

Analysis Group FCM Report – PSEG Long Island Comments

Summary

While the report represents an important effort to evaluate forward capacity markets we believe it falls short in several important respects. It does not recognize that a large share of capacity obligations is currently served under long-term bilateral contracts; the need for which could be significantly obviated by well-designed forward capacity markets. It fails to recognize the potential for hybrid markets where market participants could express their preferences for the share of procurements made under long term and spot purchases. It also fails to address important discontinuities between market capacity procurements, and the need for reliability backstop solutions and/or RMR procurements. While it identifies that the capacity markets in general meet New York's reliability needs, it fails to recognize that this success is a feature of combined spot and long-term bilateral markets - and not a feature of NYISO's spot market auction construct alone. Finally, the fundamental preference for existing capacity when new capacity competing head to head might be competitive is not sufficiently explored. The Analysis Group's conclusion that potential benefits of an FCM might be achieved by changes to the current Spot Market is not sufficiently supported.

Background

The study focused primarily on the cost/benefits of shifting fully from the current SM to an FCM, but nearly 95% of capacity on LI, and nearly half of capacity in NYC and a significant share elsewhere is procured currently under long-term bilateral contract rather than through the SM auction. When contemplating the cost-benefit of a transition to FCM, the impacts of possible transition of these long-term bilateral contracts to FCM mechanisms should be evaluated. While the current hybrid approach does address reliability needs in an acceptable manner, we believe that a well-designed forward capacity market could obviate the need for longer-term bilateral contracts, reduce procurement costs for these contracts, and allocate risks to parties most willing to bear them. We also believe that a well-designed forward market could reduce the risk and increase the response horizon for identified reliability needs.

Analysis Group mentions that NY differs in its market construct from other Northeast States with regard to the allowed length of bilateral contracts with generators. They seem to imply that this is a difference that perhaps necessitated the need for an FCM process in those markets as opposed to in NY. In our view, the trade-off between long-term bilateral contracts and FCM should be evaluated.

A market construct that includes and FCM does not need to procure capacity exclusively through the FCM – some share of procurements could continue to be made through the SM. AG should evaluate a hybrid approach, for example, maintaining the SM for some share of existing load requirements (e.g. 50%) and implementing an FCM for the remaining share of Load requirements. Limiting the share that is procured by long-term contract to the invariable portion of resource needs and procuring the variable

portion of resources needs in the SM, can significantly mitigate the risk that the FCM procures too high a quantity of capacity.

In addition, New England had a transition period to help “smooth out” some of the bumps during their implementation process. An evaluation of New England’s transition mechanisms might be helpful.

The study mentions the concern that inaccuracies in load forecasts may lead to over procurement in the FCM and ultimately higher costs to load. It should be noted that this is a concern in the current market construct which relies heavily on long-term bilateral contracts. A hybrid design, could help alleviate this concern to a certain extent.

Analysis Group points to the historical success of the NYISO planning process as evidence that the current ICAP markets are working well. However, there has not been a pure merchant generator that has entered the Zone K Market since the inception of the SM design; and during that time, LIPA planned to a different reliability standard. Thus, the evidence of historical success for the SM is inconclusive for Long Island (Zone K). It is unclear whether we have enough data to support the conclusion of historical success for the SM alone for either zones G-J or zone J. While current markets allow long term bilateral contracts, it is unclear that they could function well without them.

Analysis Group points out that an FCM results in higher offers from existing capacity due to factors such as loss of flexibility to retire, mothball or supply into other markets. Generators, however, generally do not enter markets or price their products based on the option of opportunity cost of retiring or mothballing. They are in the market to make a profit and as such price their product based on their revenue requirement and business model structures. A generator that could recover these costs if selected in an FCM would not seek to increase its offer to capture mothballing option value.

We believe that an FCM would provide more long term revenue stability for existing generators than the SM and ultimately more stable capacity costs for loads. Stability of these costs and revenues is important. Generators would know three years ahead of time where prices would be going and what new generation has committed to the market. This should allow them to make more informed decisions with a longer lead time for the market that ultimately helps smooth the market entry and exit process for supply.

Analysis Group also mentions that the need for long term RSS Agreements might be reduced under an FCM. It would be interesting to see if the data support this assumption from PJM and NEISO.

The study also mentions “deficiency risk” for units that sell forward and do not enter the market within the 3 year forward-commitment window. Are there any statistics that support this concern? For example, what percentage of resources in PJM and NEISO failed to commence operation by their forward commitment date? Was there any significant impact on reliability or market prices?

Table 2: Selected Recent Resource Changes – the Caithness I contract is incorrectly shown as a 20 year PPA as of 2012. The unit contract actually commenced in July 2009.

Analysis Group used 2020 as the proxy year for its study. They admit that as a single – year model, it does not account for dynamic multiyear economic factors, retirements, new entry, etc... They also use this as a “disclaimer” at various times during their study. (I.e. Cost to Load Analysis page 111) Should another year have been run as a sense check for comparison of results?

The study mentions that there are “other” differences between a FCM and the current SM that may impact price volatility such as annual vs. monthly clearing prices and individual unit participation. Unfortunately, Analysis Group does not elaborate on them.