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September 13, 2005

Honorable Magalie R. Salas, Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, D.C. 20426

Re: Docket No. ER03-563-030
Devon Power LLC, *et al.*

Dear Secretary Salas:

Attached please find the Statement of Alternatives Proposed by the Connecticut Department of Public Utility Control filed in the above-captioned docket. Please contact Kimberly Brickell at telephone number (202) 682-3578 if you have any questions concerning this filing.

Respectfully submitted,

/s/
Randall L. Speck

encl.
cc: Service List

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Devon Power LLC, *et al.*	)	Docket No. ER03-563-030

STATEMENT OF ALTERNATIVES PROPOSED BY THE CONNECTICUT DEPARTMENT OF PUBLIC UTILITY CONTROL

To: The Commission

Pursuant to the Commission's August 25, 2005 Notice Scheduling Oral Argument, the Connecticut Department of Public Utility Control ("CT DPUC"), the Connecticut Office of Consumer Counsel, and the Business Council of Fairfield County (formerly the Southwestern Area Commerce and Industry Association of Connecticut, Inc.) (collectively, the "Connecticut Parties") respectfully submit this statement of alternative market designs to the locational installed capacity ("LICAP") mechanism that ISO New England, Inc. ("ISO-NE") proposed and that the Initial Decision, *Devon Power LLC*, 111 FERC ¶63,063 (2005), recommended. The Connecticut Parties support and endorse the New England Resource Adequacy Market ("NERAM") proffered by a diverse group of New England parties (the "NERAM Proponents") in a concurrent filing. Although NERAM requires further development through a comprehensive stakeholder process,[1] the Connecticut Parties submit that NERAM, when fully developed and implemented, will (1) provide for just and reasonable rates based on a truly competitive supply market, (2) permit New

[1] The Connecticut Parties join and support Section I of the Pre-Oral Argument Comments of the Connecticut Municipal Electric Energy Cooperative and Massachusetts Municipal Wholesale Electric Company, filed concurrently, describing an appropriate stakeholder process.

England load to purchase the correct amount of capacity without an unnecessary surplus, and (3) ensure the lowest competitive price and minimize the need for non-market intervention.

In addition, the Connecticut Parties continue to proffer their alternative to LICAP: a Reliability Options market.[2] The Connecticut Parties expect that this market – which is similar to NERAM – will produce just and reasonable wholesale prices in New England at levels that encourage timely additions of generation capacity and ensure an efficient mix of generating technologies and demand response, thereby providing reliable electric resources for New England. Both NERAM and Reliability Options are far superior to the Initial Decision's LICAP mechanism. Unlike the administratively-imposed LICAP demand curve and its hotly contested ancillary components, NERAM and Reliability Options provide simple solutions that achieve competitive market efficiencies while assuring reliability and resource adequacy. Although excluded – improperly – from the hearing and, therefore, not yet fully developed on the record, the Commission may not adopt LICAP without full and fair consideration of the Connecticut Parties' Reliability Options evidence.

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[2] The Connecticut Parties introduced evidence through prepared testimony submitted by Dr. Miles Bidwell and Dr. Carl Pechman supporting adoption of Reliability Options in this proceeding in lieu of LICAP. Direct Testimony of Dr. Carl Pechman and Miles Bidwell, *Devon Power LLC*, Docket No. ER03-563-030 (Nov. 4, 2004) at 76-144. Capacity Suppliers moved to strike this portion of the testimony based on the Commission's November 8, 2004 Order, *Devon Power, LLC*, 109 FERC ¶ 61,154 (2004). The Presiding Judge ordered the Reliability Options testimony stricken but accepted it as an offer of proof. *See* Order Confirming Rulings, *Devon Power LLC*, ER03-563-030 (Dec. 3, 2004). Industry professionals have described the Reliability Options market design as having "many promising features that deserve more detailed scrutiny." SYNAPSE ENERGY ECONOMICS, INC., CAPACITY FOR THE FUTURE: KINKY CURVES AND OTHER RELIABILITY OPTIONS 32 (Dec. 20, 2004) *available at* <http://www.synapse-energy.com/Downloads/Synapse-paper-capacity-for-the-future.pdf>; *see also* Miles Bidwell, Reliability Options: A Market-Oriented Approach to Long-Term Adequacy, 18 ELECT. J. 11 (2005).

I. The Reliability Options Market

The Reliability Options ("RO") market uses an auction-based options product based on the energy market. The option supports generation capacity suppliers' contractual commitments to provide electricity when the options are called. The transacted product is a call option on a megawatt of capacity-backed energy associated with a specified generating facility for a designated supply period. Because ISO-NE conducts the auction about three years before the supply period, the RO sellers include both new entrants and existing generators. Buyers may be ISO-NE, distribution companies, or load serving entities ("LSEs"). The RO consists of two components – a designated strike price and a spot price based on the real-time market. ISO-NE calls ROs during scarcity conditions, when the system is stressed and additional generating resources are needed, *i.e.*, when the RO's spot price exceeds its strike price.

ISO-NE sets the strike price before the start of the auction so that all market participants will be able to account for it in their bids. The strike price is set higher than the competitive range of prices in non-shortage conditions, and might be set, for example, slightly higher than the marginal cost of the most expensive unit in the market.

The RO is both a financial call option and a physical call option because when the RO is called, the specified generating plant must be generating power or otherwise be available, *e.g.*, supplying reserves. The RO is a financial option because a generator that sells the RO must pay the option holder the difference between the spot price and the strike price when the RO is called. The RO is called whenever the

system is stressed and needs additional resources (as signaled by prices exceeding the strike price).

When the option is called, the unit must be available in order to be paid, and if it is unavailable, it must pay a financial penalty. For example, if the generating unit is available when the RO is called, then its revenue equals the preset strike price multiplied by the number of ROs sold. (The RO's financial characteristic requires that when the RO is called, the generator pays back the difference between the higher spot price and the preset strike price to the RO holder.) If the generating unit is not available, it does not receive the strike price and must pay back the spot price for the amount of contracted electricity it did not produce. ISO-NE passes this repayment back to the LSEs and, ultimately, to consumers. Requiring the unavailable generator to pay back the strike price is pragmatic, not punishing, because ultimately the customers would have had to pay the spot price to replace the electricity that the non-performer failed to produced.[3] While less reliable plants will have a higher risk of incurring a non-performance penalty, more reliable plants will receive a premium. For these reasons, physical and financial characteristics of the RO product enhance efficiency by optimally using available generating resources.

II. Reliability Options and NERAM Common Characteristics

Reliability Options and NERAM both derive from the Central Resource Adequacy Markets ("CRAM") developed by ISO-NE, the New York ISO and PJM,

[3] An additional, separate penalty could be assessed for the generator's nonperformance. For example, generators that default on their RO commitment may also be assessed an explicit charge per kW/hour for electricity not produced during the stress periods.

with assistance from the National Economics Research Association ("NERA")[4] and, therefore, share similar characteristics. Most importantly, both designs enhance competition, decrease market concentration, and eliminate barriers to new entry by (1) adopting a three-year period between the auction and the supply obligation and (2) permitting participation by potential or new suppliers that meet eligibility criteria. Thus, the significant advantages of NERAM over LICAP apply equally to Reliability Options.

Both designs adopt an open, descending clock auction that facilitates price revelation by allowing bidders to reassess and revalue their bids in successive rounds and that, ultimately, converges bid values closer to costs. Both designs permit customers to purchase only the amount of resources needed to provide adequate assurances of reliability, *e.g.*, the amount necessary to maintain a loss-of-load expectation of not less than one day in ten years. Both market designs rely on availability incentives that imitate outcomes of an uncapped energy market to assure that generators provide reliable performance in return for customers' payments. To assure resource adequacy, both designs support a portfolio of generating technologies and demand-side response. With respect to building new generation capacity, both designs are intended not only to incent timely, new construction, but also to incent an efficient mix of generation – peakers, shoulder units, and baseloads. Both designs achieve efficient prices set by competition. Both designs avoid the fatal failing of LICAP's price setting mechanism that ignores the value of improved transmission capacity.

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[4] *Central Resources Adequacy Markets for PJM, NY-ISO and NE-ISO Final Report,* February 2003. *See* http://www.pjm.com/committees/working-groups/ramwg/downloads/20040226-cram-report-final.pdf.

III. Reliability Options' Distinctive Characteristic

While Reliability Options and NERAM are similarly designed and share many fundamental aspects, the markets are not the same. The most significant functional difference is the availability component. Both NERAM and Reliability Options include elements designed to give generators strong incentives to be available when needed. NERAM adopts ISO's controversial "shortage hours" metric. In contrast, the Reliability Option market includes a built-in availability incentive that is not separable from the RO product, *i.e.*, failure to be available during a stress period imposes an automatic financial penalty. Thus, the Reliability Option avoids any debate about whether critical hours, shortage hours, or EFORd provides the better availability metric.

IV. Conclusion

The Connecticut Parties offered extensive evidence on Reliability Options as an alternative market warranting full Commission consideration. There can be no doubt that a Reliability Options market – like NERAM– is superior to LICAP in critical respects and deserves a comprehensive evaluation. Like NERAM, Reliability Options can produce just and reasonable wholesale power prices in New England based on competition between existing and new generators – not on administrative fiat – thereby stimulating new entry when additional capacity is needed for reliability. Reliability Options can also provide adequate assurances that necessary generation capacity will be provided by establishing requirements in advance and permitting new entrants and load response participation. Despite these enormous advantages, the Commission and the Presiding Judge precluded development of a full record on

Reliability Options that would enable the Commission to determine whether to adopt this market design. The Commission should rectify this error and adopt the proposed stakeholder procedure to evaluate feasible alternatives to the LICAP demand curve mechanism.

Respectfully submitted,

Date: September 13, 2005

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CERTIFICATE OF SERVICE

In accordance with 18 C.F.R. § 385.2010 (2005), I hereby certify that I have this day served, via electronic mail or first class mail, the foregoing document upon each person designated on the official service list compiled by the Secretary in these proceedings.

Dated at Washington, D.C. on this thirteenth day of September, 2005.

/s/

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