

MEMORANDUM

TO: Participants Committee Members and Alternates

FROM: Michelle C. Gardner and Emile G. Buzaid, NEPOOL Counsel

DATE: June 18, 2010

RE: Update on Initial Briefs After the Capacity Import Hearings (EL09-47, EL09-48)

The following is an update regarding the Initial Briefs submitted in the Capacity Imports Proceedings (EL09-47, EL09-48) on June 17, 2010. FERC hearings, which were held on these proceedings from May 12-26, 2010, were initiated by complaints filed in April 2009 from the Attorney General for the State of Connecticut (EL09-47) and the Connecticut Department of Public Utility Control and the Connecticut Office of Consumer Counsel (EL09-48) (collectively, the "Connecticut Representatives"). Such complaints essentially alleged that certain capacity importers, Brookfield Energy Marketing Inc. ("BEMI"), Constellation Energy Commodities Group Inc. ("Constellation"), and Shell Energy North America US LLP ("Shell Energy") (collectively, the "Capacity Importers"), manipulated the markets by entering into ICAP Import Contracts over the Northern New York AC Interface and collecting capacity revenues without ever intending to perform the obligations of capacity resources when called upon to do so by ISO New England Inc. ("ISO-NE"). The FERC later set these issues for hearing, ordering the scope to be "whether capacity importers' submission of energy supply offers at or near the \$1,000 per MWh price cap satisfy the three elements required to establish market manipulation."¹

In this report, we summarize the Initial Briefs filed by the Connecticut Representatives, the FERC Enforcement Staff, BEMI, Constellation, and Shell Energy. Reply Briefs are due July 7. An Initial Decision is expected on or before August 25. Any Participant that would like more detailed information on these proceedings may contact NEPOOL Counsel, Michelle Gardner, at mcgardner@daypitney.com or (617) 345-4697.

¹ *Richard Blumenthal, Attorney General for the State of Connecticut v. ISO New England Inc.*, 129 FERC ¶ 61,057 at P 22 (2009). Those elements are whether the capacity importers: (1) used a fraudulent device, scheme or artifice, or made a material misrepresentation or a material omission as to which there was a duty to speak under a Commission-filed tariff, Commission order, rule or regulation, or engaged in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity; (2) with the requisite scienter; (3) in connection with the purchase or sale of natural gas or electric energy or transportation of natural gas or transmission of electric energy subject to the jurisdiction of the Commission. *Prohibition of Energy Market Manipulation*, Order No. 670, FERC Stats. & Regs. ¶ 31,202, at P 49, *reh'g denied*, 114 FERC ¶ 61,300 (2005); 18 C.F.R. § 1c.2 (2010); *N.Y. Indep. Sys. Operator, Inc.*, 128 FERC ¶ 61,049 (2009). All participants agree that the third element, jurisdiction, has been met in this case.

Summary of Initial Briefs Submitted on June 17, 2010

Connecticut Representatives

In its Initial Brief, the Connecticut Representatives offered its explanations as to how BEMI, Constellation, and Shell met each element of the FERC's anti-electric market manipulation rule. In general, the Connecticut Representatives applied the same standards and detailed analysis to each of the Capacity Importers. The Connecticut Representatives alleged that the Capacity Importers manipulated the market by treating the ICAP Import Contracts as one-sided transactions. The Connecticut Representatives stated that the Capacity Importers collected capacity payments, which were higher than the payments in other markets, but priced their capacity-backed energy so unrealistically high that ISO-NE would never have an opportunity to exercise the option to call on them. They claim that this constitutes the willful avoidance of the risks and obligations associated with the high payments while ignoring the effects that this high-offer scheme had on the region and its customers. They state that the effects of this scheme harmed the reliability of the New England bulk power system and required customers to pay for, but not receive, a capacity benefit.

The Connecticut Representatives stated that the Capacity Importers ignored their "inherent obligation" to make "reasonable offers" as participants in competitive markets that have been approved by FERC. They explain that, while ISO-NE's mitigation provisions could not be applied in the situations at issue, it was wrong to absolve the Capacity Importers from the obligation to offer competitively. They reason that it is unreasonable and unlawful to interpret the ISO-NE Tariff in such a way as to allow the Capacity Importers to make non-competitive offers. Furthermore, the Connecticut Representatives claim that the high offer strategy violates ISO-NE's Tariff provisions that require the delivery of capacity-backed energy. Specifically, they state that, by offering high and by being unable to deliver, the Capacity Importers evaded the failure to deliver penalties that they should have had to pay by ensuring they would never be called on to deliver.

FERC Enforcement Staff

In its Initial Brief, FERC Enforcement Staff stated that this case is about the unintended consequences of an imperfect market design, and that this imperfect design created unique challenges for the Capacity Importers. It stated that the Connecticut Representatives wrongly confused the Capacity Importers' behaviors under this imperfection with attempts to manipulate the market. It also noted that the Capacity Importers adopted similar business methods, i.e., to meet the Tariff requirements in practically all situations, but risk the possibility that it might be called on in an hour to deliver capacity-backed energy when it could not do so. If they could not deliver when called on, FERC Enforcement Staff stated that the Capacity Importers knowingly risked that they would pay a penalty for failing to deliver.

FERC Enforcement Staff stated that the Connecticut Representatives attempted to manufacture an ISO-NE Tariff violation to support its market manipulation claim. It stated that the Connecticut Representatives manufactured an ISO-NE Tariff provision to allege that there was an "implicit" requirement to offer and bid at "reasonable" levels. FERC Enforcement Staff

stated that this manufactured ISO-NE Tariff violation goes beyond the text of the tariff and, even if such a requirement existed, a violation thereof would not form a basis sufficient for fraud under the FERC's anti-manipulation rule. It also explained that the Connecticut Representatives ignore the Capacity Importers' rational response to the incentive structure inherent in ISO-NE's flawed market design, and ignore the fact that the Capacity Importers' efforts would have permitted capacity-backed energy to be delivered in all but one hour. FERC Enforcement Staff concluded that the Connecticut Representatives did not sustain their burden to prove that the Capacity Importers' "open and unconcealed adaptations to the market design" were fraudulent or reckless.

Capacity Importers

In their Initial Briefs, the Capacity Importers addressed each element of the Commission's anti-manipulation rule to demonstrate that the Connecticut Representatives failed to carry their burden in proving their electric market manipulation claims.

BEMI stated that its high offers did not constitute a fraudulent device, scheme, or artifice, but were instead rational offers that serve legitimate business purposes. It also stated that it did not commit fraud by violating the Connecticut Representatives' manufactured "reasonable offer" requirement, that its conduct was transparent to ISO-NE, that ISO-NE does not contend that it was defrauded, that it made no material misrepresentations or omissions, that there is no evidence that it intended to defraud ISO-NE or anyone else, that the Connecticut Representatives have not shown any evidence of an intent to defraud, that its bidding directives and purchases show that it intended to deliver energy as required, that its course of conduct has shown that it delivers a significant amount of energy to ISO-NE, and, finally, that its conduct was not reckless.

Constellation stated the Connecticut Representatives' position has been an "outcome in search of a theory" since its original complaint. Constellation stated that its behavior has been consistent with the Tariff, that it was fully prepared and did deliver energy to New England, that the Connecticut Representatives failed to provide specific evidence to support their claims, that the Connecticut Representatives contrived "implicit" Tariff provisions that contain unsupported and unsustainable assertions, that the Connecticut Representatives provided irrelevant or incorrect evidence, and that the Connecticut Representatives failed to take into account the totality of the successful business transactions that Constellation conducts with ISO-NE and NYISO.

Shell stated that the preponderance of the evidence shows that it intended to perform, and performed, its obligations as a capacity import supplier at all times. It further states that it had reason to expect notice from ISO-NE to adjust its bids as necessary, that there is no basis for an implied "reasonable" price provision in the ISO-NE Tariff, that such a provision would be unfair and contrary to the intention of the drafters of the ISO-NE Tariff with regards to capacity imports, that it did not take any steps to manipulate the market by concealing against or colluding with any other market participants, and that its offers were necessary and legitimate tools for managing the risk of price spreads between the two control areas.