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**PSEG Power Connecticut, LLC**  
*An affiliate of PSEG Energy Resources & Trade, LLC*

June 20, 2008

**Via Electronic Mail**

NEPOOL Review Board  
74 Bedford Street  
Lexington, MA 02420.  
[boardofreview@conversant.net](mailto:boardofreview@conversant.net)

**Re: Review Board Docket No.: 01-NE-BD-2008 (NRG)**

Dear Sirs:

Pursuant to Section 11.7(b) of the Second Restated NEPOOL Agreement (“Agreement”), PSEG Energy Resources & Trade LLC (“PSEG ER&T”) hereby files this intervention in support of the appeal filed by NRG Energy, Inc. (“NRG”) on June 13, 2008 related to two actions of the NEPOOL Participants Committee at its June 6, 2008 meeting. Specifically, NRG has appealed the action of the Participants Committee: (i) adopting ISO-NE’s proposal for revisions to Market Rule 1 regarding compensation for units needed for reliability; and, (ii) rejecting an amendment offered by NRG that would revise the treatment of FCM de-list bids rejected for reliability by pricing such units through a reconfiguration auction. Copies of this intervention are being delivered electronically to the NEPOOL Review Board and each of the individuals identified on the attached service list.

Notices and inquiries should be provided to:

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**I. Role of the Review Board**

Pursuant to the By-Laws of The NEPOOL Review Board and Section 11.1 of the Agreement, the role of the Board is to rule on appeals before consistent the objectives of the NEPOOL organization as embodied in Section 5.1 of the Agreement:

(b) to create and sustain open, non-discriminatory, competitive, unbundled, markets for Energy, capacity and ancillary services (including operating reserves) that are (i) economically efficient and balance between buyers and sellers, and (ii) provide an opportunity for a participant to receive compensation through the market for a service it provides, in a manner consistent with proper standard of reliability and the long-term sustainability of competitive markets;

(c) to provide market rules that (i) promote a market based on voluntary participation, (ii) allow market participants to manage the risks involved in offering and purchasing services, and (iii) compensate at fair value (considering both benefits and risks) any required service, subject to the Commission's jurisdiction and review;

## **II. Background**

Market Rule 1 Section III.13.2.5.2.5 addresses how bids rejected for reliability reasons are evaluated by the ISO in the FCM. The only provision describing how de-list units rejected for reliability are compensated is the general statement that such resources "shall be compensated at a just and reasonable rate, as determined by the Commission." There is nothing more specific describing how such units should be paid, either in the original LICAP settlement or in the initial market rules implementing the settlement. Because ISO-NE rejected the de-list bids of 330MW of capacity in the first Forward Capacity Market auction (which currently operate under an RMR agreement), ISO-NE was compelled to address this issue.

## **III. Statement In Support of Appeal**

### **A. The Forward Capacity Market Should Strive to Achieve The Objectives Under the NEPOOL Agreement**

Consistent with the NEPOOL objectives under Section 5.1 of the NEPOOL Agreement, a "just and reasonable rate" should be determined by competitive market outcomes. Any pricing mechanism consistent with market principles should include:

1. **Transparency:** Assure all market participants, including transmission, demand resources, and generators understand the reliability need so that all can compete to propose solutions to solve the need.
2. **Contestability:** Allow market forces to determine the most efficient and cost effective solution. This would include tests for ensuring market outcomes reflect robust competition.
3. **Certainty and Finality:** Assure that outcomes from auctions are known and unambiguous.
4. **Market Accountability:** Assure that modification will be made to future auctions if the existing auction market does not satisfy the full reliability needs necessitating the rejection of a de-list bid for reliability purposes.

In the case of the Forward Capacity Market, the design itself was intended to determine the value of capacity on a locational basis. In so doing, it was expected that the need to

continue with out-of-market Reliability Must Run agreements would be replaced by appropriate market signals emerging from the auction.<sup>1</sup> In ordering ISO-NE to implement a locational market design for capacity, the FERC noted “we believe that ISO-NE, rather than focusing on and using stand-alone RMR agreements, should incorporate the effect of those agreements into a market-type mechanism.”<sup>2</sup> As has been echoed in nearly every protest of the eighteen RMR Agreements approved by the FERC in NEPOOL since 2002, the use of “RMR Agreements should be a last resort.”<sup>3</sup> Therefore, the proposal to continue the use of RMR, without any attempt to achieve a market solution, is both inconsistent with FERC direction, and inconsistent with the objectives of the NEPOOL Agreement.

## **B. The ISO Proposal as adopted by NEPOOL Does Not Incorporate Market Principles to Determine an Efficient Price; the NRG Proposal Does.**

- 1. Rejected De-List Bids are Counted Within the Auction as Price-Takers.** Within the FCM auction, de-list bids rejected for reliability would still be counted as capacity in order to satisfy the local (“LSR”) and Installed Capacity Requirement (“ICR”)<sup>4</sup>; however, a resource’s de-list bid would not be reflected in the auction outcome. Instead, the ISO will keep the MWs of that unit participating in the auction, effectively at a zero priced offer. Requiring the units to remain in the auction at prices below their desired offer levels suppresses the true competitive clearing price in the auction. As acknowledge by the ISO, “The market is distorted because, absent the rejection for reliability, the unit would have left the market, increasing the demand for new capacity, and likely increasing the clearing price.”<sup>5</sup>

The NRG proposal would have ISO remove the MWs associated with de-list bids rejected for reliability from the auction supply stack, and concomitantly reduce the quantity of ICR purchased in the auction. In this way, the clearing price in the auction would better reflect the supply-demand relationships required for efficient price outcomes in the auction. This component of the NRG proposal is superior to the ISO proposal adopted by NEPOOL and is consistent with the objectives for market efficiency under the NEPOOL Agreement.

- 2. There is No Market Consequence, or Market Signal, That Would Trigger a Competitive Response to Resolve the Reliability Need.** The market rules describe a process in which ISO-NE might replace the MWs from a unit needed for reliability in subsequent reconfiguration auctions.<sup>6</sup> There are three economically perverse

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<sup>1</sup> “..so that capacity within [constrained areas] may be appropriately compensated for reliability.” ER03-563 Devon Order at P37

<sup>2</sup> Devon Order at P29

<sup>3</sup> Devon Order at P31

<sup>4</sup> “Such resources shall be counted towards the Installed Capacity Requirement for the Capacity Commitment Period.” (Proposed: Section 13.2.5.2.5(b))

<sup>5</sup> This issue was identified in the rule making process, but action on it was deferred when no agreement could be reached on incorporating a provision to address this through the Alternative Capacity Price Rule. See MR1 III.13.2.5.2.5 (f) which was incorporated into the rules to specifically address the issue at a later date. Also, refer to the memo by Peter Crampton and David LaPlante to NECPUC and the NEPOOL Markets Committee dated April 18, 2007 attached.

<sup>6</sup> “The ISO shall review the results of each reconfiguration auction and determine whether the reliability need which prevented the de-listing of the resource has been met through the reconfiguration auction.”

provisions of the rules that undermine efficient pricing and competitive procurement for replacement reliability service.

First, no price signal is created to inform competitors to attempt to meet the specific need that triggered the ISO's rejection of the de-list bid. As discussed above, the capacity clearing price at that location is already distorted because the de-list bid was not allowed to set price.

Second, there is no provision in the market rules that requires the ISO to replace the unit through the reconfiguration auctions. This is because the reconfiguration auctions, as currently proposed, will clear on the same basis as the primary auction, *i.e.*, if there is no price separation in the primary auction (as was the case in the first FCA), then the reconfiguration auction would be for the entire pool. This could result in the perverse economic outcome in which the ISO procures capacity from a low priced unit in Maine while rejecting offers from other resources that could meet the reliability need in Connecticut, but were priced higher. In other words, it is only by mere chance that a cleared unit in the reconfiguration satisfies the same reliability need as the rejected unit.

Finally, the unit rejected for reliability is actually barred from participating in the reconfiguration auction. Because it already has a capacity obligation and its MWs are already counted toward meeting the ICR, it cannot compete in the very auction in which it could be replaced. This could lead to the perverse economic result in which a higher priced unit (even higher priced than the original de-list bid that was rejected) could clear in a reconfiguration auction and replace the rejected unit.

The NRG proposal is not subject to these shortcomings. First, because the rejected unit's MWs are withdrawn from the primary auction and the quantity purchased is reduced, there is no price distortion in the primary auction clearing. Second, in cases in which a unit is rejected for reliability, the NRG proposal would require that the ISO procure the needed capacity in the next reconfiguration auction. All participants would be aware of a specific purchase requirement by the ISO in a specific area. A transmission solution could be brought through the NEPOOL stakeholder process if that were a viable alternative (and could be tested against the alternative costs)<sup>7</sup>. Finally, the rejected unit would be required to participate in the reconfiguration auction and compete head-to-head with other resources seeking to replace it.

The NRG proposal also satisfies the reliability needs of the system. By requiring the rejected unit's participation in the reconfiguration auction, the market design would ensure reliability of the system as there would be a guaranteed level of participation. In addition, the total amount of capacity participating in the auction would be measured to determine if there was an adequate level of competition in the

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III.13.2.5.2.5(c). These reconfiguration auctions are held annually after the primary auction prior to the commitment period.

<sup>7</sup> If a transmission solution is available, the field of potential competitors to provide replacement capacity is expanded greatly, enhancing the competition in the reconfiguration auction.

reconfiguration auction. Pricing rules, similar to those in place in the primary auction, would be used to ensure competitive outcomes.<sup>8</sup>

### **3. The Price of RMR For Static and Dynamic De-List Bids Rejected for Reliability is Not Competitively Determined and Should be Rejected**

NEPOOL approved a set of rules that utilize the de-list bid as the RMR rate for a unit whose de-list bid was rejected in the auction. The rule change misapplies economic theory as justification and is contrary to the NEPOOL objectives of (i) voluntary participation, (ii) allowing participants to manage the risks, and (iii) compensating at fair value consistent with risks. It should be rejected.

The economic theory underlying this proposal is that any business that recovers its net avoidable going forward costs will remain in business. While this might be appropriate in making business decisions for the coming week, or even months, it is wholly inappropriate to apply such short term economic theory to units that have expressed an interest in withdrawing from the market on three year's notice. The purpose of the multi-year forward commitment is to provide contestability to existing resources from new resources seeking to participate in the market. The FCM recognizes that the appropriate bidding level for new units seeking to participate in the market is the net long run average cost of a unit.<sup>9</sup> Designing market rules that require existing plant owners provide reliability services without the opportunity of recover all of its prudently incurred costs is not good business, not good market design, and not good reliability planning. And it is contrary to the NEPOOL objective for the voluntary participation in the markets.

The level of the de-list bid, moreover, does not reflect all of the participants going forward costs. Thus, by design, it will not allow the participant to manage its risks of participation in the capacity market. Contrary to the NEPOOL objectives, the rules currently require that in creating the de-list bids "risk aversion premiums shall not be considered sufficient justification."<sup>10</sup> Included in this formulaic approach to creating de-list bids, the supplier is required to incorporate market price forecasts determined by the ISO. Specifically, the rules require the bidder to enter as its de-list bid (above  $.8 \times \text{CONE}$ ) the "Resource's net risk-adjusted going forward costs (as determined pursuant to Section III.13.1.2.3.2.1.1)" In this case, the "net" number, is determined by the rules as the gross margin of the resource over the prior three years. It is this number that is required to be used as the gross margin three years forward.<sup>11</sup>

Moreover, the intended purpose of these bidding parameters is vastly different than how they are proposed to be applied here. The underlying principle of the Forward Capacity Market is that new resources would set the price in the market using the net long run

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<sup>8</sup> See MR1 III.13.2.8.2 Insufficient Competition for how this issue is dealt with on a pool wide, or zone wide basis.

<sup>9</sup> The Internal Market Monitoring Unit shall determine whether the offer is consistent with the long run average costs of that resource net of expected net revenues other than capacity revenues. MR1 III.13.1.1.2.6.

<sup>10</sup> III.13.1.2.3.2.1.3

<sup>11</sup> III.13.1.2.3.2.1.2

average cost – clearly a value more in line with a full cost-of-service rate. Existing resources were expected to rely upon such new entry for setting the auction clearing price as the market maintained equilibrium. The bidding requirements were not designed for compensation of individual units, are not “just and reasonable” compensation as required by the rule and should not be used for that purpose here.

In contrast, the NRG proposal avoids such misapplication of the bidding rules in its entirety by basing the payment rate for a unit on the interplay of competitive forces. The ultimate result is a just and reasonable rate as determined by robust competition.

**IV. Failure of the Stakeholder Process to Uphold Competitive Market Solutions Reflects the Need for Review Board Action.**

PSEG thus supports the appeal of NRG in the proceeding and requests that the Review Board find that NEPOOL erred in straying from the objectives found in Section 5.1 of the NEPOOL Agreement.

Please contact the undersigned with any questions. Thank you.

Respectfully submitted:

/s/ Joel S. Gordon

Joel S. Gordon

## Certificate of Service

PSEG Energy Resources & Trade LLC hereby certifies that copies of its intervention in NEPOOL Review Board Docket 01-NE-BD-2008 (NRG) have been served electronically to the parties listed below.

/s/ Joel S. Gordon  
Joel S. Gordon

June 20, 2008  
date

### Service List:

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**To:** NECPUC and NEPOOL Markets Committee

**From:** Peter Cramton and David LaPlante

**Date:** 4/18/2007

**Subject:** De-List Bids Rejected for Reliability – Application of Alternative Price Rule

This memo summarizes the issue of how to treat De-list Bids rejected for reliability and recommends that they be treated as out-of-market capacity subject to the alternative price rule. This recommendation will increase the competitiveness and efficiency of the market and in particular, will increase the likelihood that replacement generation that will enable a unit that wants to de-list to leave the market will be built.

The Settlement Agreement recognized that it might be necessary to reject a de-list bid that cleared the FCA for reliability reasons. The excerpt from the Settlement Agreement addressing this is shown below:

**Bids Rejected for Reliability Reasons.** A Capacity Resource having a Permanent De-list Bid, De-list Bid, or Export Bid that is rejected for reliability reasons shall be paid a just and reasonable price (as determined by FERC) from the beginning of the Commitment Period and, for Permanent De-list Bids, for each subsequent Commitment Period (unless the reliability concern is addressed before the start of the Commitment Period) until it can be released to de-list. In such cases, the ISO shall attempt to procure replacement capacity at each FCA and annual reconfiguration auctions in order to release the Capacity Resource to de-list. Payments to such Resources shall continue only until the reliability concern is addressed (through procurement of replacement capacity or other means, such as a transmission enhancement).

Consistent with this provision of the settlement agreement, the current market rules provide that bids rejected for reliability reasons will be included as capacity to meet the Installed Capacity Requirement. However, the Settlement Agreement is silent on how these units should be treated in the Forward Capacity Auction. The market rules filed and conditionally approved by the Commission, if left unchanged, would result in de-listed units being treated as price takers in the auction.

In the stakeholder process reviewing and approving the FCM rules, representatives in the generation sector proposed that de-list bids rejected for reliability be treated as out-of-market capacity. While the ISO felt that this approach might have merit, it was too late in the stakeholder process to fully consider this proposal. However, to enable fuller consideration of the issue, Section III.13.2.5.2.5 (f) of Market Rule 1 requires that

the ISO evaluate, in consultation with NEPOOL and state utility regulatory agencies, whether to treat de-list bids rejected for reliability reasons as Out-of-Market quantities.

As noted above, the rules currently provide that the rejected bid is in the market at any price. While this approach holds the individual generator harmless because it is being paid a just and reasonable rate, it has an adverse effect on the efficiency of the market by artificially lowering the FCA clearing price. The market is distorted because, absent the rejection for reliability, the unit would have left the market, increasing the demand for new capacity, and likely increasing the clearing price.

The ISO and Dr. Cramton have considered whether the treatment of de-list bids for reliability as out-of-market capacity would improve the efficiency of the Forward Capacity Market and have concluded that it would improve the efficiency of the FCM. One of the objectives of the FCM is to attract new capacity into the market to replace capacity that wishes to de-list but can't because it is needed for reliability. However, if this de-listed capacity is treated as a price taker and not recognized in the auction clearing price at all, it will lower the auction price and decrease the likelihood that new capacity to meet the reliability need will enter the market.

The attached appendix describes out of market capacity and the Alternative Price rule in more detail.

We look forward to discussing this with you on April 24<sup>th</sup>. Our current plan is to bring draft rule changes to the NEPOOL Markets Committee in May and request a Markets Committee vote in June and a Participants Committee vote at the summer meeting in late June.

We also look forward to discussing this with NECPUC in May and June.

## Appendix

Out-of-Market quantities, for the purposes of the Forward Capacity Auction (“FCA”), are defined as a characteristic of certain capacity quantities that cannot be used to set the Clearing Price for a Capacity Zone/External Interface. The current permissible sources of Out-of-Market Capacity are as follows:

1. ISO RFP Quantity for Existing Capacity - defined as capacity procured by ISO-NE through a request for proposal.
2. Certain New Capacity Offers and New Import Capacity Offers – defined as New Capacity offered below 0.75 times CONE where the Maximum Offer Supply Curve Segment was not approved by the Internal Market Monitor.
3. Self-Supply Quantity from New Capacity – defined as new generating capacity and new import capacity designated as self-supplied in a Capacity Zone.
4. Carried-Forward Capacity (Only applicable for Import-Constrained Capacity Zones) – defined as surplus capacity carried forward from a previous FCA that represents the amount previously procured in excess of the LSR.

This rule would add a fifth type of out of market capacity for de-list bids rejected for reliability.

Section III.13.2.7.8 of Market Rule 1 explains how the Alternative Price Rule will be implemented. The rule itself is an assessment of whether the portion of the Aggregate Supply curve that is Out-of Market is a disproportionately large fraction of the Aggregate Supply curve for a Capacity Zone or an External Interface. The rule only applies to Import-Constrained Capacity Zones, the Rest-of-Pool Zone, or an External Interface, and is only active when all of the following three conditions have been met:

1. The amount of New Capacity required in the Capacity Zone for the associated Commitment Period is greater than zero.
2. The Capacity Zone does not have Inadequate Supply in the FCA
3. At the Capacity Clearing Price in the FCA, the amount of Out-of Market capacity in the Capacity Zone exceeds the amount of New Capacity Required for the Capacity Zone.

If the three conditions are met, then the Capacity Clearing Price for that Capacity Zone will be the *lesser* of the following two conditions:

1. \$0.01 below the price at which the last remaining New Generating Capacity Resource, New Import Capacity Resource, or New Demand Resource withdrew from the FCA.
2. CONE; provided that if there was Insufficient Competition and all capacity offered from the New Capacity listed above at the FCA Starting Price is still included in the Aggregate Supply curve, then the Capacity Clearing Price will be set equal to CONE.