

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

State Policies and Wholesale Markets)
Operated by ISO New England Inc., New) Docket No. AD17-11-000
York Independent System Operator,)
Inc., and PJM Interconnection, L.L.C.)

INITIAL POST-TECHNICAL CONFERENCE COMMENTS OF THE R STREET INSTITUTE

The R Street Institute (RSI)¹ hereby submits comments on the critical matter of state policies affecting ISO-NE, NYISO and PJM. The Federal Energy Regulatory Commission (the “Commission” or “FERC”) faces a critical challenge in maintaining market integrity. A practical, principled approach will support a framework to uphold competition in the face of mounting anti-competitive interventions and perhaps contribute to a curtailment of interventions.

The contentious rise in state policies marks the expansion of industrial policy, whereby government explicitly picks winners and losers through the direct support of particular resources over others. Such policies are philosophically incompatible with competitive markets. However, despite modest to moderate degrees of political interference, competitive markets will outperform regulated monopolies. In fact, over the past decade, resource investment in restructured states has still outperformed regulated states even as subsidies have consistently skewed markets. However, recent ad hoc subsidies to large-capacity resources create a step-function increase in distortionary effects. These carry with them the risk of profound market damage that may curtail the ability of the regional transmission organization (RTO) and independent system operators (ISO) markets to ensure resource adequacy.

I. PATHWAYS FORWARD

Rather than to pursue a single pathway, RSI suggests considerations for a combination of paths, beginning with thoughts on each individual option (Table 1).

¹ RSI is a pragmatic, free market-oriented think tank.

Table 1. Commission Considerations for Pathways to Address State Policy Interventions

	Commission Considerations
Path 1 – Limited or No Minimum Offer Price Rule (MOPR)	<p>Eliminating MOPR would leave competitive markets at the mercy of state political discipline, which has trended poorly. Without MOPR, increased subsidies for large-capacity resources (new or existing) could cause capital markets to freeze or, at best, dramatically increase the cost of capital as investment risk skyrockets. Such anti-competitive policy interventions clearly undermine interstate commerce, and the Commission has an obligation to protect competitive markets from egregious anti-competitive policies. Without mitigating certain policy interventions, RTO/ISO markets will no longer effectively facilitate resource adequacy.² As such, the benefits of a limited MOPR may outweigh the costs – but the costs are considerable (see Path 5 response below).</p>
Path 2 – Accommodation of State Actions	<p>The virtues and vices of accommodating state policy depend on the means of accommodation. Accommodating industrial policy, emanating from states or otherwise, is fundamentally inconsistent with the premise of competitive, non-discriminatory markets, and the jurisdictional authority of the Commission. Retaining competitive properties while accommodating discriminatory state policies may have theoretical appeal as a means of preserving competitive markets, but in practice it is likely to fail.</p> <p>State interests are heterogeneous. Even a single state’s policies are subject to marked change every election cycle. Thus, any bargain accomplished through accommodation efforts may not have political durability, even in a single-state RTO/ISO like NYISO. Compromising market design in order to preserve a competitive construct may seem like the ideal “politically-constrained” solution, but it creates a pathway to the erosion of competitive markets. For example, a two-tiered capacity market is unlikely to deter states from seeking additional policies to pick winners.</p> <p>For these reasons, RSI strongly urges the Commission not to compromise the bedrock principles of competitive electricity markets to accommodate state industrial policy ambitions. Once precedent is broken, even for a seemingly innocuous accommodation, it unleashes the specter of unprincipled evolution in market design, which risks increasingly damaging compromises that sacrifice the fundamentals of electricity competition. After underscoring that market and quasi-market paradigms are mutually exclusive, Monitoring Analytics noted that “once the decision is made that market outcomes must be fundamentally modified, it will be virtually impossible to return to markets.”³ As evidenced here,</p>

² For comments of the independent market monitors see, for example, United States Federal Energy Regulatory Commission, “Comments of David B. Patton, Ph.D. regarding State Policies Affecting Eastern RTOs,” Docket No. AD17-11-000, April 24, 2017. <https://www.ferc.gov/CalendarFiles/20170426150115-Patton,%20Potomac%20Economics.pdf>.

³ United States Federal Energy Regulatory Commission, “Statement of Joseph Bowring Independent Market Monitor for PJM,” Docket No. AD17-11-000, Technical Conference, May 1-2, 2017. <https://www.ferc.gov/CalendarFiles/20170426150935-Bowring,%20Monitoring%20Analytics.pdf>.

	<p>the specific legitimization of discriminatory practices is a gateway to market collapse under the pressure of constant industrial policy appeasement.</p>
Path 3 – Status Quo	<p>Case-by-case litigation is unavoidable in the near-term. Recent court cases have already contributed to clarifying aspects of the jurisdictional “bright line,” but continued reliance on this approach will prove contentious, expensive and inefficient. Proactive action by the Commission to define at least some market-compatible and market-incompatible policies may reduce litigation.</p>
Path 4 – Pricing State Policy Choices	<p>This may provide a pathway to cooperative federalism, but only if state choices are consistent with principles of market design. For example, states have expressed interest in improved resiliency valuation, which enhanced market design may capture. Market design changes should not deviate from using technology-neutral market products to procure discrete reliability (or resiliency) attributes at least cost. Some policies may masquerade as technology-neutral, such as those promoting fuel diversity, but in practice they result in discriminatory and preferential market design. Path 4 needs better definition to avoid the problems of precedent associated with Path 2.</p> <p>Currently, nothing prohibits states from pricing environmental externalities. In fact, under emissions pricing schemes, merchants have reduced abatement costs more than regulated monopolies, which often causes positive feedbacks that result in lower total emissions. In theory, if officials from all states within an RTO/ISO agree to price environmental externalities in RTO/ISO tariffs rather than industrial policies, it may provide a more efficient policy environment. However, the aforementioned limitations on sustaining state policy commitments may reduce effectiveness.</p>
Path 5 – Expanded MOPR	<p>MOPR is probably a necessary evil for egregious anti-competitive interventions (e.g., tethering facility-specific payment to wholesale price for large-capacity resources), but is also a medicine harsher than the disease in most other contexts. Both subsidies and administrative supply pricing is antithetical to competition. Markets can endure non-egregious subsidies better than MOPR can correct for them.</p> <p>MOPR may apply to new and existing resources to achieve its intended purpose, but confining MOPR creep is critical to avert unintended consequences. As an administrative pricing tool, MOPR has similar roots to the flawed approaches of cost-of-service regulation. For methodological shortcomings, look no further than the errors associated with net cost of new entry estimates.</p> <p>Subsidies come in myriad forms that MOPR could never fully account for. States will find means to circumvent MOPR, which encourages a policy race to the bottom. As such, MOPR containment becomes important, and the Commission could offer definition(s) of anti-competitive and discriminatory policies that qualify (e.g., threshold for triggering an artificial surplus). MOPR cannot mitigate all interventions, and inefficiently does so even for those it attempts to correct.</p>

II. PRINCIPLES AND OBJECTIVES

Likely, the ideal path forward is a combination of the aforementioned paths. Maximizing economic efficiency remains the primary objective, but the Commission may consider the prevailing political economy in selecting the optimal “politically-constrained” path forward.

The performance of competitive wholesale electricity markets primarily depends on two element groupings: 1) the quality of market design, administration and oversight and 2) the degree of political discipline. Many consumers, investors and experts consider ERCOT the gold standard. ERCOT has elements of superior market design (e.g., robust scarcity pricing) but also an underrated component of strong state political discipline. The Texas energy-only model would falter if the state legislature routinely interfered with resource investment, which would raise capital costs and deter voluntary investment. This is because investors discount “pure market” price expectations when facing the risk of political intervention.

The Commission does not have the apparent luxury of political discipline that Texas regulators enjoy. This alters the optimal approach to market design, administration and oversight. The guiding principle is market integrity, whereby the Commission protects markets from catastrophic distortions (e.g., MOPR and legal action against egregious forms of interventions) and denies proposals that fundamentally undermine market design (e.g., institutionalizing extensive discriminatory practices). Political compromises designed to avert industrial policy by breaking market design precedent are likely to prove short-lived, even as they create long-lived concerns (even a two-tiered capacity market is unlikely to satiate constantly-fluctuating state motivations to prescribe renewables investments).

The objective of upholding market integrity is to ensure competitive markets maximize economic efficiency subject to an interventionist-prone environment. A key comparison benchmark is whether this lower-quality competitive market paradigm will outperform the regulated monopoly paradigm (see Figure 1).

The Commission’s principles for litigation and MOPR have a shared basis: a legal obligation to prevent anti-competitive interventions in one state from fatally contaminating the investment climate in other states. Both tools carry significant downsides and the Commission should only pursue these avenues to the extent that the benefits outweigh the costs. Neither litigation nor MOPR can efficiently counteract all discriminatory state policies, but the Commission may use them in a targeted fashion to avoid egregious policies that would fatally undermine the ability of markets to achieve resource adequacy. The Commission must draw a line, however, as a web of federal interventions counteracting state interventions may result in resource investment less efficient than the regulated monopoly model.

Figure 1. Hierarchy of Wholesale Electric Investment Paradigms

1. High-quality competitive markets

- Quality market design, administration & oversight (minimal flaws)
- Minimal political interventions

2. Medium-quality competitive markets

- Decent market design, administration & oversight (moderate flaws)
- Modest to moderate levels of intervention (e.g., limited facility-specific subsidies facing MOPR)

3. Quality monopoly utility planning

- Transparent, robust integrated resource planning drives investments
- Competitive procurement

4. Low-quality monopoly utility planning

- Investment decisions unsupported by robust analyses (e.g., 1970s capacity overbuilds and contemporary "mega-projects")

5. Low-quality competitive markets

- Deeply flawed market design, administration & oversight (e.g., early 2000s California; extensive discriminatory tariffs)
- High level of political interventions (e.g., those resulting in high risk premiums and temporary freezes in capital markets)

6. Politically-determined investments

- No cost and risk optimization to determine investments
- Investments based on political popularity

The uptick in state interventions threatens to cross a threshold that compromises the ability of competitive wholesale markets to outperform the monopoly model. As such, states would do better to limit interventions to market-compatible policies or, secondarily, reintegrate if they seek to dictate investment decisions extensively. Likewise, attempts to accommodate state policies that fundamentally compromise market design, such as legitimizing extensive discriminatory practices, may lead to a worse investment paradigm than monopoly regulation. In contrast, pricing state policy priorities like resiliency attributes could enhance market performance.

III. DEGREE OF URGENCY

The Commission should have an extremely high sense of urgency to protect competitive markets from profoundly damaging policy interventions. In particular, deterring ad hoc subsidies for large, specific existing units (e.g., bailouts) and new builds is paramount. As noted by Potomac Economics, markets will otherwise lose credibility as interventions create financial risk that prevents market participants from responding to price signals.⁴ This does not suggest that rash changes to market design in order to appease parochial interests or anti-competitive agendas is a prudent path for the Commission.

⁴ United States Federal Energy Regulatory Commission, "Comments of David B. Patton," *passim*.

IV. LONG-TERM EXPECTATIONS

Competitive markets will likely continue as the long-term engines of resource investment in eastern RTO/ISOs, provided the Commission maintains market integrity. Competitive electricity markets have always operated under a variety of federal and state subsidies. The issue is deterring the types of interventions or market design changes that fundamentally undermine market performance. The longer quality markets exist, the greater the opportunities for the advantages of competitive markets to flow through political channels and encourage more market-compatible state policies. In particular, key constituencies including manufacturers and consumer advocates have increasingly come to realize the value of competition and have organized to resist policies that undermine markets, as, for example, in Ohio.

State behavior will improve the more state policymakers understand the importance of well-functioning electricity markets to their agendas, and the consequences of acutely disruptive interventions. Similarly, states that considered reintegration quickly backtracked after the cost implications became clear. Furthermore, ambitions for a clean energy future that motivate many state interventions will hit a harsh economic reality as the costs of industrial policy accumulate. Improved dialogue has already led to a growing realization among state officials that one-off RFPs for clean energy are not an efficient path forward. Instead, states can best achieve economic and environmental objectives through the empowerment of competitive markets, especially with market-compatible environmental policies like emissions pricing.⁵ Ultimately, states' interests align with healthy competition.

The Commission's short-term actions should remain mindful of the long-term evolution of technology and market design rationales. The notion of resource adequacy as a "common good" construct (rivalrous and non-excludable), commonly referred to as the "tragedy of the commons," has supported mandatory capacity obligations.⁶ This has caused RTO/ISOs to operate in a manner where customers share equal responsibility for resource inadequacy. New "smart-grid" technologies have the potential to isolate consequences for resource shortfalls,⁷ effectively making resource adequacy an

⁵ Devin Hartman, "Environmental Benefits of Electricity Policy Reform," R Street Institute, January 2017. <http://www.rstreet.org/wp-content/uploads/2017/01/82.pdf>.

⁶ Devin Hartman "Wholesale Electricity Markets in the Technological Age," R Street Institute, August 2016. <http://www.rstreet.org/wp-content/uploads/2016/08/67.pdf>.

⁷ James Bushnell, Michaela Flagg, et al., "Capacity Markets at a Crossroads," Energy Institute at Haas, April 2017. <https://ei.haas.berkeley.edu/research/papers/WP278Updated.pdf>.

excludable construct. Enabling the potential to “privatize the commons” means rethinking mandatory capacity obligations, which may mitigate many state policy concerns with capacity markets.⁸

V. PROCEDURAL ACTIONS

The Commission could consider initiating a formal Notice of Inquiry leading to a Notice of Proposed Rulemaking to clarify unacceptable forms of anti-competitive policy subject to MOPR and legal action. Doing so would clarify aspects of the jurisdictional “bright line.” This would offer a more proactive approach than retroactive litigation, deter egregious interventions and perhaps disarm state-federal tensions. The Commission could determine criteria to distinguish market-compatible and incompatible policies as a signal to states and to guide its legal agenda and MOPR applications.

Commission actions consistent with an education and outreach campaign would also provide extensive benefit. A dire need exists for improved understanding of wholesale market performance by those influencing and developing federal and state policies. Meanwhile, if the Commission better understands and proactively addresses legitimate state concerns with market design and performance it may mitigate state interventions aimed at “fixing” wholesale markets. A Commission-led conversation on pricing state policy choices could provide direction. Otherwise, parochial interests may steer RTO/ISO stakeholder process proposals in a direction fundamentally incompatible with principles of market design.

Competitive wholesale markets are outperforming the regulated monopoly model, but this is lost on many policymakers because of inadequate evaluation and communication. The complexity of electricity markets coupled with poor educational resources for policymakers has contributed to the prevalence of false narratives and half-truths that frequently contribute to state policy interventions (e.g., the notion that “baseload” retirements are symptomatic of inadequate markets and necessitate interventions to preserve reliability). It took extensive criticism of the market paradigm before PJM issued a landmark paper on *Resource Investment in Competitive Markets*.⁹ Such reports provide critical value to the policymaking process. Both federal and state public officials actively seek more policy-relevant information on electricity markets.

In the technical conference on state policies in eastern RTO/ISOs, acting Chairman LaFleur aptly remarked that the Commission’s role does not include validating state policy. However, the Commission

⁸ See. E.g., Rob Gramlich, “Organized Markets for the Future,” RTO Insider, May 16, 2017.

⁹ PJM Interconnection, “Resource Investment in Competitive Markets,” May 5, 2016.

<http://www.pjm.com/~media/library/reports-notice/special-reports/20160505-resource-investment-in-competitive-markets-paper.ashx>.

should consider facilitating forums, research and information dissemination on topics of interest to state and federal policymakers. This includes the economic implications of various policy interventions and market design changes (e.g., use consultants or environmental economists at Resources for the Future to evaluate the cost and innovation incentives of emissions pricing compared to green industrial policy). This could also provide tangible information on the distortionary effects of subsidies, which policymakers sometimes dismiss as theoretical, and provide a basis for affected parties to seek litigation in lieu of Commission action.

RSI urges the Commission to take leadership to improve evaluation of the performance of resource investment in competitive markets and communicate its implications in an effort to improve transparency, identify areas for improvement and facilitate a more constructive state policy environment (reporting milquetoast market trends does not accomplish this). This may include expanded in-house papers or requesting RTO/ISOs, the market monitors, or consultants to conduct such analyses. Public forums would present a welcome approach to disseminate information and sustain an ongoing dialogue with states.

VI. CONCLUSION

RSI respectfully requests the Commission consider the comments contained herein.

Respectfully submitted,

/s/ Devin Hartman

Devin Hartman
Electricity Policy Manager
R Street Institute
1050 17th St NW #1150
Washington, DC 20036
(202) 525-5717
dhartman@rstreet.org

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