino, *Planned Natgas Plants in New Jersey Clear PJM Auction*, REUTERS (May 22, 2012), *available at* http://www.reuters.com/article/2012/05/22/utilities-newjesey-pjm-idUSL1E8GM41320120522.

result in additional ratepayer costs. Meanwhile, the fate of the New Jersey program remains in the courts. The federal district court action is still pending,[142] and the state's electric utilities[143] and a group of PJM power suppliers[144] filed appeals in the New Jersey state court.

C. New England ISO

In 2011, the FERC issued an order on rehearing affirming its prior order requiring New England to implement buyer mitigation measures similar to the ones that have been implemented in the NYISO and PJM.[145] Previously, to deal with issues concerning buyer-mitigation, New England proposed a "two-tiered pricing model."[146] "Under [this] proposal, anytime an [out-of-market] resource," i.e., a resource that has received a subsidy, "clears the auction, two clearing prices [would] result."[147]

> One price, based on parties' actual offers, [would be called] the Capacity Clearing Price. All new resources [would] receive this price. The second, higher price [would be called] the 'Alternative' Capacity Price. The 'Alternative' Capacity Price [would be determined] by assuming [that] all [out-of market] offers had [been] instead offered competitively through the use of benchmark pricing [based on] the price existing resources receive.[148]

ISO-New England proposed to purchase all capacity at the Alternative Capacity Price.[149] The two-tiered would not limit overall capacity purchases to the level of the capacity requirement, as had been the past practice.[150]

The FERC rejected this proposal, stating that while it "generally agree[d] with the principles that underlie the two-tiered pricing model," the proposal "fail[ed] to appropriately balance the competing interests at issue, in particular, the objective of limiting purchases" under the New England model (leaving open the possibility that this proposal could be implemented in the NYISO and PJM).[151] Accordingly, the FERC required ISO-New England "to work with its stakeholders to develop an offer-floor mitigation construct akin to those in PJM and NYISO."[152] Specifically, it stated that both existing and new resources should compete in the same auction and be paid the same price, and should be required to bid at a level reflecting their entry costs or the cost of entry determined by ISO-NE for the asset class.[153]

Also, as in PJM and NYISO, the FERC stated that it would only allow filings "under section 206 of the FPA to request a mitigation exemption" for

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142. PPL Energy Plus, L.L.C. v. Lee A. Solomon, No. 3:11-CV-00745-PGS-DEA (D.N.J. 2011).

143. *In re* The Long-Term Capacity Agreement Pilot Program, Docket No. A5192-10T1 (N.J. Super. Ct. App. Div. 2011).

144. *In re* The Long-Term Capacity Agreement Pilot Program, Docket No. A4467-10T1 (N.J. Super. Ct. App. Div. 2011).

145. *ISO New England, Inc.*, 138 F.E.R.C. ¶ 61,027 (2011).

146. *ISO New England, Inc.*, 135 F.E.R.C. ¶ 61,029 at P 18 (2011).

147. *Id.*

148. *Id.*

149. *Id*. at P 18.

150. *Id.* at P 19.

151. *Id.*

152. *Id.*

153. *Id.* at PP 166-67.

public policy reasons and declined to create any exemptions up front.[154] The FERC stated that the decision "to grant an exemption [would] be based on each case's unique facts."[155]

Commissioners Wellinghoff and LaFleur concurred separately and urged New England to consider an exemption for renewables as in PJM:

> While it is true that all [out-of-market] capacity, regardless of intent, will have the same effect on the market-clearing price, it is also true that some [out-market] capacity is not intended to suppress the market-clearing price, but to further legitimate public policy goals, such as the progressively escalating renewable portfolio standards present in each of the six New England states. This [out-of-market] capacity is not intended to suppress the market-clearing price, but to comply with legal requirements that advance the states' environmental objectives.[156]

They declined, however, to order such an exemption. Instead, they noted that PJM had proposed, and the FERC had approved, such an exemption and they therefore "encourage[d] ISO-NE and its stakeholders to consider whether similar exemptions are appropriate for New England."[157]

V. PROPOSED REFORM

Buyer-side mitigation as currently implemented by the FERC is broken. Competitive electricity markets will be highly dependent on new entry for the foreseeable future to achieve the public policy goals of improving the emissions profile of electric generation and maintaining reliability as older generation retires. While the most recent PJM capacity auction appears to demonstrate that capacity markets have the ability to facilitate new entry as older, less efficient generators retire,[158] it should not be expected this will end state efforts to intervene. And, while the FERC has the goal of protecting the operation of competitive wholesale markets, it is difficult to believe that a system is preferred where it is necessary to determine whether every single new entrant that enters the market is uneconomic regardless of whether that entity intends to exercise market power or has the ability to exercise market power.

Some form of buyer mitigation may be necessary to allow markets to work, but the rules should not be so overly broad such that every new entrant generator is assumed to be potentially exercising market power or manipulating prices unless it can demonstrate that it is "economic." The case is especially clear when it concerns a merchant generator that is seeking to enter the market where there is no evidence of significant government intervention, e.g., a long-term out-of-market state supported contract with a generator at above-market rates. Moreover, the FERC must provide some room for states to pursue public policy goals, as it is now permitting for transmission. The FERC should at a minimum seek to create safe harbor exemptions in advance, similar to the ones that it has

154. *Id.* at P 20.

155. *Id.*

156. *Id.* at p. 61,206 (Comm'rs C. LaFleur and J. Wellinghoff, concurring).

157. *Id.*

158. Press Release, PJM Interconnection, PJM Capacity Auction Secures Record Amounts of New Generation, Demand Response, Energy Efficiency (May 18, 2012), *available at* http://pjm.com/~/media/about-pjm/newsroom/2012-releases/20120518-pjm-capacity-auction-secures-record-amounts-of-new-generation-demand-response-energy-efficiency.ashx.

approved for PJM. This section will address these two issues in turn: (1) rationally tailored mitigation, and (2) safe harbor public policy exemptions. Finally, the article will conclude by addressing the process the FERC should pursue in proposing and implementing changes to buyer-side mitigation.[159]

A. Rationally Tailored Mitigation

The FERC decided that every new plant should be tested because "defining net buyers raises significant complications and provides undesirable incentives for parties to evade mitigation measures."[160] But the FERC did not specify what these "significant complications" and "undesirable incentives" were, and still has not done so. Moreover, the FERC has now seen the "undesirable" consequences of its decision, i.e., it is possible for other market participants to contest the entry of every single new generator, which threatens the long-run sustainability of competitive markets by chilling the new entry that is essential to competitive markets. Moreover, the complex calculations and assumptions required to determine whether a generator is economic can result in a mitigation exemption for a generator that receives the most direct form of subsidy, a state mandated long-term contract where above-market costs would be absorbed by captive ratepayers.

This article proposes that the FERC should treat capacity markets as lightly regulated competitive markets where prices are assumed to be just and reasonable unless there is evidence that the price has deviated from a market result due to an abuse of market power or manipulation of the market where it can be proved that there was a specific intent to manipulate.[161] This would be more consistent with the way the FERC has implemented light-handed regulation, i.e., that just and reasonable rates result from competitive markets free from market abuse.

Proposals have been put forward that are more consistent with how the FERC should implement light-handed regulation. One proposal would limit buyer side mitigation to cases where there is an intent to manipulate prices:

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159. An additional option is whether capacity markets can be eliminated or made voluntary. If they are, there is no need for buyer-side mitigation. In *Midwest Indep. Transmission Sys. Operator, Inc.*, 139 F.E.R.C. ¶ 61,199 at P 42 (2012), the FERC found that buyer-side mitigation rules were unnecessary because "utilities own the vast majority of capacity within MISO and therefore they would not benefit from lower prices in the voluntary capacity auction." The organized wholesale market for Texas does not have a capacity market, Smith, *supra* note 6, but it appears unlikely that most organized markets will be willing to forgo capacity markets. Questions concerning whether capacity markets are necessary are assumed to be outside the scope of this article.

160. *New York Indep. Sys. Operator, Inc.*, 124 F.E.R.C. ¶ 61,301 at P 29.

161. Order No. 745, *Demand Response Compensation in Organized Wholesale Energy Markets*, 134 F.E.R.C. ¶ 61,187 at P 62, 76 Fed. Reg. 16,658 (2011) (codified at 18 C.F.R. pt. 35) [hereinafter Order No. 745] ("In the absence of market power concerns, the Commission does not inquire into the costs or benefits of production for the individual resources participating as supply resources in the organized wholesale electricity markets"); Order No. 745-A on Rehearing and Clarification, *Demand Response Compensation in Organized Wholesale Energy Markets*, 137 F.E.R.C. ¶ 61,215 (2011); Order No. 745-B Denying Rehearing, *Demand Response Compensation in Organized Wholesale Energy Markets*, 138 F.E.R.C. ¶ 61,148 (2012).

> [1.] Exempt self-supply resources [for] vertically-integrated LSEs if the resource is the result of a deliberative planning process by the LSE and the LSE is not substantially net short in the [capacity market].[162]
> [2.] Exempt a resource if the owner—and its contractual counterparty, if relevant—are not substantially net short [in capacity] and, thus, would not benefit from suppression of capacity prices. To qualify for such an exemption would require a verification process, such as: (1) the resource owner would have to show that it is not net short; (2) the resource owner would have to disclose all contracts with counterparties; and (3) the contractual counterparties would need to make available documentation that they are not substantially net short.[163]

In addition, even where the counterparty was not net short, the FERC would be able to take action and apply an offer floor or apply other remedies if it is determined by an ISO/RTO (subject to FERC review) that contracts were entered into with the specific intent to depress prices. This would allow an ISO/RTO to apply an offer floor to a generator that has been awarded by a state utility commission where the state's intent is to depress market prices instead of the pursuit of other public policy goals, such as reducing air emissions.

Indeed, even with respect to state governments, the FERC could limit its intervention to generator/net buyer contracts that are the result of government intervention and where a finding has been made that there was a specific intent to manipulate market prices.[164] At what is still the early stage of electric industry restructuring, especially capacity market development, the FERC should not expect that states will put all of their trust in competitive markets and wait and see whether reliability or environmental needs will be met. Merchant generators will claim, and the FERC has agreed to date, that allowing state intervention will ultimately undermine competitive markets and result in their failing. This may be true if states continue to intervene in competitive markets as New Jersey and Maryland have to date.[165] It is not clear, however, that states are prepared to go all the way down this slippery slope.[166]

Moreover, it is unclear why the merchant generation community should be exempt from *any* state and local government intervention in the electricity

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162. This exemption would be expected to apply mostly to public power entities that are seeking to supply or hedge their own load.

163. JOHANNES PFEIFENBERGER, ET AL., THE BRATTLE GRP., SECOND PERFORMANCE ASSESSMENT OF PJM'S RELIABILITY PRICING MODEL 150-51 (2011), *available at* http://www.brattle.com/_documents/UploadLibrary/Upload972.pdf. A similar proposal has recently been made to the NYISO by FTI Consulting, which stated that there should be exemptions for "resources not associated with or under contract to any entity possessing buyer-side market power . . . mitigation." SCOTT M. HARVEY, ET AL., FTI CONSULTING, EVALUATION OF THE NEW YORK ISO CAPACITY MARKET: SUMMARY OF DRAFT REPORT 17 (2012), *available at* http://www.nyiso.com/public/webdocs/committees/bic_icapwg/meeting_materials/2012-09-11/Evaluation_of_the_New_York_ISO_Capacity_Market_Summary_of_Draft_Report.pdf.

164. Under this proposal, public power authorities are a special example as discussed in the PJM rehearing order—at a minimum, the business model should be considered.

165. Also, if a generator has a belief that a specific case of market manipulation has occurred, it can file a complaint with the FERC and the FERC has ample tools at its disposal to determine whether market manipulation has occurred. *See, e.g.*, *Astoria Generating Co.*, 139 F.E.R.C. ¶ 61,244 (2012).

166. For example, after it conducted its RFP for contracts to finance new generation, New Jersey commented to the FERC that it is "is committed to competitive markets" but "design flaws" in PJM's market made it difficult for new entry to be financed without long-term contracts. Comments of the New Jersey Board of Public Utilities on PJM'S Revised Minimum Offer Pricing Rule, FERC Staff Technical Conference, at 4, FERC Docket Nos. ER11-2875-001 et al. (July 28, 2011).

market. State and local government intervention has occurred in all markets, through such interventions as changes in the tax code, tax-free financing and other measures on behalf of certain businesses, including actions that have benefited merchant developers. All states and localities have implemented these measures in the name of economic development and they are subject to review by the courts to determine if they impermissibly discriminate against interstate commerce. If states may limit the construction of the new generation to environmentally friendly units, which will affect market prices, then it is unclear why states could also not provide subsidies for more environmentally friendly generation.[167] Indeed, the federal government has similarly intervened in federal energy markets, by providing substantial subsidies for all forms of generation facilities, but the FERC has not considered those subsidies to date in its determinations of whether mitigation is appropriate.

A generator that operates in competitive markets has numerous business risks, and governmental intervention is one of them. An older, coal-fired generation plant could be forced to retire because a state decides to adopt a carbon tax, or because the state decides to subsidize the construction of new renewable or combined-cycle natural gas generation. Ultimately, this business risk will be reflected in the returns demanded by generators and will be reflected in market prices. But, the states that make these decisions will for the most part have to deal with the consequences of their decisions. States, of course, should not be allowed to seek to directly manipulate wholesale, interstate prices, but that is why the FERC should be allowed to block such intervention only when there is a specific intent to manipulate prices.[168]

B. Safe Harbor Exemptions for Public Policy Initiatives

This article proposes that the FERC should restrict its application of buyer-side mitigation to the most extreme cases. These "extreme" cases, however, are likely to involve direct state intervention in the market, such as occurred in New Jersey and Maryland. And this article proposes that the FERC should also provide sufficient room for state policy implementation. Accordingly, the FERC should clarify as a matter of policy that safe harbor exemptions are permissible as currently allowed in PJM and discussed in the New England Rehearing Order.[169] The New England order, however, discussed allowing exemptions for renewable power and other facilities but declined to make it clear that they are *per se* just and reasonable.[170]

Renewable facilities are encouraged by state renewable portfolio standards (RPS), in addition to federal subsidies. While the FERC authorized an exemption for those facilities so as to avoid interference with state public objectives, these facilities would most likely be built even if they were subject to mitigation because capacity revenues are a small part of their overall revenues.

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167. Connecticut Dep't of Pub. Util. Control v. FERC, 569 F.3d 477, 481 (D.C. Cir. 2009).

168. The dormant interstate commerce clause will be a further check on state action to intervene in electric markets when there is unjustified effect on interstate commerce, which would be particularly relevant for a multi-state RTO such as PJM. *See, e.g.*, Alliant Energy Corp. v. Bie, 330 F.3d 904 (7th Cir. 2003), *petition for reh'g en banc denied*, 336 F.3d 545 (7th Cir. 2003).

169. *ISO New England, Inc.*, 138 F.E.R.C. ¶ 61,027 at P 91 (2012).

170. *Id.*

The likely impact of applying mitigation would be a moderate increase in the costs of those programs rather preventing those facilities from being built. Accordingly, an exemption for those facilities is not based on the principle that it would be contrary to public policy to prevent entry, but that it would be contrary to public policy to raise the costs of those programs when the public policy is to encourage their construction. In the PJM order, the FERC also stated when justifying the exemption that the impact on capacity markets would be *de minimus*, but the FERC did not even consider at what level of MW the exemption would no longer be *de minimus*.[171] The better principle going forward is that the FERC should seek to avoid interference with state public policy goals. And the best way to accomplish this is to create clear exemptions up front to avoid disputes and litigation on a case-by-case basis. Additional exemptions could include generators needed for reliability and also a safe harbor for any state that decides to have a non-discriminatory RFP issued, e.g., based on environmental performance of the generator.

To date, the FERC has mostly resolved the issue of allowing a public policy exemption to buyer-side mitigation by providing that filings would have to be made on case-by-case basis, but it is understandable why the state governments would not want to engage in such a cumbersome process. The FERC has endorsed exemptions from buyer-side mitigation in PJM.[172] The creation of more of these kinds of exemptions would at least provide certainty as to which public policy goals states would be allowed to pursue. The FERC, however, has provided that such exemptions must be developed in the stakeholder process,[173] which raises the question of whether the FERC should continue to manage buyer-side mitigation by reviewing proposals or whether it should seek to take a more proactive stance through a rulemaking process.

C. Process

It is always a good question whether regional flexibility is best or whether a single national rule is necessary. The FERC, of course, can also adopt a "national" or uniform rule that allows for regional flexibility.[174] What we see as most appropriate here is for the FERC to commence a rulemaking or policymaking process to clarify its rules on buyer-side mitigation. The FERC has now gained enough experience with this issue such that it should be able to develop certain minimum standards that each ISO/RTO must follow and then allow for regional deviations from that rule.[175] Accordingly, the FERC should consider a major revision of its buyer mitigation rules consistent with the principles articulated in this article and follow a rulemaking process to do so.

171. 135 F.E.R.C. ¶ 61,022, at P 153.

172. *Id.* at PP 152-53.

173. *Id.*

174. Order No. 1000, *supra* note 5, at P 208.

175. Order No. 745, *supra* note 160, at P 67.