NOTICE OF NEW YORK STATE ELECTRIC & GAS CORPORATION AND ROCHESTER GAS AND ELECTRIC CORPORATION'S APPEAL OF THE NYISO MANAGEMENT COMMITTEE'S DEMAND CURVE VOTE

New York State Electric & Gas Corporation ("NYSEG") and Rochester Gas and Electric Corporation ("RG&E") (collectively the "Energy East Companies") hereby appeal the New York Independent System Operator ("NYISO") Management Committee ("MC") Demand Curve ("DC") vote.[1] The February 13 Decision approved a proposal to adopt a DC to administratively determine capacity prices ("DC Proposal"). The Energy East Companies appreciate the Board's concern. The atmosphere of political imperative to take action must be tempered by reasoned decision making.

EXECUTIVE SUMMARY

The Energy East Companies urge the Board to reject the DC Proposal and to direct its staff to work with the committees and the NYISO Market Advisor on alternative capacity market improvements that are market-based and more likely to create a stable investment environment. Energy East believes the Board should take this action for several reasons.

First, the DC Proposal is fundamentally inconsistent with competitive bid-based markets. Its reliance on administrative price setting is totally distinguishable from setting reserve requirements based on engineering criteria.

Second, the DC Proposal is not justifiable under the Federal Power Act ("FPA") because it provides for neither cost-based nor market-based rates and requires LSEs to purchase capacity above NYSRC requirements without statutory or contractual authority to do so.

Third, the NYISO has yet to present a thorough analysis that the total market revenues available from the NYISO markets are not sufficient to support new entry where needed. David Patton has observed that he reviewed data for only one Summer and was not requested to review the additional revenues generators will receive as a result of several recent market modifications described below. Solutions to inappropriate suppression of peak energy prices would send better price signals than administrative determinations to prop up capacity prices in times of surplus. Moreover, nothing is stopping generators that have threatened retirement

[1] Motion for Agenda Item #2 of the NYISO's February 13, 2003 Special MC Meeting (the "February 13 Decision").

from bidding their going forward costs in the capacity auction. If such a generator becomes the marginal capacity unit, it will surely recover what it needs to continue operation.

Fourth, the cost impacts of the DC are substantial and have not been adequately vetted.

Fifth, LSEs should not be forced to participate in a bailout of the merchant generation sector.

Sixth, viable market-based improvements to capacity markets are being developed cooperatively among market participants in PJM, New York and New England. These improvements should be considered in the NYISO, but the DC Proposal has dominated the agenda of the Installed Capacity Working Group ("ICAPWG").

Seventh, voting irregularities at the February 13, 2003 Special MC Meeting failed to uphold the committee process and the spirit of the MC By-Laws. The Board should not treat the DC as properly having achieved the requisite MC vote to enable an FPA Section 205 filing.

1. The DC Proposal Is Inconsistent with Competition and Fraught with Problems

The DC Proposal would replace the current bid-based competitive capacity market with administratively-determined prices at which LSEs would be required to purchase their capacity. The curve would essentially create a floor on prices, below which suppliers would be reluctant to enter into bilateral negotiations.

Administratively setting prices for capacity is fundamentally different than setting a capacity reserve level. Some DC proponents say "either you set a quantity or you set a price – they are equivalent intrusions on the market." This is simply not right. Setting a reserve margin requires a single judgment about the degree of reliability desired (e.g. one day in 10 years); the rest is engineering analysis. The industry has done it for years and has demonstrated institutional expertise in these judgments.

In contrast, properly setting a fair, administratively determined price requires many economic judgments, including the following:

- Which type of resource should set the price of new entry?
- What are expected electricity prices?
- What are relative fuel prices?
- Which types of resources will be on the margin and over how many hours?
- How much will the new resource run?

- What energy market revenues will the unit earn?
- What ancillary service market revenues will the unit earn?
- What are the capital costs, financial structure and required returns?

The accurate calculation of the equilibrium point where supply equals 118% of the forecast peak load on the supply curve requires the correct answer to each of these questions.

Take one current case in point. Those who advocate an administered price for capacity are using incorrect assumptions for capital costs. Now and for the foreseeable future there is an oversupply of turbines on the market. Potential new entrants will not have to pay an equipment vendor's list price for turbines, contrary to the assumptions in the NYISO "equilibrium price" calculation. The potential savings are significant -- up to $100/kW , or some $15/kW-year. In a competitive market these savings would be passed through to customers through competitive bidding. But those savings will be lost if instead loads are forced to pay a price based on an administrative determination of new entry costs. This is just one example of the risk to customers of doing an administrative determination of costs instead of leaving pricing to the market.

New York has already suffered substantial economic harm caused by administrative electricity price determinations. PURPA resulted in state determinations of utility long-run avoided costs at which the utilities were required to buy power from qualified facilities. This program in New York has cost customers billions of dollars in payments above market prices. PURPA prices have burdened New York's customers for years, contributed to the businesses downturn, and weakened the financial condition of some utilities. Nor should the NYISO take comfort in the three-year price forecasting window needed to implement the DC Proposal. Price forecasting over even shorter periods has proven highly imprecise. New York cannot afford another administrative pricing regime with adverse consequences. We must learn from the mistakes of the recent past.

2. The DC Proposal Cannot Satisfy the FPA's Just and Reasonable Standard

Under FPA Section 205, FERC may accept only those rates that are just and reasonable. FERC has traditionally required that charges be justified based on cost of service studies. Over the last decade, FERC has allowed market-based rates where the sellers have demonstrated that they lack market power. The DC Proposal is neither of these, and almost assuredly will allow some generators to recover more than competitive or cost-based prices.

Additionally, the NYISO does not have the statutory or contractual authority to order LSEs to buy more capacity than the level needed to satisfy the NYSRC's reserve requirement. This novel experiment is not reconciled with the statutory requirements of the FPA.

3. The NYISO Has Not Provided Reasonable Analyses of Whether Total Market Revenues Are Inadequate and, If so, What Energy Market Improvements Are Needed

The NYISO has not seriously analyzed the total market revenues available to support new generation where needed. It is not reasonable to implement the DC Proposal without first analyzing and vetting this point with the appropriate committees. To do otherwise needlessly takes what should be conducted in an orderly committee process at the NYISO down to FERC.

David Patton indicated at the MC meeting that the only analysis concerning the total revenues available to suppliers was contained in the Summer 2002 Review of the New York Electricity Markets (October 15, 2002) ("Summer 2002 Review"). David Patton concluded that current market revenues do not support new entry in upstate NY. At the MC meeting, however, he acknowledged that in a properly functioning market with excess generation, prices should not support new entry. The "analysis" concluded that there is "significant uncertainty"as to whether current market revenues are sufficient to incent new entry in New York City ("NYC"). Additionally, the analysis only examined Gas Turbines ("GTs") and added the caveat that "other investments may be economic." This is an important point warranting close inspection. David Patton reached this conclusion without considering the additional energy market revenues attributable to several market modifications designed to improve scarcity price signals.

The failure to reduce the DC by the margins of energy and ancillary services sales is fundamentally flawed. A cursory review of the NYISO's February 13, 2003 DC Proposal reveals that in NYC the capacity payment alone for year two of the DC is $151 per kW/year while the cost of new entry is $159 per kW/year.[2] Once the additional margins from energy and ancillary service sales are added, total market revenues will be far in excess of the cost of new entry resulting in the wrong price signal and causing a more substantial wealth transfer at consumer expense.

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[2] Proposal for Implementing a Demand Curve Spot Market Auction in the NYCA Installed Capacity Market, Management Committee Meeting Presentation, February 13, 2002, at pages 6 and 9.

Notwithstanding the high demand curve price relative to total market revenues and the cost of new entry, we question whether the DC will stimulate any new investment. It is the wrong type of mechanism to address the financial community's concerns. If, however, the NYISO were confident it would bring on new investment, then it should be concerned that it is guaranteeing supra-competitive prices. Setting the curve to cover the cost of entry based on simple cycle turbine prices well above market assures unjustifiably higher prices. Upon a reduction in entry costs of $15 per Kw/year, the $151 per kW/year capacity payment *alone* in year two would produce $8 per kW/year more than the cost of new entry, without one cent of energy market revenues. In the "Rest of State" the proposed capacity payments, current energy market and ancillary services revenues, and increased energy market revenues as a result of the market modifications discussed below will assure substantial wealth transfers. Were the DC sufficient to stimulate investment, speculation at best, both situations just noted have something in common - the wrong price signals and increased consumer costs. Moreover, were the DC to induce any type of investment, it would induce the wrong type of investment. With pricing set two years out, only peakers may be financially viable. The wrong price signals for the wrong duration do not make for an efficient market. Through all this, no new generation is assured. Only wealth transfers are guaranteed.

Through no fault of his own, in his Summer 2002 Review, David Patton does not address several important points. He was not asked to.[3] The estimates of total market revenues available for suppliers was backward looking over only one capability period and failed to consider additional revenues available to capacity suppliers as a result of recent modifications to the energy market. For example, the Summer 2002 Review did not consider additional revenues attributable to any of the following initiatives:

- The NYISO has modified the demand response program to allow economic curtailment bids to set prices, which will increase RTM energy prices, which will also cause upward pressure on DAM prices;
- The NYISO recently completed modeling of Con Edison's 138 kV system, which is expected to decrease out-of-merit calls on in-City generation that also depressed energy prices;
- The NYISO continues work to increase convergence between BME and SCD which may result in higher, but more efficient, price signals;

[3] The independence of the market advisor is obviously an issue about which FERC is concerned as expressed in the SMD NOPR. The proper scope of analysis performed just to support or to critically and thoroughly evaluate an ISO proposal of the magnitude of the DC Proposal may present a good case study of whether greater independence is needed.

- The NYISO's scarcity pricing program (approved at the January 9, 2003 MC meeting) will set energy prices at $ 1,000 per MWH during shortages of ten-minute reserves and is scheduled for implementation prior to the Summer of 2003.

These points make it clear that energy market price signals will increase. The problem of the lack of scarcity pricing in the energy market, which has been identified by the market monitor, should be fixed in the energy market and not in the capacity market. The market monitor's recommendations and the measures noted above were approved by the NYISO committees and are supposed to improve the accuracy of energy market pricing and the economics of new entry. To the extent there exists a perceived gap between the cost of new entry and the market revenues available to a new entrant, these changes in energy pricing could eliminate that gap.

All of these factors would need to be analyzed, along with other conditions over a longer period of time in order to evaluate total market revenues that are available in NY. Such an analysis should have been timely vetted in the appropriate committees before the vote on the proposal. Nor should this point come as a surprise to the Board because such an analysis was specifically requested at the December 17, 2002 Board Liaison Committee meeting. On the current record, the NYISO Board cannot have confidence that the markets produce insufficient revenues to support new entry.

In any event, one point remains eerily simple and unanswered. Certain suppliers have dramatically threatened to retire generation. Why can't needed generators bid enough to cover their going forward costs? There are no restrictions on the capacity bids of most suppliers. If a unit is needed because it has become the marginal capacity unit, then it will be able to recover its going forward costs from the capacity market under the current market design. It is absolutely irrational to think that a generator would be placed on stand by or retired before its owner attempted to bid in its going forward costs.

4. The NYISO has Not Adequately Addressed the DC's Cost Impacts

The NYISO has not performed a reasonable analysis of the cost impacts of implementing the DC Proposal. The NYISO's estimate covered only the first year of the DC Proposal. Regardless of whose estimates you use, implementing the DC Proposal would likely impose hundreds of millions of dollars per year in additional costs on New York's already

heavily burdened consumers.[4] In the absence of properly vetted analysis of the total market revenues and the impacts of the DC, it is not appropriate for the Board to advance the DC Proposal. Moreover, the DC Proposal may impair LSEs from fully hedging their capacity requirements because the DC creates uncertainty as to how much capacity each LSE will have to purchase until after the auction. Also, the DC will essentially create a price floor on all ICAP transactions, including bilaterals. Thus, the DC would replace the free interplay of supply and demand with a new system of mandated purchases of ICAP at administratively-determined prices.

In sum, the NYISO committees did not receive from the NYISO reasonable and thorough analyses of the total market revenues available to generators or the costs of the DC Proposal. The costs are estimated by at least one reputable economist to be hundreds of millions of dollars each year. The DC Proposal would raise hedging impediments for LSEs. Through it all, there has been no adequate explanation of why bids from the marginal capacity unit cannot cover going forward costs. This is not a reasonable record upon which the Board can go forward. The hundreds of millions of dollars of costs, caused by the DC Proposal, would demand a more probative analysis, the scope and assumptions for which should be fairly and even-handedly vetted among the stakeholders, not just like-minded parties. The Board Audit Committee should also work with MPAAS[5] on the controls in place to make certain this decision is the result of good analysis.

5. LSEs Should Not Be Forced to Bailout Merchant Generation

Underneath the policy rhetoric is the argument that we need to artificially prop up the price that LSEs pay for capacity or the capital markets will not finance new entry when it is needed. This is unfounded and unfair. The fundamental premise of competitive entry is that private investors take the risks – and reap the rewards – of their investments. In any capital intensive industry there are going to be periods of scarcity and periods of oversupply. During the scarcity periods prices will be well above levelized replacement cost. Conversely, during periods of oversupply prices can be extremely low. We have already experienced the above-

[4] Even the proponents of the DC Proposal have conceded to costs ranging bewteen $43 million and $250 million in the first year alone (David Patton Presentation, "Demand Curve Estimates," NYISO Management Committee Meeting, January 9, 2003) while others have estimated the added cost for the three-year phase in of the DC Proposal could exceed $700 million.

[5] MPAAS is the NYISO Market Participant Advisory Audit Subcommittee and includes representatives of parties that support the DC Proposal.

replacement prices in some markets where the rewards to private investors have been ample – and customers have paid the price. Now when we have a period of oversupply, it is unacceptable for these private investors to demand that we change the rules and require customers to buy their capacity at an inflated price.

6. Alternative Market-Driven Capacity Market Improvements Should be Considered

The DC Proposal's radical administrative "solution" is inferior to other market-based modifications. The ICAPWG was supposed to review other capacity market refinements with an opportunity for full vetting once the DC Proposal was fully discussed. The DC Proposal has dominated the agenda of the ICAPWG over an extended period of time and has precluded full discussion of these other alternatives. The Energy East Companies working with other market participants have built upon the work of the Resource Adequacy Market Working Group ("RAMWG") to offer a market-based alternative to address the alleged short- and long-term capacity market problems. The RAMWG is the successor to the Joint Capacity Adequacy Group. Market participants and staff of PJM, NY and ISO-NE have participated in this process. The ISOs supported it in their recent FERC SMD filings. The DC Proposal represents a huge departure from this broader regional approach.

In short, the Energy East Companies' proposal would (i) lengthen the ICAP obligation procurement period ("OPP") back to six months for the summer of 2003 and extend it to one-year thereafter; (ii) use the summer Dependable Maximum Net Capability ratings for the entire year while allowing additional winter capacity to the extent necessary to replace summer-only capacity, (iii) institute a procurement process to enable resources that are only available during portions of the year to be combined to create a portfolio meeting annual supply requirements; (iv) allow for load shifts created by retail access with a monthly swap of remaining capacity obligations among LSEs and (v) reduce the deficiency charge commensurate with the security associated with the one-year OPP.

Energy East would refine this further by introducing a Centralized Capacity Market ("CCM") which is under development by the RAMWG. The CCM proposal will standardize regional market reliability designs and minimize seams issues. The CCM would centralize the procurement with each ISO acting as the agent for LSEs. An auction would be used for the procurement of 100% of LSEs' requirements of Unforced Capacity for a one- to three-year procurement period commencing two years in the future. Suppliers and LSEs would still

be able to hedge price volatility by entering into bilateral transactions or contracts for differences. The CCM proposal also allows for the continued use of existing procedures to allocate capacity obligations to LSEs within each region. The CCM approach will provide the forward market signal necessary to create a stable environment and to incent new generation and relies on competition to assure the proper price signal, instead of administrative determinations. The Board should encourage all parties to work on market-driven capacity market refinements.

7. MC Members' Votes Were Inappropriately Excluded

The process by which the DC Proposal was approved was irregular to say the least. Irregularities included: (i) a rush to approval despite the existence of other alternatives that need to be fully discussed and evaluated before the DC Proposal is approved and implemented; (ii) the last-minute dissemination of critical information requested; (iii) the exclusion of four new legitimate MC members without a concrete basis. A vote rightfully taken including the four legitimate MC members resulted in failure of the DC Proposal. Disturbingly, Energy East Companies' request for critical information on the impacts of the DC Proposal to prepare for the 10:00 a.m. February 11, 2003 Business Issues Committee Meeting was not met until after the close of business on February 10, 2003.[6] (As noted, a reasonable analysis of revenue adequacy was never provided.) Moreover, the Special MC Meeting was held just two days later. In its presentation to the Management Committee, the NYISO stated that, "Following the December 13, 2002 BIC denial of an initial [DC] proposal, *some* parties have worked to develop an alternative [DC] proposal." The "alternative Demand Curve proposal" was created by a select group of like-minded parties. Were this whirlwind that resulted in the DC vote in compliance with the MC By-Laws, the path by which the DC Proposal passed did not allow adequate vetting of the issues.

CONCLUSION

The Energy East Companies urge the Board to reject the DC Proposal. It interferes with competition via administrative price setting and is fraught with problems. It is not justifiable under applicable FPA standards and FERC precedent. The NYISO does not have the legal authority to force LSEs to buy more capacity than needed to satisfy reliability

[6] Despite repeated requests, the requested information was not provided until 5:14 p.m. the night before the Business Issues Committee meeting the next morning.

standards. The NYISO has not presented credible analyses supporting the need for administratively increased capacity prices or quantifying the DC's cost impacts on already burdened customers. Bailing out merchant generation is unfair and shifts risks from parties that reaped the benefit of high prices in past years to the loads that paid those prices. Alternative capacity market refinements are actively under development in NY and both neighboring ISOs. With a few added refinements, more stable capacity markets are readily attainable without administrative price setting. Finally, the process through which the DC was approved raises troubling due process issues. The NYISO Board should not take an inadequate proposal that supplants market forces with administrative price setting, predicated on inadequate analysis and based on the record described above to FERC. For all of the reasons discussed above, the Energy East Companies urge the Board to reject the DC Proposal and to direct its staff to work within the committee process on alternative capacity market improvements.

Respectfully submitted,

/s/
Stuart A. Caplan
Huber Lawrence & Abell
605 Third Avenue
New York, NY 10158
(212) 455-5505
scaplan@huberlaw.com
Authorized Agent and Counsel for
New York State Electric & Gas Corporation
Rochester Gas and Electric Corporation