

January 12, 2004

TO: John Buechler - New York Independent System Operator

FROM: Tom Rudebusch, for the New York Municipals

RE: *Initial Comments on Cost Recovery and Cost Allocation Issues*

On December 29, 2003, the NYISO requested comments on certain cost recovery and cost allocation issues related to electric system upgrades needed for reliability purposes. The following are the initial comments of certain New York Municipal Electric Utilities.

COST RECOVERY

Whether the NYISO Tariff should be the vehicle for TO=s cost recovery for future regulated reliability upgrades?

The NYISO Tariff is (and should be) the vehicle for the Transmission Owners to recover the costs associated with future regulated reliability upgrades. Under the NYISO OATT, Section 15.4 addresses the obligation of a Transmission Owner to expand the system for a firm point-to-point transmission customer:

The Transmission Owner, at the ISO=s request, will use diligence to expand or modify its applicable portion of the NYS Transmission System to increase Transfer Capability, provided the Transmission Customer agrees to compensate the Transmission Owner for such costs pursuant to Section 27.¹

¹ The NYS Transmission System is defined as the entire NYS system, including facilities under the NYISO=s control and all remaining transmission facilities.

For its part, Section 27.0 of the NYISO OATT states that: A... the Transmission Customer shall be responsible for such costs to the extent consistent with Commission policy.@ The NYISO OATT relies on FERC policy to determine how the transmission customer is responsible for the cost of new facilities. The FERC=s clear and long-standing policy is that the cost of network upgrades must be rolled-in to transmission rates: in other words, included in the transmission owner=s revenue requirement and allocated to all transmission customers.

The FERC expressly prohibits Aand@ pricing, whereby a transmission customer is responsible for a transmission rate for service *and* for the incremental cost of new facilities. *See Inquiry Concerning the Commission=s Pricing Policy for Transmission Services Provided by Public Utilities Under the Federal Power Act, Policy Statement, FERC Statutes and Regulations, Regulations Preambles 1991-1996 &31,005, at p. 31,146 (1994) (hereinafter APricing Policy@).*

The Commission will permit Aor@ pricing, where a customer is assessed the higher of the incremental cost of an upgrade or the transmission rate, but not both. Another method is to get a transmission credit on charges based on the up-front cost of new facilities. There is a narrow exception to the general policy that allows direct assignment of the costs of facilities that are Anot integrated@ with the grid, for example, radial lines or controllable merchant facilities.

Whether the NYISO Tariff should also include recovery for non-transmission solutions to reliability needs?

The NYISO Tariff does not (and should not) include cost recovery for non-transmission solutions to reliability needs in transmission rates. Separate treatment is required for costs recovery for non-transmission solutions.

NYISO or TOs (or both) to file for recovery under NYISO OATT?

The NYISO Tariff provides that Transmission Owners file for recovery of transmission costs under the Transmission Service Charge (ATSC@). The NYISO does recover its transmission-related costs under the NYISO OATT.

The New York Municipals are willing to consider cost recovery filings by the NYISO to the extent the NYISO installs and owns transmission facilities.

Whether cost recovery should be divided between the NYISO Tariff and TO=s retail tariffs and, if so, how?

Cost recovery is (and should be) divided between the NYISO Tariff and retail tariffs. Transmission Customers under the NYISO OATT should pay an appropriate allocation of the Transmission Owner=s transmission revenue requirement; retail customers should the remainder. The New York Municipals strongly believe in comparable treatment for all transmission users.

PSC vs. FERC roles in providing cost recovery?

FERC regulates cost recovery under the NYISO OATT, and FERC should make sure that Transmission Customers under the NYISO OATT do not pay more than their fair share of the costs to the Transmission Owners of providing transmission service. The PSC should make sure that retail customers contribute their fair share to the Transmission Owners= transmission revenue requirement.

In the context of FERC=s Wholesale Market Platform, FERC sees a role for Regional State Committees (ARSC@). FERC commissioners have indicated that they could be favorable to regrading the PSC as the RSC for the NYISO. To the extent the PSC, acting as a RSC, sanctioned the need for a reliability upgrade, FERC has indicated they would respond favorably to including the appropriate costs in FERC-jurisdictional transmission rates.

Whether incentives should be provided for construction of regulated reliability upgrades?

The New York Municipals oppose additional incentives for construction of regulated reliability upgrades. The parties should be aware that the FERC has set for hearing PJM=s Regional Transmission Expansion Plan on the issue of whether the Transmission Owners over-recovery when incentive rates are proposed and the Transmission Owner has pre-existing rates for transmission. *See Allegheny Power System, et al.*, 106 FERC & 61,003 (January 2, 2004).

COST ALLOCATION

Determination of Abeneficiaries@ of reliability upgrades?

The beneficiaries of reliability upgrades are all wholesale and retail customers served by a Transmission Owner, which is a corollary of the rolled-in approach to pricing. The United States Court of Appeals has stated that: AFERC favors rolled-in cost allocation where a system is integrated.@ *Sierra Pacific Power Co. v. FERC*, 793 F.2d 1086, 1088 (9th Cir. 1986). The Court goes on to say that AFERC=s policy of rolling-in transmission costs in integrated systems is apparent from even a cursory examination of FERC and judicial decisions.@ *Id.* at 1089-90, *citing Otter Tail Power Co.*, 12 FERC & 61,169 (1980), among other cases.

The *Otter Tail* case is related to the Supreme Court case in which the Court found that it was a violation of the antitrust laws for a power company to refuse to provide transmission service to municipalities which were establishing electric systems. *Otter Tail Power Co. v. United States*, 410 U.S. 366 (1973). On remand, the Commission had to determine an appropriate transmission rate, and it approved a rolled in cost allocation:

Commission precedent strongly favors use of the rolled-in method of transmission allocation. Given a finding that the system operates as an integrated whole, transmission

costs have generally been rolled-in, absent a finding of special circumstances. The principal reason behind adoption of this methodology is that an integrated system is designed to achieve maximum efficiency and reliability at a minimum cost on a system-wide basis. Implicit in this theory is the assumption that all customers, whether they be wholesale, retail or wheeling customers, receive the benefits that are inherent in such an integrated system.

12 FERC at 61,420, *citations omitted*.

Even if the new facilities would not be installed *Abut for@ a particular customer=s* request for service, the additional facilities are part of a system expansion used by and benefitting all users due to the integrated nature of the grid. Regardless of the reason for the system upgrade, all costs incurred on the network are prohibited from direct assignment. *Entergy Gulf States, Inc.*, 99 FERC &61,095, at p. 61,399; *Consumers Energy Co.*, 95 FERC &61,233, at p. 61,804 (2001); *Public Service Co. of Colorado*, 59 FERC &61,311 (1992); *reh=g denied*, 62 FERC &61,103, p. 61,061 (1993). While parties may have an interest in asserting that they should not pay for the cost of certain facilities because they were not needed *Abut for@ another customer=s* request, FERC=s Pricing Policy prohibits *Aand@ pricing*.

Benefits to be based on reliability criteria?

See previous answer.

ARegional@ vs. Alocal@?

The New York Municipals oppose a voltage cut-off to determine regional versus local benefits. They propose a functional test: facilities are included where they assist in carrying power from points of supply to Load Serving Entities at points of delivery. This is consistent with FERC policies.

The New York Municipals remind the parties that the FERC has expressly found that Niagara Mohawk=s transmission facilities include all facilities from 345 kV to 23 kV. *See Niagara Mohawk Power Corp.*, 42 FERC & 61,143 (1988). In that case, Niagara Mohawk argued to the administrative law judge that there should be a separate allocation for facilities below 115 kV. *Niagara Mohawk Power Corp.*, 33 FERC & 63,002 at 65,021 (1985). The judge ordered that, *Aall* transmission lines, from 345 kV to 23 kV, should be rolled-in together and allocated using a single demand allocator.*@ Id.* The Commission affirmed. The Commission quoted with approval the testimony of the Staff witness, that subtransmission lines:

[...] carry bulk power from points of supply to points of distribution. As such, they improve the reliability of the system and should be considered part of the integrated system.

42 FERC at 61,533. The FERC stated that increased reliability is a benefit to all customers on the system and the costs thereof should be shared by all customers on the Niagara Mohawk system.

The New York Municipals believe this finding is applicable to all the New York Transmission Owners.

ABright Line@ criteria vs. ACase-by-Case@ determination?

The New York Municipals believe that a bright line test using a functional approach to determine wholesale transmission service is appropriate. They oppose using voltage cut-off as a bright line. They also believe the bright-line test will conserve resources and ensure consistency compared to a case-by-case review.

Consider ISO-NE cost allocation proposal?

Obviously, the parties need to consider recent FERC transmission pricing orders, including PJM and ISO-NE. The parties need to consider the similarities and differences in this settings. For example, the ISO-NE cost allocation proposal reflects the historic NEPOOL treatment of Pool Transmission Facilities (PTF) and the difference between PTF and non-PTF facilities. Stakeholders in New England are accustomed to paying two pancaked transmission rates, a PTF rate and a non-PTF rolled-in rate. This is not the case in New York.

Please contact me if you have any questions.