



STATE OF NEW YORK
EXECUTIVE DEPARTMENT
STATE CONSUMER PROTECTION BOARD

George E. Pataki
Governor

Teresa Santiago
Chairperson and Executive Director

March 7, 2003

Richard J. Grossi
Chairman, New York Independent
System Operator Board of Directors
C/O William J. Museler
President and CEO
New York Independent System Operator, Inc.
3890 Carman Road
Schenectady, NY 12303

Re: Motion in Opposition to Notices of Appeal to the New York Independent System Operator Board of Directors Regarding the Management Committee's February 13, 2003 Decision to Approve the Demand Curve Proposal.

Dear Chairman Grossi:

In accordance with the Procedural Rules for Appeals to the NYISO Board, the New York State Consumer Protection Board ("CPB") respectfully submits this Motion in Opposition to the Notices of Appeal of a February 13, 2003 decision by the New York System Operator's ("NYISO's") Management Committee. The CPB requests that the NYISO Board of Directors deny the Notices of Appeal and approve the Management Committee's February 13, 2003 decision. The arguments raised by the Appellants are not new and were thoroughly discussed by the Management Committee and Business Issues Committee. The "demand curve" proposal was first presented at the Installed Capacity Working Group in May 2002. Over the past nine months, interested parties have had an

opportunity to discuss their concerns with the demand curve proposal and present other alternatives to address flaws in the capacity market. The CPB believes that the outcome of that process should not be put aside in favor of contentions that were considered and rejected.

Argument

The market for electricity is different from other markets. When the generation and acquisition of electric power was deregulated, the market could have been left to operate completely on its own without any installed capacity or generation adequacy requirements. In that case, the market would have determined not only the price for capacity but also the amount of capacity and the level of reliability. However, such an approach was deemed too risky for consumers and the state's economy. Hence, to maintain the level of reliability to which consumers were accustomed, the 18% reserve margin that was required under regulation was maintained.

Under regulation, utilities complied with the 18% reserve requirement and would often exceed it. When additional capacity was needed due to load growth or retirements, utilities would build additional units. If reserve margins were above minimum requirements, utilities would still be compensated for that excess capacity.

Under the current deregulated market structure, the situation is quite different. Load serving entities ("LSEs") are required to purchase their forecasted peak load, plus 18% to meet their reserve requirements. To ensure that LSEs meet their margin requirements, the NYISO imposes a very severe penalty on violators. Conversely, there is no obligation for LSEs to purchase beyond the 18% reserve requirement. This leads to a situation where capacity is highly valued when the system is short of the 118% requirement. However, capacity beyond the 118% level is currently not compensated.

The NYISO's market design for capacity has led to prices that may not be adequate to either retain existing capacity or attract new generation. The average market clearing price for capacity in the upstate region for the most recent twelve months was approximately \$1.00/kW month. This winter, capacity prices have been even lower. In contrast, the carrying cost for a new gas turbine is approximately \$7.00/kW month. In other words, a new plant entering the market, even though it may derive some revenues from the sale of energy, may not be able to recover its costs. These prices make it difficult to justify new generation and make it very challenging for some existing plants to stay in business. Similarly, capacity prices for the downstate region, where the need for new generation is more critical, may also be below the cost of new entry.

Although the NYISO believes that the state will have adequate power supplies this summer, it is extremely concerned about the need for generation in New York. Just last week, the NYISO forecast a peak load of 31,430 MW for the summer of 2003. To meet the 18% reserve requirement of 5,657 MW, a total of 37,087 MW must be available. However, the total installed capacity available from in-state resources assuming all plants operate at capacity is 36,527 MW. This means that New York will require approximately 560 MW of capacity from out-of-state resources and/or demand response resources, even under the most optimistic assumptions. The shortfall will be even greater next year if no new generation is added.

In a press release issued February 25, 2003, the NYISO's president and CEO said the following:

Despite the forecast for this summer, New York still needs to focus on getting new generators sited and built on an expedited basis. New York's electric demand continues to rise and shows little sign of abating. Unless significant generating capacity is added to the system – and soon – demand is going to overwhelm supply and reliability will be at risk.

This demonstrates the need for additional generation and the need to maintain existing generation. Although the Athens plant and some other small projects are expected to add approximately 1,200 MW to the State's resources this year, the current design of the capacity market creates the likelihood that some plants may be retired. For instance, the 1,700 MW Oswego plant in upstate New York may not be profitable, since it operated only 3 percent of the time during 2001. Similarly, the 1,200 MW Bowline plant in the Hudson Valley ran only 16 percent of the time in 2001. If these plants were to stop operating, the state would not achieve the 18% reserve requirement despite additions of new capacity. This has obvious implications for the reliability of the state's electric system. In addition, it has substantial implications for energy prices. According to Dr. Patton, each 1 percent reduction in reserves below the 118 percent level would increase energy prices by approximately \$100 million. Further, under current NYISO rules, substantial deficiency payments are required when the 18% reserve requirement cannot be met.

The situation is especially critical in New York City where the NYISO has estimated a peak load forecast of 11,020 MW for the summer of 2003. Eighty percent or 8,816 MW of this forecasted demand must be available from in-city resources. Since the available supply from in-city resources is only 8,749 MW, this leaves New York City deficient by 67 MW.

The NYISO, most market participants and many observers have recognized the urgent need for new capacity in New York and that the current market design for compensating generators for selling capacity in New York needs revision. Interested parties have been working for almost one year to address those concerns in a balanced manner. Some earlier demand curve proposals advanced by the NYISO, were, in our view,

not in consumers' interest, and therefore, did not merit our support. For example, the CPB voted against a version of the demand curve proposal advanced by the NYISO in December. However, we believe that the version of the demand curve recently approved by the NYISO's voting committees will address the capacity pricing design concerns, lead to more stable prices and benefit consumers.

Under the current market design there is an abrupt change in the value of capacity beyond the 18 percent reserve requirement. LSE's acquire capacity up to the 118 percent level to meet their NYISO requirement. However, the compensation for capacity falls to zero beyond that level. This design does not represent the true value of capacity to the system. The demand curve will smooth out this abrupt change in the value of capacity at the 118 percent level. Capacity prices will gradually decline for capacity beyond the 118 percent level and will eventually fall to zero at a specified level.

Stable prices as a result of the demand curve should benefit both generators and consumers. Generators with greater assurance of stable revenue flows should find it easier to finance projects. Consumers would have greater assurance that adequate reserves would be available to reduce the possibility of supply interruptions, avoid price spikes in peak periods and place downward pressure on energy prices.

The Consumer Protection Board has carefully evaluated the impact of the existing market design for the capacity market and compared it with the proposed demand curve. We believe that overall, consumers will be better off under the demand curve than without it. We recognize that capacity prices may increase in the short run as a result of the demand curve. For example, Dr. Patton has estimated that prices in the first year under the demand curve will be approximately \$68 million higher in New York City and \$111 million higher in the rest of the state. However, without the demand curve, a capacity

shortfall, which the NYISO's forecasts demonstrate is possible, would result in a deficiency penalty. Under existing NYISO rules, a deficiency penalty is required whenever the system is short of the 118 percent target. Dr. Patton has estimated that this may result in additional charges of \$335 million for New York City and \$840 million for the rest of the state. These deficiency payments total more than six times the estimated additional charges that would be applicable under the demand curve.

The benefits of the demand curve are even more compelling in the long run. The resulting stability in revenue for generators is expected to lead to incremental generation. That generation would help obviate price spikes in peak periods. In addition, it would place downward pressure on energy prices throughout the year, to the benefit of all New York consumers. As estimated by the NYISO, each 1 percent increase in capacity beyond the 18 percent reserve requirement would reduce energy prices by approximately \$100 million.

Conclusion

For the reasons explained herein, we urge the NYISO Board of Directors to deny the Notices of Appeal and instead ratify the February 13, 2003 decision of the Management Committee.

Sincerely,

Tariq N. Niazi
Chief Economist