UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

ISO New England Inc. and New England Power Pool	))	Docket No. ER10-787-001
New England Power Generators Association Inc. v. ISO New England Inc.	)))))	Docket No. EL10-50-001
PSEG Energy Resources & Trade LLC, PSEG Power Connecticut LLC, NRG Power Marketing LLC, Connecticut Jet Power LLC, Devon Power LLC, Middletown Power LLC, Montville Power LLC, Norwalk Power LLC, and Somerset Power LLC v. ISO New England Inc.	)))))))))	Docket No. EL10-57-001

REQUEST FOR REHEARING OF THE PSEG COMPANIES AND THE NRG COMPANIES

Pursuant to Section 313 of the Federal Power Act, 16 U.S.C. § 825l(a), and Rule 713 of the Federal Energy Regulatory Commission's ("Commission") Rules of Practice and Procedure, 18 C.F.R. § 385.713 (2010), PSEG Companies[1] and the NRG Companies[2] (collectively "Joint Complainants") hereby request rehearing of the Commission's April 13, 2011 *Order on Paper Hearing and Order on Rehearing*, 135 FERC ¶ 61,029 (2011) ("Hearing Order") that modified the Forward Capacity Market ("FCM") construct in New England.[3]

[1] The PSEG Companies are PSEG Energy Resources & Trade LLC and PSEG Power Connecticut LLC.

[2] The NRG Companies are NRG Power Marketing LLC, Connecticut Jet Power LLC, Devon Power LLC, Middletown Power LLC, Montville Power LLC, Norwalk Power LLC, and Somerset Power LLC.

[3] Joint Complainants are both members of the New England Power Generators Association ("NEPGA"), which is filing a concurrent rehearing request. Joint Complainants fully support the NEPGA rehearing, but file this separate document to emphasize certain flaws in the Hearing Order.

I. Introduction

The Hearing Order appears to take on faith that the FCM reforms accepted by the Commission will provide capacity suppliers a just and reasonable rate of return on their capital invested to provide capacity reliability services to the New England region. This assumption, however, is not justified by the record in this proceeding. Capacity markets do not, and should not, *guarantee* revenue sufficiency; however, the Federal Power Act ("FPA") and the U.S. Constitution require that the Commission ensure that the market provides capacity suppliers with a *reasonable opportunity* to earn a return of, and on, capital. However, the underlying record does not support the Hearing Order's faith-based assertion that the approved market structure, taken as a whole, provides any such reasonable opportunity.

The record evidence, in fact, shows the contrary. Joint Complainants submitted detailed economic models developed by noted FCM expert Dr. Miles Bidwell demonstrating that the FCM construct approved by the Commission denies capacity suppliers any reasonable opportunity to realize a just and reasonable rate. Inadequate compensation is assured, Dr. Bidwell testified, unless the vertical demand curve utilized in New England is tempered with a mechanism designed to stabilize prices around the levelized cost of new entry ("CONE"). Otherwise, any surplus is likely to push the market to its minimum price level. The original FCM design envisioned that dynamic de-list bids would prevent prices from falling to unsustainable levels. However, the Hearing Order effectively eliminated the primary market price stabilizer – the dynamic de-list bid – from the FCM construct, and did not replace it with an alternative means of stabilizing prices. Without a price stabilization feature, the FCM construct is likely to return extremely low prices, making it mathematically impossible for an investor to earn an acceptable return, even over the long-term; *i.e.*, it becomes impossible for annual capacity prices to average out to the levelized cost of building a new capacity resource over the expected life of the facility. Ultimately, a failed capacity construct will result in an inefficient boom/bust capacity cycle that will increase costs to consumers and decrease reliability in New England.

Anticipating the Commission's decision, Dr. Bidwell found that a market with the following set of parameters would deny capacity suppliers any reasonable opportunity to earn a return of and on capital:

(i) Dynamic de-list bids capped at $1.00 / kW-month;

(ii) A substantial surplus caused by existing out-of-market ("OOM") capacity;

(iii) A floor price substantially below the true cost of new entry; and

(iv) An upper bound, or cap, on capacity prices.

Despite Dr. Bidwell's plain testimony, the Hearing Order approved a market design with exactly these features.

The Commission has the statutory obligation to establish a just and reasonable market design that provides capacity suppliers the reasonable opportunity to recover their fixed costs. The Commission is likewise required to support its decision based on evidence in the record, and to support its findings and analysis based on reasoned decision-making. The Hearing Order fails on each of these accounts, and rehearing is warranted.

II. STATEMENT OF ISSUES

Pursuant to Rules 203(a)(7) and 713(c)(1), 18 C.F.R. §§ 385.203(a)(7) and 385.713(c)(1) (2010), the Joint Complainants present the following identification of errors and statement of issues:

1. The Hearing Order wrongly concludes that the approved FCM construct can reasonably be expected to return clearing prices that average, over time, the levelized cost of new

entry. The record evidence demonstrates the contrary; namely, that the approved construct denies capacity suppliers any realistic opportunity of earning a just and reasonable rate of return.

ISO New England, Inc., 125 FERC ¶ 61,102 (2008); *Devon Power LLC,* 115 FERC ¶ 61,340 (2006); *Bridgeport Energy, LLC*, 113 FERC ¶ 61,311 (2005); *Devon Power LLC,* 103 FERC ¶ 61,082 (2003); *Devon Power LLC,* 107 FERC ¶ 61,240 (2004).

2. The Hearing Order erred by not providing more than a cursory response to record evidence demonstrating that capacity suppliers are denied any reasonable opportunity to earn their fixed costs, plus a profit, over the long-term by the market design approved by the Hearing Order. This error leads directly to the Hearing Order's finding that its preferred market structure was just and reasonable, and is not the product of reasoned decision-making.

   Chevron, U.S.A., Inc. v. NRDC, 467 U.S. 837 (1984); *Consol. Edison Co. v. FERC*, 347 F.3d 964 (D.C. Cir. 2003); *Idaho Power Co. v. FERC*, 312 F.3d 454 (D.C. Cir. 2002); *Canadian Ass'n of Petroleum Prods. v. FERC*, 254 F.3d 289 (D.C. Cir. 2001); *NorAm Gas Transmission Co. v. FERC*, 148 F.3d 1158 (D.C. 1998); *K N Energy, Inc. v. FERC,* 968 F.2d 1295 (D.C. Cir. 1992); *Tenneco Gas v. FERC*, 969 F.2d 1187 (D.C. Cir. 1992); *Moraine Pipeline Co. v. FERC*, 906 F.2d 5 (D.C. Cir. 1990); *Tarpon Transmission Co. v. FERC*, 860 F.2d 439 (D.C. Cir. 1988); *City of Charlottesville v. FERC*, 661 F.2d 945 (D.C. Cir. 1981); *Laclede Gas Co. v. FERC*, 873 F.2d 1494 (D.C. Cir. 1989); *City of Vernon v. FERC*, 845 F.2d 1042 (D.C. Cir. 1988).

3. The Hearing Order reverses, without adequate explanation, Commission precedent on critical issues, including (i) the level of appropriate dynamic de-list bid mitigation; (ii) the need to reset the CONE parameter; (iii) the need to design its capacity construct to return the levelized cost of new entry; (iv) the important price stabilization role played by dynamic de-list bids; (v) the sufficiency of energy and ancillary service revenues to return fixed costs; and other issues.

   Chevron, U.S.A., Inc. v. NRDC, 467 U.S. 837 (1984); *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983); *Blumenthal v. FERC*, 552 F.3d 875 (D.C. Cir. 2009); *Consol. Edison Co. v. FERC*, 347 F.3d 964 (D.C. Cir. 2003); *Idaho Power Co. v. FERC*, 312 F.3d 454 (D.C. Cir. 2002); *Belco Petroleum Corp. v. FERC*, 589 F.2d 680 (D.C. Cir. 1979); ISO-NE Market Rule 1, Appendix A, Section III.A.5.2.1.

4. The Hearing Order wrongly interprets prior precedent in finding that capacity markets with a vertical demand curve require no price stabilization feature. The Hearing Order erred in effectively eliminating the dynamic de-list mechanism, declining to install a demand curve, or imposing some other price stabilization mechanism. The Order does not substantively address our evidence that there is no chance capacity suppliers will earn just and reasonable returns without a stabilization mechanism.

   5 U.S.C. § 706(2)(A); *Tesoro Alaska Petroleum Co. v. FERC*, 234 F.3d 1286 (D.C. Cir. 2000); *New York Indep. Sys. Operator, Inc.*, 133 FERC ¶ 61,030 (2010); *ISO New*

England Inc., 125 FERC ¶ 61,102 (2008); *PJM Interconnection, LLC,* 119 FERC ¶ 61,138 (2007).

5. The Hearing Order erred in denying capacity suppliers the opportunity to collect their actual costs by employing a Net Risk-Adjusted Going-Forward Cost de-list bid methodology that does not account for: (i) any fixed cost investment; (ii) any company-specific risk premium; or (iii) the uncertainty surrounding new environmental compliance costs.

   Chevron, U.S.A., Inc. v. NRDC, 467 U.S. 837 (1984); *Consol. Edison Co. v. FERC*, 347 F.3d 964 (D.C. Cir. 2003); *Idaho Power Co. v. FERC*, 312 F.3d 454 (D.C. Cir. 2002); ISO-NE Market Rule 1, Section III.13.1.2.3.2.1.2.

6. The Hearing Order incorrectly asserts that its preferred capacity construct does not constitute a taking, in prohibition of the United States Constitution, in part, because of specious arguments that a capacity supplier's participation in FCM is voluntary.

   5th and 14th Amendments to the U.S. Constitition; *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942); *Bluefield Waterworks & Imp. Co. v. Public Service Commission of W. Va.*, 262 U.S. 679 (1923); *Penn. Coal Co. v. Mahon*, 260 U.S. 393 (1922).

7. The Hearing Order wrongly imposes excessive mitigation of dynamic de-list bids, and is not tailored to protect against specified instances of impermissible market power, as required by law.

   Edison Mission Energy v. FERC, 394 F.3d 964 (D.C. Cir. 2005); *Panhandle Eastern Pipe Line Co. v. FERC*, 196 F.3d 1273 (D.C. Cir. 1999); *ISO New England Inc.*, 125 FERC ¶ 61,102 (2008); *New England Power Pool*, 101 FERC ¶ 61,344 (2002).

8. The Hearing Order erred in declaring the cost of new entry reset to be moot, while continuing to use the cost of new entry as the basis for the price floor. Additionally, the Commission has the obligation to use reasoned decision-making to set the price floor at a level that permits the reasonable opportunity to earn a profit, which it did not do in the Hearing Order.

   Louisiana Pub. Serv. Comm'n v. FERC, 184 F.3d 892 (D.C. Cir. 1999); *Panhandle Eastern Pipe Line Co. v. FERC*, 196 F.3d 1273 (D.C. Cir. 1999); *Northeast Energy Assoc. v. FERC*, 158 F.3d 150 (D.C. Cir. 1998); *Mississippi Valley v. FERC*, 659 F2d 488 (5th Cir. 1981); *New York Independent System Operator, Inc.*, 134 FERC ¶ 61,058 (2011).

9. The Hearing Order erred in allowing subsidized imports to affect FCM clearing prices. Further, the Order appears to subject import bids to a differing level of mitigation than internal resources would be subject to, resulting in undue discrimination between these classes of resources.

Order on Paper Hearing and Order on Rehearing, 135 FERC ¶ 61,029 (2011) ("April 23 Order").

III. REQUEST FOR REHEARING

A. The Hearing Order Fails to Approve a Just and Reasonable Rate.

1. The Hearing Order Neglected to Evaluate Whether the Proposed Market Design Provides the Proper Long-Term Price Signals.

The establishment of a market construct designed to return long-run average costs is a predicate to any just and reasonable capacity construct. This predicate is notably missing from the market design approved in the Hearing Order. As described by the Commission:

> if generators wish to participate in the FCM on a long-term basis, the FCM market rules give them an opportunity over time to recover not only going forward costs, but also additional fixed costs and a profit. The purpose of the New England FCM is to attract and retain sufficient capacity to maintain ISO-NE's Installed Capacity Requirement, and to do so, ***FCM capacity prices will need to average out over time to the cost of new entry***.[4]

The Order repeatedly reminds us that a just and reasonable capacity construct provides no guarantees of revenue sufficiency, or that clearing prices in any particular year will meet investors' expectations. While a just and reasonable market design provides no guarantee of recovery in any particular year, it is still true that *the market must be designed with this goal in mind*.[5] Otherwise, the "reasonable opportunity" to earn a return of, and on, a unit's costs is transmuted into a "theoretical possibility" of recovery, but with no practical possibility of achieving such a result.

The Hearing Order, unfortunately, falls into the admittedly appealing trap of simply assuming that the market will work to achieve this price level over time, and does none of the

[4] *ISO New England, Inc.*, 125 FERC ¶ 61,102 at PP 42 & 43 (2008) (emphasis added).

[5] *See Bridgeport Energy, LLC*, 113 FERC ¶ 61,311 at P 29 (2005) (FERC stated that, with regard to the FCM, a just and reasonable FCM market design requires that resources must be provided the opportunity to recover their costs).

hard work of discerning whether a capacity resource, receiving the capacity prices resulting from this FCM construct, would have any reasonable prospect of recovering its capital investment and other fixed costs over its expected life time. Is the capacity construct approved in the Hearing Order actually designed to return, over the long-term, the average cost of building a new capacity resource? The answer to this threshold question is a resounding "no."

The record evidence in support of our position is compelling. Dr. Bidwell anticipated the changes to the FCM construct approved by the Hearing Order and ran an economic simulation estimating capacity rents that several hypothetical units would expect to make over their expected lifetimes. His conclusion: limiting dynamic de-list bids to $1.00 / kW-month while mandating the use of Net Risk-Adjusted Going-Forward Cost bidding results in a market design that provides a "vanishingly small" opportunity to compete for just and reasonable returns.[6] The Hearing Order erroneously ignored this hard data, which undermines the Hearing Order's premise that its approved market design provides anything more than an illusory promise of earning a return on and of capital.

The Hearing Order, in fact, identifies no record evidence to support its implicit assumption that the market structure approved by the Commission is designed with this goal in mind. Instead, the Commission appears to rely exclusively on its finding that the previously-effective FCM construct met this requirement.[7] However, the pre-existing FCM construct had the benefit of an explicit design goal of producing prices that average, over time, the cost of new entry. In particular, the pre-existing FCM included dynamic de-list bids that were intended to "stop the clock" once prices decrease below 80% of CONE. That element of the original FCM

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[6] Initial Affidavit of Dr. Miles Bidwell, submitted July 1, 2010 at p. 3 ("Initial Bidwell Affidavit").

[7] *See Devon Power LLC,* 103 FERC ¶ 61,082 (2003); *Devon Power LLC,* 107 FERC ¶ 61,240 (2004); *Devon Power LLC,* 115 FERC ¶ 61,340 (2006).

design has been gutted by the Hearing Order. As a result, the apparent assumption that the modified construct approved by the Hearing Order has the same design goal and provides the same "reasonable opportunity" as intended under the previously effective structure is unwarranted.[8]

Further, Dr. Bidwell's analysis discredits this assumption, as discussed below. His models demonstrate that a market without a price stabilization mechanism is inconsistent with the goal of providing suppliers the reasonable opportunity to recover their costs over time. Instead, average annual prices decrease to such a level that it becomes virtually impossible to recover to the long-run average cost of capacity resources as mandated under a just and reasonable market design. The Commission previously reached the same conclusion when it stated that: "[i]n any single year, compensation below the cost of new entry would not, by itself, drive away future investment. *As long as the prices in other years are higher and the average price approximates the cost of new entry, New England can still attract investment*."[9]

In order to be sustainable on appeal, the Commission will be required, on rehearing, to identify substantial record evidence that a capacity supplier, responding to legitimate FCM price signals, would have a reasonable opportunity to earn a return of, and on, capital.[10] While "[a] just and reasonable rate is not a product of any single formula, but is instead a rate within a broad ambit of various rates which may be just and reasonable," the rates that result from the Hearing

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[8] Joint Complainants do not suggest that the prior FCM construct was just and reasonable; only that the architects of the initial FCM Settlement intended the market to return, on average, the levelized cost of new entry, and included mechanisms such as the 0.8 * CONE dynamic de-list bid threshold to help achieve that result.

[9] *ISO New England, Inc.*, 125 FERC ¶ 61,102 at P 44 (2008) (emphasis added).

[10] *Blumenthal v. FERC*, 552 F.3d 875 at 881 (D.C. Cir. 2009) (quoting *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) ("To withstand review under that standard, FERC must have 'examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including a "rational connection between the facts found and the choice made.'") (internal quotations and citation omitted).

Order are outside of this "range of reasonableness," and thus not acceptable under Section 205.[11] Notably, the Hearing Order failed to indentify any contrary evidence in the record (nor does any exist).

In addition, because the FCM construct is designed to produce clearing prices around the cost of new entry, accurately identifying and applying CONE is critical to FCM's success. As we discuss below, setting a realistic level for CONE is assuredly not moot, as it lies at the very heart of the Commission's capacity jurisprudence.

2. The Hearing Order Ignores the Numbers on Dynamic De-list Bids.

The Hearing Order found that limiting dynamic de-list bids to a trivial $1.00 / kW-month would result in a just and reasonable market structure, without adequately considering the critical price stabilization role that dynamic de-list bids play in the FCM construct. The ugly truth is that the capacity markets in New England are so over-supplied[12] that the dynamic de-list bid will become the de facto capacity clearing price in New England for the foreseeable future. A $1.00 / kW-month clearing price is simply unsustainable and will result in the collapse of the New England capacity markets. Dr. Bidwell plainly testified that restricting de-list bids to $1.00 / kW-month makes the probability that capacity suppliers will be able to recover their capital investments "vanishingly small." As the Commission itself explained:

> Joint Complainants' witness Bidwell asserts that without the 0.8 * CONE threshold, annual prices will fall so far below CONE that it will be effectively impossible for a capacity supplier to recover its fixed operating costs over the expected life of the facility, after only a few annual [Forward Capacity Auctions]. Joint Complainants state that, without the 0.8 * CONE threshold, consumers will end up paying more in the long run since rational suppliers will not enter and stay

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[11] *See Belco Petroleum Corp. v. FERC*, 589 F.2d 680, 689 (D.C. Cir. 1979), *citing Permian Basin Area Rate Cases*, 390 U.S. 747, 767 (1968); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944); *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585-86, (1942).

[12] Largely by virtue of out-of-market capacity resources that the Hearing Order decided should be allowed to continue distorting FCM clearing prices despite the availability of a well-supported price-adjustment mechanism to blunt such harm prospectively.

in a market that does not provide even the opportunity to earn a return on their investment.[13]

The Commission's response to this critique is comprised of three elements, which do not directly answer the issues we raised, and taken together, are unconvincing and wholly inadequate to warrant *Chevron*-type[14] deference:[15]

- [We] disagree with the argument offered by generator parties that the 0.8 * CONE threshold for dynamic de-list bids is necessary to limit the volatility of the market on the downside. A resource's de-list bid is not intended to serve as a price stabilizer; it is intended to represent the offer a competitive supplier would accept voluntarily to commit its resource as a capacity resource.

- Such capacity revenues would make a contribution to the supplier's fixed costs, as would infra-marginal energy and ancillary services revenues.

- No assurance for cost recovery is made for participating in competitive markets, only an opportunity to do so.

We address each of these unconvincing arguments in turn.

First, the Commission's statement that dynamic de-list bids are not designed to check market volatility is flatly contradicted by (i) the Commission's own orders approving the original FCM settlement and (ii) the testimony of Dr. Bidwell, Mr. Stoddard,[16] and Dr. Peter Crampton, the three original architects of the descending clock auction format. The Commission previously recognized that the FCM construct, with its vertical demand curve, does not offer the same protections against unreasonable price volatility as the downwardly sloping demand curve[17]

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[13] Hearing Order at P 307.

[14] *Chevron, U.S.A., Inc. v. NRDC*, 467 U.S. 837, 842-44 (1984)); *see also Consol. Edison Co. v. FERC*, 347 F.3d 964, 972 (D.C. Cir. 2003) ("FERC's interpretation of tariffs receive Chevron-like deference.") (citing *Idaho Power Co. v. FERC*, 312 F.3d 454, 461 (D.C. Cir. 2002)).

[15] Hearing Order at P 315.

[16] *See* Stoddard Testimony at p. 78 ("With no demand curve to add price stability to the FCA, the relatively looser review standards for supply priced below an agreed level – 0.8 * CONE – was designed as a stabilizer on the low side. New entry into a readily contestable market is the stabilizer on the high side.")

[17] Note that Joint Complainants are not asserting on rehearing that the Commission erred in not creating a demand curve; simply that the Forward Capacity Market requires a price stabilization mechanism in order to produce just

approved in other markets.[18] Further, the Commission, as well as the parties to the initial FCM Settlement, clearly envisioned that dynamic de-list bids would be necessary to protect against prices falling to unsustainably low levels. In that order, the Commission held that:

> A dynamic de-list bid must be at least 20 percent below CONE . . . Over the long run, the average price for capacity should reflect CONE, in order to attract new entry needed for reliability. The costs of an existing unit would ordinarily be below the entry cost of a new unit, *and we conclude that a default level for existing resources that is at least 20 percent below the cost of a new entrant (and at least 20 percent below the likely average price of capacity over time) is reasonable*.[19]

The Administrative Procedures Act[20] requires that the Commission explain such a radical U-turn in its thinking and justify its new decision to eliminate dynamic de-list bids from the market, without including another price stabilization feature.[21]

As Dr. Bidwell goes on to explain: "[i]n conditions of surplus the ability of plants to dynamically de-list at 0.8 CONE was intended to provide a potential limit to the downward volatility. The 0.8 CONE benchmark is a protection that is intended to keep the short-term market price from being driven down to levels from which the long-term competitive average would be impossible to regain and the market's viability would be destroyed."[22] He goes on to explain that "[t]he ability to dynamically de-list at 0.8 CONE was intentionally made part of the

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and reasonable results. A demand curve is one such price stabilization mechanism that the Commission has approved in other markets.

[18] *See, e.g.*, *PJM Interconnection, LLC*, 119 FERC ¶ 61,138 at P 108 (2007) (finding that vertical demand curves: (i) "fail to reflect the value of incremental reliability"; (ii) result "in extremely volatile pricing, because as long as supply exceeds the required amount, the price falls precipitously, while, when capacity is short, price will rise to the deficiency penalty level"; and (iii) that sloping demand curves reflect "a reasonable trade-off between capacity and energy prices.")

[19] *ISO New England Inc.*, 125 FERC ¶ 61,102 at P 77 (2008) (emphasis added).

[20] 5 U.S.C. § 706(2)(A).

[21] *See Panhandle Eastern Pipe Line Co. v. FERC*, 196 F.3d 1273, 1275 (D.C. Cir. 1999) (holding that the agency may not abandon its prior policy without providing a reasonable explanation for "the reasons for its departure").

[22] Dr. Bidwell, Second Affidavit, p. 13.

market structure to reduce potential market volatility."[23] Even Prof. Peter Crampton, testifying on behalf of load-side interests in the original FCM Settlement proceeding, explained the importance of the price stabilization role of dynamic de-list bids: "[limiting the downward price movement] decreases risk for both suppliers and demanders. As a result of the reduced risk, the equilibrium capacity price is reduced further. Thus, the proposal benefits rate payers in two ways: 1) reduced risk, and 2) a lower expected capacity price."[24] Despite this evidence, the Hearing Order erroneously assumes that dynamic de-list bids play no role in providing price stability. This incorrect assumption directly leads to the Commission's decision to effectively eliminate the dynamic de-list mechanism.

Second, the Hearing Order largely ignores the specific results of Dr. Bidwell's mathematical models. Dr. Bidwell quantified the harm to capacity suppliers inflicted by eliminating any price stabilizing tool in dollars and cents. His specific findings conclusively demonstrate that limiting dynamic de-list bids to $1.00 / kW-month results, not in capacity resources earning contributions to their fixed costs, but in capacity resources experiencing virtually certain losses of both debt and equity. Specifically, had the Commission addressed the following findings in the Hearing Order, the outcome would have been materially altered:[25]

- Current capacity revenues are insufficient to allow a typical generating facility to pay both its debt service and its fixed [Operations and Maintenance ("O&M")] costs.

- Even were the plant to slash O&M expenditures by over 33% in a desperate attempt to stanch the financial bleeding, it would *still* be unable make its full debt payments.

- A typical new peaking generator could expect to lose between $5 and $15 / kW *per year* of its equity, based on current capacity payment levels. This would

[23] Dr. Bidwell, Second Affidavit, at p. 3.

[24] Crampton memo at p. 1, Attachment A to Dr. Bidwell, First Affidavit.

[25] *See* Joint Complainants Reply Brief at p. 7 – 8.

amount to between $500,000 and $1.5 million annually for a 100 MW peaking generator.

- Firms that invested in new generation facilities over the past several years have seen the value of their investments decrease between 58 and 77 percent, based on econometric cash flow models.

- While it is theoretically possible that capacity prices could increase to the necessary level to allow for full cost recovery even after many years of suppressed prices, such an outcome would require single-year capacity prices to increase far above the starting price of the FCM.

Further, Dr. Bidwell states that these findings hold true whether he examines the $1,000 / kW Frame 7 power plant analyzed by Mr. Ungate,[26] or the similar $600 / kW plant analyzed by Mr. Reed in 2007, even using a generous 50/50 debt to equity financing structure and very favorable interest rates available only to investment-grade firms.[27] Such an outcome would, ultimately, limit the ability of the New England markets to attract new competitive capital. From this evidence, Dr. Bidwell concluded that: "[m]y spreadsheet financial analysis showed that the cash flow being earned by competitive modern generation plants in today's FCM is such that if the plants were sold today, <u>all of them would lose all of their equity</u> and then depending on assumptions about original construction cost and current O&M expenses, <u>would lose varying proportions of their debt</u>."[28] On rehearing, the Commission should recognize that this is the very definition of a confiscatory rate structure and address these arguments in a meaningful way.[29]

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[26] *See* Affidavit of Christopher Ungate, NEPGA Initial Brief.

[27] Mr. John Reed estimated that it would cost $602 / kW (in 2006 dollars) to build a plant in the Rest of Connecticut ("ROC"). Under Mr. Reed's assumptions, this investment would require first year payment of $8.04/ kW-month. See Table 1 "Estimated Benchmark Capacity Costs: Frame Units," Summary of Testimony of Mr. John Reed Testimony, Exhibit ISO-3, Docket No. ER03-563-30 filed on September 3, 2004.

[28] Dr. Bidwell, Second Affidavit, at p. 33 (emphasis added).

[29] The Court's precedents enforcing the requirement that the agency meaningfully respond to arguments are legion. *See, e.g.*, *Canadian Ass'n of Petroleum Prods. v. FERC*, 254 F.3d 289, 299 (D.C. Cir. 2001) (citations omitted); *NorAm Gas Transmission Co.*, 148 F.3d at 1165 ("[T]he Commission not only failed to provide an adequate response to [petitioner]'s argument, it failed to take seriously its responsibility to respond at all. . . . We hold that the Commission's dismissive treatment of [petitioner]'s market center objection, which was hardly a response at all, was not the product of a reasoned decisionmaking process.") (citing cases); *K N Energy, Inc. v. FERC*, 968 F.2d 1295, 1303 (D.C. Cir. 1992) ("[I]t most emphatically remains the duty of this court to ensure that an agency engage the

As Dr. Bidwell further explained, logic clearly shows that the structure approved by the Commission is not sustainable. Prices in most years will be set at levels significantly below the levelized cost of new entry – either by dynamic de-list bids of $1.00 / kW-month, or a unit's Net Risk-Adjusted Going-Forward Costs (which will rarely exceed the dynamic de-list price, given the Commission's approval of ISO New England's new, more restrictive bid mitigation practices).[30] Every once in a while – when new entry is needed – prices may clear at levels approaching CONE.[31] Taking the average of CONE (or some percentage discount off of the benchmark prices under the minimum offer price rule) and $1.00 / kW-month will by definition return average annual capacity prices significantly below sustainable levels. This common-sense analysis is confirmed by Mr. Stoddard.[32]

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arguments raised before it-that it conduct a process of reasoned decisionmaking."); *Tenneco Gas v. FERC*, 969 F.2d 1187, 1214 (D.C. Cir. 1992) ("Subsumed in the substantial evidence requirement is the expectation that agencies will treat fully 'each of the pertinent factors' and issues before them. Otherwise, the opportunities for notice and hearing in administrative proceedings would be largely illusory, with agencies free to disregard those facts or issues that prove difficult or inconvenient.") (citation omitted); *Moraine Pipeline Co. v. FERC*, 906 F.2d 5, 9 (D.C. Cir. 1990) ("Thus, by failing to respond to [petitioner]'s arguments and to articulate its decision based on evidence in the record, the Commission breached its obligation to engage in reasoned decisionmaking.") (citing *Tarpon Transmission Co. v. FERC*, 860 F.2d 439, 445 (D.C. Cir. 1988); *City of Charlottesville v. FERC*, 661 F.2d 945, 950 (D.C. Cir. 1981)); *Laclede Gas Co. v. FERC,* 873 F.2d 1494, 1498 (D.C. Cir. 1989) ("[W]here a party raises facially reasonable alternatives to FERC's decision . . . the agency must either consider those alternatives or give some reason, within its broad discretion . . . for declining to do so." (internal citation omitted)); *City of Vernon v. FERC*, 845 F.2d 1042, 1048 (D.C. Cir. 1988) ("No matter how rudimentary a claim, an agency is not entitled under the APA to respond with a non sequitur.").

[30] As the Hearing Order summarized, "[a]s a result, ISO-NE states that it is expected that most acceptable static or permanent de-list bids under this revision will be *nearly zero* since a resource providing energy and ancillary services would incur few or no additional costs in order to provide capacity." Hearing Order at P 316 (emphasis added).

[31] Prices are extremely unlikely to exceed the levelized cost of new entry, if for no other reason than because state entities with responsibility to fulfill state energy policy objectives and the economic incentive to keep prices low can enter into contracts that provide for the contracted resources to offer just at their allowable benchmark under the minimum offer price rule directed by the Commission in the Hearing Order. This scenario is the most likely basis for setting clearing prices in the new FCM, other than when de-list bids are the marginal resource.

[32] *See* Stoddard Testimony at p. 32-33 ("If mitigation rules allow few or no de-list bids priced above $1 in the FCA as ISO proposes, any surplus supply is likely to crash the market down to $1. How, then, can the FCM return an *average* price equal to the cost required by new entry? Each low-priced year would need to be offset by at least one high-priced year when prices range well above the (true) CONE value. That is a very unlikely result.")

None of these specific arguments are cited or addressed by the Commission. "Unless an agency answers objections that on their face appear legitimate, its decision can hardly be said to be reasoned."[33] The Commission identifies no errors in Dr. Bidwell's model and does not even address the data he provided, except in cursory fashion.[34] The numbers do not lie. No rational, profit-seeking enterprise would voluntarily choose to enter such a marketplace because they would be guaranteed to lose most of their investment. Any capacity construct with economic destruction as its guaranteed outcome will fail. Thus the Order's conclusion that the approved market construct is just and reasonable is unsupported and not entitled to *Chevron* deference.[35] Had the Hearing Order considered the evidence, the Commission would have recognized that a market where prices are set by Net Risk-Adjusted Going-Forward Costs when in surplus and by a price at or below the long-run average cost of entry when in shortage does not provide long-run average revenues equal to the levelized cost of new entry that the Commission has long recognized as the hallmark of a sustainable market.

Third, static or permanent de-list bids, which must follow a rigid formula in the tariff,[36] do not represent the level which a capacity supplier would accept "voluntarily" to commit its resource as a capacity resource. Rather, the tariff limits such bids to the "Net Risk-Adjusted Going-Forward Cost" of a resource to a formula based on its historic costs and revenues. Estimating costs and revenues nearly four years in advance is not nearly so precise an exercise, particularly in the face of uncertain new environmental requirements that are likely – but not certain – to require extensive new capital investment in existing infrastructure. There is simply

[33] *Tesoro Alaska Petroleum Co. v. FERC*, 234 F.3d 1286, 1294 (D.C. Cir. 2000) (citing cases).

[34] "[T]he Commission must respond to objections and address contrary evidence in more than a cursory fashion." *Transmission Agency of N. Cal. v. FERC*, No. 09-1213, --- F.3d ---, 2010 WL 5060995 at *3 (D.C. Cir. Dec. 10, 2010) (citing *NorAm Gas Transmission Co. v. FERC*, 148 F.3d 1158, 1163-65 (D.C. Cir. 1998)).

[35] *See*, *supra*, n. 14.

[36] *See* ISO-NE Market Rule 1, Section III.13.1.2.3.2.1.2.

no mechanism in the tariff for a supplier to capture that uncertainty or to reflect its own tolerance or aversion to risk in developing its de-list bid. In addition, the tariff's de-list bid formula explicitly excludes debt and other real fixed costs, such as taxes and insurance. Many, if not all, suppliers count these costs when evaluating their decisions to continue participating in a market or continuing to operate, and would include such costs in a de-list bid if given the opportunity under the tariff. So, while the tariff's formulation of de-list bids is intended to reflect some idealized minimum price offer, it is in no sense reflective of the level that real suppliers would "voluntarily" offer to take on capacity obligations.

Fourth, the Commission's citation to infra-marginal energy and ancillary services (E&A) revenues as a source of making up any revenue shortfalls is disingenuous. The New England market design is intended to minimize fixed cost recovery from the energy and ancillary services markets. E&A revenues earned by units are carefully constrained by market rules mandating units to bid at marginal cost. The Commission recognized this facet of the northeastern RTO market designs in its recent order in NYISO, which specifically stated that E&A revenues are designed to recover fixed and variable operations costs, but are not going to make a meaningful contribution to fixed costs.[37]

Moreover, there is a long track record in New England demonstrating what happens when units are forced to rely exclusively on energy revenues: units needed for reliability seek to retire and customers pay the costs. As the ISO described in 2005, the lack of a functional capacity construct brought the market to the brink of failure:[38]

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[37] *See e.g.*, *New York Indep. Sys. Operator, Inc.*, 133 FERC ¶ 61,030 at P 51 (2010) (finding stringent energy market mitigation rules mandating marginal cost bidding just and reasonable because generators are expected to "receive revenues to contribute to the recovery of their fixed, i.e., capacity, costs from the capacity market.")

[38] ISO New England Inc.'s Answer to Joint Motion To Appoint Settlement Judge, Devon Power Company, LLC, et al, Docket No. ER03-563-030, October, 2005.

> As the Commission is well aware, the need for a locational capacity market has been a paramount concern for over two years. During that time the need for, and approval of, Reliability Must Run ("RMR") contracts has skyrocketed to ensure continued reliability in New England. . . . During this period, few new generation projects have been planned for the region. We now face a need for new capacity in the 2008 to 2010 timeframe and, without an effective capacity market, New England will not get the investment it needs for reliability through a market solution.

Further, it has always been understood, and in fact is explicitly captured in the tariff provisions for calculating static and permanent de-list bids, that de-list bids in the FCM construct are to be net of anticipated E&A net revenues. In the likely scenario of prices being set by static or dynamic de-list bids, there is no contribution to fixed costs for the marginal resource, and with de-list bids in the range of $1.00 / kW-month, there is only trivial contribution to any unit's fixed costs.

Fifth, the Commission does not explain yet another reversal in its view of whether bids of less that 0.8 * CONE require mitigation. In this Order, the Commission accepts as gospel the assertion that market monitor review is appropriate for bids over $1.00 / kW-month. In its prior orders, however, the Commission adopted a very different, and wholly reasonable, approach, and determined that bids of less than 0.8 * CONE were *de facto* reasonable:

> [W]e disagree with the state parties that the Commission should require ISO-NE to file generator-specific going forward cost data. . . . A dynamic de-list bid must be at least 20 percent below CONE, and is only entered into the auction in an auction round where the clearing price is at or below that level. Over the long run, the average price for capacity should reflect CONE, in order to attract new entry needed for reliability. The costs of an existing unit would ordinarily be below the entry cost of a new unit, and we conclude that a default level for existing resources that is at least 20 percent below the cost of a new entrant (and at least 20 percent below the likely average price of capacity over time) is reasonable.
>
> Moreover, we conclude that it is acceptable to establish a default level of compensation at a reasonable level, because of the administrative convenience that it provides: generators submitting de-list bids below this level do not need to provide cost support and the market monitor need not expend the resources to review the bids. In addition, some going forward costs (especially opportunity

> costs) may be difficult to quantify, so allowing a default bid level would avoid the burden of attempting to quantify these costs.[39]

Again, the Commission provides no satisfactory explanation for its reversal, as required by the courts.[40]

Sixth, the courts have been clear that over-mitigation is no more acceptable than under-mitigation. As Joint Complainants explained, bidding at prices twenty percent below the price level that the Commission has stated is necessary as a long-term average rate is *per se* evidence that such a bid is *not* an exercise of market power. The simple fact is that a unit offering capacity and setting price at 0.8 * CONE *cannot* recover its equity, as Dr. Bidwell demonstrates. The same holds true for every capacity supplier in the same zone. Further, the D.C. Circuit has imposed significant hurdles on attempts by the Commission to impose additional, unwarranted mitigation.[41] As the D.C. Circuit has previously recognized in addressing mitigation schemes, it is insufficient to determine that mitigation "may well do some good by protecting consumers and utilities against price increments caused by the exercise of market power" without a simultaneous showing that the mitigation "does not also wreak substantial harm – in curtailing price increments attributable to genuine scarcity that could be cured only by attracting new sources of supply."[42] Joint Complainants assert that the record is bereft of evidence demonstrating that the proposed mitigation scheme "does not wreak substantial harm" consistent with the D.C. Circuit's ruling. The failure of the Commission to narrowly tailor its mitigation to specific unpermitted exercise of market power, coupled with its prior findings that bids at 0.8 *

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[39] *ISO New England Inc.*, 125 FERC ¶ 61,102 at P 77-78 (2008).

[40] *See supra*, n. 21.

[41] *See also New England Power Pool*, 101 FERC ¶ 61,344 at P 28 (2002) ("The Commission will approve only mitigation measures that address well-defined structural problems in the market.")

[42] *Edison Mission Energy v. FERC*, 394 F.3d 964, 968–70 (D.C. Cir. 2005), which held that unjustified mitigation is "the epitome of agency capriciousness," and citing to the "potential ill effects of forcing down prices absent structural market distortions."

CONE presented no appreciable risk of allowing prohibited market power, renders the Hearing Order's imposition of a $1.00 / kW-month mitigation scheme arbitrary and capricious.

While there is clearly a zone of reasonableness surrounding the proper mitigation level for such bids, the $1.00 / kW-month price approved by the Hearing Order is well below any FCM auction price, and well below the audited costs of providing reliability services. The Hearing Order ignored evidence demonstrating that the fixed O&M costs of eleven typical plants ranged from $3.16 to $7.45 / kW-month, with a median of $3.85 / kW-month and a capacity-weighted average of $4.11 / kW-month.[43] This data, taken from fully contested RMR proceedings, makes it clear that limiting dynamic de-list bids to $1.00 is well below the zone of reasonable unit costs, and will impose unjustified administrative burdens on capacity suppliers. The evidence is thus clear that $1.00 / kW-month results in excessive mitigation.

B. The Hearing Order Does Not Meaningfully Respond to Joint Complainant's Constitutional Taking Arguments.

The Hearing Order does not dispute the Joint Complainants' assertion that a market mechanism that fails to provide generators the reasonable opportunity to recover their fixed costs would constitute a taking, violating both the 5th and 14th Amendments and the Federal Power Act.[44] However, the Commission's analysis of Joint Complainants' takings arguments presupposes that the Commission has adopted a market structure that provides generators the

[43] *See* Affidavit of Robert Stoddard at pp. 62-63. Critically, these costs ***exclude*** debt coverage, return on equity, taxes, insurance, and other non-discretionary operating items.

[44] *See ISO New England,* 119 FERC ¶ 61,045 at P 118 (2007) ("The Commission offers the following example as an illustration of how ISO-NE's proposed FCM rules can result in unjust, unreasonable, and confiscatory ratemaking….") *See also Bluefield Waterworks & Imp. Co. v. Public Service Commission of W. Va.,* 262 U.S. 679, 690 (1923) ("*Bluefield*"), which states that "[r]ates which are not sufficient to yield a reasonable return on the value of property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment."

reasonable opportunity to recover their fixed costs. As discussed above, this presupposition is simply incorrect.[45]

In discussing Joint Complainants' arguments, the Hearing Order notes that "competition among utilities to serve customers is a mechanism to bring about just and reasonable rates."[46] We do not disagree. In fact, competition has saved ratepayers untold billions of dollars since the restructuring of the electric industry began in the 1990's. We similarly do not take issue with the Commission's statement that "as in all markets, regardless of what 'investment-backed expectations' a resource may have had at the time that it chose to enter the ISO-NE markets, each market entrant was aware of the possibility that at some times, it might earn substantially more than a traditional cost-based rate, but that at other times, it might earn less than its costs."[47] We are not seeking guaranteed profits. The Commission is likewise correct when it states that it is "responsible only for assuring that [a resource] is provided the opportunity to recover its costs, not a guarantee of cost recovery."[48] The fundamental question that we raise on rehearing is whether the Hearing Order actually adopted a market construct that provides the aforementioned "reasonable opportunity."[49] Given that: (i) Dr. Bidwell examined a variety of potential market

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[45] A market that does not provide this opportunity represents a taking of private property for public use without just compensation, and is prohibited by the Fifth and Fourteenth Amendments to the U.S. Constitution. As the Supreme Court explained:

> Rates which are not sufficient to yield a reasonable return on the value of property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment.

FPC v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944) ("*Hope*") (also stating that "just and reasonable" rates must provide "enough revenue not only for operating expenses but also for the capital costs of the business" and be sufficient for the utility to "maintain its credit and attract capital").

[46] Hearing Order at P 254.

[47] *Id*.

[48] *Id*.

[49] To the extent that participation in the energy and capacity markets is insufficient, even over the long term, to recover fixed costs, plus a profit, the rates approved by the Commission are not lawful and must be changed. *See, e.g.*, *Penn. Coal Co. v. Mahon*, 260 U.S. 393, 413 (1922) (a regulation that "reaches a certain magnitude" in

scenarios, and showed that each scenario resulted in a loss of capital, the opportunity to recover a return of and on equity is illusory under the existing market; and (ii) that no party submitted evidence challenging Dr. Bidwell's conclusions; the approved market design fails to meet the FPA minimum criterion and must be changed.

1. "Voluntary" Participation in the FCM is only Voluntary if there is Another Option.

In attempting to refute Joint Complainants' taking arguments, the Hearing Order asserts that participation in the FCM construct is voluntary. As a voluntary market, the Commission reasons, a capacity supplier can simply avoid what would otherwise be a confiscatory taking by gracefully leaving the FCM market construct, and recovering its costs elsewhere. This is a mischaracterization of the New England market structure, which relies on just and reasonable capacity *and* energy and ancillary services revenues in order to provide just and reasonable compensation.

First, the suggestion that a capacity supplier forgo capacity revenues in order to ensure that it has a reasonable opportunity to seek a just and reasonable return is not a sensible response.[50] The New England markets are designed to provide compensation of fixed costs *primarily* through the capacity market.[51] A capacity supplier that voluntarily forgoes capacity market revenues in favor of seeking to recover their fixed costs from an E&A market specifically designed to return only variable costs has no chance of recovering its capital investment.[52] The

depriving an owner is a regulatory takings); *see also Bluefield Waterworks & Imp. Co. v. Pub. Serv. Comm'n of West Virginia*, 262 U.S. 679, 692 (1923).

[50] Joint Protesters are reminded of the old saw that "the operation was successful but the patient died."

[51] *See e.g., New York Indep. Sys. Operator, Inc.*, 133 FERC ¶ 61,030 at P 51 (2010) (accepting energy market rules requiring marginal cost bidding, and noting that are generators are expected to "receive revenues to contribute to the recovery of their fixed, i.e., capacity, costs from the capacity market").

[52] Indeed, the energy market mitigation rules of ISO-NE explicitly restrict the energy offers of resources that do not have capacity supply obligations to follow the same rules as resources with such obligations and offer their energy

Commission certainly cites no precedent – nor does any such precedent exist – for the supposition that the government may provide capacity suppliers two value-destroying options – one slightly worse than the other – and not run afoul of the 5th Amendment or the FPA. In short, if the capacity market construct is not itself just and reasonable, then a capacity supplier has effectively zero chance of earning back its fixed costs – no matter how competitive the unit may otherwise be. If the E&A markets were designed to allow recovery of fixed costs, there would be no reason for capacity markets. The simple existence of capacity markets in the northeast RTOs is evidence of the Commission's understanding that the E&A markets, in and of themselves, cannot be expected to enable capital recovery, particularly in light of stringent energy market mitigation measures. Again, the Commission errs in presupposing that its capacity construct is just and reasonable without analyzing the underlying economics, as suggested by Dr. Bidwell.

Second, it is very difficult for a capacity supplier to leave the FCM market construct unless it is willing to shut down. Permanent, static and dynamic de-list bids are subject to reliability review by ISO-NE, and if a de-list bid is rejected, the unit would be forced to accept a capacity supply obligation and would be paid based on its approved de-list bid price; *i.e.*, its Net Risk-Adjusted Going-Forward Costs. The only guaranteed way to leave the market is for a capacity supplier to place a Non-Price Retirement Request. This commits the unit to leaving *both* the energy and capacity markets, surrendering its interconnection rights, and ceasing to operate if its request is accepted. Even in the event the ISO determines the unit is needed for reliability the supplier can carry out its retirement plans despite the reliability need. As a result,

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very close to their short-run marginal costs, ensuring that such resources will not be able to price any contribution to their fixed costs into their energy and ancillary market participation. *See* ISO-NE Market Rule 1, Appendix A, Section III.A.5.2.1.

economically de-listing from the FCM and continuing to operate in the E&A markets is, again, a theoretical possibility with very little practical likelihood of occurring.

Third, the existing market rules do not expressly allow a capacity supplier to include new environmental capital expenditures, opportunity costs, company-specific risk premiums, or other incremental costs, in its static de-list bids. Instead, these bids are limited to the supplier's Net Risk-Adjusted Going-Forward Costs, which ISO New England currently interprets as precluding even reasonable estimation of likely environmental capital expenditures necessary to keep a facility operating over the next four years. Given the significant new environmental requirements that are in the process of being finalized by the Environmental Protection Agency, this is a massive risk factor. Allowing dynamic de-list bids at 0.8 * CONE provided resources some level of protection against being required to either prematurely retire or accept a clearing price below its actual cost of providing capacity service. A real life example is playing out right now: the owner of the Salem Harbor assets was recently forced to shut down its units (effective FCA 5), rather than be subjected to mitigated de-list bids that would have left it in danger of being unable to recover legitimate environmental compliance costs.[53] Given the uncertainty swirling around the environmental rules recently issued by the Environmental Protection Agency, it is not reasonable to require a unit to place a bid to provide capacity nearly four years forward without being able to include a reasonable estimate of its fixed costs, including incremental capital expenditures resulting from mandatory environmental rules, in its bid. If the unit is needed for reliability, it will be paid its de-list bid price, which is designed to exclude any consideration of known and potential future capital and other fixed costs, supplemented by E&A revenues which, as described above, are intended to return only *de minimis* contributions to fixed

[53] *See Motion to Intervene and Comments of Dominion Resources Services, Inc.*, Filed March 23, 2011 in Docket No. ER11-3034-000.

cost recovery. Given the level of uncertainty with respect to costs, and the minimal capacity and E&A revenues available in this circumstance, units are likely to choose the retirement path, even if they would be economical at a price level more in line with their actual fixed costs. This will impose unnecessary costs on the region, both in direct costs for more expensive replacement capacity, and in indirect costs as a result of the lost jobs and other economic benefits of the existing generating plants. In addition, system reliability may be adversely impacted and congestion may be increased, depending on which units are forced to prematurely retire.

C. The Commission Erred in Extending the Floor for Only Two Years and at a Rate that Does not Reflect the Actual Cost of New Entry.

The Commission erred in finding that (i) the CONE parameter is not relevant to the FCM construct, despite using it to set the floor price in the next two to three auctions; (ii) arguments surrounding whether the CONE parameter should be reset were moot; and (iii) a floor price based on 60% of an outdated CONE estimate provides for just and reasonable mitigation of the historical out-of-market resources that entered the market in FCAs 1, 2 and 3. Given the current surplus in the region, there is a reasonable possibility that FCAs 5, 6, and 7 will also clear at the floor, so the rate at which the floor is set is most assuredly not moot and will instead be the defining element of the FCM construct through at least the 2016/2017 Delivery Year.

1. A Fundamental Price Formation Tool Cannot be Deemed "Moot".

The Hearing Order's decision to sidestep questions of what it actually costs to bring a capacity resource into the New England market and to tailor its market design to provide a reasonable opportunity to recover that level of investment, is a fundamental error. Similarly, it was not the product of reasoned decision-making to find that arguments surrounding the proper calculation of CONE are moot, while also using 60% of that "moot" number to set prices in New England for at least the next three auctions, particularly given that, as discussed below, the

CONE parameter that previously existed in the ISO New England tariff bears no relation to the actual cost of new entry.

2. The April 23 Order Recognized the Importance of the CONE Parameter, and Directed Parties to Brief this Specific Issue. The Hearing Order Does Not Justify this U-Turn in Policy.

The April 23 Order setting the FCM construct for hearing stated that "we do agree with the generator parties that the proper CONE value is important, since it is tied to numerous aspects of the FCM."[54] The Hearing Order inexplicably reversed the Commission's prior stated position, noting only that it was proposing to eliminate some - but certainly not all - uses of the CONE parameter in the FCM. Continuing to use the outdated CONE parameter as a benchmark for the floor price, when there is a clear possibility that the auction will clear at the floor, is an important continuing usage of this "moot" figure. An agency is prohibited from making such changes without adequately explaining its departure from prior precedent. *See Panhandle Eastern Pipe Line Co. v. FERC*, 196 F.3d 1273, 1275 (D.C. Cir. 1999) (holding that the agency may not abandon its prior policy without providing a reasonable explanation for "the reasons for its departure").[55]

3. The Hearing Order Shirked its Obligation to Determine that the Floor Price is Just and Reasonable.

Even leaving aside the issue of whether determining the actual cost of new entry is moot, the Commission has an independent obligation to ensure that the value it uses for its floor price is designed to provide a reasonable lower bound on the auction price, in keeping with the overall

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[54] April 23 Order at P 151.

[55] *See also*, *Northeast Energy Assoc. v. FERC*, 158 F.3d 150 (D.C. Cir. 1998) (remand for failure to explain deviation from past precedent and policy); *Louisiana Pub. Serv. Comm'n v. FERC*, 184 F.3d 892 at 897 (D.C. Cir. 1999) ("We therefore hold that the Commission's 180 degree turn away from Kentucky Utilities was arbitrary and capricious. For the agency to reverse its position in the face of a precedent it has not persuasively distinguished is quintessentially arbitrary and capricious."); *Mississippi Valley v. FERC*, 659 F2d 488, 506-07 (5th Cir. 1981) ("While the Commission is entitled to depart from previous policies, to engage in reasoned decision making the Commission must explain the basis for any departure.")

objective of ensuring that the FCM produces prices that, on average and over time, approximate the long-run incremental cost of building, owning and operating a capacity resource in the region. Instead of designing a floor price, either based on a predetermined cost of new entry or other logical basis, the Hearing Order side-stepped the difficult issues and instead picked an arbitrary price based on what all parties admit is an outdated CONE parameter that has been adjusted by virtue of the flawed FCM rules and thus bears no relation to the actual costs a new market participant would be expected to incur in order to provide capacity services. This failure is part and parcel of the problems identified in Section A above; namely, that the Hearing Order takes on faith and in disregard for the record evidence that its preferred market structure will be expected, over the long-run, to return prices that approximate the cost of new entry in such a manner that would incent investment in New England.

The Commission has the legal obligation to establish an FCM floor price based on reasoned decision-making, and one that provides capacity suppliers the "reasonable opportunity" discussed in detail above. As the Commission has long held, a vertical demand curve market (such as the FCM auction structure utilized by New England) must have a price stabilization mechanism, or the market will go into freefall in surplus conditions.[56] The unresolved out-of-market entry from the early FCM auctions created the surplus conditions, and without an adequate floor, will cause prices to remain significantly below the long-run average cost of new entry for the foreseeable future.[57]

4. The Current Cost of New Entry Used to Set the Floor is Unreasonable; the Cost of New Entry in Other Markets Continues to Increase, While Capacity Values in New England Plummet.

[56] *See supra*, Section A.1.

[57] Witness Stoddard presented a convincing case that, absent Commission action, the surplus will remain for 19 years, thus obliterating the value of an entire generation of capacity suppliers.

Under the FCM rules adopted by the Hearing Order, the CONE parameter is currently set at $5.349 and is used in order to set the price floor used in FCAs 5 and 6 (and, presumably, given ISO New England's indication that the new rules will not be available for implementation until FCA 8. The $5.349 / kW-month value is so far below the actual costs of bringing a new power plant into the market that it must be thrown out. Accurately determining the cost of new entry is critical if capacity suppliers are to have any hope of recovering their fixed costs, plus a profit, over the long term. To this end, the Commission must ensure that the market rules properly identify the actual cost of new entry. The Commission appeared to agree, setting the cost of new entry for hearing:[58]

> [T]he CONE value in ISO-NE is well below the CONE values in both NYISO and PJM. While we do not agree with the logic offered by the generator parties as to why ISO-NE's CONE value is relatively lower, it still leaves open this issue of an appropriate value for CONE going forward. . . . [Thus,] we will require the Filing Parties and others to address in their First Briefs in the paper hearing, above, the issue of the proper CONE value.

Empirical costs of bringing cost of capacity to market in other regions of the country continue to rise. The April 23 Order setting the FCM for hearing noted that "it is clear that the CONE value in ISO-NE is well below the CONE values in both NYISO and PJM."[59] Since that order was issued, NEPGA provided the Commission with extensive data on the costs of building a new plant in New England.[60] In addition, new data on the cost of constructing a new proxy generating unit in California, PJM, and NYISO continues to show rapid increases in the cost of bringing new capacity to market:

Market	**Range of Net CONE Values in $/ kW-month (combustion turbine)**

[58] *Order on Forward Capacity Market and Related Complaints*, 131 FERC ¶ 61,065 at P 151 (2010).

[59] *Id.*

[60] Joint Complainants note that Dr. Christopher Ungate of consulting firm Sargent and Lundy, filing as part of NEPGA's initial brief, calculated the actual costs of building a new power plant in New England.

CAISO	$12.37 - $14.01 (North and South of Pass 15, respectively)[61]
NYISO	$7.81 - $23.24 (Rest of State and New York City Zone J, respectively)[62]
PJM	$7.36 - $10.41 (depending on location within PJM)[63]

Further, the cost of new entry used in the FCM market has fallen precipitously over the first four years of FCM's operation (from $7.50 / kW-month to $5.35 / kW-month today). This decrease in the "cost" of bringing capacity to market is not attributable to any decrease in the actual cost of constructing a new power plant, but was instead a negotiated price determined in the initial FCM Settlement, and does not today constitute a reasonable benchmark for setting capacity prices. Certainly, the "CONE" rate in New England is well outside the zone of reasonableness when compared against the actual costs of power plant construction. The Hearing Order provides no compelling justification for not using the actual levelized cost of constructing a new facility, particularly when that data was provided to the Commission, and presents no compelling rationale for finding that such arguments are now moot, after specifically ordering them briefed only 12 months ago.[64]

Using the clearly outdated $5.35 / kW-month rate as the basis for setting the floor, using a number that the April 23 Order questioned and that the Hearing Order refused to endorse, is a

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[61] *See* 2010 CAISO Annual Report on Markets, Tables 2.9 & 2.10, *available at*: http://www.caiso.com/2b66/2b66baa562860.pdf

[62] Taken from the curves filed in Docket No. ER11-2224-000 and approved, subject to modification, in *New York Independent System Operator, Inc.*, 134 FERC ¶ 61,058 (2011).

[63] *See* PJM Tariff, Attachment DD, §5.

[64] Joint Complainants note that Dr. Christopher Ungate of consulting firm Sargent and Lundy, filing as part of NEPGA's initial brief, calculated the actual costs of building a new power plant in New England.

recipe for market failure. As we have explained repeatedly throughout this Rehearing Request, the success or failure of FCM hinges on its ability to return a price level that approximates a true cost of new entry, on average, over the expected lifetime of the facility. Without a target to aim at, it is impossible for the Commission to judge the relative merits of this construct in a reasonable manner.

D. The Hearing Order Creates a Truck-Size Loophole for Out-of-Market Imports.

The Hearing Order (at P 190-191) properly notes that, under the offer floor construct that the Commission is ordering, consideration must be given to the appropriate treatment of import capacity resources. The Hearing Order concludes, at P 191, that, while most imports would be treated as existing capacity (emphasis added):

> The exception would be for imports where a specific new external resource is identified as the sole support for the import, *and* where a significant investment (such as the construction of a new transmission line to import power from an adjacent control area) is made to provide capacity to New England. We think that these latter resources are clearly new resources that are devoted to the New England market over the long term, and should therefore be treated like new internal resources for mitigation purposes. Thus, we conclude that such an import, supported by a clearly identified new external resource, should be subject to an offer floor associated with a benchmark price related to the external resource's technology type.

The Commission should reconsider its decision to require that a new external resource both be designated as the source for the import *and* make significant investment in transmission to achieve the import. Rather, the test should be that either of these elements would suffice to require the import to be subject to an offer floor.

By way of illustration, assume there are existing resources in an external control area, but that the owner of those resources cannot export additional capacity to New England due to limitations on the transmission interface. If the owner invests in additional transmission to increase its ability to export, that investment, in and of itself, is the investment needed to bring additional capacity to the market. Economic theory requires that the new investment be subject to an offer floor or market monitor review of its actual costs, otherwise the project sponsor will be able to bid below the applicable benchmark. It is not necessary for the owner of the external resources to identify any specific resources, or to commit them for any period longer than a single year, for this investment to constitute a "new" capacity resource that should be subject to the same mitigation as new resources constructed within the New England region. Any other conclusion would result in different mitigation schemes applying to both internal and external capacity resources, which would result in undue discrimination.

The Hearing Order makes several references to the commitment of external resources "for the long term" as somehow being important in whether to subject them to offer floor mitigation. Under the current rules, it is clear that only imports that are being provided under a pre-existing multi-year contract with a buyer in New England qualify as "existing" resources, and that otherwise imports are treated as "new" each and every year. Likewise, if the hypothetical owner of resources in the previous paragraph commits either its resources or the transfer capability of its new transmission line under a long-term agreement to a buyer in New England, then the capacity would be considered "existing" *after it has cleared once in a capacity auction as "new."* However, in order to clear that first time, it must be subject to the same mitigation that all other new resources face, *i.e.*, the offer floor mitigation directed by the Commission.

To accomplish this, the Commission need only change "and" in the third sentence of P 191 to "or," reflecting that either of these conditions is sufficient by itself to constitute a "new" import resource subject to mitigation.

IV. CONCLUSION

WHEREFORE, for the foregoing reasons, the Joint Protestors respectfully request that the Commission grant rehearing in this proceeding and revise the market rules so that capacity suppliers in New England are provided the reasonable opportunity, over the long-run, to earn a return of and on their investment.

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, DC this 13th day of May, 2011.

/s/ *Gretchen Hunt*
Gretchen Hunt