THE COMMONWEALTH OF MASSACHUSETTS
BEFORE THE
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

	)	
Western Massachusetts Electric Company	)	**D.T.E. 97-120**
Electric Industry Restructuring Proposal	)	
	)	

DIRECT TESTIMONY OF
HENRY Y. YOSHIMURA

Concerning WMECo's Proposed Standard Offer Procurement Procedure

On Behalf of:

THE COMMONWEALTH OF MASSACHUSETTS
DIVISION OF ENERGY RESOURCES

September 25, 1998

Direct Testimony of Henry Y. Yoshimura
Concerning the Proposed Standard Offer Procurement Procedure
Western Massachusetts Electric Company, D.T.E. 97-120

Q. **MR. YOSHIMURA, PLEASE IDENTIFY YOURSELF FOR THE RECORD AND SUMMARIZE YOUR EXPERIENCE AND QUALIFICATIONS.**

A. My name is Henry Y. Yoshimura. I am the Senior Manager of Economics and Public Policy for XENERGY Consulting, Inc., 2001 West Beltline Highway, Madison, Wisconsin 53713. Before joining XENERGY Consulting, Inc. ("XENERGY") in September 1997, I was a Senior Consultant with La Capra Associates, a Boston-based consulting firm specializing in utility regulatory matters. Before joining La Capra Associates, I served on the staff of the Massachusetts Department of Telecommunications and Energy ("DTE" or "Department", formerly the Department of Public Utilities) for about nine years and held several positions including Senior Economist, Assistant Director of the Electric Power Division, and finally Director of the Electric Power Division.

As Director of the DTE's Electric Power Division, I trained and managed teams of Department staff working in the areas of utility price structures and ratemaking, integrated resource planning, utility and non-utility power production, the environmental impacts of electricity generation, and demand-side management. I participated in the development and implementation of numerous regulatory policies such as marginal cost-based rate design, cost recovery standards for utility generation, competitive bidding regulations for non-utility generation, and integrated resource planning. I have bachelor and graduate degrees in economics from the University of Montana. Overall, I have worked as an economist and public policy analyst in the electric power industry for more than 15 years.

In addition to my work with the DOER, I am presently managing a study for the Research Institute for Small and Emerging Businesses to provide recommendations on how such businesses can best respond to restructuring. Also, I follow the development of policy issues and decisions with respect to electric industry restructuring in all 50 states, the District of Columbia, and the Federal Government as the manager of XENERGY's Regulatory Database and Web Site. At the present time, I am directing the development of a similar database and web site that will contain detailed information on electric industry restructuring and related topics for the National Association of Regulatory Utility Commissioners. The regulatory database projects that I manage expose me to the range of electric industry restructuring issues and to the manner in which the states and the Federal government have addressed these issues.

With respect to the Massachusetts restructuring process, I advised the Division of Energy Resources ("DOER") in a series of proceedings including the Department's rulemaking concerning electric industry restructuring – i.e., D.P.U. 95-30 and D.P.U. 96-100. I also assisted the DOER in settlement negotiations with Massachusetts Electric Company ("MECo") concerning the structure of MECo's restructuring plan, including the structure of the Standard Offer bidding process. I also assisted the DOER on matters concerning the formation of the Massachusetts Electric Industry Restructuring Act (i.e., Chapter 164 of the Acts of 1997), and on the Department's rulemaking process in which restructuring rules were promulgated earlier this year in D.P.U./D.T.E. 96-100.

Finally, I have assisted the Massachusetts High Technology Council and the Massachusetts Operational Services Division to develop strategies for the purchase of

electricity from competitive suppliers in a competitive market. The Massachusetts High Technology Council ("MHTC") is an alliance of business members with commercial and industrial facilities (some with multiple facilities) located throughout the Commonwealth of Massachusetts.[1] The Operational Services Division ("OSD") is the agent of the Massachusetts state government with the responsibility for procuring goods and services representing the "best value" to the Commonwealth. Given electric industry restructuring in Massachusetts, the OSD is responsible for purchasing generation and related services for approximately 140 executive state agencies (as well as potentially interested quasi-public authorities, judicial branch facilities, and 351 Massachusetts cities and towns). For the MHTC and OSD aggregation groups, I have been responsible for developing baseline regulatory and market studies, generation service procurement RFP's, and/or reviewing generation service bids. Because of this work, I am familiar with issues pertaining to competitive procurement of power, and have seen how the structure of the Massachusetts Standard Service Transition Rate (aka "Standard Offer" or "Standard Service") has impacted the development of the generation service market.

Q. **WAS YOUR DIRECT TESTIMONY AND ALL SUPPORTING EXHIBITS AND/OR SCHEDULES PREPARED BY YOU, OR UNDER YOUR SUPERVISION AND GUIDANCE?**

A. Yes.

Q. **WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

A. The DOER retained me to review two aspects of Western Massachusetts Electric Company's ("WMECo" or "Company") proposal in this proceeding. First, I was asked to review the Company's proposed Standard Offer procurement procedure. Second, I was asked to review the manner in which WMECo proposes to establish its Standard Service

[1] At the time I was retained to assist MHTC in the fall of 1997, the MHTC aggregation consisted of about 65 members. At the present time, MHTC has about 200 members.

Transition Rate and to present to the Department an alternative methodology that better meets the intent of the Massachusetts Electric Industry Restructuring Act, Chapter 164 of the Acts of 1997 ("Act").[2] In this volume of direct testimony, I address the structure of the Company's proposed Standard Offer procurement procedure. My direct testimony concerning the Standard Service Transition Rate methodology will be submitted on October 9, 1998.

HAVE YOU REVIEWED THE COMPANY'S PROPOSED STANDARD OFFER PROCUREMENT PROCEDURE?

A. Yes, I have.

Q. **DO YOU HAVE ANY CONCERNS REGARDING THE COMPANY'S PROPOSED STANDARD OFFER PROCUREMENT PROCEDURE?**

A. Yes, I do. According to the Act,

> [t]he standard service transition rate shall be offered for a transition period of seven years at prices and on terms approved by the department *and shall require a distribution company to purchase electricity after a competitive bid process that is reviewed and approved by the department.* St. 1997, c. 164, § 193 (G.L. c. 164, § 1B(b)), emphasis added.

Thus, Massachusetts Law requires that the generation used to serve Standard Offer customers be procured by WMECo using a competitive bid process. The DOER asked me to review WMECo's Standard Offer procurement proposal to ensure that the process is one that employs a fair competitive bidding mechanism. A fair competitive mechanism would engender a robust response among potential suppliers and would identify the most beneficial supplier(s) of Standard Offer generation. However, I have many concerns with WMECo's proposal and find that the Company's procurement procedure is biased and may discourage participation among qualified suppliers.

---

[2] The full and official name of the Act is: "Chapter 164 of the Acts of 1997: An act relative to restructuring the electric utility industry in the Commonwealth, regulating the provision of electricity and other services, and promoting enhanced consumer protections therein."

Q. **PLEASE SUMMARIZE YOUR CONCERNS WITH THE STANDARD OFFER PROCUREMENT PROCEDURE.**

A. WMECo's proposal must be carefully scrutinized by the DTE because, under WMECo's proposal, WMECo affiliates would be allowed to bid for the opportunity to provide generation to supply the Standard Offer. The evidence strongly suggests that WMECo affiliates are likely to participate as competitive generation suppliers in the Company's Standard Offer bidding process. For example, on January 30, 1998, WMECo mailed an RFQ to about 200 potential suppliers of Standard Offer generation. Despite the wide circulation of the RFQ among many potential suppliers, the Company reported that WMECo only received one response to its RFQ, which was from an NU affiliate. If a Northeast Utilities affiliate responded to WMECo's first Standard Offer solicitation, it is reasonable to presume that the affiliate will participate in future solicitations.[3] In that circumstance, Northeast Utilities, the parent company of WMECo, is not indifferent with respect to the success or failure of its competitive generation supply company in winning the bid to supply the Standard Offer. If Northeast Utilities has a stake in the outcome of the Standard Offer bid, WMECo cannot be assumed to be neutral with respect to the outcome of the Standard Offer bidding procedure.

The issues associated with affiliates participating in the competitive solicitation of an affiliated electric company are familiar to the Department. These issues were debated and addressed extensively in D.P.U. 86-36 and D.P.U. 89-239. During this sequence of rulemaking proceedings, the Department struggled with the appropriate pricing and ratemaking treatment to be afforded new electric generation investments made by jurisdictional electric utilities. Prompted by the competitive bidding regulations affecting

[3] Of course, the poor response to WMECo's initial Standard Offer procurement process could also be indicative of other flaws in that process.

Qualifying Facilities promulgated by the Department in D.P.U. 84-276-B, the Department sought to establish a utility generation planning process that would evaluate all potential energy resources (both supply- and demand-side) on an equal, least-cost basis. The Department decided that a competitive bidding process was the best method by which to achieve its least-cost objectives. However, the Department also permitted electric companies, or their affiliates, to participate in their own competitive solicitations. Given the potential for electric companies to bias the evaluation process in favor of their generation affiliates, a complex set of rules was established requiring tight Department oversight of the solicitation process in order to guard against biased energy resource selections. For example, the integrated resource management regulations promulgated by the Department in D.P.U. 89-239 (1990) required a four-phase review of electric company energy resource selections. While the Department determined that electric company participation in the competitive solicitation was desirable, necessary, and consistent with the public interest, the Department was also very concerned with potential "self-dealing" – i.e., energy resource procurement decisions that unfairly favored projects proposed by the electric company, or by its affiliate, in the competitive solicitation process. Because of this concern, electric companies were required to file with the Department for review and approval the project selection criteria and ranking formula by which energy projects would be evaluated. 220 CMR 10.03 (1990). After the resource procurement RFPs were approved by the Department and issued by the electric company, competitive bids made by the "host company" were required to be submitted to the Department, under sealed bid, one day before all other bids were due. 220 CMR 10.04(2)(f) (1990). This requirement was intended to prevent the electric company from changing its bid(s) after reviewing the bids made by other participants. The application of the electric company's project evaluation criteria and formula, the selection of projects, and the execution of final contracts were also subject to Department review. 220 CMR 10.05 and 10.06 (1990). While the electric company was allowed to use its judgment and discretion in determining

which project proposals would result in the greatest net benefit to ratepayers, the electric company was also required to "demonstrate the reasonableness of its decision(s)...." 220 CMR 10.05 (2)(g) (1990).

The adoption by the Department of what appears to be an administratively burdensome review process was necessitated by the fact that electric companies and their affiliates were allowed to bid in their own competitive solicitations.[4] Had electric companies not been allowed to participate in their own competitive solicitations, multiple regulatory reviews promulgated by the Department in D.P.U. 89-239 (1990) would not have been necessary. Of course, the Department's integrated resource management process had serious flaws[5] that are addressed by the creation of a competitive generation service market. However, implementing a competitive generation service market in which unregulated generation affiliates are allowed to serve the customers of its regulated distribution affiliate creates similar "self-dealing" opportunities that the Department attempted to address in D.P.U. 86-36 and D.P.U. 89-239. Accordingly, WMECo affiliate participation as a contender in the Company's Standard Offer bidding process necessitates that the DTE carefully regulate the procurement process.

Because WMECo is not completely neutral to the success or failure of its generation affiliate, the procedure must be scrutinized for potential biases. Such biases could affect the outcome of the proposed bidding procedure in two fundamental ways. First, the true low cost/low risk provider(s) may not be identified and selected to supply Standard Offer service. Second, the presence of potential biases may discourage otherwise qualified suppliers from

---

[4] Another reason was to ensure that demand-side resources (i.e., conservation and load management resources) were evaluated on an equal footing with supply-side resources. However, the need for multiple reviews of the resource evaluation and selection process was driven by host company participation in the competitive solicitation.

[5] For example, the process relied on long-term forecasts of customer load, fuel costs, technology performance, etc. The process did not adequately shield utility ratepayers from the risk that actual events may turn out to be radically different than that assumed in these forecasts.

participating in the bidding process. While the first issue could be addressed to a degree through regulatory scrutiny of the application of the approved bidding process at the completion of the process (i.e., after the bids have been submitted, evaluated, and winners selected), the second issue is more insidious and cannot be effectively addressed through regulatory review of the process after it has ended.[6] Given the fact that WMECo is not a neutral party, the structure and potential application of the bidding procedure becomes more critical so as to encourage potential bidders to incur high opportunity costs associated with the substantial amount of time and effort needed to develop a competitive offer. In order to create a successful solicitation, the structure of the bid process, in practice as it is administered and in perception of bidders well before it begins, must be fair.

Q. **IS THERE ANYTHING ABOUT THE OVERALL STRUCTURE OF WMECO'S PROPOSED STANDARD OFFER PROCEDURE THAT CAUSES YOU TO BE CONCERNED? IF SO, PLEASE INDICATE WHAT CAN BE DONE TO ADDRESS YOUR CONCERNS.**

A. Yes. I have three concerns with the structure of WMECo's proposed solicitation procedure. These include:

1. **The Standard Offer bidding procedure, combined with WMECo's nuclear PBR proposal, creates an unfair opportunity for Northeast Utilities to earn returns in excess of those authorized by the DTE at the expense of the competitive market.**

The Standard Offer bidding procedure, when combined with WMECo's proposed nuclear PBR formula, is of great concern. According to the Company's nuclear PBR formula, WMECo would share with ratepayers – through the variable portion of the Transition Charge – 25 percent of the net profits or losses associated with the difference between going-forward revenues and going-forward costs.[7] If approved, the Company's PBR formula would be in

[6] It is difficult, if not impossible, to determine what might have occurred had the bid process been designed differently **B** e.g., been designed to be more fair to potential participants.

[7] WMECo also proposes that the "unavoidable" portion of going-forward costs be collected from ratepayers through the Transition Charge.

effect for the period prior to WMECo's divestiture of its share of the Millstone nuclear units. Before divestiture, the Company anticipates selling entitlements in the available energy and capacity from WMECo's nuclear units into the wholesale market. Unregulated affiliates of WMECo are free to purchase entitlements in energy and capacity from the Company's nuclear entitlements, and to use the energy and capacity to supply the Standard Offer. Allowing the Company (and Northeast Utilities) to retain 75 percent of nuclear generation revenues earned in excess of avoidable nuclear operating costs, and allowing the Company affiliates to buy WMECo nuclear entitlements and turn around and sell the generation back to WMECo Standard Offer customers creates several problems.

First, WMECo's proposal allows the Company to retain a majority of the profit associated with short-run sales of nuclear generation in addition to earning a full return of and on its undepreciated nuclear generation investment through the fixed portion of the Transition Charge. Given that WMECo proposes to recover a full return through the fixed portion of the Transition Charge, it is unreasonable to also allow the Company to retain the *additional* returns earned through short-run market sales of nuclear generation.

Second, and more importantly, the gains made by WMECo through the sale of nuclear entitlements to a Northeast Utilities generation affiliate enables Northeast Utilities to offer the nuclear generation back to WMECo Standard Offer customers at prices that other potential competitors cannot meet. For example, since the majority of the short-term profits associated with the purchase of nuclear energy and capacity are retained by the Company (in addition to returns on nuclear ratebase earned through the fixed portion of the Transition Charge), the unregulated generation affiliate could sell the acquired nuclear generation back to customers at no margin above cost. This gives Northeast Utilities, as a supplier of competitive services, a substantial competitive advantage over other potential competitors.

In addition, it is also possible for Northeast Utilities to earn net profits even if the Company's nuclear generation is sold back to Standard Offer customers at a price lower than

the price at which the nuclear entitlement was acquired by the unregulated affiliate. The earnings produced by WMECo's nuclear PBR formula, which allows WMECo to retain 75 percent of the revenues in excess of avoidable costs, could more than cover the price discount offered by the Company's unregulated generation supplier in the Standard Offer procurement process. Of course, Northeast Utilities has every incentive to set the Standard Offer price at levels exceeding the cost of acquiring the nuclear entitlement to the extent competitive conditions allow. In this instance, the Company would extract substantial margins from Standard Offer customers in three different charges for the same set of nuclear assets: (1) through the fixed portion of the Transition Charge, (2) through the nuclear PBR formula, and (3) through Standard Offer sales.

Accordingly, it is possible for Northeast Utilities to gain from the interaction between the Standard Offer bidding procedure and the nuclear PBR approach while effectively freezing out other competitors from (1) purchasing WMECo's entitlements, (2) supplying retail customers through the Standard Offer, and/or (3) supplying retail customers through offers that potentially compete with the Standard Offer.

Exhibits HYY-1 through HYY-5 include five different scenarios that illustrate how Northeast Utilities could gain from the interaction between its nuclear PBR formula and its Standard Offer bidding procedure. Using different combinations of nuclear entitlement acquisition costs and Standard Offer bid prices, my examples show that Northeast Utilities is able to harm both ratepayers and competitors under a wide range of bidding strategies.[8] According to my examples, Northeast Utilities could reap a net gain of between 3 to 12 mills per kWh, while preventing others from purchasing Millstone generation at its true wholesale market value and, simultaneously, retain most of WMECo's customers on the Standard Offer.

[8] These scenarios are not intended to show all of the potential ways in which this system could be gamed. Rather, they are intended to be illustrative.

The ability of Northeast Utilities to game the Standard Offer bid process in a variety of ways will necessarily discourage other knowledgeable competitors from participating in the bid process. A less than robust bid process is contrary to the Company's stated goals for this bid and contrary to ratepayer interests.

The simplest and most reliable solution to this structural problem is to prohibit an affiliate of WMECo from participating in the Standard Offer bid process.[9] Prohibiting WMECO affiliates from participating in the bid eliminates almost all of the potential problems associated with DTE review of affiliate transactions. In fact, prohibiting WMECo affiliates from participating in the Company's Standard Offer auction would address many of the other structural and procedural problems described herein. Disqualifying just one potential supplier from serving the Standard Offer would not appreciably impair the competitiveness of the market.

However, if WMECo affiliates are allowed to bid, safeguards must be built into the evaluation procedure to ensure that the Standard Offer process results in aggressive competition among qualified bidders, a fair evaluation of bid proposals, and the selection of the most beneficial proposal(s). Some potential solutions include:

1. Before divestiture, WMECo should not be allowed to sell their nuclear entitlements to WMECo affiliates.

2. If a WMECo affiliate wishes to use a WMECo-owned generation asset to serve the Standard Offer, the Company should be required to credit ratepayers through the Transition Charge all (i.e., 100 percent) of the going-forward profits earned from the sale of unit output.

---

[9] While affiliates of distribution companies are "eligible to participate in the competitive solicitation process" *with respect to the provision of default service* (See St. 1997, c. 164, § 193 (G.L. c. 164, § 1B(d)), that mandate does not apply to the provision of Standard Offer service with respect to the statute (See St. 1997, c. 164, § 193 (G.L. c. 164, § 1B(b)). Thus, it appears that the Department has the authority to exclude affiliates of distribution companies from the Standard Offer bidding process if the public interest so requires.

3. WMECo affiliates should not be allowed to bid WMECo-owned generation assets to serve Standard Offer loads. Once such units are divested, however, the Company's nuclear PBR mechanism expires and such units can be used to serve Standard Offer loads.

4. To the extent WMECo affiliates submit the best bids, WMECo affiliates should be allowed to serve only a portion of Standard Offer load. In other words, WMECo affiliates should not be allowed to serve more that a fixed portion – for example, not more than 40 percent – of Standard Offer load.

If WMECo affiliates are allowed to participate in the Company's Standard Offer bid, I prefer because of its simplicity Alternative 1 – i.e., WMECo should not be allowed to sell their nuclear unit entitlements to WMECo affiliates prior to divestiture.

Alternative 2 also deserves very serious consideration. Since WMECo's proposal would require all ratepayers to pay through the Transition Charge a return of and on the ratebase associated with the Millstone units, ratepayers should receive 100 percent of the going-forward profits earned from unit output regardless of who purchases the output. In addition, ratepayers should be shielded from any positive increases to Transition Costs if Northeast Utilities decides to operate the unit at a loss. Shielding ratepayers from potential going-forward losses is justified because of the returns on Millstone ratebase that ratepayers must pay through the Transition Charge, and because such a policy would give Northeast Utilities the incentive to run the plants in an economically efficient manner which would serve to mitigate stranded costs. I believe that going-forward profits through Millstone generation sales should be reflected in the Transition Charge since all ratepayers bear the capital cost of the Millstone units through the fixed portion of the Charge. Obviously, such a policy would radically change the PBR formula. Issues concerning the Company's nuclear PBR proposal will be addressed by another DOER witness.

Alternative 3 above requires more Department oversight. Under this alternative, a WMECo affiliate that acquires WMECo's nuclear entitlements, but is not allowed to use them

to supply the WMECo Standard Offer, requires the Department to review power sales contract paths in order to ensure that such entitlements were not being used to supply the Standard Offer, and that the cost of such contracts was being allocated to the appropriate purchasers. With respect to Alternative 4, the DOER sees some drawbacks in implementing a proportional limit to the amount of Standard Offer load that WMECo affiliates can serve. This is because such a policy only reduces the impact of the interaction between the Company's PBR formula and an affiliate's use of WMECo's nuclear generation to supply the Standard Offer – such a policy does not cure the fundamental defect. In order to address the structural deficiency in the Company's proposal, the link must be broken between the Company's PBR mechanism and the use by an affiliate of WMECo's nuclear generation to supply the Standard Offer.[10]

Given these complexities,[11] I prefer a simpler approach which would be to prohibit WMECo affiliates from purchasing WMECo nuclear entitlements prior to divestiture, or to prohibit WMECo affiliates from participating in the Standard Offer bidding process altogether.

2. The bidding procedure is biased towards bidders that own or have large entitlements to available generation for the entire period of the Standard Offer.

In order to conduct a solicitation that will generate a robust response from the market, WMECo asserts that the Company must be flexible in accepting a variety of proposals from

[10] As suggested above, another way to address this issue is to change the Company's nuclear PBR mechanism by modifying the benefits retained by the Company resulting from sales of nuclear entitlements into the market. However, this issue is not within the scope of my testimony and will be addressed by another DOER witness later in this proceeding.

[11] DTE review of contract paths or cost allocations associated with the wholesale generation supplier of WMECo's Standard Offer could raise jurisdictional issues. While the purchase of generation by a distribution company to serve retail loads is subject to state jurisdiction, oversight over the resources and costs associated with wholesale generation supply are typically under federal jurisdiction.

the market. While I agree with WMECo's objective, I do not believe that the four options provided by the Company in its proposed request for proposals accomplishes this objective. WMECo proposes that bids be submitted in accordance with the following options:

(1) Bundled Supply Option – an offer to serve the entire Standard Service load for the entire Standard Offer period;

(2) Base Load Standard Offer – the provision of firm energy, capacity and ancillary services, in not less than one megawatt increments, around the clock at a 100 percent load factor for the entire Standard Offer period;[12]

(3) Load Following Standard Offer – the provision of firm energy, capacity and ancillary services to meet WMECo's Standard Offer load obligations net of the energy provided by suppliers of Base Load Standard Offer service, if any, for the entire Standard Offer period; and

(4) Alternative Bidding Option – the provision of generation services to supply the Standard Offer load that does not conform to any of the above options including single year and partial load requirements.

In order to submit a bid under any of the first three options, the supplier must already own or have virtually guaranteed access to a substantial amount of existing capacity. Obviously, only a company with a supply portfolio the size of WMECo's or larger can supply Option 1. Under Option 2, bidders can bid one megawatt slices of power at a 100 percent load factor. While this implies that generation suppliers of different sizes may participate, most existing baseload capacity consists of larger plants – nuclear plants like the Millstone units for example. Thus, this option is biased towards those who have ready access to large amounts of baseload capacity such as Northeast Utilities. Only one "Load Following" service provider will be awarded a contract under Option 3. Accordingly, the bidder must have a substantial amount of available load following capacity in order to provide WMECo with

[12] In addition, the megawatts bid in any year must be greater than or equal to the megawatts bid in any subsequent year.

Option 3 service. All told, these options are biased in favor of large generation companies that have the capability to serve all or a substantial portion of WMECo's Standard Offer load.

This leaves only Option 4 as the potential means by which suppliers with smaller supply portfolios can participate in WMECo's Standard Offer bid. However, it is not clear how a single year bid, for example, submitted under Option 4 would be evaluated relative to multi-year bids submitted under the other options. WMECo's proposal does not adequately spell out how it would evaluate bids that provide electricity for only a subset of years relative to bids that provide electricity for the entire Standard Offer period. The only way bid proposals representing a period less than the Standard Offer period can effectively compete against bids submitted under any of the first three options is to assemble a sufficient number of Option 4 bids that supply the entire Standard Offer period. However, since the bidding system envisioned by WMECo allows only one round of bidding,[13] bidders under Option 4 have a very limited opportunity to formulate a consortium of bids that can effectively compete against Options 1-3. Accordingly, those using Option 4 do not appear to have a realistic opportunity to win the bid.

In order to correct the problems associated with Option 4, Option 4 should be structured in a manner which allows for multiple rounds of bidding (like an auction) which enables bidders to see other Option 4 bids. This would enable Option 4 bidders to react to problems in the collective Option 4 pool of bids. For example, if Option 4 bidders find that no one submitted a proposal covering one of the years in the transition period, such bidders

[13] Under the WMECo proposal, a supplier's initial bid is its last and final bid, unless WMECo specifically negotiates with the supplier to change its bid. According to the Company's proposal, such negotiations are completely at WMECo's discretion. This is in contrast to the system approved for use by Massachusetts Electric Company in which those choosing to participate in the alternative auction process are allowed to improve their bids based on the responses of other bidders.

should be given an opportunity to correct the deficiency in subsequent rounds of bidding.[14] This flexible auction structure was adopted in the Massachusetts Electric Company alternative Standard Offer bidding procedure.[15] I recommend that a similar structure be adopted here.

In addition, I presume that bidders can submit a Bundled Supply Option for only a proportion of Standard Offer load pursuant to Option 4. Assuming this to be the case, the large supplier bias associated with Option 1 is somewhat addressed. However, Options 1-3 are defined very precisely whereas Option 4 represents "non-conforming" proposals. While specific non-conforming proposals may be superior to others, they appear to be at a disadvantage relative to bids made pursuant to Options 1-3. It is preferable, therefore, to modify Option 1 itself in order to make it clear that bidders can propose a Bundled Supply that serves only a proportion of Standard Offer load. The proportion can include 100 percent.

Another solution to this issue would be to hold the Standard Offer bid more often than once for the entire transition period. For example, holding the bid on an annual basis eliminates the necessity for Option 4 bidders to anticipate potential deficiencies in power supplies in other years. However, holding an annual Standard Offer bid is likely to be burdensome from an administrative perspective. Holding the bid every two to three years (i.e., holding the bid once every two years which divides the transition period into three, two-year periods, or holding the bid once every three years which divides the transition period into two, three-year periods) is more feasible from an administrative perspective and addresses some of the structural deficiencies in WMECo's Standard Offer bidding procedure. Holding the bid more often also addresses the issue of risk – this will be addressed in more detail in the next section of my testimony.

---

[14] Of course, changes to bids previously submitted can be made only if they improve the bid.

[15] I assisted the DOER in negotiations with Massachusetts Electric Company with respect to the development of this flexible auction structure.

3. **Holding only one bid to determine the supplier(s) of Standard Service for the remaining Standard Offer period places great risks on the supplier(s) of such service and on the customers of the Company.**

According to WMECo's proposal, the Standard Offer would be procured all at once, barring default of Standard Offer providers, for the remaining Standard Offer period. In addition to biasing the selection process in favor of those who already own substantial entitlements to existing generation capacity, a once and for all bidding procedure places great risks on the supplier(s) of such service and could discourage otherwise qualified bidders from participating in the process. In order to address these risks, suppliers must hedge their offer which could result in bid prices exceeding the actual market price of power for certain periods of time. If Standard Offer providers increase their bids relative to expected future market prices in order to hedge against the risk of higher than expected market prices, the cost of Standard Offer service would end up being higher relative to expected market prices. In my opinion, that outcome is likely.

If the price of Standard Offer service reflected supplier bids, customers would have the incentive to leave the Standard Offer once its price became higher than the market price. However, WMECo proposes that the price of Standard Offer service be based on a fixed schedule, starting at 2.8 cents per kWh in 1998, which bears no relationship to prices bid by Standard Offer suppliers, nor to current market prices. Thus, customers have no incentive to leave the Standard Offer even if the cost of providing such power is higher than the current market price.[16] In addition, the Company proposes to defer, securitize, and recover through future Transition Charges (with interest), any difference between the revenues charged to Standard Offer customers and the costs associated with Standard Offer supply. Such

[16] Customers have the incentive to leave the Standard Offer once its price exceeds the market price.

Transition Charges cannot be bypassed and would be collected from all customers, including those who did not consume Standard Offer power. Since the Standard Offer price is expected to be lower than the market price for a number of years, customers are denied a price signal that would otherwise give them the incentive to seek alternatives to the Standard Offer. This increases the level of Standard Offer deferrals which would eventually be passed on to all ratepayers through the Transition Charge.

This situation is exacerbated by the uncertainties and the inexperience all players have with respect to the newly restructured electric industry. Indeed, other states in the region have not yet allowed their constituencies to choose their generation service provider. Given that we are still in a shake out period with respect to the restructured electricity market, it is reasonable to limit the risks to which suppliers and customers are exposed to the extent possible. By requiring a once and for all bid covering the period of greatest uncertainty, however, WMECo's proposal unnecessarily exacerbates the risks borne by Standard Offer generation suppliers, and the risk of higher Transition Charges at the end of the transition period caused by additional cost of deferrals.

As mentioned earlier, the obvious solution to this structural problem is to hold the Standard Offer bid more often. I recommend that the Standard Offer be put out to bid once every two to three years. Holding the Standard Offer bid on a more periodic basis reduces risks to both suppliers and consumers, and addresses some of the problems concerning bid Option 4. If the Standard Offer bid is held less frequently than every year, I also recommend that a more flexible auction system be adopted such as the system adopted by Massachusetts Electric Company which allows for multiple rounds of bidding as described above.

Q. **YOU IDENTIFIED THE STRUCTURAL PROBLEMS ASSOCIATED WITH WMECO'S STANDARD OFFER PROCUREMENT PROPOSAL. PLEASE IDENTIFY ANY SPECIFIC PROCEDURAL PROBLEMS YOU HAVE WITH THE COMPANY'S PROPOSAL.**

A. There are several specific procedural problems with WMECo's proposal. Correcting these procedural problems does not address the structural problems mentioned previously. For example, having a neutral, third party evaluate all bids does not address the problems created by the interaction between the Company's proposed nuclear PBR mechanism and the Standard Offer procurement process. However, once the fundamental structural problems have been corrected, other problems must be addressed including the following:

1. **The role that third party observers play in the bid evaluation process is unclear.**

Because WMECo is not a neutral party with respect to the outcome of the Standard Offer procurement process, the Company proposes that third party observers be part of the proposal evaluation process. According to the WMECo proposal:

> [t]o facilitate the participation of a neutral observer, the Company has retained the firm of Rumla, Inc. of Walnut Creek, California, an independent third party to help in the selection of the Standard Offer Service supplier(s).... In addition, WMECo is open to the involvement of another neutral observer in the evaluation process of the submitted proposals who represents the concerns of the Attorney General Office, the Division of Energy Resources, and the DTE.

However, it is not clear what role these observers will have in the process. For example, will the bids be independently evaluated by Rumla with no substantive input from WMECo, or are the bids going to be evaluated by WMECo? If evaluated by WMECo, what role does an observer like Rumla (or for that matter, the Attorney General, DOER, and the DTE) play in the process? What do the observers get to observe and how will their concerns be addressed in the process?

The role of the third party observer in the bid evaluation process must be sufficiently well defined and substantive. To the extent WMECo affiliates are allowed to participate in

the bidding process, I recommend that an independent and neutral third party be used to evaluate all Standard Offer bids independently of WMECo ("bid evaluator"). The selection of the bid evaluator should be mutually agreeable to the Company, the Attorney General, the DOER and the DTE.[17] Once the bid evaluator completes its evaluation of Standard Offer bids, it should submit a report simultaneously to the Company, the Attorney General, the DOER, and the DTE, which includes the bid evaluator's Standard Offer supply recommendations.[18] After reviewing the report and its recommendations, the Company should file a petition with the DTE for review and approval of WMECo's selection of Standard Offer generation suppliers. If the Company's selection differs from the recommendations made by the bid evaluator, the Company must justify its recommendations. Such a procedure would be more conducive to a fair bid evaluation process.

2. **The bid procedure must be structured to exclude the possibility of WMECo affiliates having access to commercially sensitive materials submitted to WMECo by competitors, and to exclude the possibility of WMECo affiliates changing their bids after the due date.**

WMECo's proposal does not provide for a procedure that guarantees the confidentiality of commercially sensitive materials, especially with respect to disclosures to WMECo's unregulated affiliate, and does not provide for a procedure that will eliminate the hypothetical possibility of WMECo's affiliate changing its bid after the due date. To address these issues, several safeguards must be put in place. First, using an independent, neutral third party to evaluate bids as described above will better ensure that commercially sensitive materials will be kept out of the hands of potential competitors. Second, all parties having access to commercially sensitive materials, including bid evaluators and government parties, should sign a binding nondisclosure agreement.

---

[17] To the extent the parties cannot come to a mutual agreement, the DTE would make a final determination.
[18] Commercially sensitive material used by the bid evaluator would not be submitted as part of this report.

If an independent, neutral third party is used to evaluate bids, including the bids of Company affiliates, all such bids could be filed with the bid evaluator by the same due date. If an independent, neutral third party is not used to evaluate bids, bids by WMECo affiliates should be filed with the DTE in a sealed envelope a day before all other bids are due, and would be opened only to verify the authenticity of the affiliate's bid if it happened to win the solicitation. Unfortunately, such a procedure does not address the possible use of commercially sensitive material by a WMECo affiliate in future dealings.

3. **It is not clear how risks will be evaluated relative to other bid attributes such as price.**

WMECo plans to evaluate bid proposals through a combination of three methods. WMECo plans to compare competing bids in terms of:

1) total NPV cost of service for the entire transition period,
2) year-to-year cumulative annual present values of the cost of service, and
3) the relative risk associated with each bid in relation to price and load forecast uncertainties.

While the first two methods are quantitative and seemingly straightforward, it is unclear how the Company plans to integrate the three methods to determine the best bids.

More crucially, it is unclear how the Company plans to evaluate the risk associated with each bid. Elements of risk are sometimes subjective and not easily quantifiable. While it is important to evaluate the relative risks associated with each proposal, any element of subjectivity or judgment exercised by WMECo in the evaluation process could be called into question, especially if an affiliate of WMECo participates in the bid. I suggest that WMECo be more explicit with respect to how risks ought to be assessed and incorporated into the bid evaluation process.

4. **The RFP gives WMECo too much discretion with respect to rejecting any bid for any reason, or to change the RFP requirements unilaterally.**

According to the first page of the Draft Request for Proposals to Provide Standard Offer to Customers of Western Massachusetts Electric Company, August 1998,

> WMECo expressly reserves the right to disregard any submission, to seek clarifications of any submissions, to negotiate modifications to any submissions, to unilaterally change the requirements of this RFP, including the solicitation schedule, to withdraw its plans for the solicitation process as described herein, and to invite or exclude any respondent to this RFP ("Respondent") seeking to participate in the solicitation as WMECo sees fit.

It is essential for evaluators of Standard Offer proposals to receive all relevant information which would allow the evaluators to review all bids on an equal footing, and to ensure that all bidders are responsive to bid requirements. However, WMECo's proposed RFP allows the Company to reject any bid for any reason, negotiate changes to particular bids after observing the bids of all others, and to change the RFP requirements (including the evaluation criteria) after they have been published. This unmitigated degree of discretion is particularly worrisome given that WMECo could use its discretion to improve the relative standing of bids submitted by an affiliate.

Accordingly, the language should be modified to spell out the conditions by which bids can be disqualified, changes to bids allowed, and changes to RFP criteria made. For example, bidders should be disqualified if their proposal is deficient, or if the bidder is unresponsive to reasonable requests for information needed to evaluate the bid proposal (of course, such requests should be equally applicable to all proposals). In addition, only the best two or three proposals in each bid Option category as identified in the initial bid evaluation round should be allowed to negotiate to improve their proposal, if at all. Finally, changes to RFP criteria should be subject the DTE approval before implementation. Such safeguards would better

ensure a fair bid evaluation process if WMECo affiliates are allowed to participate in the Standard Offer solicitation.

Q. **DOES THIS CONCLUDE YOUR DIRECT TESTIMONY ON THE COMPANY'S PROPOSED STANDARD OFFER PROCUREMENT PROCEDURE?**

A. Yes.