

READ AND LANIADO, LLP

ATTORNEYS AT LAW
25 EAGLE STREET
ALBANY, NEW YORK 12207-1901

(518) 465-9313 MAIN
(518) 465-9315 FAX

KEVIN R. BROCKS
CRAIG M. INDYKE
DAVID B. JOHNSON
SAM M. LANIADO
HOWARD J. READ

JEFFREY B. DUROCHER
STEVEN D. WILSON

RICHARD C. KING
OF COUNSEL

Via Hand Delivery

October 25, 2005

Mr. John W. Boston
Chairman of the NYISO Board of Directors
c/o Mr. Mark S. Lynch
President and CEO
New York Independent System Operator, Inc.
3890 Carman Road
Schenectady, NY 12303

Re: Appeal of Management Committee's Rejection of Motion to Apply a 3% Annual
Inflation Component to Voltage Support Service Rate

Dear Chairman Boston:

Pursuant to the Procedural Rules for Appeals to the ISO Board, please find enclosed an original and three copies of Independent Power Producers of New York, Inc.'s ("IPPNY") appeal of the Management Committee's October 11, 2005 decision to reject Motion 6a, which recommended that the Board support a tariff filing at the Federal Energy Regulatory Commission that would, among other things, apply a 3% annual inflation component to the base costs to adjust the base costs for inflation costs in 2004 and 2005 in calculating the rate for voltage support service in Rate Schedule 2 of the NYISO Services Tariff for the 2006 calendar year. A copy of the enclosed Notice of Appeal has been delivered to Diane Egan today for circulation to all members of the Management Committee via electronic mail.

IPPNY respectfully requests that it be given the opportunity to present oral argument before the Governance Committee with respect to this appeal.

Very truly yours,

David B. Johnson

Enclosures

cc: Diane Egan, via e-mail
Robert Fernandez, Esq., via e-mail
Carl Patka, Esq., via e-mail
Brad Kranz, via e-mail

NOTICE OF APPEAL

Independent Power Producers of New York, Inc. (“IPPNY”),¹ acting through its members on the New York Independent System Operator (“NYISO”) Management Committee, hereby appeals the Management Committee’s October 11, 2005, rejection of Motion 6a.² Motion 6a recommended that the NYISO Board of Directors (“Board”) support a tariff filing at the Federal Energy Regulatory Commission (“FERC”) that would, among other things, apply a 3% annual inflation component to the base costs to adjust the base costs for inflation costs in 2004 and 2005 in calculating the rate for voltage support service (“VSS”) in Rate Schedule 2 of the NYISO Market Administration and Control Area Services Tariff (“Services Tariff”) for the 2006 calendar year (the “Inflation Component”).

IPPNY respectfully requests that, at a minimum, the Board direct the NYISO to file necessary tariff amendments with FERC that would apply the Inflation Component to the VSS rate for implementation in 2006. Immediate action is necessary because if nothing is done by December 31, 2005, the existing VSS rate expires. The existence of voltage problems identified in the NYISO’s recently issued draft CRPP Reliability Need Assessment (“RNA”) indicates that a reactive power compensation plan is urgently needed to incent suppliers to provide critically needed VSS to maintain system reliability. NYISO staff has supported the Inflation Component as one enhancement to the VSS rate to help assure reliability and Mr. Mark Younger shows in his attached affidavit that the Inflation Component is reasonable.

¹ IPPNY is a not-for-profit trade association representing more than 100 companies involved in the development and operation of electric generation facilities and the marketing and sale of electric power in New York.

² IPPNY member KeySpan-Ravenswood, LLC does not join in this appeal.

APPLICATION OF THE INFLATION COMPONENT IS JUSTIFIED AND LONG OVERDUE.

There is no dispute that VSS is a critical ancillary service that supports both the New York bulk power system and lower voltage systems. As indicated by the voting on Motion 6a and the two alternative motions, 6b and 6c, the primary dispute is whether the single, cost-based rate of \$3919/MVAr per year, which has been in place since 2002, adequately compensates suppliers for providing VSS. Load interests seek to avoid any increase in the VSS rate and claim, without any basis, that further studies are needed before the NYISO decides whether to apply the Inflation Component. A brief review of the long history of attempts to enhance the VSS program, the analysis supporting the Inflation Component, and the NYISO's urgent call for increased VSS demonstrates that further delay of the application of the Inflation Component is not only unreasonable but imprudent.

When the NYISO commenced operations in 1999, the Services Tariff required the NYISO to pay suppliers for VSS pursuant to a formula that relied, in part, upon the submission of FERC Form 1 data or its equivalent. However, as explained by the NYISO in a filing subsequently submitted to FERC seeking to revise Rate Schedule 2 of its Services Tariff ("2001 VSS Filing"),³ reliance on FERC Form 1 data was an artifact of vertically integrated utility operations. Merchant generators did not then and do not now compile FERC Form 1 data, so the NYISO proposed to pay suppliers based on a pre-established per MVAr rate that was applicable to generating units that had been owned by vertically integrated utilities.

To derive the per MVAr rate, the NYISO used the total annual cost for VSS included in the FERC approved Open Access Transmission Tariff filings that had been submitted by the New York

³ See FERC Docket No. ER02-617-000, New York Independent System Operator, Inc., "Filing of Amended Rate Schedule 2 for Market Administration and Control Area Services Tariff, to Provide Payments for Voltage Support Service, and Request for Expedited Action, and Request for Ratification of Prior Payments" (December 27, 2001).

transmission owners (“TOs”) when they owned the generating facilities. The NYISO divided this cost by the gross MVAR output of reactive power that could be expected from this generation capacity. The resulting payment level, \$3919 per MVAR, was made to suppliers for their lagging capability measured on a gross output basis. In its 2001 VSS Filing, the NYISO committed to work with Market Participants to “evaluate alternatives that might be used to pay for the needed supply of Voltage Support Service in 2003 and beyond.”⁴ The VSS rate was made effective for one year.

Due to limited resources to address voltage issues, the NYISO applied the same \$3919 per MVAR rate to pay suppliers for voltage in 2002, 2003, 2004 and 2005. Each time a tariff filing was made by the NYISO to extend the existing rate for a one year period. Over this time period, the NYISO expressed concern with New York’s ability to maintain adequate voltage levels. In early 2004, based on study results investigating why system voltage levels were lower than predicted by system study models during summer peak loads in 1999, 2001 and 2002, the NYISO proposed a series of enhancements to the VSS rate.⁵ Because these proposals could not be fully developed through the stakeholder process in time to be implemented by January 1, 2005, the Management Committee conditioned the extension of the \$3919/MVAR rate for 2005 upon the NYISO’s commitment to develop further enhancements with Market Participants by the end of the first quarter of 2005.⁶

In its filing to FERC to continue the \$3919/MVAR rate into 2005, the NYISO stated it committed to report to its Market Participants on the cost impacts, testing and scope of enhancements to the VSS rate by the end of the first quarter of 2005 and, if warranted, to file tariff revisions to implement changes as early as mid-2005. In its December 28, 2004 letter order accepting the NYISO’s filing,

⁴ *Id.* at 7.

⁵ *See*, New York Independent System Operator, Inc., September 23, 2004, Operating Committee Meeting Materials, “Operations Reactive Studies.”

⁶ *See* October 1, 2004 Management Committee Meeting, “Motion From The Meeting,” Motion #1.

FERC recognized the importance of adequate voltage support on the New York system and directed the NYISO to file an informational report by April 30, 2005, to keep FERC up-to-date on either the NYISO's plans to implement VSS enhancements or the reasons it did not plan to make changes.

Beginning in January, 2005, the NYISO met with stakeholders to discuss proposals for enhancing the VSS program. During these meetings, Market Participants identified a series of changes that could be addressed in the short term as well as an additional set of issues that required more extensive changes to the VSS market and hence were longer term in nature. After learning the position of each Market Participant and hearing extensive debate among Market Participants at Market Structures Working Group ("MSWG") meetings, the NYISO came forward with a proposal to resolve the open short-term issues.

At a MSWG meeting held on April 12, 2005, the NYISO proposed to update the VSS compensation rate by (i) updating costs associated with generation additions and retirements; (ii) modifying the rate to reflect a change from a gross to net MVAr compensation basis; and (iii) applying a 3% annual inflation factor compounded across the four years in which VSS suppliers faced inflation costs.⁷

Load interests challenged the reasonableness of the NYISO's proposed 3% annual inflation factor but failed to provide any analysis of their own to counter the NYISO's proposal and support their arguments. The load interests also failed to explain why they did not object to the application of a 3% annual inflation factor for updating the ICAP demand curves (used to calculate a levelized carrying cost for the proxy gas turbine over a 20-year period), which has a much greater cost impact on load than the VSS Inflation Component, but object to applying the 3% annual VSS Inflation Component compounded

⁷ See, http://www.nyiso.com/public/webdocs/committees/bic_mswg/meeting_materials/2005-04-12/2005-04-12_vss_update_mswg_r1.pdf.

over a two (2) year period in updating the VSS rate.⁸ Load interests also argued that if the NYISO were to update the VSS rate to account for inflation, it also must reflect the impact of depreciation on the VSS rate. Load interests requested that VSS suppliers address these issues.

In its information report filed with FERC on May 2, 2005, the NYISO noted that all parties agreed that the current rate of \$3919/MVAr is based on cost information that is out of date but that stakeholders could not agree on a methodology for updating the rate. The NYISO stated that it intended to continue discussions with stakeholders on the rate during the second quarter of 2005.

During the discussions that took place following the NYISO's May 2, 2005 information report, Mr. Younger reported on a technical analysis of the reasonableness of the Inflation Component. Mr. Younger's analysis is summarized in the attached affidavit. In response to the depreciation issues raised by some load interests, Mr. Younger's attached affidavit demonstrates that depreciation is already taken into account in the initial setting of the VSS rate so no offset to account for this factor is warranted. Moreover, Mr. Younger's analysis reveals that the Inflation Component is justified.

Mr. Younger's analysis of the appropriate inflation factor was discussed at several meetings, including meetings of the NYISO's MSWG, Business Issues Committee and Management Committee. While some load-oriented Market Participants have continued to object to Mr. Younger's inflation analysis during those meetings, no party has provided any analysis to support either an alternative inflation rate or the position that VSS costs are somehow not subject to inflation. As a result, deadlock was reached; no motion was able to satisfy the 58% threshold required for passage.

⁸ During deliberations on the VSS rate for 2006 at the September 21, 2005 BIC meeting, a motion to adopt revisions to the VSS program that included the 3% annual inflation component compounded over a four year period beginning in 2002 was defeated (Motion # 2). A subsequent motion offered by one of IPPNY's members proposed, as a compromise, that an inflation component of 3% per year for only the years 2004 and 2005 be included in the 2006 VSS rate. This compromise motion was also defeated (Motion #3). In an effort to continue to arrive at consensus, only the compromise motion that included a 3% inflation component for two years was presented to the Management Committee, where it again was defeated. This Appeal again seeks to have the compromise inflation factor adopted by the Board.

Further delay of the application of the Inflation Component is not only unreasonable but imprudent. The NYISO's recently issued draft RNA explains that load growth in SENY, with the minimal addition of approximately 1250 MW of net new generating capacity in that area over the last ten years, has led to increasing demands on the transmission system to meet capacity and energy needs in SENY. The draft RNA cautions that the increasing demands placed on the transmission system in conjunction with other system changes, such as generating unit retirements and neighboring control area system changes, will result in violations of voltage (reliability) criteria at much lower transfer levels than previously observed. The result is that transfers into SENY will be limited by voltage constraints rather than the thermal limits of transmission lines. The draft RNA concludes that the reduced capability to make power transfers to SENY and continuing load growth in SENY results in resource adequacy criteria violations as early as 2008, not to mention the impact on energy prices of reduced transfer capability.

The draft RNA also concludes that the TOs in SENY will need to develop regulated backstop solutions to address this reactive compensation need, which has been characterized by the NYISO as an estimated minimum of 1000-1500 MVARs of both static and dynamic compensation on the bulk and non-bulk transmission system. In addition, the TOs may need to reconfigure transmission facilities to eliminate critical contingencies that result in voltage constraints.

At a time when the market should be signaling the increasing value of VSS to address the pressing need to eliminate voltage constraints, the Management Committee's rejection of the application of the Inflation Component is a major step backwards from reasonable and prudent system planning and market design. It is the wrong time to be sending signals that VSS is not a valuable service by continually decreasing, in real terms, the compensation paid to those providing, or making investment decisions in new facilities that may be capable of providing, voltage support service.

It would be equally ill-advised for the Board to fail to endorse the Inflation Factor and fail to file to extend the VSS compensation as reflected in motion 6a or to ask Market Participants to spend additional time trying to reach resolution of these issues themselves. On January 1, 2006, there will no longer be a VSS rate in place in New York absent Board action. The Market Participants have spent the better part of a year trying to resolve these issues to no success. Market Participant positions are well known and have been unchanging for some time now. More time is highly unlikely to yield a resolution and, in fact, only will serve to penalize VSS suppliers while more discussions proceed.⁹ The Board simply cannot allow such a result to occur, particularly given the acknowledged and growing importance of this service.

CONCLUSION

In light of the foregoing, IPPNY respectfully requests that the Board direct the NYISO to file necessary tariff amendments with FERC that would apply the Inflation Component to the VSS rate for implementation in 2006.

Respectfully submitted,

READ AND LANIADO, LLP
25 Eagle Street
Albany, New York 12207
(518) 465-9313 (tel)
(518) 465-9315 (fax)

Attorneys for
Independent Power Producers
of New York, Inc.

By: _____
David B. Johnson

Dated: October 25, 2005
Albany, New York

⁹ Indeed, to do so may very well set a troublesome precedent. Suppliers alone cannot accumulate the 58% vote that is needed to pass a motion as the total vote allocated to the generator and other supplier sector is limited to a total of 43%. Based on this precedent, loads may take the approach that they will not agree to any change that will cost dollars knowing that, at worst, a delay financially works in their favor and against the needs of suppliers.

AFFIDAVIT OF MARK D. YOUNGER

Mark D. Younger, having been duly sworn, deposes and states as follows:

1. My name is Mark D. Younger. I am employed as Vice President of Slater Consulting. My business address is 69 Werking Road, East Greenbush, New York 12061. My resume is available upon request.
2. I write this affidavit in support of the Appeal of Independent Power Producers of New York, Inc. (“IPPNY”) of the NYISO Management Committee’s (“MC”) rejection, on October 11, 2005, of Motion 6a. Motion 6a recommended that the NYISO Board of Directors (“Board”) support a tariff filing at the Federal Energy Regulatory Commission (“FERC”) that would, among other things, apply a 3% annual inflation component to reflect inflation costs in 2004 and 2005 in calculating the rate for voltage support service (“VSS”) in Rate Schedule 2 of the NYISO Market Administration and Control Area Services Tariff for the 2006 calendar year (the “Inflation Component”).
3. I was asked to evaluate the reasonableness of the suppliers’ proposal to seek an Inflation Component. My analysis, which is described in detail below, indicates that such an Inflation Component is easily justified. A copy of the presentation I made to both the Business Issues Committee (“BIC”) and the MC may be found on the NYISO’s website under the September 21, 2005 BIC meeting materials.
4. To address the need to account for inflation in setting the VSS rate I first looked at the underlying components of the cost based methodology for determining VSS payments that was included in the NYISO’s original tariff.
5. That methodology relied upon allocating the capital costs maintenance costs from specified FERC Form 1 accounts or their equivalents.
6. The capital costs were based upon the gross investment costs generally associated with turbogenerator units and accessory electrical equipment.
7. These costs in these accounts increase over time as a result of (i) generator maintenance and major overhauls; and (ii) O&M costs for supervision and engineering.

8. Turning first to the capital costs, to estimate how much the capital costs associated with VSS service would change from year to year I reviewed the cost data for fossil steam units in the New York Investor Owned Electric Utilities (“IOUs”) FERC Form 1 filings from 1990 through 1994. I used data from the fossil steam units because they were the largest category of generation that was owned by the IOUs at the time. I chose data from the early 1990s because there were no significant new plants added, nor plants retired, in these years and therefore it was possible to determine how the costs would increase for a broad enough selection of units to serve as an average value.
9. The results of my analysis were that the turbogenerator account cost increased by 3.13% per year while the accessory electric equipment account increased by an average of 1.18% per year. Inflation was 3.20% during this time period. The cost of the turbogenerator account is more significant in determining the final rate. Therefore the inflation impact on the capital costs for existing individual units is only slightly below inflation.
10. Turning next to the O&M cost components, the accounting determination of VSS costs includes O&M costs for supervision and engineering. These costs rise with the cost of labor. The compensation inflation rate for private industry for the past 6 years has averaged 3.88% per year while inflation over the same time period has been approximately 3% per year.
11. A final factor in the NYISO’s current voltage support payment rate is that the rate is an average rate applied to all units. This rate was developed from the New York Utilities FERC approved charges for Voltage Support Service in their individual OATTs preceding the NYISO commencing operation.
12. Over time older units with a generally lower accounting determined VSS costs retire and new units with higher accounts costs for VSS support are added. As this transition occurs it causes the average cost across all units to increase.
13. Load on the NYISO system is growing at approximately 1.4% per year. The retirement rate since the NYISO began operating through 2008 (the last year with reliable announced retirement plans) is

approximately 1% per year. Consequently, new generation needs to be added at approximately 2.4% per year to cover load growth plus generation retirements.

14. The annual increase in the average rate to represent new units replacing older units and meeting load growth is upwards of 1% per year.
15. The inflation on existing unit capital and maintenance costs and the transition impact on the average rate are additive.
16. The combined impact justifies including a 3% per year inflation factor on the VSS rate that is paid to generators.

Mark D. Younger

Sworn to before me this
day of October, 2005.

Notary Public