UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Maine Public Utilities Commission )
v. ) Docket No. EL07-38-000
ISO New England Inc. )

REQUEST FOR REHEARING OF
THE MAINE PUBLIC UTILITIES COMMISSION, THE MAINE OFFICE OF
THE PUBLIC ADVOCATE, THE MASSACHUSETTS ATTORNEY GENERAL,
THE MASSACHUSETTS DEPARTMENT OF PUBLIC UTILITIES AND THE
NEW ENGLAND CONFERENCE OF PUBLIC UTILITY COMMISSIONERS
§ 825l (2000), and Rule 713 of the Federal Energy Regulatory Commission’s
Public Utilities Commission (“MPUC”), the Maine Office of the Public Advocate
(“MOPA”), the Massachusetts Attorney General (“Mass AG”), the Massachusetts
Department of Public Utilities (“MA DPU”) and the New England Conference of Public
Utility Commissioners (“NECPUC”) (collectively, “State Parties”) respectfully submit
this Request for Rehearing of the Commission’s “Order Denying Complaint”1 issued in
the above-captioned proceeding on February 3, 2009. As discussed below, the
Commission erred by (1) determining that a negotiated rate was not compensatory; (2)
concluding that there was no double recovery because different services are provided
under the Forward Capacity Market (“FCM”) and Schedule 2; (3) relying on the game
theoretic model in determining that double recovery of capital cost compensatory
revenues was “highly unlikely”2; (4) concluding without any evaluation that the capacity

(“February 3 Order”).
2 February 3 Order at P 44.
cost ("CC") rate provides appropriate financial inducement to invest in additional VAR\textsuperscript{3} capability; and (5) finding that changing the CC rate would amount to a change in the FCM settlement package.

I. BACKGROUND

Schedule 2 of ISO New England Inc.’s Open Access Transmission Tariff ("ISO-NE OATT") sets forth the rules that govern eligibility for compensation and payment for reactive power supply and voltage control service in New England.\textsuperscript{4} To the extent a generation facility is directed by ISO New England Inc. ("ISO-NE") to produce or absorb reactive power, that facility is compensated under the Schedule 2 rate for its provision of reactive power and for the energy costs associated with the reactive power provided. The generator also is compensated for the capability to provide reactive service.

The existing rate design under Schedule 2 of the ISO-NE OATT ("Schedule 2") consists of a fixed capacity cost ("CC") component and three variable components: (1) Lost Opportunity Cost ("LOC"), which compensates a generator for the lost opportunity in the energy market when the generator would otherwise be economically dispatched but is directed by ISO-NE to reduce real power output to provide more reactive power; (2) the cost of energy consumed ("SCL"), which compensates for the cost of energy consumed by a generator solely to provide reactive power support;\textsuperscript{5} and (3) the Cost of Energy Produced ("PC") component which compensates a generator that was not economically dispatched when it is directed to

\begin{itemize}
  \item \textsuperscript{3} "VAR" stands for "Volt-ampere-reactive." Reactive power is measured in Vars.
  \item \textsuperscript{4} See Schedule 2 to ISO-NE’s OATT at Original Sheet No. 735.
  \item \textsuperscript{5} The Complaint, as amended, did not propose changes to the LOC, SCL, or PC components of Schedule 2.
\end{itemize}
come on line or increase power above its economic loading point to provide local reactive support. The Revised Amended Complaint concerns only the CC component of Schedule 2.

At the time the CC component was originally negotiated, the monthly capacity payment that would be applicable if the load serving entity had not purchased sufficient capacity through the bilateral market\(^6\) was $0.17/kW month.\(^7\) In the New England Power Pool (“NEPOOL”) filing implementing the original negotiated CC component of the Schedule 2 rate, advocates for a reactive capacity charge asserted that a capital cost component under Schedule 2 was important because “…the capital costs covered by the CC charge are not necessarily recoverable in the market-based real power markets and therefore it is appropriate to establish an administratively set rate to allow generators to recover such costs and be incentivized to provide VAR support capability and service.”\(^8\) In comparison to the $0.17/kW month 2001 ICAP deficiency charge, the capacity Transition Payments under the FCM Settlement are in the range of $3.05 to $4.10 per kW month.\(^9\) The first FCM auction resulted in a capacity price of $4.50 per kW month.\(^10\) Under the FCM, the capacity payments equal the cost of new entry.\(^11\)

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\(^{6}\) This payment was called the Installed Capacity (“ICAP”) deficiency charge.

\(^{7}\) Sithe New England Holdings, LLC v. FERC, 308 F.3d 71 (2002).


\(^{9}\) See Devon Power, LLC, 115 FERC ¶ 61,340 at P 30 (June 16, 2006) (“Devon Power”), FERC Docket Nos. ER03-563-030 and -005 at P 30.

\(^{10}\) This was the floor price for the first auction. See ISO New England Inc., Transmittal Letter dated March 3, 2008 at 2 in Docket No. ER08-633-000.

On October 13, 2006, the NEPOOL Participants Committee (“NEPOOL”) voted on changes to the Schedule 2 rate. NEPOOL approved a rate increase to the CC component of Schedule 2. On December 29, 2006, in a joint filing at the Commission, ISO-NE and NEPOOL (“Joint Filers”) proposed the increase to the CC component of the Schedule 2 rate which had been approved by NEPOOL at its October 13, 2008 meeting. The proposed rate would have increased the original negotiated rate from $1.05 to $2.32/kVAR-year.\textsuperscript{12} The MPUC, the Central Maine Power Company (“CMP”) and the New Hampshire Public Utilities Commission (“NH PUC”) protested the CC component rate increase arguing, in relevant part, that because the revenue stream from the FCM settlement compensates generators for their capital costs of providing generation and the same equipment is needed to provide reactive service, the two revenue streams constituted a “double recovery” for generators.\textsuperscript{13} In response to the protests, the Joint Filers stated that there was no double recovery during the transition period because the transition payments were lower than the Cost of New Entry (“CONE”) to be used in the first Forward Capacity Auction (“FCA”). In comparison to the transition period, the Joint Filers noted that under the first FCA, the capacity payments will be set by the market and will reflect the actual cost of new entry.\textsuperscript{14} Accordingly, ISO-NE committed to:

\textsuperscript{12} ISO New England Inc., Docket No. ER07-397-000, Transmittal Letter at 3 (December 29, 2006).


proposing, for implementation prior to the first FCA commitment year, Tariff provisions to ensure that Resources eligible for CC payments under Schedule 2 for providing reactive supply and voltage control do not receive double compensation.  

On February 28, 2008, the Commission issued an Order in which it accepted and suspended the proposed rate schedule and set the proposed rate for hearing and settlement procedures. With respect to the double recovery issue, the Commission stated:

… [T]he Commission is concerned that double recovery can occur during the first FCA since the payments equal the cost of new entry. The ISO commits to proposing, for implementation prior to the first FCA commitment year, Tariff provisions to ensure that Resources eligible for CC payments under Schedule 2 for providing reactive supply and voltage control do not receive double compensation. Accordingly, the Commission will require ISO-NE to implement, prior to the commencement of the first FCA commitment year beginning June 1, 2010, tariff provisions to ensure that resources eligible for CC payments under Schedule 2 that provide reactive supply and voltage control do not receive double compensation.

The settlement procedures resulted in a settlement of the CC rate but left open the double recovery issue, as it applies both during the Transition Period and during the FCM.

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15 Id. (emphasis added)

16 ISO New England, Inc., 118 FERC ¶ 61,163 (2007) (“February 28 Order”). With regard to the transition period, the Commission also determined that there is no double recovery stating that “transition payments do not compensate resources for their reactive power capabilities since they are below the cost of new entry.” ISO New England and NEPOOL Participants Committee, 118 FERC ¶ 61,163 at P. 30. The MPUC, the NHPUC and CMP filed a request for rehearing on this double recovery issue during the transition period and NECPUC filed comments in support of the request for rehearing. See Request for Rehearing of the Maine Public Utilities Commission, the New Hampshire Public Utilities Commission, and Central Maine Power Company, Docket No. ER07-397-001, filed March 30, 2007; see also Request for Leave to Answer and Answer to Request for Rehearing of the New England Conference of Public Utility Commissioners, Docket No. ER07-397-001, filed April 18, 2007. This request for rehearing is still pending. See ISO New England Inc. and NEPOOL Participants Committee, 123 FERC ¶ 61,294 (2008).

17 Id. at P 30 (emphasis added).

18 The Settlement Agreement provided that no Settling Party may seek a change to the settled CC Rate of $2.19/kVAR-yr. pursuant to either Section 205 or Section 206 of the Federal Power Act, except for the limited purpose of addressing the issue of any double recovery of capacity costs that
On February 26, 2007, the MPUC filed a Complaint addressing two aspects of Schedule 2. One was the socialization of the PC charges. However, this aspect of the original Complaint was removed in the Revised Amended Complaint, which was filed on September 25, 2008.\(^{19}\) The remaining issue in the Complaint, therefore, is the issue of whether Schedule 2 should be revised to eliminate or reduce the CC component of Schedule 2, since recovery of the generation units’ capital costs is already provided for under the FCM market rules.

ISO-NE filed an answer to the Complaint asserting that there was no double recovery based primarily on a theory of how it expected generators to bid into the FCM. Several generators also opposed the Complaint. NECPUC, MOPA, the Mass AG and EnerNOC and Bangor HydroElectric (“BHE”) filed comments supporting the Complaint.

II. SPECIFICATION OF ERRORS

Pursuant to Rule 713(c)(1), 18 C.F.R. § 385.713(c)(1) (2008), the State Parties respectfully submit that the Commission, in the February 3 Order, acted arbitrarily and capriciously, and therefore erred:

\begin{quote}
\hspace{1cm}arises from the combination of Schedule 2 CC rate payments and payments made in accordance with the FCM settlement (1) if the Commission concludes on reheating in Docket No. ER07-397-001 and/or in response to the Amended Complaint in Docket No. EL07-38-000 that changes are required under the Federal Power Act to eliminate any such double recovery of capacity costs and/or (2) in connection with the requirement in \textit{ISO New England Inc.}, 118 FERC ¶ 61,163 at P 30 (2007), that ISO-NE “implement, prior to the commencement of the first FCA commitment year beginning June 1, 2010, tariff provisions to ensure that resources eligible for CC payments under Schedule 2 that provide reactive supply and voltage control do not receive double compensation.”
\end{quote}

\(^{19}\) All references herein to the “Complaint” refer to the September 25, 2008 Revised Amended Complaint unless otherwise noted.
(1) in concluding that because the Capacity Cost component of ISO-NE’s Schedule 2 rate was a negotiated rate, the Capacity Cost component cannot also be compensatory;

(2) in concluding that there is no double recovery because FCM and reactive service are different services;

(3) in concluding that ISO-NE’s game theory ensures that FCM generators will not double recover Capacity Cost compensatory revenues;

(4) in concluding that the Capacity Cost component of ISO-NE’s Schedule 2 Rate provides appropriate financial inducement to invest in additional VAR capacity; and

(5) in concluding that eliminating or modifying the Schedule 2 rate would amount to a change in the FCM Settlement package.

III. STATEMENT OF ISSUES

Pursuant to Rule 713(c)(2) of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.713(c)(2) (2008) and Order No. 663-A, the State Parties specify the following issues to which they request Commission consideration:

(1) Whether the Commission abused its discretion or acted in an arbitrary and capricious manner in concluding that because the Capacity Cost component of ISO-NE’s Schedule 2 rate was a negotiated rate, the Capacity Cost component cannot also be compensatory. See Motor Vehicle Mfrs. Ass’n v. State Farm Mutual Automobile Insurance Co., 463 U.S. 29, 43 (1983) (The agency must the relevant data and must offer a “rational connection between the facts found and the choice made.”); see also Greater Boston Television Corp. v. FCC, 444 F.2d 941 (D.C. Cir. 1970) (departure from precedent without acknowledgment and explanation is arbitrary).

(2) Whether the Commission abused its discretion or acted in an arbitrary and capricious manner in concluding that there is no double recovery because FCM and reactive service are different services. See Motor Vehicle Mfrs. Ass’n v. State Farm Mutual Automobile Insurance Co., 463 U.S. 29, 43 (1983) (The agency must the relevant data and must offer a “rational connection between the facts found and the choice made.”); see also Arizona Public Service Co. v. United States, 742 F.2d 644, 649 n.2 (D.C.Cir.1984).

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(“Whatever the allocation of the burden of proof, mere conjecture and abstract theorizing offered in a vacuum are inadequate to satisfy us that the agency has engaged in reasoned decisionmaking”).

(3) Whether the Commission abused its discretion or acted in an arbitrary and capricious manner in concluding that ISO-NE’s game theory ensures that FCM generators will not double recover Capacity Cost compensatory revenues. *Motor Vehicle Mfrs. Ass’n v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 43 (1983) (The agency must the relevant data and must offer a “rational connection between the facts found and the choice made.”); *see also Greater Boston Television Corp. v. FCC*, 444 F.2d 941 (D.C. Cir. 1970) (departure from precedent without acknowledgment and explanation is arbitrary).

(4) Whether the Commission abused its discretion or acted in an arbitrary and capricious manner in concluding that the CC Rate provides appropriate financial inducement to invest in additional VAR capacity. *Motor Vehicle Mfrs. Ass’n v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 43 (1983) (The agency must the relevant data and must offer a “rational connection between the facts found and the choice made.”); *see also Arizona Public Service Co. v. United States*, 742 F.2d 644, 649 n.2 (D.C.Cir.1984) (“Whatever the allocation of the burden of proof, mere conjecture and abstract theorizing offered in a vacuum are inadequate to satisfy us that the agency has engaged in reasoned decisionmaking”).

(5) Whether the Commission abused its discretion or acted in an arbitrary and capricious manner in concluding that eliminating or modifying the Schedule 2 rate would amount to a change in the FCM Settlement package. *Motor Vehicle Mfrs. Ass’n v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 43 (1983) (The agency must the relevant data and must offer a “rational connection between the facts found and the choice made.”); *see also Greater Boston Television Corp. v. FCC*, 444 F.2d 941 (D.C. Cir. 1970) (departure from precedent without acknowledgment and explanation is arbitrary).

IV. ARGUMENT

A. The Commission’s Conclusion That There is No Double Recovery Because the Capital Cost Component of Schedule 2 Is a Negotiated Rate Does Not Address the Purpose of the Capital Cost Component of Schedule 2 and Conflates the Terms “Cost of Service” and “Compensatory.”

The February 3 Order adopts, *verbatim*, the argument made by ISO-NE that the Complaint is based on “‘a phantom cost-of-service basis,’” February 3 Order at P
42, and that “the CC Rate component is ‘a negotiated value and is not set equal to, nor is it intended to recover, the cost of service of any particular generating Resource’,” id., quoting ISO-NE’s October 14, 2008 Answer (emphasis added). The February 3 Order errs by conflating the term “cost of service” with the term “compensatory” and concluding that any rate that is a “negotiated,” rather than “cost of service,” rate cannot be compensatory. In doing so, the Order fails to recognize that both the FCM and the CC component of Schedule 2 are compensatory rates. The February 3 Order also loses sight of the fact that the reason that the Commission found that there was no double recovery during the transition period in Docket No. ER07-397-000 is that the transition payments, according to the Commission, are not fully compensatory.21

The February 28 Order stated:

The Commission agrees with ISO-NE that transition payments do not compensate resources for their reactive power capabilities since they are below the cost of new entry; however the Commission is concerned that double recovery can occur during the first FCA since the payments equal the cost of new entry.

February 28 Order at P 30 (emphasis added). Thus, the Commission’s finding in the February 3 Order that the FCM revenues are not compensatory cannot be reconciled with the Commission’s February 28 Order in Docket No. ER07-397-000.

Further, the Commission has stated that one of the purposes of capacity payments is compensatory. For example, in Docket No. ER03-563-000, the Commission concluded that the transition payments provide “reasonable rates for existing generators,”

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21 Several parties, including several of the State Parties, have sought rehearing of this decision. This rehearing remains pending. See Order Granting Rehearing, 123 FERC ¶ 61,294 (June 20, 2008).
and that one of “the Commission’s stated goals in this proceeding is to ensure that existing generators are appropriately compensated.”22

Thus, as the Commission recognized in Devon Power, the focus is on an entity’s opportunity to recover fixed costs whether that occurs through a market or through a cost of service regime:

[exists]tisting capacity resources are currently operating in an auction-based market, and will continue to do so under the LICAP mechanism. When operating in a market, units are not guaranteed any particular level of compensation, and accept the risk that they will receive low revenues in exchange for the opportunity to earn higher revenues. Furthermore, generating units providing capacity, regardless of their level of depreciation, will still be entitled to the opportunity to recover their fixed costs plus a rate of return. This is an ongoing process in both a cost-based and auction-based market regime.23

Thus, the issue is not whether there is a cost of service or market scheme to recover costs for the units, or whether the rates were arrived at by settlement or by hearing. The issue is whether generators have an opportunity to recover their capital costs under the FCM.24 Since the Commission has determined that they do,25 then a second revenue stream aimed at providing recovery of capital costs for the same equipment is redundant, and, therefore, unjust and unreasonable.

Just as the FCM is compensatory, so is the Schedule 2 CC Rate. As the initial filing of the CC rate indicated, the purpose of the capital cost component of Schedule 2 is to “to allow generators to recover such [capital] costs and be incentivized to

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22 Devon Power, 113 FERC ¶ 61,340 at P 102.
23 See Devon Power, LLC, 110 FERC ¶ 61,315 at P 44 (emphasis added)
24 Id. at 26.
25 Id.
provide VAR support capability."^{26} NEPOOL and ISO-NE confirmed this compensatory purpose of the CC component of the rate in Docket No. ER07-397-000 in describing the CC component as one “which compensates generators for the fixed capital costs incurred by a generator associated with the installation and maintenance of the capability to provide reactive power.”^{27} Further, no party has refuted the fact that the same equipment is used to provide both services. Accordingly, the Commission erred in (1) finding there was no double recovery simply because the FCM and the CC rate were not developed using a cost of service approach; and (2) departing, without explanation, from its earlier decisions regarding the compensatory nature of the FCM.

**B. The Conclusion That There is No Double Recovery Because FCM and Reactive Service are Different Services Is Illogical, and Leads to Absurd Results.**

The February 3 Order, again adopting the arguments of ISO-NE, states that FCM and reactive service “are two distinct services, designed to achieve different purposes.”^{28} The Commission’s determination is illogical because it ignores the fact that there are additional revenue streams for the actual provision of VAR services, and leads to the conclusion that even if the same equipment is used to provide distinct services, multiple revenue streams through which generators receive or have an opportunity to receive compensation not only for the provision of those services but for the same capability of that equipment are not duplicative. Brought to its extreme, this argument would allow for multiple revenue streams providing compensation for the same

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^{26} Seventy-third Agreement, Transmittal Letter at 10.


^{28} February 3 Order at P 39.
generation equipment for every multiple task that the equipment is used for. Allowing multiple revenue streams in compensation for the same equipment, is, by definition, unjust and unreasonable because it results in excessive rates. In fact, as discussed below, the conclusion is inconsistent with the Commission’s earlier decisions rejecting an argument from generators that FCM resources were used only for resource adequacy purposes.

The February 3, 2009 Order also errs by trying to bolster the conclusion that there is no double recovery by relying on and expanding language taken out of context from another decision. The February 3 Order states:

Furthermore, in another earlier order, we found that, with respect to compensation for reactive service, “if generators are asked to provide additional services including VAR support or regulation, they will be compensated for those services through the appropriate ISO tariff or markets, not through the FCM.” Thus, we previously found that reactive service is a unique service the compensation for which is not covered by capacity payments, whether transition payment or auction revenues.

February 3 Order at P 41 (internal citations omitted). However, the case relied upon by the Commission involved a question of the appropriate level of compensation for two generators located in Connecticut, which had not been allowed to delist in the Forward Capacity Auction (“FCA”) due to a concern that the units were needed to meet the area transmission requirements. The generators had argued that because the units were needed to meet the area transmission requirements, they should receive additional compensation that reflects the additional reliability service provided by these generators (in addition to providing resource adequacy).

In response to this argument, ISO-NE argued that a resource purchased under the FCM is not used only for adequacy services. Rather, ISO-NE argued that the
FCM resource is bound to follow all ISO-NE rules, including the requirement to provide security, and there are no market rules or operating procedures that limit ISO-NE’s ability to dispatch resources for only adequacy reasons. Among other arguments, ISO-NE also stated that with existing markets for nodal energy, locational capacity, locational forward reserves, reactive power, and regulation, plus uplift payments for resources called out of merit, there is no basis for creating another market to price security as a separate product, especially when the number of potential providers is so small that the market would not generate a competitive price.

The Commission accepted ISO-NE’s arguments and rejected the argument for a separate security service both because there were other revenue streams, including net commitment period compensation, which includes one aspect of VAR service, but also because security service is included in the FCM. The Commission, in fact, adopted the ISO-NE view that “under FCM, load is paying each resource to operate as needed to maintain reliability throughout the system: if resources in the capacity market were only used for adequacy purposes as argued by the generators, the system would be inoperable.”

Thus, the language cited in the February 3 Order did not stand for the proposition for which it was cited, “that reactive service is a unique service the compensation for which is not covered by capacity payments, whether transition payment or auction revenues.” Rather, the Commission simply found that (1) with all of the other revenue streams available, a generator not allowed to delist for reliability reasons did not

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29 This uplift is called Net Commitment Period Compensation (“NCPC”). NCPC includes uplift from several different reasons for running resources out of merit, including providing VAR support.

need an additional revenue stream for “security service,” and (2) security service is included in the services covered by FCM.

C. The February 3 Order Changes, without Adequate Explanation, the Standard Set for ISO-NE Compliance in Docket No. ER07-397-000 Because ISO-NE’s Game Theory Does Not Ensure that FCM Generators Will Not Double Recover.

In the February 3 Order, the Commission states: “[e]ven if we were to accept *arguendo* that the combined revenue streams from the Forward Capacity Market and provision of reactive service create the potential for some double recovery, sellers’ bidding incentives in the Forward Capacity Auction make such double recovery highly unlikely.” February 3 Order at P 44. This conclusion is not based on substantial evidence because (1) it is based on a false assumption; (2) it fails to recognize the effect of the price floor in the first three auctions on bidding behavior; and (3) the inputs to ISO-NE’s analysis are conjectural and not based on actual data. In addition, the Commission acted arbitrarily and capriciously in not addressing the arguments presented by the MPUC, NECPUC, the MOPA and the Mass AG.

1. The game theoretic model is based on an incorrect assumption.

The MPUC, NECPUC, the MOPA and the Mass AG had argued that the game theoretic analysis developed by ISO-NE was based on an incorrect assumption. Specifically, MPUC pointed out numerous flaws in the ISO-NE game theoretic analysis:

While the Answer discusses at length the bidding strategies that would occur under various scenarios, this discussion contains an underlying erroneous assumption—that there is an “opportunity cost” of providing the capability of meeting minimum VAR requirements. 31 The Montalvo Testimony, for example,

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31 Opportunity Costs of providing reactive service are already provided for under Schedule 2 under the Lost Opportunity Costs (“LOC”) provisions.
states that although “relative to the total revenue opportunities available for the set of markets the VAR CC Rate payments are very small,” Montalvo Testimony at 8, line 25 to 9, line 1, a generator that “expects less revenues from non-capacity sources (e.g. energy, ancillary services), it must increase its FCA bid/offer (again all other things equal) to earn the same net revenues (which at the margin equal the Resource’s net opportunity costs.).” Montalvo Testimony at 9, lines 2-4. Thus, the Montalvo Testimony appears to include as an opportunity cost the revenue the generator would expect to get from the Schedule 2 CC rate as an opportunity cost without ever determining that there is an underlying cost-based justification for that payment in view of the FCM revenue stream. Further, the Affidavit of Jinye Zhao, PH.D., Attachment 2 to the ISO-NE Answer, states that the game theory analysis assumes that “a Qualified Generator Reactive Resource has only two possible strategies: offering at a price only equal to its ICAP cost or offering at a price equal to ICAP plus minimum VAR capability cost.”32 The error of these statements is the assumption that there are separate capability (capital) costs of providing reactive service. ISO-NE has nowhere refuted the evidence provided by the MPUC in the Waine Whittier Affidavit that the same equipment is used for both services. In fact, the witness for the Indicated Suppliers, Robert B. Stoddard, acknowledges that “in many cases the equipment needed to meet interconnection requirements for new generators will be the same as the equipment needed to provide reactive service . . .” Indicated Suppliers Answer, Affidavit of Robert B. Stoddard at P 5. Therefore, there is no incremental capability cost of providing reactive service beyond the capital costs of providing generation service.33

The February 3 Order addresses none of these points. Rather, it simply adopts the ISO-NE analysis:

We agree with ISO-NE that any potential for double recovery is sufficiently reduced to ensure that the CC Rate component is just and reasonable. That is, qualified, VAR-capable generating resources have an incentive to reduce their FCM bids by the amount of their net revenues from the CC Rate component, given that resources which do not provide reactive service (e.g., demand resources and imports) do not need to recover the costs of such reactive

32 Zhao Affidavit at 4, P 7; see also Appendix to Zhao Affidavit (setting forth its assumptions for the game theory analysis and identifying as a separate component (“BV”) in the analysis the cost of meeting the minimum VAR requirements).

33 Motion for Leave to Answer and Answer of the Maine Public Utilities Commission and the Maine Office of the Public Advocate to the Answers of ISO New England Inc. and Indicated Suppliers at 6-7 (emphasis in original).
Thus, the February 3 Order contains the same flawed assumption underlying ISO-NE’s analysis: that there is an additional capital cost to supply reactive service. However, as the MPUC pointed out, this analysis assumes that without the CC revenue stream, generators would increase their bids to recover the capital cost to supply reactive service. But since these costs are already recovered under the FCM, there is no additional cost to recover. Because the February 3 Order fails to address this critical flaw in the ISO-NE answer, the February 3 Order itself is fatally flawed.

2. The February 3 Order failed to address the effect of the Price Floor in the First Three Auctions.

Further, MPUC, NECPUC, the MOPA and the Mass AG had argued that even accepting, arguendo, the validity of the game theoretic formula, the conclusion that there would likely not be double recovery is still wrong, because the theory does not contemplate the existence of the price floor in the first three auctions.

NECPUC and the MOPA stated:

As long as there is a capacity surplus and a floor, ISO-NE’s own theoretical construct does not hold up, even accepting, arguendo, ISO-NE’s incorrect assumption that there are incremental capacity costs of providing minimum reactive service beyond the capital costs of providing generation service. ISO-NE posits that capacity sellers will voluntarily reduce their bids to net their reactive service payments from their bids. Even if there were a way to ensure that this would actually occur, and there is not, existence of a price floor places in question even the theoretical underpinning for ISO-NE’s refusal to implement changes to Schedule 2 to ensure that generators do not double recover their equipment capital costs. In the first FCA, for which ISO-NE is obligated to ensure that there is no double recovery, the auction stopped, consistent with

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Footnotes:

34 February 3 Order at P 44.
35 Under Market Rule 1, during the first three auctions, “[t]he Capacity Clearing Price shall not fall below 0.6 CONE.” ISO-NE Market Rule 1 § III.13.2.7.3.
Market Rule 1, when the price reached the price floor of 0.6 CONE ($4.50 per kW month).

The failure of the ISO-NE Answer to account for the existence of the price floor is a significant flaw in ISO-NE’s analysis because the price floor prevented the auction from reaching the market price of capacity. Therefore, it is unlikely that the existence of the Schedule 2 revenue stream caused generators to reduce their bids to net out the Schedule 2 CC payments as hypothesized in the Montalvo Testimony. Accordingly, rather than ensuring that there will be no double recovery prior to the first FCA, ISO-NE’s response that it does not need to reduce the CC component of Schedule 2 assures that there will be at least some generators that receive double recovery for the first and likely the second and third FCAs.  

While ISO-NE tried to deflect this argument by suggesting that an entity would supply its lowest offer that would cover its costs, this argument fails because even if a generator actually bid below the pre-determined price floor, it would still receive the price set by the floor.

The February 3 Order is completely silent on the MPUC, NECPUC and MOPA’s discussion of the flaws in the ISO-NE’s game theory justification for not modifying the Schedule 2 CC rate to address the double recovery of capacity revenues by generators receiving both FCM and CC component Schedule 2 revenues. This failure to address a critical argument renders the decision arbitrary and capricious.

3. The Inputs to the Game Theoretic Analysis are Conjectural and Therefore the Conclusion that the Combination of VAR CC Payments and FCM Payments Will Not Overcompensate Resources is Conclusory and Conjectural.

The February 3 Order failed to address the argument made by several of the State Parties that the ISO-NE’s claim that the combination of VAR CC payments and

FCM payments will not overcompensate resources is conclusory and conjectural because the input parameters to the game theoretic analysis are conjectural. ISO-NE maintains that several parameters in the analysis have been “estimated.”37 These parameters are:

a. a VAR resource’s opportunity cost of meeting minimum VAR requirements,
b. a VAR resource’s opportunity cost of participating in the capacity market,
c. the probability that a Qualified Generator Reactive Resource would set the Forward Capacity Market clearing price if its minimum VAR service revenues were included in its Forward Capacity Market offer, and
d. the probability that a Qualified Generator Reactive Resource would set the Forward Capacity Market clearing price if its minimum VAR service revenues were netted out of its Forward Capacity Market offer.38

However, it is clear that these parameters were not “estimated” based on observed data, but rather based on “belief” alone, premised on the findings of the markets monitors that the first Forward Capacity Auction was competitive.39 Other inputs were merely “supposed.”40

Where no actual data exists as the basis for the inputs to the analysis, it was erroneous to rely upon the analysis to conclude that the sellers’ bidding incentives in the Forward Capacity Auction make double recovery “highly unlikely.” February 3 Order at P 44. This analysis was based on mere conjecture and abstract theorizing that is

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37 Answer of ISO New England Inc., Attachment 1 (Testimony of Marc D. Montalvo at 6).
38 Id.
39 See, e.g. Answer of ISO New England Inc., Attachment 2 (Jinye Zhao Aff. at P 10.) (“Therefore, it is reasonable to believe that including the minimum VAR capability cost into the bid will lead to a slim possibility that a Qualified Generator Reactive Resource can be cleared in the auction, i.e. the probability ‘p’ is fairly small’); Jinye Zhao Aff., Appendix at 5 (“Thus, it is fair to believe that p is a very small number”; “for most VAR capable resources, Bv is usually relatively small compared to Av”; and “Additionally, Av and Aα are typically comparable, thus it is reasonable to approximate q by ½”).
40 See, e.g. Jinye Zhao Aff., Appendix at 5 (“suppose that Av = 0.98 * Aα, Bv = 0.1 * Aα, then it yields that π1 = 0.92, π2 = 0.91 and π3 = 0.96. Assume the probability p = 0.2, then p is less than πi, i=1, 2, 3.”) (emphasis added).
inadequate as a basis for reasoned decision making.\textsuperscript{41} The Indicated Suppliers’ affiant, Robert Stoddard reaches a similar conclusory opinion based on the competitiveness of the FCA, but has not provided an analysis explaining why a seller’s best bidding strategy is to bid into the FCA its revenue requirements net of the CC Rate payments in all cases.\textsuperscript{42} Moreover, ISO-NE concedes that “it is arguable that the above results could be biased because of the inexperience of resources with the new capacity market or the uncertainty of payment policies during the transition period.” Jinye Zhao Aff. at P 13. Therefore, the conclusion suggested by the analysis, that suppliers will reduce their FCM bids by the amount of their net revenues from the CC Rate component, cannot even be demonstrated to a reasonable certainty to constitute substantial evidence. There is no basis to conclude that ISO-NE’s game theory, based on inputs that are mere conjecture, “ensures that resources eligible for CC payments under Schedule 2 that provide reactive supply and voltage control do not receive double compensation.” February 28 Order at P 30.

D. If the Purpose of the CC Rate Is to Provide a Financial Inducement to Provide Reactive Service Outside of the Deadband, the Rate is Unjust and Unreasonable Because there Has Never Been a Determination of What Level of Compensation is Necessary to Provide this Inducement.

The February 3 Order states “[t]he CC Rate component also provides an appropriate financial inducement for qualified resources to invest in additional dynamic VAR capability, which ISO-NE currently relies on to reliably operate the system.” February 3 Order at P 42. (emphasis added). However, it never addresses the Complaint’s contention that given the existing payments for capital costs, there is a need

\textsuperscript{41} Arizona Public Service Co. v. United States, 742 F.2d 644, 649 n.2 (D.C. Cir. 1984).
\textsuperscript{42} Indicated Suppliers Comments, Stoddard Aff. ¶¶ 10, 12.
to determine whether additional revenues are necessary as inducements to provide
“additional VAR capability.” *Id.* In addition, NECPUC and MOPA raised the following
questions about the factual underpinnings of the need for financial inducements to invest
in the capability to provide reactive service outside of the deadband:

> While NECPUC may share ISO-NE’s view that reactive service capability
> is valuable, it is unclear whether a need for additional financial inducements, and
> in particular for the CC payment within the dead band, is supported by the facts.
> For example, are new generators in fact not capable of providing capability
> outside of the dead band? Since generators offering reactive service are
> compensated for opportunity costs, is there already an incentive to offer this
> service outside of the dead band? Are there any other benefits to generators in
> having the additional capacity to provide reactive service outside the dead band?
> How many generators currently are capable of providing service outside of the
dead band? What are the incremental costs of providing capacity to provide
service outside of the dead band? All of these questions should be addressed.

NECPUC and MOPA Answer at 14.

Thus, the Commission’s statement that “the CC Rate component also
provides an appropriate financial inducement for qualified resources to invest in
additional dynamic VAR capability, which ISO-NE currently relies on to reliably operate
the system,” February 3 Order at P 42, is not adequate justification for determining that
there is no double recovery. Rather, as stated in the Complaint, NECPUC’s Answer and
the MPUC Answer to ISO-NE’s answer, if there is a need for additional revenue beyond
capital cost compensation, the Commission should have opened an investigation pursuant
to Section 206 of the Federal Power Act to determine what revenue is needed.

**E. The Commission Erred In Concluding That Modifying the Schedule 2 Rate Would Amount To A Change In the FCM Settlement Package.**

The February 3 Order also denied the Complaint because it determined
that changing the Schedule 2 rate was a change to the FCM Settlement package. It
adopted the Indicated Suppliers’ claim that they had relied on the existence of the CC rate
in negotiating the FCM settlement. The February 3 Order concluded that, “[t]he Commission does not believe it is just and reasonable to change this piece of the settlement package.” February 3 Order at P 46. However, the conclusion that the existence of the Schedule 2 CC rate was somehow embedded in the FCM Settlement even though there was no mention of it in the FCM Stipulation or the Order accepting the Stipulation was erroneous. As the MPUC stated in its answer:

Indicated Suppliers argue that eliminating the CC Component of Schedule 2 “would amount to a material change in the compensation parties should reasonably have expected following the Settlement Agreement.” Indicated Suppliers Answer at 9 and Stoddard Affidavit at P 9. Indicated Suppliers’ implication that all revenue streams that were not mentioned in the FCM were required to remain static is illogical. The absence of any assurance in the FCM Settlement that the Schedule 2 CC Rate would continue made any reliance on the continuation of this revenue stream unreasonable. Further, Indicated Suppliers cannot expect ancillary services to remain static simply because these services were not mentioned in the FCM Settlement Agreement. Such an approach would put a choke hold on the ability of the Commission to ensure that the wholesale electric markets are just and reasonable. It is much more likely that generators did not consider the existence or non-existence of the Schedule 2 payments in negotiating the FCM Settlement where the Schedule 2 CC annual payments are a very small fraction of what generators receive from transition payments and the FCM auctions.

MPUC Answer at 11. The Commission’s unquestioning acceptance of Indicated Suppliers’ claim that they had relied on the existence of the Schedule 2 revenues in negotiating the FCM Settlement even though there was no mention of these revenues in the Settlement was erroneous. To suggest that all revenue streams not addressed in the FCM Stipulation must remain static puts “a choke hold on the ability of the Commission to ensure that the wholesale electric markets are just and reasonable.” Id. Further, this conclusion is inconsistent with the Commission’s direction in ER07-397-000 that the ISO-NE implement tariff provisions to ensure that there is no double recovery. Clearly,
there is nothing in the FCM Settlement that prevents the Commission from adjusting the Schedule 2 Rate, as was implicitly recognized in Docket No. ER07-397-000. Accordingly, the Commission’s determination that changing the CC rate was a material change to the FCM Settlement package was erroneous.

The February 3 Order’s additional rationale that the changing the CC rate would “simply lead a new resource to raise its offers to cover those lost CC Rate component payments, ‘likely leading to the same level of total compensation..., but raising the FCM clearing price payable to all resources should that [resource], be the marginal resource,’” suffers from the same flaw discussed above. It assumes, erroneously, that there is an incremental capacity cost to provide reactive service.

V. CONCLUSION

WHEREFORE, for the foregoing reasons, the State Parties respectfully request that the Commission grant rehearing of the February 3 Order consistent with the arguments contained hereinabove.

Dated: March 5, 2009

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing document either by first class mail or electronic service upon each party on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C., this 5th day of March, 2009.

/s/ Harry A. Dupre
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