UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

ISO New England, Inc.) Docket No. EL00-62-026

COMMENTS AND LIMITED PROTEST OF CENTRAL MAINE POWER COMPANY, THE MAINE PUBLIC UTILITIES COMMISSION, THE MAINE PUBLIC ADVOCATE AND THE VERMONT DEPARTMENT OF PUBLIC SERVICE

Pursuant to Rule 214 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission ("FERC" or "Commission"), 18 C.F.R. § 385.214, and the Commission's Notice of Filing issued on June 13 and the Notice of Extension of Time issued June 21, 2001, Central Maine Power Company, the Maine Public Utilities Commission, the Maine Public Advocate and the Vermont Department of Public Service (collectively "Commenters"), intervenors in this docket, hereby submit Comments and Limited Protest in the above-captioned proceeding. With one limited but critical exception, Commenters generally endorse ISO-New England's ("ISO-NE's") Installed Capability ("ICAP") market reform proposal. ISO-NE's proposal is the culmination of intense negotiation among New England Power Pool ("NEPOOL") participants, most elements of the proposal barely missed approval by the super-majority of NEPOOL participants required by the Restated NEPOOL Agreement ("RNA") for approval of tariff changes. The proposal generally constitutes a marked improvement over NEPOOL's current ICAP requirement.

While Commenters generally support ISO-NE's restructured interim ICAP proposal, we urge the Commission to correct the proposal's one fatal flaw by increasing the 5 percent limitation on the amount of ICAP a participant can purchase during the cure period. As discussed below, the requirement that a Load Serving Entity ("LSEs") purchase 95 percent of its ICAP obligation prior to the relevant monthly supply period, even though the LSE's actual obligation is not known until after the end of the supply period, is unreasonable. This

requirement places each LSE at significant risk of under-purchasing ICAP and, therefore, incurring the 20 percent penalty or overbuying ICAP to mitigate this risk. In either scenario, the LSE and its customers are unfairly penalized for factors, such as load shifts and monthly peak changes, beyond the LSE's control.

In addition to correcting the 5 percent limitation, we request the Commission to defer ruling on the long-term aspects of ISO-NE's proposal, which we understand ISO-NE submitted at this stage for informational purposes only. While we decline to comment at this time on ISO-NE's preliminary discussion of its long-term ICAP proposal, we reserve the right to comment on that proposal when it is filed for Commission approval. Also, we reserve the right to protest the implementation details of ISO-NE's interim ICAP proposal once ISO-NE has determined those details.

OVERVIEW

In its March 6, 2001 order on rehearing, the Commission, in imposing an $8.75/kW-month NEPOOL ICAP deficiency charge, acknowledged that that charge was not the only possible just and reasonable rate. *ISO New England, Inc.*, 95 FERC ¶ 61,174 (2001), Slip Op. at 5 ("March 6 Order"). Indeed, the Commission stated that the $8.75 charge was only an interim charge, in place only until ISO-NE filed an alternative proposal. *Id.*, Slip Op. at 6. On June 4, 2001, ISO-NE accepted the Commission's invitation and filed an interim restructured ICAP proposal. ISO-NE's proposal, for the most part, recreated a compromise proposal that barely missed receiving the super-majority vote necessary for approval by the NEPOOL Participant Committee.

As such, ISO-NE submitted the filing at issue pursuant to its emergency authority under Section 6.17 of the ISO Interim Agreement, since no ICAP proposal had received the requisite NEPOOL approval and the Commission had requested ISO-NE to file a new ICAP proposal within 90 days of FERC's March 6, 2001 Order. *See id.* ISO-NE also submitted the outline of a proposal for long-term reform of the NEPOOL capacity markets.

As the Commission knows, the ICAP issue sparked great controversy among New England stakeholders. In the aftermath of the March 6 Order, a number of New England stakeholders successfully sought review of the Commission's orders setting the $8.75 ICAP deficiency charge from the United States Court of Appeals for the First Circuit. *See Central Maine Power Co. v. FERC*, Nos. 01-1376, *et al.* (1st Cir. June 8, 2001). At the same time, NEPOOL participants from disparate stakeholder groups engaged in extensive discussions and negotiations concerning how to revise the ICAP requirement and set the ICAP deficiency charge. These efforts resulted in consideration of two ICAP restructuring proposals at the NEPOOL Participants Committee Meeting held on June 1, 2001. These proposals, though not approved by the Participants Committee, contained several common features, including the establishment of a cure period and a new mechanism for allocating deficiency charge revenues. ISO-NE's proposal incorporates most features favored by the majority of NEPOOL participants, with one striking exception, the 5 percent limitation on purchases during the cure period.

COMMENTS AND LIMITED PROTEST

At the outset, we commend ISO-NE for its submission of a compromise proposal that constitutes a substantial improvement over NEPOOL's current ICAP requirement and market. The ISO proposal transforms ICAP into a product by requiring generators to commit their units for dispatch through the submission of energy bids and to receive ISO-NE's approval prior to any planned maintenance outages. The ISO proposal further tries to redress one of the major sources of unfairness in the ICAP market, namely that purchasers do not know their precise ICAP obligation until after-the-fact. ISO-NE proposes a two-week cure period so that participants who receive notice of ICAP deficiencies may purchase ICAP from holders of surplus ICAP during a two-week cure period following the end of the supply period.

Commenters had initially supported a lower deficiency charge. However, at the June 1, 2001 Participants Committee meeting, a wide range of stakeholders, including a number of generation owners, agreed to a compromise proposal on the deficiency charge. Commenters are willing to support this compromise, which is adopted virtually verbatim, in the ISO-NE proposal. This support does not, in any way, indicate our agreement that these higher charges are correct, but rather our willingness to resolve this issue and move on. Our willingness to compromise here also extends largely from ISO-NE's substantial redesign of the ICAP market. Commenters are only willing to accept ISO-NE's proposed range for the deficiency charge, however, provided the Commission revises the cure limitation. To inhibit gaming and promote fairness, we recommend that the Commission either: (1) allow unlimited cure during the two-week cure period; or (2) extend the cure percentage to allow each participant to cure all deficiencies, provided the participant has purchased the lower of 15 percent of ISO-NE's forecasted requirement or 15 percent of the actual ICAP requirement in any supply period.[1] The Commenters' proposal is further explained below.

I. The 5 percent Cure Limitation is Unreasonable and Likely to Distort the ICAP Market

Ideally, Central Maine and other load serving entities ("LSEs") would know their ICAP purchase obligation before they would be required to purchase ICAP. In the present NEPOOL market, however, such advanced knowledge is not possible. ISO-NE indicates that it is not presently feasible for it to administer the ICAP settlement process using a purchase requirement based on forecasted load. Consequently, ISO-NE proposes to continue its current practice of setting an LSE's ICAP obligation after the close of the relevant supply period. ISO-NE

[1] Even though the ICAP forecasts ISO-NE provides are for market monitoring and mitigation purposes, that is the only number ISO-NE provides relevant to a participant's ICAP obligation prior to notifying the participant of its actual obligation, after-the-fact.

recognizes that its inability to determine ICAP obligations in advance is a drawback in the implementation of a truly efficient and competitive capacity market product. *See* ISO-NE Transmittal Letter at 15.

Participants working to improve the efficiency of the ICAP market developed the cure period to remedy the problems and unfairness caused by the retrospective determination of Participants' ICAP obligation. Without this cure period, LSEs face the undesirable option of: (1) inefficiently overbuying ICAP to ensure that possible load shifts will not result in the imposition of a deficiency charge; or (2) imprudently risking underbuying and incurring the deficiency charge. The cure period liberates LSEs from this double-bind, allowing LSEs to cover their known ICAP obligations and ICAP sellers to trade any still-available ICAP.

Although at the June 1, 2001 Participants Committee meeting there was some discussion over limitations on the amount of an entity's ICAP obligation that could be purchased during the cure period, no entity, including the ISO, suggested that an LSE could only cure 5 percent of its deficiency. ISO-NE's June 4, 2001 proposal, however, contains just that low a restriction on the amount of ICAP that can be purchased during the cure period. ISO-NE's proposal requires each Participant obligated to purchase ICAP on a monthly basis to purchase 95 percent of its ICAP requirement in advance of the monthly supply period. ISO-NE requires each participant to cover almost all of its ICAP obligation in advance, even though the amount of ICAP that the LSE must purchase during that period is unknown and will remain unknown until at least two weeks after the supply period closes. The proposal provides a two-week cure period during which Participants who are ICAP deficient may purchase ICAP on a bilateral basis to cover up to 5 percent of their final settlement obligation. There is no cure permitted for any ICAP deficiency

that exceeds 5 percent, and that excess is subject to the full deficiency charge applicable to the particular participant.

ISO-NE's tandem 95 percent pre-settlement ICAP purchase obligation and 5 percent cure limitation allow for only a very small margin of error. This margin is simply inadequate in a system where ICAP purchase forecasts are based on three-month prior data and ICAP purchase obligations are not finally known until well after the supply period has ended. Factors entirely out of the LSE's control, such as load shifts and monthly peak changes on its own or other LSEs' systems, will impact its final ICAP obligation. Even ISO-NE cannot ensure that its forecasts will be so accurate as to have only a 5 percent margin of error.

Further, the 5 percent limitation also will likely spur LSEs to overbuy or even hoard ICAP to mitigate the risk of incurring any ICAP deficiency in excess of the 5 percent cure limitation, which will be subject to the ICAP deficiency charge. Overbuying will cause a false scarcity in the ICAP market, artificially inflating the bilateral contract price. Ultimately this behavior will impair the ICAP market's efficiency and distort its effectiveness as a signal for the need for new capacity construction. Thus, ISO-NE's 5 percent cure limitation injects a market flaw into an otherwise workable interim ICAP solution.

The interaction between the 5 percent cure limitation and the revenue-sharing aspect of ISO-NE's proposed deficiency charge revenue allocation formula may result in additional market flaws. Under the proposed allocation formula, holders of surplus ICAP and non-deficient LSEs will share in the distribution of deficiency charge reserves, similar to PJM's allocation arrangement. To the extent ICAP sellers withhold ICAP (to a degree not detectable through ISO-NE's market monitoring mechanism) and buyers hoard ICAP to ensure that they are not short, deficiency pool revenues will be increased and the price of ICAP will be driven up in future months.

In addition, by increasing its unsold surplus of ICAP, a generator could increase the share of deficiency charge revenue to which it is entitled. A generator could also increase its

allocation of the deficiency charge revenue by decreasing the number of covered LSEs with whom it must share revenue. For all these reasons, the Commission should reject the 5 percent cure limitation.

II. The Cure Limitation Should be Eliminated or Relaxed

Commenters believe the preferred way to negate the unfairness created by a retrospective ICAP obligation would be to remove any limitation on the amount of an entity's ICAP obligation that can be purchased during the cure period. ICAP sellers, however, have raised the competing concern that no cure limitation may hamper bilateral contracting during the period in advance of the supply period. While we agree that buyers should not have incentive to delay all their purchases until the cure period, a penalty that pinches too hard, such as the 5 percent cure limitation, can produce inefficient outcomes. "[H]igher penalty levels," this Commission has stated in the analogous context of pipeline imbalance provisions, "often operate to limit and distort market forces." *Transcontinental Gas Pipe Line Corp*., 91 FERC ¶ 61,004 at 61,018 (2000). In Order No. 637, for example, the Commission noted that circumstances of high penalty levels, high overruns and /or imbalance penalties may cause shippers to fail to maximize their use of pipeline transportation, or to contract for more transportation capacity than they need.[2] The thrust of FERC's directive in Order No. 637 was "to replace systems using negative incentives such as penalties with ones using services to induce desirable behavior." *Transcontinental*, 91 FERC at 61,018.

If the Commission does not permit unlimited ICAP purchases during the cure period, the commenters propose that the amount of ICAP that can be purchased during this period be increased. We propose that the Commission allow ICAP purchasers to cure <u>all</u> ICAP deficiencies, provided the purchaser has purchased in forward market the lowest of 15 percent of the ICAP's forecast obligation or 15 percent of the actual ICAP obligation, whichever is lower.

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[2] Regulation of Short-Term Natural Gas Transportation Services, and Regulations of Interstate Natural Gas Transportation Service, Order No. 637, 65 FR 10156 (February 25, 2000), FERC Stats. & Regs. Regulation Preambles ¶ 31,901 at 31,308 (2000).

This approach balances the need to provide incentives to maintain supply and the concern with penalties that encourage overbuying. While our proposal does not eliminate reliance on some degree of projection and estimation, it gives ICAP purchasers greater latitude in acting on their assessment of the accuracy of ISO-NE's forecasts. At the same time, it ensures that active trading occurs in the forward markets.

Allowing a more liberal cure opportunity will not encourage LSEs to lean on the system for reserves. Nor would expanding the opportunity to cure deficiencies invite gaming, since LSEs incurring deficiencies—even if they intentionally under-purchased installed capability -- could not bank on the existence of offsetting over-purchases by others. Indeed, assuming that customers actually would have the ability to engage in intentional and persistent underpurchasing, the logic is that they *all* would be able to do so, *i.e.*, that deviations from capacity requirements would be in the same direction. Giving customers the clear right to cure, *i.e.*, to trade shortfalls and overages, moreover, would be consistent with the Commission's holding in Order No. 587-G[3], that pipelines should be required to offer their customers the similar right to trade imbalances.

To illustrate how our suggested approach would operate, we provide the following examples.

1. For A, ISO-NE forecasts an ICAP obligation of 100 kW. A's actual obligation turns out to be 110. A must have purchased at least 85 kW, and A can purchase the remaining 25 kW without incurring a penalty.

2. For B, ISO-NE forecasts an ICAP obligation of 100 kW. B's actual obligation is only 90 kW. If B correctly assessed ISO-NE's estimate as excessive, B could have purchased as little as 76.5 kW, and B may purchase the outstanding 13.5 kW without paying a penalty.

[3] Standards for Business Practices of Natural Gas Pipelines, III. FERC Stats. & Regs. Preambles ¶ 31,062 (1998).

III. ISO-NE Properly Exercised its Authority Under Section 6.17 of the Interim ISO Agreement in Filing its Interim Restructured ICAP Proposal.

It is not surprising, given the short period of time since the Commission issued its March 6 Order, that NEPOOL failed to achieve the supermajority required under the RNA to adopt an interim ICAP proposal. Arguably the March 6 Order anticipated this failure by inviting ISO-NE to submit an alternative to the $8.75 deficiency charge within 90 days. *See* Slip Op. at 6. Indeed, the Commission's expectation that ISO-NE would submit a new ICAP proposal was a cornerstone of its March 6 Order. *See id.*; *see also* Opposition of the Federal Energy Regulatory Commission to Motion for Stay at 8 (" . . . any alleged harm could be readily mitigated by a prompt filing of a new ICAP charge by ISO-NE"). The Commission imposed an interim $8.75 rate to remain in place only "until such time as the ISO supports an acceptable superseding proposal, whether it be a market-driven mechanism or a different ICAP deficiency charge." March 6 Order, Slip Op. at 5; *see also* Opposition at 8 ("The $8.75 charge was intended solely as an interim measure due to the inadequacy of record evidence to support a different charge").

Furthermore, failure to resolve the ongoing ICAP issue promptly will undermine competition in the New England electric generation markets. Consequently, both to comply with the March 6 Order and to protect competition, ISO-NE was entitled to exercise its emergency authority under Section 6.17 of the ISO Interim Agreement and submit the ICAP proposal now before the Commission.

IV. The Commission Need Not Consider the Long-Term Aspects of ISO-NE'S Market Redesign Proposal at This Time.

ISO-NE's filing includes elements of a long-term ICAP market redesign proposal that gives the Commission and NEPOOL participants some idea of what ISO-NE considers an appropriate redesign of the ICAP market. However, as ISO-NE's proposed long term revisions are clearly in the preliminary stage, Commenters urge the Commission to defer consideration of these long-term suggestions until ISO-NE (or NEPOOL) formally submits a comprehensive

long-term proposal for Commission approval. Commenters similarly defer comment and protest on the long-term aspects of ISO-NE's proposal until such formal proposal has been submitted.

CONCLUSION

For the reasons set forth above, we respectfully request the Commission to (1) approve ISO-NE's proposed deficiency charge and interim reformed ICAP market; (2) modify ISO-NE's proposed interim market to either (a) eliminate any limitation on transactions in the cure period; or (b) broaden the cure limitation to 15 percent of the ICAP's forecast obligation or 15 percent of the actual obligation, whichever is lower. In addition, we ask the Commission to defer consideration of the long-term capacity market reforms until NEPOOL has the opportunity to consider and vote on the proposal. We also reserve the right to challenge the details of ISO-NE's implementation of its interim proposal, once those details are finalized.

Respectfully submitted,

Richard Lorenzo
Heidi Marie Werntz
Huber Lawrence & Abell
1001G Street, N.W.
Washington, D.C. 20001
Phone: (202) 383-3868
Fax: (202) 737-7006

Attorneys for Central Maine
Power Company

Harvey L. Reiter
John E. McCaffrey
M. Denyse Zosa
Morrison & Hecker, L.L.P.
1150 18th St., N.W., Suite 800
Washington, D.C. 20036-3816
Phone: (202) 785-9100
Fax: (202) 785-9163

Attorneys for the Maine Public
Utilities Commission and the
Vermont Department of Public Service

Stephen G. Ward
State House Station # 112
Augusta, ME 04333-0112
207-287-2445

Maine Public Advocate

CERTIFICATE OF SERVICE

I certify that I have this day served, by first-class mail, postage prepaid, a copy of the foregoing document on each party named in the official service list in this proceeding.

Dated at Washington, D.C., this 28th day of June, 2001.

Heidi Marie Werntz
Huber Lawrence & Abell
1001 G Street, N.W.
Washington, D.C. 20001
(202) 383-3868