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CC: Economic Studies Process Working Group

At the recent meeting of the Economic Studies Process Working Group, I suggested that the debates of the Committee regarding the proper role of schedules N and K (and the studies to be conducted under them) was a discussion in search of a forum. By this I meant some parties seemed to think it sufficient to declare that the Committee's role was limited (either by FERC Order or ISO jurisdiction) to only the subset of "clichés dressed up as issues" such parties thought would lead to a particular result. Such assertions included both the notion that we could simply "move ahead" with the approval of particular projects under Schedule N, and the idea that particular "economic studies" would magically spit out some compulsory "answer". The reason I call these approaches clichés is because reliance on any isolated concept in a policy or factual vacuum is always intellectually suspect. As long as the working group continues to be a battleground over whose clichés should have precedence, I am concerned that, though it will always be possible to produce arbitrary motion, progress will elude us.

The initial problems before the Committee, as I see them are:

1. To avoid being distracted by the clichés and;
2. To identify a framework for decision which puts each issue in its appropriate context in terms of the varied policy objectives and financial concerns of participants in the New England market.

I hope this letter may provide a starting point for the development of such a framework. I am certain that much of what I say will displease nearly everyone, but if that motivates others to bring forth their own suggested alternative frameworks for decision, it may yet serve a useful function.

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The Significance of FERC's "Approval" of N and K.

I see little significance in FERC's "approval" of N and K to the merits of the decisions that need to be made by the Committee. Neither tariff provision is self-executing. N suggests that socialization may be available for projects that "lower production costs", but it does not define how that is to be determined, over what time span, with what degree of certainty, or how any such decision on a particular project must be rationalized with policies already embedded in ISO New England's tariff (such as the requirement that generators pay for their own interconnection costs).

As I noted at the meeting, this is not a question of whether any particular upgrade could be classed as a "generator interconnection" as currently defined by the ISO tariff. The issue is whether the ISO New England tariff is to be interpreted as an irrational hodge-podge of arbitrary provisions, or whether the interpretation and implementation of Schedule N and K should be consistent with other policy objectives of the tariff. This does not mean (to my mind at least) that "under no circumstances" should an economic upgrade that looks like a generator interconnection be broadly socialized. Rather, it implies that the "process" for choosing which economic upgrades (if any) are to be socialized should be logically consistent with principles embedded in other portions of the tariff and market rules.

For these reasons, I would not go so far as Chairman Hibbard and declare that "anything that even smells like a generator interconnection" should never be socialized. I would agree, however, that before any such socialization occurs, there must be a "process" (not necessarily just a study) that provides a rationale consistent with the market objectives that motivate other sections of the tariff. As suggested by Connecticut, one of these elements may very well be some way of formalizing voluntary participation in funding. Competitive market decisions are characterized by a greater degree of voluntary assumption of risk than regulated outcomes.

In this respect, I note that the wording of schedule N, taken literally, contains a rather bizarre, "through the looking glass" possibility of ISO New England compelling ratepayers to fund transmission projects that lower "production costs", but do not lower (and might even raise) delivered cost to consumers. The notion that it would be an acceptable outcome to compel ratepayers to fund transmission for the sole purpose of increasing supplier surplus, because FERC has "approved" Schedule N, creates a real-world political consideration that those who insist schedule N is "self-executing" would be unwise to ignore. It should also give the ISO a certain amount of intellectual discomfort as it tries to explain to itself how such an outcome would ever be consistent with a free choice made by any consumer or buyer in a competitive market.

Finally, if because of these ambiguities and uncertainties, Schedule N is not an appropriate vehicle to move forward with projects that the region may reach some level of consensus on as being "important", then it certainly would behoove the region to have a

discussion of how we can move forward with such projects based on such consensus, rather than nitpicking at one another about whether Schedule N does or does not compel certain results.

The Committee cannot forestall aggrieved parties from rushing to FERC with a complaint claiming that Schedule N compels various forms of irrational decision-making. I confess a fear that given the Commission's recently expressed passion for anything that conducts electricity, a poor result may ensue from any such complaint. Unfortunately, however, this is not a risk that we can mitigate by rushing to make an equally poor decision ourselves.

The Role of Uncertainty.

Every attempt to forecast economic activity in these markets and the relative cost effectiveness of particular investments is destined to be wrong. This inevitability is compounded by the fact that, to be "cost effective", a particular action has to be better than what would otherwise have occurred under a series of other options all of which are equally difficult to value. Those who argue that "certainty" is needed before economic upgrades should be considered, set an impossible hurdle for any economic upgrade ever to be accepted. For instance, even if we had signed contracts from every generator a new line might connect, and these contracts guaranteed the delivery of their power at a fixed price, the economic wisdom of entering into such long-term contracts would still be dependent upon a host of variables in the market which cannot be predicted with certainty. The future may, in fact, prove that a particular line would have been more valuable to us without encumbering it with such contracts.

Studies and scenario analysis can assist parties in making more or less reasoned decisions about what risks they are willing to take given the uncertainty involved, but tolerance for risk is notoriously driven by many other factors. For instance, there is at least an implication in remarks made by many participants at the meeting, that uncertainties in construction costs, commercial viability, and operational suitability of certain types of assets (e.g. wind) are to some extent counter-balanced by the greater social and environmental desirability of these projects. This is not an invalid economic consideration, it is merely an expression of a value proposition which is not easily captured in an "economic study" even after we have tried to internalize specific externalities, like air quality, through RGGI and other mechanisms.

Despite uncertainty, however, people do make investment decisions in these markets. What breaks the uncertainty log jam is generally not another round of studies which magically produce an "answer", but a voluntary decision by some investing party that a certain perceived risk is acceptable in light of the value to be achieved. Both those who insist that economic studies must prove "certain benefits" and those who insist that whatever falls out the end of a particular economic study should compel particular investment decisions, are overlooking this key dynamic of a competitive market.

There will be no certainty. Therefore, there needs to be a way for parties to act intelligently in the face of uncertainty to express a voluntary preference to assume particular risks.

The Role of Economic Studies.

This suggests two possible uses for economic studies to break the uncertainty log jam that, in a competitive market, is broken by voluntary assumption of risk. The first is to try to define, in advance and for all time, a specific type of study with agreed upon inputs to be weighted in certain fashions which, if they produce results in certain ranges, will compel investment. In order for this model to retain any semblance of a competitive market dynamic, parties must be satisfied in advance that a particular form of mechanical manipulation of inputs will arrive at the same conclusion regarding the wisdom of a particular investment which they themselves would arrive at for any and every project that might come up. For these reasons, this is an extremely tall order. We have already noted that the tolerance for uncertainty and risk is not universal across investors and not even consistent for a single investor across projects of different type and quality. The dynamic of a competitive market is some function of these differing and shifting risk and reward tolerances. The attempt to capture this dynamic in a single study methodology for all investors in all projects is, almost by definition, a betrayal of competitive market dynamics.

The second approach is to establish an agreed upon set of studies in the form of questions that should be answered about any particular project, and then to provide a limited open season for interested investors to suggest alternative sensitivities or embellishments that would assist them in determining their tolerance for assuming the risk of investment in a particular project. In the end, however, the value of the “answers” produced by such studies cannot be separated from the answers’ ability to persuade particular investors that a certain investment is worth the risk. In short, part of the “study process” in any competitive market is the evaluation of competing investments by market participants.

To summarize these last two sections on uncertainty and the role of studies in terms of Schedule N:

Schedule N does not specify the form of analysis that must be done to assure production costs are minimized. There is no form of analysis that can produce an “answer” with certainty that production costs are minimized (or even reduced) over any particular time frame. There is no restriction in Schedule N that says the “study process” must be limited strictly to manipulation of particular estimates and inputs by the ISO, or that limits the types of inputs (e.g. independent investor willingness to invest) that could be used to make the determination. Thus, Schedule N does not seem to preclude the more competitively based use of studies outlined in the second scenario directly above.

Can New England Develop and Facilitate a “Market” for Economic Upgrades?

I believe the answer to this is, “yes.” Any such market, however, needs to be based on competitive principles, not on mandated socialization based on the disingenuous assumption that a certain form of study provides a “answer” that compels investment. Compulsory investment is not a characteristic of competitive markets.

It is impossible to separate the notion of an “economic upgrade” from the competitive market context in which it is embedded. The tariff itself provides that there needs to be an opportunity for a “market response” before an economic upgrade is considered. As pointed out in our discussions, this is ludicrous if competitive economic solutions in the market cannot also rely on compulsory investment under certain economic tests. I cannot improve upon Chairman Hibbard’s analysis of the economic inconsistencies that arise from embedding economic favoritism into the transmission planning process for particular types or locations of units which are supposedly competing against other resource options to produce an economically efficient solution of the supply problem. Yet neither do I accept the current dichotomy embedded in the tariff which seems to insist that there is either transmission or there is a market; and never the twain shall meet. This appears to me to lead to inefficiencies that might be cured without jeopardizing competitive market principles.

As I emphasized at our meeting, there is no natural market for electricity. The products we currently trade are some of the most hyper designed abstractions imaginable, made possible only through a massive investment in control and coordinated reliability infrastructure which makes the most complex SEC regulation look like a kindergarten doodle. This does not imply that what we have is not a market, but rather that it is a market for specified products which we have consciously defined in order to capture certain economically efficient outcomes. The case of economic upgrades seems to me to be an instance where a viable product which could produce economic efficiencies if competitively sourced, does not have an adequate trading platform to achieve its full potential benefit. Although I have great respect for its developers, I do not believe merchant transmission as it is currently structured is sufficient to capture all of the viable economic opportunities for transmission expansion that are available. Connecticut’s idea of instituting a sort of open season facilitated by ISO New England study protocols coupled with a method of reflecting recovery under a license plate or zonal tariff mechanism might help facilitate the development of economic transmission opportunities.

Certain rules for standardizing the value of such upgrades and allowing those funding such upgrades to capture appropriate value might be expanded from experience with elective upgrades. It is not unreasonable to presume that the value of such upgrades to purchasers could be enhanced by voluntary agreements among generation project developers to award renewable credits or emission cap and trade values associated with their projects to those who volunteer to finance a line.¹ This could allow the market to express various state’s, region’s or individual participant’s willingness to grant added value or exhibit increased risk tolerance for investments designed to further particular types of generation, without embedding that economic decision in a compulsory tariff provision which requires every state, every region or every consumer to make the same value decision. In short, it would seem a reasonable role for the ISO under Schedule N to facilitate the development of a competitively sourced product known as an economic transmission upgrade by providing a secure and predictable voluntary cost recovery mechanism

¹ There is nothing that “stops” this type of agreement now except that each of the individual projects needs to initiate a separate negotiation process which is itself then dependent upon actions by ISO or others in other areas. A trading platform that facilitated the aggregation of various value streams into a single resource decision process could be useful.

under its tariff, and take other reasonable steps to reduce transaction costs (much as it does for energy and capacity) by providing a “trading platform”.

In this respect, I would adopt Connecticut’s view that unless all relevant parties in New England consented, no economic upgrade would be socialized over all load in New England. However, I would supplement that by striving to create an efficient means by which less broadly socialized investments could rely upon the tariff mechanism to effectuate voluntary funding commitments and under which sponsors could capture appropriate benefits for their contribution.

Final Thoughts.

I realize that this “framework” leaves a myriad of details unaddressed. Most importantly, it does not specify who the appropriate decision-making body or bodies are for determining whether a zone or region or its ratepayers will invest in a particular project. There are also clearly technical questions regarding what level of granularity the ISO or individual transmission company tariffs can assume in order to collect differentiated revenues based on participation in various projects by different customers. This complication seems to me, however, preferable to either the non-market “all-or-nothing” approach of compulsory funding by everyone under N if certain study results occur, or the more market oriented, but nonetheless “all-or-nothing” approach suggested by Connecticut in which either complete consensus occurs or a project simply will not qualify for funding.

If this general framework is acceptable, it seems a reasonable path forward procedurally would be:

1. To have Connecticut further develop its open season and voluntary assumption of funding ideas by providing a preliminary Strawman regarding how such willingness to pay would be formalized and by whom;
2. To the extent its open season idea can accommodate some of the other value streams available (such as offers by prospective resources to provide green credits to sponsors of particular investment) such clarity could be useful;
3. If ISO believes there are technical or settlement challenges which would limit its ability to allocate costs to certain levels of granularity, this will obviously impact the flexibility of the voluntary investment protocol;
4. Any party who feels we ought to go back to arguing about “studies” in a vacuum should feel free to make the case and propose a framework for moving forward to gain consensus on what studies and what particular results from studies should compel region wide investment under N.

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I appreciate the opportunity to offer these perspectives on our debate and I thank any reader who has had the patience to wade through this rather rambling dissertation for the courtesy of their attention.

Sincerely,
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