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To: NECA Board of Directors

From: The Power Markets Committee

Date: October 11, 2007

Re: Power Markets Committee Report

The following is the report of the Power Markets Committee ("PMC") for the October 11, 2007 Board meeting. Based on discussions with committee members, this report and future reports of the PMC will contain regular features that have a bearing on competitive power markets. These features are (1) Developments in Neighboring Markets (Chris Bursaw is the reporter); (2) Developments at the state level in New England (Paul McCary is the reporter) and (3) Quarterly Performance of the Wholesale Power Markets in New England (Joe Cavicchi is the reporter). The PMC, of course will continue reporting on developments in the courts, at the Federal Energy Regulatory Commission ("Commission") and in NEPOOL and ISO-New England ("ISO-NE"). Contributors to this report are Chris Bursaw, Joe Cavicchi, Paul McCary and Seth Parker.

The Power Markets Conference scheduled for November 1, 2007 is set. The efforts of Chris Bursaw, Joe Cavicchi, Sandi Hennequin, Seth Parker, Jeff Perry and, of course, our benevolent dictator, Lois, are very much appreciated.

I. The United States Supreme Court Will Review Decisions of the Ninth Circuit Court of Appeals that Limited Application of the Mobile-Sierra Doctrine

On September 25, 2007 the United States Supreme Court agreed to review two decisions of the Ninth Circuit Court of Appeals, *Calpine Energy Services, et al. v. Public Utility District No. 1 of Snohomish County Washington et al.* and *Morgan Stanley Capital Group v. Public Utility District No. 1, et al.*

The Ninth Circuit had held that long-term wholesale power contracts entered into between wholesale suppliers and load-serving entities must be abrogated by the Commission if the rates to the buyers in these contracts fell outside a "zone of reasonableness" measured by

contemporaneous marginal costs of production. The contracts in question were entered into in response to the western energy crisis and by the time the buyers under these contracts sought review by the Commission, rates under the contracts exceeded spot market prices. The Commission had held that the contracts should remain in full force and effect. The Ninth Circuit reversed the Commission's findings and remanded the cases back to the Commission.

The decisions of the Ninth Circuit in these cases significantly limited and may have obviated the *Mobile-Sierra* doctrine, a long standing rule that applied to regulatory review of contracts entered into in the wholesale power markets. Under *Mobile-Sierra* a wholesale power contract may not be abrogated except in "extraordinary circumstances" of "unequivocal" public necessity. In light of the implications of the Ninth Circuit's decision to the stability of contractual relationships in the wholesale power markets, a number of entities, including the Electric Power Supply Association and other trade organizations, asked the Supreme Court to review the Ninth Circuit's decisions. Interestingly the Commission did not seek review, and moreover, argued that the Supreme Court should not grant review.

II. Advance Notice of Proposed Rulemaking Wholesale Competition in Regions with Organized Electric Markets Comments of ISO New England

FERC issued an Advance Notice of Proposed Rulemaking (ANOPR) in Docket Nos. AD07-7-000 and RM07-19-000 to strengthen wholesale power markets in deregulated markets, which includes ISO-NE, NYISO, and PJM. ISO-NE submitted the following comments to the four issues for which FERC requested comments:

- Improving Demand Response
- Increasing Long-Term Power Contracting
- Strengthening Market Monitoring Policies
- Improving Responsiveness of RTOs and ISOs

Improving Demand Response

In general, ISO-NE supports integration of demand resources into the wholesale markets and is actively seeking this goal. ISO-NE believes that wholesale market mechanisms are superior to regulation as a vehicle for extracting these benefits. ISO-NE notes that they have made significant progress in encouraging demand response and developing market designs that enable demand resources to participate in the wholesale market. ISO-NE also notes that New England is actively encouraging provision of ancillary services by demand resources. Its Demand Response Reserve Pilot Program permits small resources (less than 5 MW) to provide operating reserves and its Asset Related Demand infrastructure permits Dispatchable Asset Related Demand to participate directly in the wholesale energy and reserve markets. In response to arguments that demand response programs allow for "double" compensation through wholesale payments and retail savings, ISO-NE stated its price-responsive programs provide for such double payment and it would support the elimination of such payment and the implementation of dynamic retail pricing as soon as possible.

Increasing Long-Term Power Contracting

ISO-NE observes that the stability of market structures is an important element in enabling, and minimizing barriers to, long-term contracting. ISO-NE also agrees with the Commission that market participants should have the opportunity to develop a portfolio of supply arrangements that suits their needs, including the option of long-term contracts. ISO-NE notes that while it may be appropriate for an RTO to provide information that can assist entities seeking long-term supply arrangements, it would be difficult for RTOs to post information regarding long-term supply arrangements unless the parties to bilateral transactions are required to provide information on their transactions.

Strengthening Market Monitoring Policies

ISO-NE generally supports the proposed notification to the Commission, state commissions, and market participants of any recommendations for rule or tariff changes but cautions that in some cases the notification of a market rule or rule deficiency may effectively broadcast the existence of a loophole in the rules that may be exploited until the rules are ultimately modified. ISO-NE, however, disagrees with the Commission in that an MMU's performance or mitigation functions can compromise its independence in evaluating and reporting on market performance. ISO-NE believes that the MMU's independence stems from its code of conduct or contractual obligations regarding conflicts of interest, its access to information sources, and its direct reporting relationship to the RTO Board of Directors. The MMU has no discernible interest that would keep it from reporting on problems with mitigation procedures or evaluating market rules for improved market performance.

Improving Responsiveness of RTOs and ISOs

ISO-NE agrees that customer responsiveness is a crucial measure of an RTO's success and must begin with the Board of Directors. However ISO-NE does not believe that customer responsiveness can be achieved by choosing one option from a limited menu. Rather, each region must assess its unique history, stage of market development, and stakeholder structure in creating processes to ensure the responsiveness of its Board and Management to stakeholders. Moreover, it is ISO-NE's position that it is the overall structure, and no single feature, that creates a culture of responsiveness. ISO-NE believes that it has created a culture of responsiveness through a structure that has evolved in response to changes in the marketplace and other characteristics that are unique to New England. ISO-NE therefore believes that each RTO and ISO should have the freedom to develop a responsive structure that will be most effective for its region. ISO-NE also agrees with the Commission that customer representatives and other stakeholders must have some effective form of direct access to Board members.

III. The Report on Demand Response and Advanced Metering

In September 2007 the Staff of the Commission reported on the state of demand response across wholesale and retail markets and investment in and installation of advanced metering infrastructure ("AMI"). This report updated a Staff report on the same subject matter that was published in August, 2006. The next report on these subjects will be published in 2008 and

every even year thereafter. In the organized markets (wholesale power markets under the operating control of an ISO or RTO) with the exception of the fledgling Southeast Power Pool, there was a substantial increase in demand response enrollment in 2007 as compared to 2006. *E.g.* for ISO-NE staff reported 1,037 MWs enrolled in 2007 as compared to 597 MW in 2006. With respect to state activities to foster demand response at the retail level, the report summarized legislative and regulatory initiatives in six states, only one of which, Connecticut was located within New England. The initiatives cited by the Staff predominantly involved improving the price signal to retail loads.

AMI functions described in their report include interval metering, remote meter reading, remote connect/disconnect and development of home-area networks. The report noted that the Energy Policy Act of 2005 (“EPACT ‘05”) required state regulatory authorities to conduct “investigations” of AMI and to issue decisions as to their findings. By July, 2007 most states had open proceedings. Of the twelve states that had concluded their “investigation,” only two states (Ohio and New Hampshire) adopted some form of AMI. California and New York in proceedings considered to be outside the mandate of EPACT ’05 have ordered some form of AMI for retail customers.

IV. The Commission’s Dictionary for Electric Quarterly Reports

In an order issued September 24, 2007, the Commission established a data “dictionary” of terms that are used for and in the report of Electric Quarterly transactions. In a series of orders extending back to 2002 (Order 2001 issued April 25, 2002) the Commission has required public utilities (this term includes wholesale power marketers, merchant generators selling at wholesale) to file quarterly reports containing data on sales and currently effective contracts. These orders required that the utilities conform their reporting to formats prescribed by the Commission and dictated by the Commission’s software systems. To facilitate reporting the Commission has issued a dictionary containing some 25 pages of definitions and terms to be used in filing quarterly reports. This dictionary should be consulted by any entity having a filing requirement or seeking information concerning particular wholesale transactions or contracts.

V. ISO-NE’s Compliance Filing for the Forward Capacity Market

On August 31, 2007 ISO-NE and NEPOOL filed a compliance filing with the Commission to comply with certain parts of the Commission’s order of April 16, 2007 conditionally accepting the Market Rules implementing the Forward Capacity Market (“FCM”). The principal elements of this compliance filing dealt with the review of de-list bids by the ISO’s internal market monitoring unit (INTMMU) and revisions to static de-list bids for rating reductions due to ambient air conditions. Other elements of the filing involved capacity imports over the HQ interconnection and various administrative and clarifying changes to the Market Rules.

Under the FCM Market Rules, existing capacity resources were authorized to opt out of the capacity market (and the resultant capacity supply obligations) by submitting de-list bids into the Forward Capacity Auction (“FCA”) (*i.e.*, bids indicating the price at which the existing capacity resource no longer wanted to offer capacity). If the FCA cleared at a value below the

de-list bid the resource would not receive a capacity supply obligation. As a check on the possible exercise of market power by existing resources, certain thresholds were established (e.g., bids from existing capacity above 0.8 times the cost of new entry) that would trigger an inquiry into the de-list bids by the INTMMU. If the INTMMU determined that a de-list bid was inconsistent with the going forward and opportunity costs of the de-listing resource, the INTMMU could reject the de-list bid.

The Commission ordered revisions to these rules in its April 17, 2007 order and in a rehearing order of July 25, 2007. The compliance filing attempts to revise Market Rule 1 to comport with these orders. Specifically, the filing provides that upon a finding that a de-list bid is inconsistent with a resource's net risk-adjusted going forward and opportunity costs, the INTMMU must provide the resource with a detailed explanation of its finding and an estimate of costs as determined by the INTMMU. The resource has a choice to submit a de-list bid based on the INTMMU estimate or not submit a new de-list bid and challenge the INTMMU's estimate before the Commission. Per the filing, and as clarified by the Commission's July 25, 2007 order, if the resource submits a de-list bid based on the INTMMU's estimate it waives its right to challenge the INTMMU's findings at the Commission.

With respect to de-list bids for reductions in ratings due to ambient air temperatures, the filing revises the rules to enable resources whose output is anticipated to be reduced by increases in ambient air temperatures to submit de-list bids at less than 2 times the cost of new entry. In essence these revisions incentivize resources to reduce temperature losses by costs at less than 2 times the cost of new entry and to bid this temperature dependent capacity into the FCA.

Consistent with a number of Commission pronouncements concerning the functions, roles and responsibilities of market monitors employed by ISOs and RTOs, the Commission in the April 17 order held that the INTMMU did not and should not have the authority to determine whether there has been an attempt at market manipulation or physical withholding. The compliance filing revises the Market Rule to require the INTMMU, in the event it determines there may be an attempt at market manipulation or physical withholding, to report the matter to the Commission's Office of Enforcement.

VI. ISO-NE Memos-Procedures to Implement the Forward Capacity Market

On September 13, 2007 representatives from ISO-NE, NEPOOL, and New England Conference of Public Utility Commissioners ("NECPUC") issued a memo to NEPOOL Participants Committee members that establishes a process and schedule by which NECPUC, market participants and ISO-NE will resolve issues arising under the FCM qualification process and the current interconnection procedures of ISO-NE. To qualify for an FCA new capacity resources must meet certain qualification criteria, including project milestones, part of which is the requirement to be able to be physically interconnect to the bulk power system. The current "interconnection queue" system, which applies today to the FCM, operates on a "first come-first served" basis. For all intents and purposes resources at the front of the line will have their interconnection studies performed ahead of resources behind them in line. These studies can be critical to a project, its financing and ultimately its viability. The obvious dilemma is that "first

come” resources may preclude more viable later in line resources from qualifying for an FCA. In the views of some, such a result is not optimal given the overall objectives of the FCM.

The Commission has ordered that the issues raised by the FCM qualification process and the interconnection queue be resolved on a collaborative basis involving NECPUC, market participants, NEPOOL and ISO-NE. The memo of September 13, 2007 outlines the process and schedule. There are three phases to the process. The first phase will encompass the period of September through December, 2007. The second phase, January through May, 2008 and the third phase, June through October, 2008 culminating in a filing at the Commission. Presumably the filing will reflect a “consensus” among the collaborators but given what’s at stake, don’t count on it.

On September 26, 2007 Vamsi Chadalavada, Senior Vice President, Market and System Solutions, of ISO-NE sent a memo to the NEPOOL Participants and Markets Committees describing steps to be taken in preparation for the first FCA in February, 2008. The memo denominates the activities between September 2007 and February, 2008 as Phase I of a four phase project to implement fully the FCM by 2010. One of two important elements of Phase I is a schedule of training activities commencing with a bidders conference on October 17 and ending with the second of two mock auctions and two training sessions in January, 2008. The second important element is information transfer from ISO-NE to market participants concerning the interaction of the FCM and other markets managed by ISO-NE (*e.g.* how does FCM relate to the Locational Forward Reserves Market). Additional information concerning this schedule can be obtained via e-mail to matedu@iso-ne.com.

VII. Developments in Neighboring Markets

New York

On September 19, NYISO’s Board of Directors approved the 2007 Comprehensive Reliability Plan (CRP) for New York’s bulk electricity grid. According to the CRP report, planned transmission system upgrades and proposed market-based solutions, if built will meet or exceed reliability requirements through 2016.

The CRP report is the culmination of the NYISO’s Comprehensive Reliability Planning Process, which provides a plan for meeting the reliability needs of the state’s electricity grid over a 10-year planning horizon. The CRP relies primarily on market-based solutions, which are monitored and updated twice a year by the NYISO. Regulated, backstop solutions offered by Transmission Owners were not needed.

On October 4, the NYISO filed FERC Docket No. EL07-39-000 (NYISO Filing of its proposal for revised market rules for NYC Installed Capacity (ICAP). In this compliance filing, the NYISO proposes to retain the existing ICAP market structure, including the current set of ICAP auctions and the use of ICAP Demand Curves, but to refine the mitigation measures for the New York City Locality to prevent the exercise of both buyer and seller market power in the ICAP market under the appropriate circumstances.

PJM

PJM, at the time of this writing, is conducting its RPM auction for 2009-10. This is its third auction in the new capacity market. Results will be posted on Friday October 12.

On September 13, Duquesne Light Company, a transmission owner and Load Serving Entity in western Pennsylvania, filed a complaint at the FERC seeking an emergency order telling PJM to cease and desist from including load in the Duquesne zone in the peak load forecast PJM will use in the base residual auctions. Duquesne apparently was not pleased with the higher costs of capacity, had not adequately hedged and was desirous of meeting their capacity needs through MISO. Although there is a mechanism in the RPM construct to opt out of capacity obligations through self-supply, Duquesne did not do this. FERC responded on Sept. 28 by dismissing the complaint, finding that Duquesne failed to establish a basis for excluding load in its Zone from the October 1, 2007 auction.

On September 20, the FERC issued an Order to assure independence of PJM Market Monitoring. This was the result of the PJM Market Monitor having raised allegations during an April technical conference that PJM management had interfered with his work. The Commission took up the matter after complaints were filed charging PJM's interference had violated its tariff. In the Order, the Commission found that PJM had not violated its tariff, but that the tariff might need to be modified to reform the relationship between PJM and its market monitor. The Order directed all parties to enter into a settlement process.

VIII. Developments in the States

Connecticut

Long term capacity RFP pursuant to 2005 Energy Independence Act. On August 22 the DPUC awarded four long term contracts to energy project developers (Kleen Energy 620 MW baseload CCGT, Waterbury Generation 68 MW dual fuel peaker, Waterside Power 98 MW dual fuel peaker and Ameresco 5 MW energy efficiency). On October 3, NRG Energy filed an appeal in Superior Court challenging these awards, principally focusing on the selection of the Kleen project over a competing baseload repowering bid submitted by NRG.

Cost of service peaker proposals pursuant to 2007 legislation. In January of 2008, each electric utility must, and other persons may, submit proposals to build peaking generation on a cost of service basis. Within 120 days, the DPUC is to approve such plans unless they conclude that they are not in the ratepayers' best interest. The DPUC is currently undertaking an informal proceeding to establish ground rules for these submissions. Docket No. 07-08-24.

The commission is also conducting proceedings examining deployment of smart meters, time of use pricing, revenue decoupling.

Maine

The Maine Commission is actively re-examining whether electric distribution companies should be allowed to re-enter the generation business. Docket No. 2007-317.

Separately, the Commission is looking into the special competitive problems in Northern Maine markets with an eye toward the following possible outcomes: (1) allowing or requiring MPS to acquire generation assets and provide retail service directly to customers; (2) reintroducing cost-based regulation in the region; (3) repealing retail access in the region; or (4) aggregating the load in the region for the purpose of contracting for supply. Docket No. 2006-513.

Finally, the investigation into alternatives to NEPOOL will continue with a Phase II proceeding in Docket No. 2006-364. In Phase I, the Commission previously found that (1) significant inequities exist in the current ISO-NE transmission cost allocation system and the pricing of generation services; (2) there are no insurmountable legal, economic or technical barriers to CMP and BHE withdrawing from the ISO-NE regime; and (3) there are reasonable alternatives to Maine's continued participation in ISO-NE, most notably, the development of a common Maine/Canadian Maritimes market.

IX. Market Performance – Summer 2007

The attached charts show that ISO-New England electricity markets have been relatively stable during the last several months exhibiting less volatility compared to recent years. Although the forward markets have continued to trade at levels above subsequently realized day-ahead market prices, forward prices have been dropping and are beginning to be closer to recently observed spot market prices. Day-ahead LMPs have been fairly stable and somewhat lower than values observed in 2006. It remains to be seen whether average annual LMPs will be below those observed last year, but the differences thus far have not been large. Of particular interest is the reduction in congestion prices observed within New England. The absolute difference between LMPs in higher priced regions versus lower priced regions has shrunk considerably throughout the year. This is attributable to ASM Phase II, the energization of some new transmission lines, and how the ISO calls on RMR units. Regardless of these lower LMP differentials, the ISO is now incurring various costs it did not incur during 2006 making it difficult to assess if the reduced congestion is economically beneficial. Overall, market prices have been more stable as gas prices have been less volatile (and demand has not been unexpectedly elevated). The extent to which this pattern continues will be dependent on this fall and winter's fuel markets.

During the past several months ISO-NE has released and discussed its RSP-07. Of particular interest in this most recent report is the reduction in expected required new generation resources when compared to the two previous years' RSPs. For example, in RSP-06 there was indication that almost 200 MW of generating resources would be required in 2009, and slightly more than 1,000 MW in 2010. RSP-07 indicates an expected need for generating resources of only 60 MW in 2010, and increasing to over 800 MW in 2011. A comparison between the two plans reveals that an increase in the amount of assumed existing capacity resources between

RSP-06 and RSP-07 is driving the difference, although it is not clear what the source of the increase represents. A comparison of the same years' CELT reports does not explain the difference and it may be that expected improvements in demand response are being accounted for in RSP-07. The likely effect of these changes in forecasted needs will be a marked reduction in capacity procurement in the first FCM auction.