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Documenting Electric Capacity Transactions

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Wholesale electricity transactions are fungible, widespread, and commonly traded both on exchanges and over the counter. Yet wholesale electricity transactions often exclude the corresponding obligation in many markets to provide a volume of capacity corresponding to the physical electricity volumes. As parties increasingly try to monetize and/or optimize these capacity obligations, they are encountering practical difficulties in documenting these capacity transactions and aligning them with the related physical electricity volumes.

Electric capacity is the capability of a resource to meet demand. In other words, it is not electric energy itself but instead the *ability to product* energy. The Federal Power Act and the Energy Policy Act of 2005 expanded the role of the Federal Energy Regulatory Commission (“FERC”) in overseeing electric grid reliability. Together, the legislation conferred authority to FERC to enforce mandatory Reliability Standards and to designate an Electric Reliability Organization to develop and promulgate reliability standards subject to FERC approval.¹ To achieve this task, FERC designated the North American Electric Reliability Corporation (“NERC”) as the Electric Reliability Organization charged with developing the mandatory Reliability Standards, which includes a Reference Margin requirement for each independent system operator (“ISO”). Many ISOs, including those discussed in this paper, achieve their respective Reference Margin requirements through capacity markets intended to incentivize future generation projects. Ultimately, FERC and NERC work together to ensure that regional entities are carrying out their reliability responsibilities and complying with Reliability Standards in a proper manner.

To comply with those reliability responsibilities, most load-serving entities (each, an “LSE”) have an obligation to ensure that resources are in balance and are available to stabilize the grid. Spikes in demand or outages, particularly unplanned outages, require the grid have access to more capacity than anticipated at any given moment. Each ISO deals with capacity in its own way, and LSEs have various ISO-dependent options for acquiring the capacity it needs to satisfy its obligations. Accordingly, capacity transactions cannot be documented in a cookie-cutter fashion; instead, LSEs and their counterparties must carefully consider their respective obligations and options within a given ISO to determine the form and function of a capacity transaction.

This paper expands on the accompanying presentation, and is intended to be used as a resource for further exploring the topic and for direction to further reading. In the pursuit of

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¹ See Federal Power Act § 215, 16 U.S.C. § 824o. NERC defines a “Reliability Standard” as a requirement, authorized under the Federal Power Act, to provide for the reliable operation of the bulk-power system. See Glossary of Terms Used in NERC Reliability Standards, available at http://www.nerc.com/pa/Stand/Glossary%20of%20Terms/Glossary_of_Terms.pdf.

describing the ways capacity transaction are documented, this paper first provides an overview of the nature of capacity and how it is defined or viewed in several ISOs. Following such overview, the paper describes how capacity transactions are currently documented and ending on discussion of the legal issues attendant to capacity transactions, such as the ways parties may determine collateral and security obligations, or how liquidated damages may be determined or enforced. The first section relates to an overview of capacity, and specifically capacity in ISO New England (“ISO-NE”), PJM Interconnection (“PJM”), Southwest Power Pool (“SPP”), California ISO (“CAISO”), and the Electric Reliability Council of Texas (“ERCOT”). The second section discusses documenting electric capacity transactions, and this paper concludes with a discussion of issues arising from the documentation of capacity transactions.

I. Capacity Overview

As mentioned above, electric capacity is generally described as the capability of a resource to meet demand. More than that, though, it is also a term commonly used to describe a product that LSEs and other market participants may buy and sell—either on a bilateral basis or, depending on the ISO, directly from the ISO through an auction process. Capacity may be acquired through generating capacity that a resource owns, through purchases under contract, through demand response, or through capacity market auctions. Where applicable (*i.e.*, in most ISOs with the exception of ERCOT), such a mechanism serves as a market signal to incentivize investment or to increase efficiency while at the same time ensuring a buffer exists for situations where outages or periods of high demand place strain on the grid. As mentioned, the ISOs discussed in this overview handle capacity differently—in some instances the differences are minor and in others vast.

a. ISO-NE’s Concept of Capacity

ISO-NE defines capacity as “the rated and continuous load-carrying ability, expressed in megawatts or megavoltamperes, of generation, transmission, or other electrical equipment.”² It operates a Forward Capacity Market (“FCM”) which holds an annual Forward Capacity Auction (“FCA”) to promote economic investment in supply and demand resources.³ Resources compete with one another in the FCA to purchase or sell a capacity supply obligation, which amounts to a commitment to supply capacity three years in the future.⁴ Capacity supply obligations are measured and sold in megawatts that a seller is willing to supply at specific price points.⁵ In

² Glossary and Acronyms, ISO New England, available at <https://www.iso-ne.com/participate/support/glossary-acronyms#c>

³ Forward Capacity Market, ISO New England, available at <https://www.iso-ne.com/markets-operations/markets/forward-capacity-market>

⁴ *See id.*

⁵ Forward Capacity Auction Mechanics, ISO New England [hereinafter FCA Mechanics], available at <https://www.iso-ne.com/markets-operations/markets/forward-capacity-market/fcm-participation-guide/fcm-auction-mechanics>.

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