ORAL ARGUMENT HAS NOT BEEN SCHEDULED

Nos. 12-1060, *et al.*

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

NEW ENGLAND POWER GENERATORS ASSOCIATION, INC., ET AL.,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

REPLY BRIEF OF PETITIONERS NEW ENGLAND POWER GENERATORS ASSOCIATION, INC., NRG POWER MARKETING LLC, CONNECTICUT JET POWER LLC, DEVON POWER LLC, MIDDLETOWN POWER,LLC, MONTVILLE POWER LLC, NORWALK POWER LLC, AND SOMERSET POWER LLC

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GLOSSARY OF TERMS

Capacity	The ability to produce electric energy, typically measured in kilowatts or megawatts.
Commission	Respondent Federal Energy Regulatory Commission
Commitment period	The time period during which a supplier in a forward capacity auction agrees to provide capacity.
CONE	A value in the ISO New England tariff ostensibly reflecting the "cost of new entry."
Forward capacity auction	A descending-clock auction to procure capacity for a given commitment year, conducted by ISO New England at least three years in advance.
Forward capacity market	An organized market for capacity administered by ISO New England where the capacity is purchased and sold three years before the period in which it will be offered.
ISO	Independent System Operator
ISO New England	The independent regional transmission operator responsible for operating the transmission grid and administering organized wholesale electricity markets in the New England region.
Kilowatt (kW)	A measure of real power equal to one thousand watts.

Load	The total amount of power carried by an electric system at a point in time. The term "load" is often used synonymously with "demand." It is sometimes used as a shorthand for end-use customers.
Load-serving entities	Utilities (investor- or government-owned) that serve end-use customers (*i.e.*, load).
Megawatt (MW)	A measure of real power equal to one million watts.
NEPGA	Petitioner New England Power Generators Association, Inc.
NRG Companies	Petitioners NRG Power Marketing LLC, Connecticut Jet Power LLC, Devon Power LLC, Middletown Power LLC, Montville Power LLC, Norwalk Power LLC, and Somerset Power LLC
Tariff	A Commission-approved document stating the rate or rates to be charged by a particular company or utility.
Uneconomic entry	Entry into the capacity market at a price below the true cost of new entry.

INTRODUCTION AND SUMMARY OF ARGUMENT

I. The Commission's refusal to correct the ongoing effects of uneconomic entry into New England's forward capacity market should be reversed. "[A]ll uneconomic entry has the effect of depressing prices below the competitive level" and thereby produces "unjust and unreasonable rates." *ISO New England Inc.*, 135 FERC ¶61,029 at P61 (2011) (quotation marks omitted) (JA___). The Federal Power Act declares unjust and unreasonable rates "unlawful." 16 U.S.C. §824d(a). The Commission nonetheless failed to apply buyer-side market-power mitigation rules to existing uneconomic capacity that will artificially suppress capacity prices for years to come.

The Commission contends that its mitigation rules exist solely to prevent *future* uneconomic entry, but that cannot be squared either with the statute or with the Commission's own statements recognizing uneconomic entry's ongoing price-suppressing effect. Unlawfully depressed rates do not become lawful in the future merely because the uneconomic entry that depresses them occurred in the past. As its brief confirms, however, price-suppression is the Commission's goal: The Commission's asserted justification for ignoring past uneconomic entry is that artificially low prices will drive disfavored but otherwise economic suppliers from the market. *See* FERC.Br. 66, 69, 77-78. That is the very evil proscribed by the Act.

The Commission's orders also fail to adequately explain or support its decision to exempt past uneconomic entrants, and future uneconomic imports, from its new mitigation rules. The Commission's substitute remedy — a temporary extension of a flawed price-floor — has no persuasive justification.

II. The Commission's new $1/kW-month de-list bid threshold also cannot be sustained. The Commission does not dispute that, as a result of its new threshold, forward capacity auction prices will regularly crater to $1/kW-month, a mere fraction of the cost of new entry. It does not dispute that, with prices so low, it will be nearly impossible for prices to average out over time to the cost of new entry; suppliers will have a "vanishingly small" chance of recovering their costs; and otherwise viable facilities will be abandoned. Nor does the Commission attempt to reconcile those results with its — and this Court's — repeated recognition that auction prices over time must average out to the "cost of new entry" for new resources. Instead, the Commission now contends that cost of new entry is irrelevant and asserts that auction prices should be "nearly zero." Its failure to explain that fundamental shift in philosophy epitomizes unreasoned decisionmaking.

The Commission contends that dramatically lowering the dynamic de-list bid threshold is needed to ensure that zonal pricing produces "no" risk of market power. But it never explains why eliminating any risk of market power through radical revision of the auction process, rather than balancing competing concerns, is appropriate. The lack of explanation is telling, since the Commission agrees there was no evidence that market power was exercised even at the earlier, higher dynamic de-list bid threshold. In any event, having set the appropriate price level at the cost of new entry, the Commission may mitigate market power when it threatens to prevent prices from reaching that target. But fears about market power cannot justify setting an entirely new target. Market-power mitigation is a means, not the end.

The Commission's choice of $1/kW-month is also arbitrary. That figure is the lowest price the Commission could find in reconfiguration auctions. But reconfiguration auctions have lower prices than forward capacity auctions because they have different functions, different participants, lower volumes, and less risk. The Commission nowhere justifies its refusal to make adjustments to account for those differences.

ARGUMENT

I. The Commission's Failure to Apply Adequate Buyer-Side Mitigation is Arbitrary, Capricious, and Unlawful.

The Commission's decision not to apply buyer-side mitigation violates the Federal Power Act's requirement that the Commission implement "just and reasonable" rates for wholesale electricity. 16 U.S.C. §824d(a). It is also arbitrary and capricious.

A. The Commission's Refusal to Apply Mitigation to Existing Uneconomic Suppliers Produces Future Unjust and Unreasonable Rates.

Because the Federal Power Act prohibits rates that are "less than compensatory," *Farmers Union Cent. Exch., Inc. v. FERC*, 734 F.2d 1486, 1502 (D.C. Cir. 1984), the Commission is required to set rates that will permit suppliers to cover not only their operating expenses but also "the capital costs of the business." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). The Commission has recognized that in forward capacity markets, "prices will need to average out over time to the cost of new entry" into the wholesale generation market. *ISO New England Inc.*, 125 FERC ¶61,102 at P43 (2008). When a subsidized generator enters the market at *less* than the cost of new entry (*i.e.*, "uneconomic entry"), prices will be artificially depressed, and the resulting rates will be unjust and unreasonable. 135 FERC ¶ 61,029 at PP61, 170 (JA___, ___).

The Commission admits that uneconomic entry distorts the New England forward capacity market, and that past efforts to address that problem have failed. *Id.* at PP214, 218 (JA___, ___). The Commission also admits that, by exempting those "resources that had already entered" the market from its new offer-floor mitigation rules, FERC.Br. 60-61, it is refusing to mitigate fully the continuing effects of that uneconomic entry.

The Commission attempts to defend this exemption on two principal grounds. First, it asserts that the purpose of the new mitigation rules is only "the prevention of uneconomic market entry," rather than the correction of its continuing effects. FERC.Br. 61; *see also* 135 FERC ¶ 61,029 at P214 (JA___); *ISO New England Inc.*, 138 FERC ¶ 61,027 at P39 (2012) (JA___). That is nothing less than a concession that the Commission is refusing to obey the statute. Uneconomic entry depresses prices below competitive levels and results in unjust and unreasonable rates. 135 FERC ¶ 61,029 at PP61, 170. When that happens, the Commission must both: (i) prevent *further* illegal price depression; *and* (ii) correct the *existing* price depression so that rates are just and reasonable. The Commission's admission that it is pursuing only the former goal is fatal: It establishes that the Commission's orders leave power rates at unjust and unreasonable levels.

Second, the Commission contends that because *correcting* uneconomic entry would allegedly "send inaccurate price signals" to the forward capacity market, its orders merely "weigh competing interests in order to achieve a reasonable outcome." FERC.Br. 61. The Commission is wrong about the price-signaling effect of eliminating market distortion. *See* pp. 7-8, *infra*. But more importantly, the Commission's authority to balance interests can be exercised only within the Act's substantive constraints. The Commission has discretion to balance competing interests when selecting *among* different just and reasonable rates. But it has no power to balance away the statutory right to just and reasonable rates in the first place. *See FPC v. Texaco, Inc.*, 417 U.S. 380, 394 (1974) (Commission may not "set at naught an explicit provision of the Act"). In short, the Commission cannot deliberately preserve artificially depressed, anticompetitive prices because it prefers to pursue goals other than the ones Congress prescribed.

B. The Commission's Refusal to Apply Mitigation to Historical and Interim Uneconomic Entrants is Arbitrary, Capricious, and Unlawful.

The Commission's orders are also procedurally defective. The Commission's explanations for allowing price suppression by past uneconomic entrants, both "historical" and "interim," do not satisfy the requirements of reasoned decisionmaking. Nor is the partial substitute relief it implemented — a temporary extension of the malfunctioning price floor — calibrated to address the problem.

1. The Commission's Refusal to Mitigate Past Uneconomic Entry is Unreasoned and Unreasonable.

The Commission attempts to defend exempting past uneconomic entry from prospective mitigation principally on the ground that mitigating such entrants would "send improper price signals." FERC.Br. 69. According to the Commission, correcting current price depression would "produce higher capacity prices and, thereby, encourage older, higher-cost resources to *remain in the market* rather than retire." FERC.Br. 66 (emphasis added); *id.* at 69; 138 FERC ¶61,027 at P39 (JA___). But that only underscores the problem with the Commission's approach. Tellingly, the Commission does not contend that disfavored suppliers would leave the market if prices were competitive and accurately reflected the cost of new entry. Instead, the Commission asserts that it must be allowed to leave prices below competitive levels *so that* disfavored suppliers are driven under. That is not a justification for permitting unlawfully depressed rates; it is why they are unlawful.

Moreover, the Commission does not address the inconsistency between its theory that mitigating uneconomic entry produces incorrect price signals and its separate finding that "*fail[ing]* to address [uneconomic] capacity surpluses do[es] not provide the long term price signals that support private investment." *ISO New England Inc.*, 131 FERC ¶ 61,065 at P87 (2010) (JA___) (emphasis added); *see* FERC.Br. 69-70. The Commission has not even attempted to make sense of that contradiction. Nor has it confronted the record evidence demonstrating that it is *failing* to mitigate past uneconomic entry that will distort price signals. *See* Op.Br. 30; R.180, Ex. 5 at 13:9-17 (Milgrom Test.) (JA___); R.180, Ex. 6 at 30:16-19 (Kalt Test.) (JA___).

In any event, the Commission's decision to elevate concerns about price signaling over correcting *buyer-side* market power abuses cannot be squared with its approach to *seller-side* market power. The Commission has never hesitated to impose new seller-side market-power mitigation on existing (and not just future) generators. *See* Op.Br. 31. Nor has it ever suggested (and it is impossible to imagine) that failing to correct artificially *inflated* prices would be acceptable because it will drive disfavored *buyers* out of the market. That inconsistency is fatal to the Commission's position, for "similar legal standards should apply to claims of monopolization [by sellers] and to claims of monopsonization [by buyers]." *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.*, 549 U.S. 312, 321-22 (2007).

The Commission never meaningfully responds to this objection. Instead, the Commission mentions the difference in its treatment of buyer and seller market power only obliquely, and argues that it *did* mitigate buyer-side market power "by extending the price floor until the new offer floor is implemented." FERC.Br. 69. But the price floor is too low to mitigate uneconomic entry's effects (which indeed is why it is being replaced with an offer floor), and the Commission has admitted that the effects of uneconomic entry will persist after the temporary extension expires. The Commission again has no response.

In the proceedings below, the Commission claimed that its treatment of buyer-side market power was "consistent with" previous orders concerning the New York City capacity market. *See* 135 FERC ¶ 61,029 at

P215 & n.151 (JA___) (citing *New York Indep. Sys. Operator, Inc.*, 122 FERC ¶ 61,211 at PP100-01, 118-19 (2008)). But the case it cites is distinguishable because, unlike here, the uneconomic entry in *New York ISO* occurred before the Commission implemented any market-power mitigation rules. *See* Op.Br. 31-32. That distinction is confirmed by two later decisions, *Astoria Generating Co. L.P. v. New York Indep. Sys. Operator, Inc.*, 140 FERC ¶ 61,189 (2012), and *Astoria Generating Co., L.P. v. New York Indep. Sys. Operator, Inc.*, 139 FERC ¶ 61,244 at P132 (2012), in which the Commission *did* mitigate uneconomic entry in the New York City market once such rules were in place. *See* NEPGA.Interv.Br. 15-16.

Rather than respond to this argument, the Commission mischaracterizes it. Petitioners did not contend that the orders below were invalid because they are "inconsistent with" the later *Astoria* rulings. FERC.Br. 70. Rather, petitioners observed that the rulings demonstrate why *the Commission's* attempt to equate its orders here with the 2008 *New York ISO* case is unavailing.

Finally, the Commission misunderstands the point of petitioners' observation that the rationale of its orders is broadly inconsistent with its statutory mandate and earlier Commission precedent. *See* FERC.Br. 71-72;

Op.Br. 33-34. The Commission's statutory province is electricity rates, not power-producing facilities. *See* 16 U.S.C. §824d(b)(1). For that reason, the Commission has held that the States retain regulatory authority over generating facilities, including the right to "require retirement of existing generators." *Connecticut DPUC v. FERC*, 569 F.3d 477, 481 (D.C. Cir. 2009). In this case, however, the Commission asserts *its own* desire to encourage such retirement as the reason for refusing to mitigate price-suppressing uneconomic entry.

The Commission's misunderstanding of petitioners' argument also leads it to assert, inaccurately, that petitioners failed to preserve this issue for appeal. In fact, petitioner NEPGA made precisely this argument in its request for rehearing, citing the same *Connecticut DPUC* decision, and the Commission took note of that argument in its rehearing order. *See* R.193 at 20-21 (NEPGA Clarification Req.) (JA___); 138 FERC ¶61,027 at P33 & n.33 (JA___). The inadequacy of the Commission's response should not be mistaken for petitioners' failure to raise the issue.

2. The Commission's Refusal to Mitigate "Interim" Uneconomic Resources is Unreasonable and Unlawful.

The Commission also acted arbitrarily and capriciously by refusing to mitigate uneconomic capacity that entered the market during the "interim" period in the fourth and fifth capacity auctions. *See* Op.Br. 34-37.

The Commission contends that petitioners waived this argument by failing to raise it on rehearing. FERC.Br. 72. But in their request for rehearing and clarification of the Commission's *third* order in this case — the April 13, 2011 order — petitioners argued that the Commission "erred" because the order "does not describe what mitigation will be applied to Interim OOM [*i.e.*, out-of-market entry in auctions four and five]" and asked the Commission to clarify "what mitigation will be applied to Interim OOM for the period when the new mitigation rules go into effect." Pets.' Reh'g Req. 9-10 (JA___-___); *id.* at 34 (JA___). To be sure, petitioners elsewhere took the position that the April 13 order was silent on the treatment of interim uneconomic entrants, *see id.* at 34 (JA___), but the order itself required ISO New England to develop proposals for an offer-floor based mitigation regime that would apply only to "new resources." 135 FERC ¶ 61,029 at P169.

On the merits, the Commission's explanation is unpersuasive. As described above, when the Commission refused to apply the offer-floor mitigation rules to past uneconomic entrants in the first three capacity auctions, it explicitly stated that this exemption was not "based on a 'reliance interest.'" 138 FERC ¶61,027 at P40 (JA___). But then, the Commission exempted uneconomic entrants in the fourth and fifth auctions — entrants who, unlike their predecessors, *knew* that the alternative price rule would be replaced with an offer-floor price regime — based on "fairness" concerns. *Id.* at P46 (JA___).

The Commission's sole defense of that inconsistency is that "[u]nlike capacity in auctions one through three, capacity seeking to bid into auctions four and five had notice that the mitigation rules might change." FERC.Br. 72-73. Precisely. The only difference between interim entrants and their predecessors is one that *cuts against* reliance: The interim entrants had notice of the impending change in the rules. There is no rational reason why that difference should lead to more solicitous treatment of the interim entrants' supposed reliance interests.

Similarly, there is no support for the Commission's purported distinction between entry through the fifth auction and entry during the sixth auction. Neither auction five nor auction six had been conducted when the Commission issued its April 2011 order putting would-be new entrants on notice that offer-floor-based mitigation would be implemented. The Commission contends that "investment in auction five capacity already had occurred," whereas ordering further mitigation for auction six could prevent below-cost capacity from entering that auction. FERC.Br. 73. But the whole point of conducting the auctions three years in advance is to "provide appropriate signals to investors when new infrastructure resources are necessary with sufficient lead time to allow that infrastructure to be put into place before reliability is sacrificed." *Devon Power LLC*, 115 FERC ¶ 61,340 at P65 (2006); *see also PJM Interconnection, L.L.C.*, 115 FERC ¶ 61,079 at P72 (2006). The premise of the forward capacity market is that investment will occur *after*, not *before*, the auction occurs. The Commission wrongly assumes the opposite by suggesting that investment in capacity that entered through the fifth auction would have occurred before that auction took place.

3. The Commission's Extension of the Price Floor is Not Reasonably Calculated to Address Market Distortion.

Having refused to apply new market-power mitigation rules to past uneconomic entrants, the Commission offered a wholly inadequate substitute: a temporary extension of the auction price floor, then set at 60% of "CONE" (a value meant to reflect the cost of new entry), until the new rules are implemented. *See* 135 FERC ¶ 61,029 at PP 216-17 (JA___). One might call that an arbitrary and capricious consolation prize. Op.Br. 37-40. The Commission did not even attempt to correlate the effect of the price floor's extension with the effect of artificial price suppression. Nor could it do so: The record evidence shows that the price floor is unreasonably low to begin with. *See id.* at 38; R.156 Ex. 3 (Ungate Test.) (JA___); R.156 Ex. 2 (Stoddard Test.) (JA___). It thus cannot correct for the effects of uneconomic entry. And the Commission's *temporary* extension of the price floor for a four-year period from the second through the fifth auctions fails to account for the Commission's own findings that "the price-suppressing effects of a new [uneconomic] resource could extend *beyond*" that limited period. 135 FERC ¶ 61,029 at P 69 (emphasis added) (JA___) (rejecting proposed six-year limitation on future mitigation as too short to adequately mitigate effects of uneconomic entry).

The Commission's contention that petitioners believe that "the price floor should be higher and last longer," FERC.Br. 76, thus misses the point. Petitioners merely observe that the Commission has a statutory obligation to eliminate the effects of uneconomic entry, which could be accomplished by applying the *new* offer-floor rules across-the-board — to future, interim, and past entrants alike. Petitioners point to the term of the price-floor extension as one reason it represents an inadequate substitute for the actual solution: direct application of the mitigation rules to *all* uneconomic entrants.

The Commission has no meaningful response. Rather than attempting to show that the value of CONE is accurate, the Commission simply describes in abstract terms how that value was calculated. *See id.* at 77. It nowhere accounts for the record evidence cited in petitioners' brief or even addresses the Commission's own acknowledgment that ISO New England's CONE value is "well below" the CONE values in neighboring markets. 131 FERC ¶ 61,065 at P151 (JA___); R.156, Ex. 2 at 82:16-17 (Stoddard Test.). Nor does the Commission explain why it can rely on the adequacy of CONE for price-floor purposes while simultaneously dismissing as "moot" challenges to its calculation. Op.Br. 38-39; 135 FERC ¶ 61,029 at P343 (JA___).

The Commission likewise never responds to petitioners' argument that, by the Commission's own admission, the effects of prior uneconomic entry will endure after the temporary price-floor extension expires. Here again, the Commission says only that extending the floor further would "send the wrong price signals regarding the need for capacity, and thereby discourage some old and inefficient existing capacity from retiring." FERC.Br. 77-78. In other words, the Commission likes the temporary price-floor extension precisely because it will *not* cure the effects of uneconomic entry and raise prices to competitive levels. The Commission thus elevates its policy preferences over its statutory duty.

C. The Commission's Failure to Ensure Adequate Mitigation of Uneconomic Imports is Arbitrary, Capricious, and Unlawful.

The Commission has recognized that uneconomic entrants who import their energy into the New England market can artificially depress prices. *See* 138 FERC ¶ 61,027 at P98 (JA___); 135 FERC ¶ 61,029 at P170 (JA___). But the Commission decided not to apply mitigation rules to uneconomic imports unless two conditions are satisfied: (1) "a specific new external resource is identified as the sole support for the import," *and* (2) "a significant investment (such as the construction of a new transmission line to import power from an adjacent control area) is made to provide capacity to New England." 135 FERC ¶ 61,029 at P191 (JA___). Petitioners asked the Commission to make the test disjunctive, but the Commission refused.

The Commission defends that decision on two grounds. It first contends that, because it is "difficult to determine what resources support an import," it will not be "clear that new resources are being devoted to the New England market over the long term" unless both criteria are satisfied. FERC.Br. 78-79 (quotation marks omitted). For that reason, the Commission claims to have "put in place a standard that . . . ensures that only new resources, whether internal or external, are mitigated." *Id.* at 79. In reality, the Commission's rule ensures that *no* external resources will be mitigated. As petitioners explained, "it is inconceivable that any entity will fail to structure its import arrangement to avoid satisfying at least one of the two criteria for mitigation." Op.Br. 41. The Commission offers no response to that point because there is none. *See* FERC.Br. 78-80.

Moreover, the Commission's empirical defense of its rule has no content. It did not, for example, compare the greater price-suppressive effects of its conjunctive tests with the benefits of petitioners' proposed disjunctive test. Op.Br. 42. Nor has it provided any explanation for that failure. *See* FERC.Br. 78-80. Instead, the Commission rests only on its own *ipse dixit* that the conjunctive test is better. *Id.* at 79.

Finally, the Commission's rule cannot be defended on the ground that it prevents undue discrimination; rather, the rule produces it. *See id.* at 79-80. The only undue discrimination that will occur under the Commission's approach will be against new resources in New England, which will be disadvantaged relative to external resources. *See* Op.Br. 43.

II. The Commission's Decision To Set A Dynamic De-List Bid Threshold Of $1/kW-Month Is Arbitrary And Capricious.

The Commission has not justified its new dynamic de-list bid threshold. When the Commission initially approved forward capacity markets, it explained that auction prices must "average out over time to the cost of new entry" to attract new entrants when needed. 125 FERC ¶ 61,102 at P43. Cost of new entry is thus "a key factor in determining appropriate rates for capacity." *Maine PUC v. FERC*, 520 F.3d 464, 473-74 (D.C. Cir. 2008). The Commission likewise acknowledged the critical role of "dynamic de-list bids" in setting prices, declaring that they would "establish a reasonable default level of compensation for units needed for reliability." 125 FERC ¶ 61,102 at P77.

Defending its decision to foreclose dynamic de-list bids until prices reach record lows, the Commission now says "cost of new entry" is irrelevant. Instead, it urges that prices should approach the "nearly zero" "*added* costs" that an *existing* supplier would incur "to also provide capacity." FERC.Br. 82, 89. But the Commission never acknowledges, much less justifies, that change in pricing philosophy. And it ignores its prior ruling that dynamic de-list bids presumptively set the proper "level of compensation." Most important, the Commission's brief (like the challenged orders) never responds to evidence showing that, if suppliers cannot dynamically respond to price declines at auction until they hit $1/kW month, suppliers will have a "vanishingly small" chance of ever recovering their costs over time. Those failures of explanation cannot be reconciled with reasoned decisionmaking. And by shifting its aim from cost of new entry to the different ("nearly zero") price target, the Commission has calibrated the auction to produce unjust and unreasonable results. The Commission's effort to sidestep those issues requires reversal.

The Commission claims its changes are justified by market power concerns flowing from its move to "zonal pricing." But that refinement cannot justify a wholesale change in the amount generators should be expected to earn in the long run. It ignores existing and less damaging means of addressing any market-power concerns. Op.Br. 54-55. And it fails to justify precluding dynamic responses to price changes until prices hit the arbitrary threshold of $1/kW-month. *Id.* at 56-60.

A. The Commission Never Reconciles Its Decision With Prior Rulings or the Requirement of Just-and-Reasonable Rates.

The Commission and this Court repeatedly have agreed that capacity auction prices must "average out over time to the cost of new entry." 125 FERC ¶ 61,102 at P43; Op.Br. 47. The Commission has likewise acknowledged that "a dynamic de-list bid establishes a reasonable default level of compensation for units needed for reliability." 125 FERC ¶ 61,102 at P77; Op.Br. 53. Forward capacity auctions therefore formerly relied on both: They linked the threshold for dynamic de-list bidding to an estimate of the cost of new entry; and they relied on dynamic de-list bidding to establish reasonable compensation. *Maine PUC*, 520 F.3d at 473. By pegging the dynamic de-list bid threshold to CONE, the auction regime made it possible for prices to average out to cost of new entry in the long run: It allowed suppliers to exit the auction when decreases in price so departed from CONE as to prevent average prices from approaching cost of new entry over time.

The Commission now reverses course. Addressing the role of dynamic de-list bidding, it issues a denial, "reject[ing]" the "claim that de-list bids are intended to limit downward price volatility." FERC.Br. 87. But the Commission's prior rulings are clear that dynamic de-list bids were designed to establish the "reasonable default level of compensation for units needed for reliability." 125 FERC ¶ 61,102 at P77. If the Commission wants to adopt a new regime in which dynamic de-list bids have virtually no role in setting prices, it must acknowledge the change and "supply a persuasively reasoned explanation for modifying [an] earlier position that is itself rationally grounded in the evidence before the agency." *Telecomms. Research & Action Ctr. v. FCC*, 836 F.2d 1349, 1358 (D.C. Cir. 1988) (citation omitted). Here, the Commission does neither.

The Commission, moreover, nowhere denies that its new $1/kW-month threshold is a fraction of previous measures of cost (whether of new entry or estimates from approved reliability-must-run contracts).

Embracing that difference, the Commission declares that capacity prices should "be quite low since the *added* costs for providing capacity" for entities already providing energy and ancillary services "in many cases is nearly zero." FERC.Br. 89 (emphasis added). But the Commission has previously ruled that prices should average over time to the "cost of new entry," which includes fixed costs. *See* Op.Br. 47. The Commission does not acknowledge, much less justify, its shift from the cost of new entry to the marginal cost or "added costs" of participants *already* in the market (and already providing capacity, *see* Op.Br. 56-57).

Nor could it. Capacity markets use cost of new entry to permit recovery of the fixed costs (*e.g.*, the cost of building a plant) precisely because other markets do not. "[E]nergy markets are not designed or expected to recover more than marginal costs" because "other markets, such as the capacity markets, address the recovery of fixed costs." *NYISO*, 135 FERC ¶ 61,157 at P 25 (2011). If reasoned decisionmaking means anything, it must preclude the Commission from ruling in one proceeding that fixed costs are to be recovered in capacity markets while advancing in another, without explanation, the contradictory theory that capacity prices should reflect only marginal (and not fixed) costs.

The Commission thus errs in urging that comparables like reliability-must-run contracts are "intended to provide total cost recovery," while "market-based rate Forward Capacity market auctions are not intended to guarantee total cost recovery." FERC.Br. 90. The cost *estimates* in those contracts — many times the dynamic de-list bid threshold — are relevant. And the Commission nowhere explains how suppliers are supposed to recover fixed costs if such costs are not reflected in capacity prices.

Ultimately, the Commission never denies that, if suppliers cannot respond to price declines during the auction until prices fall to $1/kW-month, auction prices will regularly clear at $1/kW-month. Op.Br. 49-50. Nor does it dispute that, as a result, market participants will have a "vanishingly small" chance of recovering their costs over the long term. *Id.* at 51-52. That also requires reversal. The Commission's rationale is that it need only provide a meaningful "opportunity" to recover costs. 138 FERC ¶ 61,027 at P110 (JA___). But the Commission ignored record evidence that its new regime offers no such opportunity. Indeed, the regime is designed not to do so.

The Commission concedes that the resulting prices may "accelerate" plant retirements — rendering many uneconomic — but urges that such a result "would be appropriate" because New England currently has excess supply. FERC.Br. 92-93. But the Commission also asserts that a $1/kW-month threshold "would not unduly discourage competitive new entry." *Id.* at 93. The Commission never identifies how prices so low that they require abandonment of multi-billion dollar facilities, and so low as to prevent cost-recovery in the long term, can simultaneously create incentives to invest billions in new ones when needed. The Commission's "seeming blindness to the possible impact" of its $1/kW-month threshold, "and its tendency to elevate into affirmative benefits what are at best palliatives, seem impossible to square with the requirement of reasoned decisionmaking." *Associated Gas Distribs. v. FERC*, 824 F.2d 981, 1025 (D.C. Cir. 1987).

B. The Shift To Zonal Pricing Does Not Justify Replacing A CONE-Based Threshold With A $1/kW-Month Figure.

The Commission asserts that it needed to virtually eliminate dynamic de-list bidding until prices hit new lows to address market power concerns produced by zonal pricing. FERC.Br. 87. That justification appears in the Commission's *own* rationale for its ruling only once, in the span of two sentences. 138 FERC ¶ 61,027 at P121 (JA___). It is also a non-sequitur. Either prices should average out of time to cost of new entry, or they should not. Market-power mitigation may be invoked to better approach that lodestar not as an excuse for abandoning it.

Nor did the Commission balance the risks of market power against the costs of intruding on the auction's operation. Op.Br. 55. Instead, it selected a price so low that there could be "*no* market power concerns." FERC.Br. 81. The Commission nowhere explains why zero risk is appropriate given the devastating effect on the auction's operation. Nor did the Commission address whether that was necessary given its ability to review auction results and rectify any exercise of market power in that process. Op.Br. 47-48. The Commission's failure to consider the efficacy of that alternative renders its wholesale change to the auction arbitrary in the extreme.

In any event, the Commission has made clear that it "will approve only mitigation measures that address *well-defined structural problems in the market*." *New England Power Pool*, 101 FERC ¶ 61,344 at P28 (2002) (emphasis added). Here, the Commission precluded dynamic responses to price, converting auction participants into passive price takers until price hits historic lows. It set the new threshold at "six times lower than the initial threshold for dynamic de-list bids ($6/kW-month)," "over four times lower than the current threshold ($4.28)," 138 FERC ¶ 61,027 at P112 (JA___), and a tiny fraction of the cost estimates the Commission approved when accepting reliability-must run agreements, 135 FERC ¶ 61,029 at P309 (JA___). It did so even though "there was *no evidence* that market power was exercised when the threshold was set at 0.8 times Cost of New Entry." FERC.Br. 88 (emphasis added).

The Commission invokes the possibility that suppliers will have "an incentive" to exercise "market power" by "withhold[ing] (via de-listing) a portion of their capacity in order to cause a zone to separate." FERC.Br. 87. But market mitigation is appropriate to address only well-defined structural problems. The Commission's "mere mention of the possibility of" an unquantified future risk that market power may be exercised cannot justify all but eliminating the role of dynamic de-list bidding "in the here-and-now regulatory world of FERC's own design," particularly where the Commission fails to respond to numerous objections. *Fla. Power & Light Co. v. FERC*, 85 F.3d 684, 688 (D.C. Cir. 1996). "Professing that an order ameliorates a real industry problem but then citing no evidence demonstrating that there is in fact an industry problem is not reasoned decisionmaking." *Nat'l Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831, 843 (D.C. Cir. 2006).

The Commission also defends its choice to decouple the dynamic de-list bid threshold from CONE by noting that sellers may submit *static*, rather than dynamic, de-list bids. FERC.Br. 91. But static and dynamic de-list bids fundamentally differ, which is why previous auctions permitted both. Op.Br. 59-60. Dynamic de-list bids promote flexibility by allowing sellers to bid in real-time, responding to the full panoply of market information. While acknowledging that static de-list bids "limit flexibility," the Commission considered that issue not "a serious impediment." FERC.Br. 92. But that is assertion, not analysis. And it ignores contrary evidence — that preventing dynamic de-list bidding until prices hit $1/kW-month will cause prices regularly to crater to that level; preclude prices from averaging out to the cost of new entry over time; and present suppliers with a vanishingly small chance of recovering fixed costs. Unless that was the Commission's goal, the Commission's answer is no answer at all.

C. The $1/kW-Month Threshold Is Arbitrary.

The Commission concedes that the $1/kW-month de-list bid threshold, to the extent it reflects anything, represents the *lowest* price it could find in *reconfiguration* (not forward capacity) auctions. The Commission acknowledges the "small data set from reconfiguration auctions," FERC.Br. 84; their "lower volume," *id.* at 89; and their "shorter forward procurement period," *id.* The Commission nonetheless contends that reconfiguration auctions "represent a reasonable estimate of the price at which a competitive supplier would choose to commit its resource as a capacity resource." *Id.*

The Commission, however, never explains why the *lowest* reconfiguration auction price it could find — one that was 40% to 50% lower than the other reconfiguration auction prices — represents a "reasonable estimate." That lowest-achieved price presumably reflects particular conditions, such as a limited group of low-cost suppliers and a period of low risk and lax demand. The Commission never explains why the lowest price it could find is an appropriate starting point at which suppliers should be permitted to respond dynamically to falling prices. Op.Br. 58. The whole point of an auction is to have suppliers exit the market when prices are too low for them, not to force them to remain in the market until prices reach the lowest depth ever recorded.

The Commission also never explains why it failed to adjust reconfiguration auctions to compensate for differences that produce concededly lower prices. For example, the economic and legal risks involved in accepting an obligation to provide limited capacity one year in the future, as in reconfiguration auctions, pale in comparison to the risks of accepting an obligation to provide more capacity three years out, as in forward capacity auctions. Although the Commission claimed to be looking for a "reasonable estimate," *see* FERC.Br. 89, it selected the lowest price reached in another auction, with lesser risks and correspondingly lower prices, without making any effort to compensate for those differences. If that is not arbitrary and capricious, nothing is.

There is another reason reconfiguration auctions have lower prices — participants already have capacity obligations. The costs of providing *additional* capacity are much lower than accepting an obligation in the first instance. Op.Br. 56-57. The Commission nonetheless asserts that "de-list bids, like reconfiguration auctions, are used by existing, rather than potential new, market participants." FERC.Br. 90. That compares apples to orangutans. A seller submitting a de-list bid is an existing market participant only in the sense that it has chosen to participate in the auction and thus might acquire a capacity obligation for the relevant period for the right price. Reconfiguration auctions, by contrast, involve participants that are already obligated to supply capacity. Such participants are differently situated; the prices they would accept are different as well.

Finally, the Commission promises its rulings "will be updated to account for new information and market experience." FERC.Br. 91; *id.* at 93. But the Commission cannot avoid review by promising to revisit an arbitrary and capricious ruling after the damage is done. Market-based auctions cannot provide adequate incentives for investment if the Commission may disregard prior rulings without reasoned explanation or arbitrarily rig the auction to depress prices. Yet that is precisely what the Commission did here.

CONCLUSION

The Court should grant the petitions and vacate the orders below.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

Pursuant to Rule 32(a) of the Federal Rules of Appellate Procedure and Circuit Rule 32(a)(2), I hereby certify that the textual portion of the foregoing brief (exclusive of the disclosure statement, tables of contents and authorities, certificates of service and compliance, but including footnotes) contains 5,982 words as determined by the word-counting feature of Microsoft Word 2000.

/s/ Ashley C. Parrish
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CERTIFICATE OF SERVICE

Pursuant to Rule 25 of the Federal Rules of Appellate Procedure, I hereby certify that I have this 5th day of February 2013, served a copy of the foregoing documents electronically through the Court's CM/ECF system. All participants in the case are registered CM/ECF users and will be served by the appellate CM/ECF system.

/s/ Ashley C. Parrish
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