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Lowering Prices by Raising Costs: Market Rule Responses to "Sponsored" Entry

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Insight in Economics™

Responses to “price making”

- “Renewable energy development, demand response, economic development, transmission investment and other public policy goals often require regulatory mandates that interact with the operations of markets in ways that make the investors price makers”

- Responses through market rules:
  - New York ISO “in-city” mitigation
  - PJM Minimum Offer Price Rule (“MOPR”)
  - ISO New England Alternative Price Rule

Recent Changes

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- ISO New England Forward Capacity Market included an APR from the beginning to discourage sponsored entry that would have the goal of depressing the capacity clearing price
  - Expansion of the APR currently before the FERC
  - Other modifications proposed as well
- PJM recently began its response to the P3 complaint (complaint requests amendments to the MOPR following New Jersey legislation)
  - PJM expects to offer various simplifications of that rule to make it more effective

Two Different Approaches to Addressing Sponsored Entry

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1. Mitigation of entrant's offer

- the primary intent is to prevent sponsored entry
  - A minimum offer price replaces the entrant's bid in the capacity market
  - Entrant may not clear – could be discouraged from entering

2. Correction of market outcome

- the primary intent is to limit the impact of sponsored entry on the capacity clearing price
  - The entrant's bid is used to determine whether it clears
  - An alternate price is calculated by re-pricing sponsored entrant at an estimate of its competitive offer

Response to New Jersey Law Falls Into the First Camp

- Proposal includes:
  - Mitigating offers from sponsored capacity to a high percentage (90-100%) of the standardized cost of the class
  - Continue to mitigate until resource has cleared two auctions
  - Sponsored entrant may not clear
- The effect of the rule is to increase cost to the sponsor
  - Sponsored resource may not get capacity payment
  - Sponsored entrant does not depress capacity clearing price
- Rule most clearly accomplishes objective if rule prevents entry from being sponsored in the first place

Question Remains Whether Incentives to Sponsor Fully Removed

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- Certainly such a rule increases the cost to sponsoring entry
- But sponsor may have objectives that they view as worth the cost imposed by the mitigation
- If sponsored resource is built despite the disincentive
  - Capacity clearing price is set as if sponsored entry had not occurred and it is possible that capacity clearing price then reflects the cost of new un-sponsored entry
  - This price may encourage more new resources to enter even though the market is long
  - This price may distort shorter term or intermediate term decisions (e.g., demand-side or retirements) by failing to signal that there is surplus capacity

ISO NE Proposal Takes Second Approach

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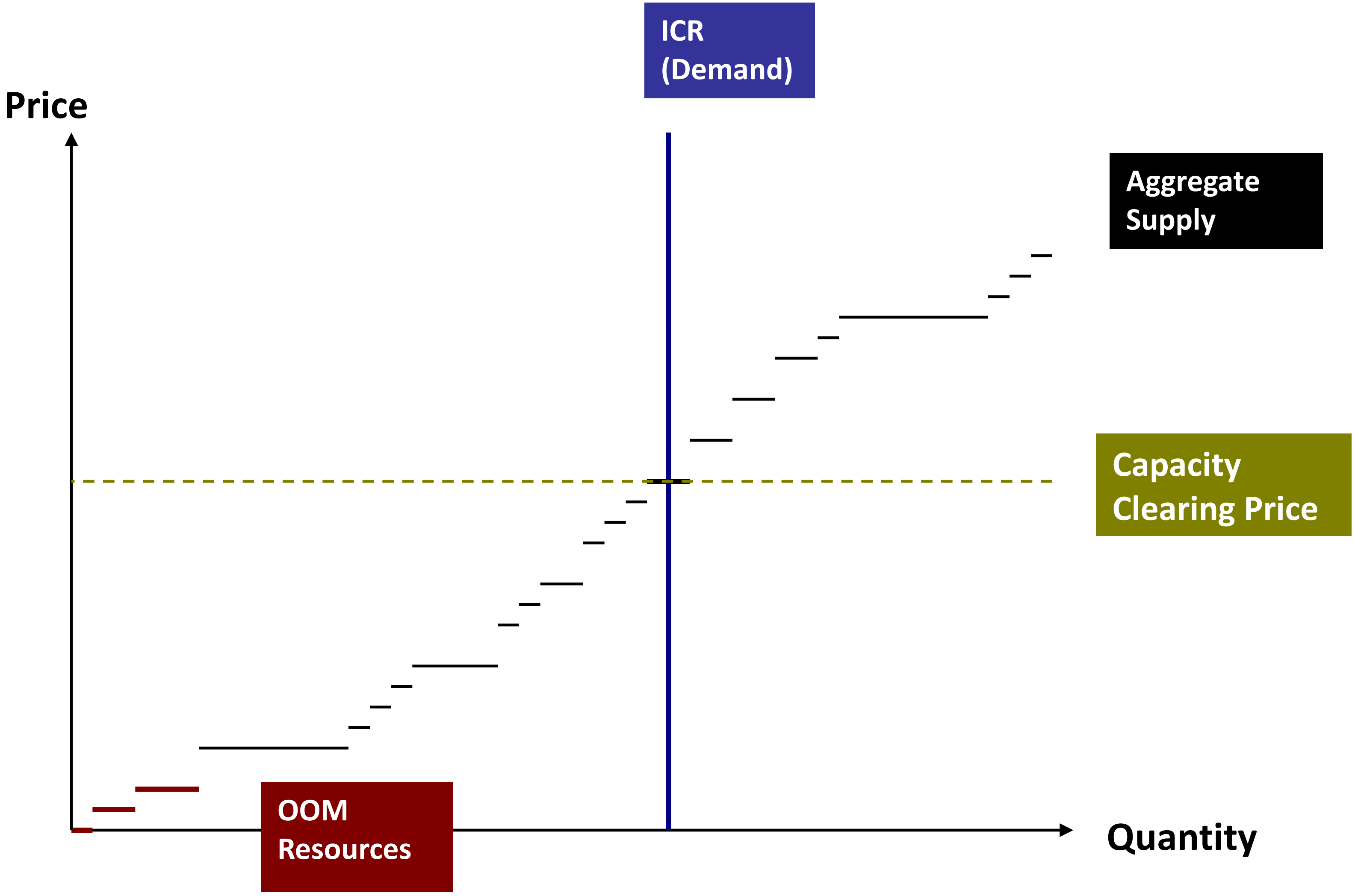
- Proposal includes:
  - Clearing the auction using the offers of sponsored entrants (as submitted without mitigation)
  - Sponsored entrants can clear and a capacity clearing price is established
  - An alternative capacity price is calculated re-pricing the offers of sponsored entrants at a competitive level
- Two-tiered pricing:
  - New resources receive (the lower) capacity clearing price for a five year period
  - Existing and “in-between” resources receive (the higher) alternative capacity price subject to sunset provision
- Rules accomplishes objectives of establishing price that corrects for offers from sponsored resources

OOM Resources Bid As They Wish in Setting the Clearing Price



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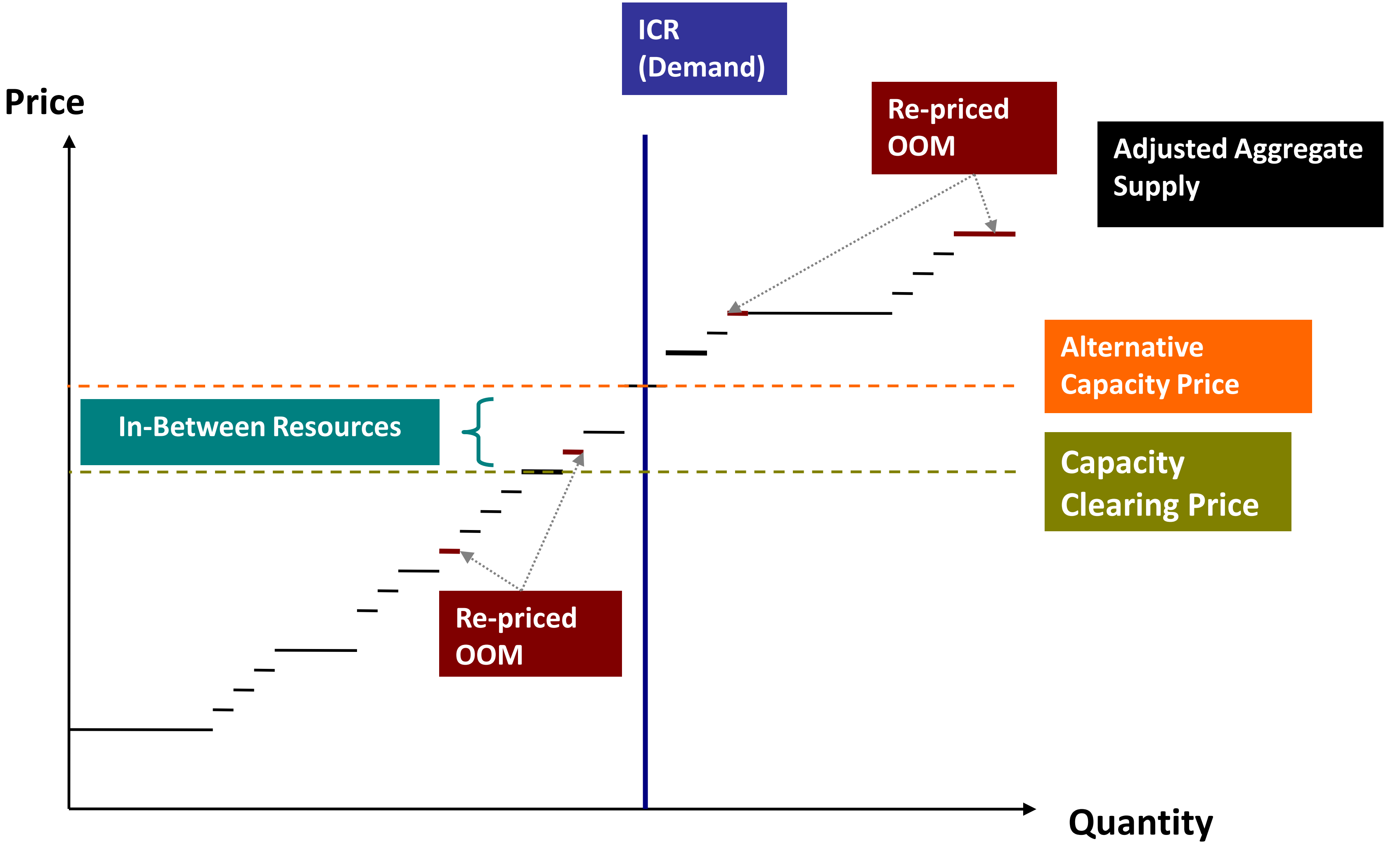

The Second Approach – Correcting Market Outcome Is a More Modest Goal

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- Primarily aims to correct the capacity clearing price so that resources that entered before sponsored entry maintain the opportunities they expected when they formulated their entry price
- Disincentives to entry are a part of this approach as price suppression effect of sponsored entry is corrected
- Emphasis is not as much preventing entry as in correcting the market impacts
  - Recognizes that if sponsored entry has occurred some decisions should be based on a lower price that reflects a surplus
  - Correction to price maintained over time – until load growth and resource retirements offset sponsored entry

Both Approaches Have Pros and Cons

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- The first approach puts all its eggs in the basket of preventing sponsored entry
  - If entry is actually deterred it works
  - However, there are challenges to deterring entry given that benefit of achieving certain objectives (e.g., “reliability”) may be perceived to be worth the cost
  - If entry is not deterred the market may have residual distortions
- The second approach in some sense accepts that sponsored entry may occur
  - Approach provides disincentives to such entry but is more focused on correcting the impact
  - While potentially less potent than the first approach in preventing sponsored entry, it lets the capacity price reflect the surplus that may occur if entry is sponsored despite disincentives
- Both approaches only affect capacity markets and do not consider effects on energy markets

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