**Motion in Opposition by the City of New York, Consumer Power Advocates, New York Energy Buyers Forum, Consolidated Edison Company of New York, Inc., New York State Electric & Gas Corporation, Rochester Gas and Electric Corporation and Central Hudson Gas & Electric Corporation to Appeal of the Independent Power Producers of New York, Inc. to the December 13, 2002 Business Issues Committee Decision To Deny a Motion to Institute a Demand Curve**

## I. Summary

Pursuant to § 15.03 of the New York Independent System Operator's ("NYISO") Management Committee By-Laws, the above-referenced parties hereby oppose the appeal of the Independent Power Producers of New York, Inc. ("IPPNY" or "Appellants") of the December 13, 2002 decision of the NYISO Business Issues Committee to reject by a substantial majority a motion to institute a Demand Curve in the unforced capacity ("UCAP") market operated by the NYISO.

The Demand Curve proposal rejected by the NYISO Business Issues Committee is inherently contrary to the competitive market being developed by the NYISO because it imposes pre-determined prices on load serving entities (LSEs). Moreover, the Demand Curve proposal would have very significant rate impacts on consumers while failing to provide benefits commensurate with its high costs. In essence, the Demand Curve offers only a contingent benefit – the avoidance of possible deficiency prices – but imposes costs that will be both substantial and certain. Finally, its implementation would almost certainly artificially preserve old and inefficient power plants, thus denying or delaying another competitive energy market benefit: the introduction of efficient, lower cost generation accompanied by sharp reductions in air emissions.

The perceived difficulty that the Demand Curve proposal seeks to address can be met in other ways that would be far less expensive and intrusive on the operation of the wholesale energy markets. Such alternatives as power purchase agreements, the use of

which IPPNY has recently championed,[1] would more effectively encourage new entry by highly efficient generators to supplant inefficient incumbent facilities. The limited and targeted use of such agreements would be a far more effective means of addressing needs where the possibility of energy deficiency is a realistic concern.[2] Contrary to the proponents' claims, implementation of a Demand Curve would discourage the use of such agreements.[3]

## II. Discussion

### A. The Creation of a Demand Curve Would Be Contrary to the Competitive Energy Market That Has Been Fostered and Implemented by the NYISO and the Mere Existence of Market Volatility Does Not Justify Such Regulatory Intervention

The central precept behind the creation of the NYISO was that it would oversee an orderly transition to a deregulated wholesale electricity market in this State. The restructuring order of 1998 contemplated that grid management would be kept separate and distinct from the setting of prices, thus preserving the independence of the NYISO. The underlying goal was to encourage the influence of competitive forces in the wholesale electricity market, while providing consumers with a manageable transition to

---

[1] *See* IPPNY Publication "Charting a Course for the Future – New York's Electricity Markets Today & Tomorrow," Executive Summary, p. 3 (November 2002), which identifies the foremost long-term goal for the New York power industry as having the PSC restructure the regulatory market rules to provide incentives to LSEs to enter into forward energy and capacity contracts with generators. Con Edison itself has requested a Declaratory Ruling by the PSC to assure the company of full cost recovery associated with any contract arising from the RFP (PSC Cases 96-E-0897 and 00-M-0095, Con Edison Petition filed December 26, 2002).

[2] Another improvement would be to reinstate longer-term LSE requirements, such as a return to the six-month capacity procurement period. At the June 2001 BIC and Management Committee meetings, the market participants approved changes to the capacity market which included a move to unforced capacity as well as a monthly capacity procurement period. A BIC motion to retain the six-month requirement was supported by end users and transmission owners, but in the end did not receive enough support to pass. The generators that supported this shorter term are the very ones that now complain that the short-term market does not work.

[3] LSEs will not know in advance the quantities that will be offered for sale and therefore the amount of capacity that they will be required to purchase. Thus, the least-risk strategy for LSEs would be to wait until the last minute and purchase all of their requirements through the NYISO demand curve process rather than enter into PPAs.

a new market form. Implementation of a Demand Curve would represent a clear retreat from that vision.

Overall electricity market volatility has clearly increased since the advent of the restructuring process in New York State. This is true not only in the capacity market, but in virtually every aspect of the State's electricity markets. For consumers of electricity, the peak summer price plateaus under the former regulated system have been replaced by slopes that are not only far steeper than their predecessors, but have reached higher peaks.[4]

This pattern, while disconcerting to electricity consumers who were promised lower prices under deregulation, is not surprising. A hallmark of market deregulation is increased price volatility. Significant price oscillations are not only likely, but also virtually inevitable in moving from a regulated environment to one that relies heavily on market-based price decisions. While the latter is inherently more uncertain than is a highly regulated market, that fact should not be viewed as a problem. In fact, IPPNY itself has recognized the value of volatility in that it "encourages development of new and/or more efficient power plants."[5]

New York State, like many other areas of the country that have undertaken the electricity restructuring process, has admittedly experienced electricity market conditions that have caused great distress among some market participants. Many merchant generators have encountered precipitous declines in both their share prices and their credit ratings that are entirely unrelated to the restructuring in New York. Revelations of

[4] In August of 2001, for example, wholesale electricity prices soared in the New York Control Area. While summer 2002 prices never reached the highest peak experienced in 2001, July and August prices far exceeded those seen in comparable summer periods prior to 2000.

[5] *See* IPPNY Publication "Charting a Course for the Future – New York's Electricity Markets Today & Tomorrow," Executive Summary, p. 4 (November 2002)

gross misconduct in energy trading activities have cast a pall over portions of the industry. Entities that were viewed as highly credit-worthy a year or two ago now struggle with total or partial loss of investor confidence. Most of the problems experienced by energy firms are a product of the excesses that too many members of the industry engaged in, thereby giving rise to a loss of investor confidence.[6]

It is undeniable that it is currently difficult to finance infrastructure projects. However, the underlying causes for reluctance to invest and build are undoubtedly numerous, and cannot be traced solely or even primarily to the New York capacity market. It is far too facile to simply say, as Appellants do, that the current NYISO market is "fatally flawed" and that only a Demand Curve can cure it. Indeed, not one of the Appellants claimed that the capacity market was "fatally flawed" when merchant energy companies had sound credit ratings and high share prices. Instead, they proposed and voted for measures that increased capacity market volatility, such as shortening the capacity procurement period.

Appellants now contend that new energy supply resources are not entering the New York market, thereby raising the threat of future deficiencies.[7] Such a contention is highly dubious at best. For example, in New York City, currently one of the state's most constrained markets, new generation facilities with a capacity of more than 900 MW (equal to nearly five years worth of projected in-City load growth) are now under construction in the City, and should be on line by mid-2005.[8]

---

[6] *See* "How Energy Traders Turned Bonanza Into an Epic Bust " in The Wall Street Journal, p. A1 (December 31, 2002)

[7] IPPNY Appeal, pp. 1-2; *see also* Keyspan-Ravenswood Appeal, p. 2.

[8] These projects are Keyspan-Ravenswood (250 MW with an operational date expected in late 2003), the Con Edison East River re-powering (adding approximately 175 MW in late 2004), and NYPA Poletti (500 MW now expected by mid-2005). Other potential new sources include the PSEG Cross-Hudson generator lead (550 MW now in the late stages of a PSC Art. VII application process, with a possible operational date

In a capacity market that is currently 5% (or some 1500 MW) above the 118% requirement (exclusive of imports), it is entirely reasonable to have very low UCAP prices.[9] Such prices can hardly be characterized as a "flaw" any more than high electricity prices on 100-degree summer days constitute a market flaw. The mere fact that some generators may now be experiencing an unsatisfactory return is simply not a reason to radically redesign the New York market. They will almost inevitably face periods of scant profits just as at other times they will have earnings far superior to typical regulated rates of return. [10] In short, there will be fat and lean times.[11]

Simply stated, one of the key characteristics of a deregulated market is and must remain the higher degree of risk borne by all market participants – a risk accompanied by the possibility of greater gains that are the counterpart to that increased risk. Particularly where the existence of the current lean period is more likely attributable to extrinsic financial market factors than it is to New York-specific causes, the NYISO should be reluctant to address a temporary problem with a costly permanent "solution" that may not truly solve anything.

Finally, in complaining about the revenues received for the sale of UCAP, IPPNY completely misses the point as to why UCAP or installed capacity exists as a product.

---

in 2005), and at least the possibility of a Con Edison contract growing out of the current RFP (500 MW by the first half of 2006). In aggregate, these projects would add nearly 2000 MW of generating capacity in New York City.

[9] *See* Mark Reeder, "Government Intervention into Wholesale Electric Markets to Assure Generation Adequacy" (November 6, 2002), which notes at p. 3 that the NYISO had a generation reserve margin of nearly 23% for 2002 as a whole. *See also* the NYISO 2002 Load and Capacity Data (Gold Book).

[10] In some cases, the low or non-existent profits are largely a function of company cost structures such as highly leveraged positions or injudicious purchasing decisions, and thus largely unrelated to market revenues.

[11] This is not to say that in a unique and extremely critical market such as electricity that untrammeled free market forces can simply be permitted to hold sway and thereby risk the welfare of the public. During the early stages of the transition to a free market, the NYISO has made a decision to place some limits on generation pricing where market power concerns have justified it, such as in the use of price caps on the divested generation assets in New York City.

The amount of capacity that an LSE has to purchase is a derived quantity that is calculated to justify a reserve level that corresponds to the probability of shedding load no more than once in 10 years. Thus, the main function of UCAP and its predecessor ICAP is to preserve reliability.[12] IPPNY is therefore incorrect in assuming that there is compensable value to capacity over the reserve requirement. Since the amount of capacity purchased is set at a level sufficient to meet the reserve requirement, quantities in excess of this requirement have no value towards meeting the reserve requirement and, as such, are not entitled to any revenues.

### B. The Demand Curve Will Not Assure New Generation Capacity, but Will Impose Far Higher Electricity Prices on Consumers

Appellants state that the Demand Curve proposal "*. . . will induce construction* of new and retention of needed existing capacity . . ."[13] Appellants' stated certitude about the future outcome is clearly not warranted. No one can guarantee that implementation of the Demand Curve will itself actually result in the construction of new generation. Indeed, the supporting affidavit submitted by IPPNY uses language that is considerably more circumspect than Appellants' claim in this regard: "The ICAP demand curve . . . *should make the funding of new generation easier*."[14] This statement both acknowledges a lack of certainty concerning future investment decisions and recognizes that capacity revenue alone will not be determinative in those decisions. Such revenue would at best be an incremental factor that prospective investors in new generation would consider in

[12] This point was recognized by the U.S. Court of Appeals for the 1st Circuit when it stated that "ICAP is not devised to compensate past investment, but to spur sellers to make new investments and buyers to meet their reserve capacity obligations." *Sithe New England Holdings v. FERC*, 308 F.3d 71, 78 (1st Cir. 2002).
[13] IPPNY Notice of Appeal, p.2 (emphasis added)
[14] Affidavit of Mark D. Younger, ¶ 16, p. 3 (emphasis added)

evaluating the merits of such an investment. Accordingly, the NYISO should not expect the proposed Demand Curve to give rise to new entry.

This lack of certainty on the assured benefits of the Demand Curve is particularly noteworthy because the anticipated rate impact of the Curve on consumers - a factor wholly ignored by Appellants - is far from trivial. The Department of Public Service staff, which supports a form of the Demand Curve quite different from that sought by IPPNY, has been forthright in acknowledging that its own estimate of the rate impact attributable to the Curve would be upwards of $400 million annually in New York City alone, *i.e*., a rate increase of approximately 8-10% in consumers' entire electricity bills attributable solely to the increase in capacity costs.[15] While some may dispute the DPS figure or its underlying assumptions, it remains an actual rate impact estimate that has been provided to the NYISO market participants.[16] Moreover, the cost estimate of more than $400 million originates with declared supporters of a Demand Curve, not its opponents, and thus there can be no suggestion that it represents an inflated or wildly speculative number.

The many unexpected developments in electricity markets in recent years should induce a measure of humility in anyone attempting to predict the true benefits and costs of electricity market redesign efforts. At a minimum, however, there must be a demonstrable correlation between the likely burdens and benefits associated with a redesign proposal. This is particularly true with a change that clearly will entail far-

[15] DPS estimate to ICAP Working Group members on December 11, 2002 (estimate based on the 2003 Con Edison service territory exclusive of the Orange & Rockland area).

[16] When asked, the NYISO staff proponents of the Demand Curve declined to estimate its rate impact, suggesting that it would be too speculative to do so. *See* Minutes of the December 13, 2002 BIC meeting.

reaching effects on consumers. The Demand Curve proposal fails to meet this test, and on that basis alone should not be adopted.[17]

### C. The Demand Curve Proposal Is Over-Inclusive and Would Confer Unwarranted Benefits on Environmentally Damaging and Inefficient Generation Sources

As the Demand Curve makes no distinction between new and existing generation sources, the benefits that it confers on generators may well flow largely to existing generation sources rather than to new market entrants. Appellants inferentially suggest that such an outcome would be beneficial in that it would encourage existing generators to remain in the New York market.[18] However, generators' economic circumstances vary widely, and a substantial number of them are undoubtedly well compensated under the current NYISO market model.

The proposed Demand Curve is therefore potentially too blunt an instrument – one that would confer a considerable windfall on those generators that already operate highly efficient facilities that are at no present risk of retirement or closure. Equally important, new alternatives that offer the prospect of attracting new generation facilities are already beginning to emerge. In at least one such instance, IPPNY itself has praised the willingness of a regulated LSE to seek to enter into a PPA with a new in-City generation source.[19]

---

[17] A far more constructive step to correct market distortions would be to adjust the NYISO deficiency charge to at most 1.25 times the cost of a gas turbine, thus conforming the charge both to economic realities, and to the policies of the ISO regions adjoining New York State. PJM, for example, uses the actual cost of a GT without the use of a multiplier.

[18] IPPNY Appeal, p. 2

[19] Con Edison has limited its recently announced RFP to new in-City generation projects, thus illustrating the potential greater flexibility attainable through the use of a PPA as opposed to a Demand Curve. Such an alternative offers the ability to target results more narrowly, and to avoid the over-inclusiveness that would impose costs without providing parallel public benefits. The Con Edison RFP was publicly praised by IPPNY Executive Director Gavin Donohue as a "good effort to encourage new plant construction" in

There is also no necessary correlation between New York State earnings and investment in this State. Many merchant generators and other developers have broad geographic reach, and capacity revenues earned here might well flow to projects located elsewhere. This fact further undercuts the Appellants' claimed direct connection between enhanced capacity revenues and the establishment of new generation facilities here.

Moreover, the deregulation process should be expected to lead to the reduced use or closure of less efficient power plants, as the DPS staff itself recognizes: "the retirement of old and inefficient plant is a normal thing . . . and it would be wrong to assume that this . . . should be prevented."[20] Without the assured rate of return characteristic of a traditional regulated market, plants with particularly high heat rates will likely yield relatively quickly to more efficient competitors - a process that will also provide considerable environmental benefits.

Thus, the phasing out of a 30-year old upstate plant should not itself be a cause for alarm. To the extent that the prospect of an immediate plant closure might lead to a capacity deficiency and thereby threaten system reliability, a more sensible and narrowly tailored answer would be the use of a PPA.[21] This would both prevent a precipitous plant closure, and simultaneously provide an interval that would permit potential new market entrants (whether new in-state facilities or imports) to realistically assess the energy prices they would need to provide in order to supplant the older facilities when the PPA

---

the article "Con Edison Bid for Power Seen Aiding Struggling Developers" published by the Dow Jones News Service (December 20, 2002)

[20] *See* Mark Reeder, "Government Intervention into Wholesale Electric Markets to Assure Generation Adequacy" at p. 5 (November 6, 2002)

[21] Preferably a short-term PPA to deal with the consequences of an immediate plant closure, but long-term agreements as a rule to provide greater forward visibility to potential generation investors. Were such PPAs necessary in order to temporarily avoid a capacity deficiency, they should be narrowly drawn to cover only the going forward costs of the necessary units, and the associated costs should be borne by the capacity-deficient LSEs.

period ended. Such a process would be far more likely to provide an orderly succession of energy suppliers, and would markedly improve environmental conditions without imposing needless costs on the rate-paying community. Even if a PPA were not to materialize in such a situation, the loss of in-state capacity would tend to raise prices, attracting imports that could respond almost immediately to New York State market anomalies. An old and inefficient plant operating at a 3% load factor[22] is surely a candidate for replacement (or repowering) in the relatively near term. As such, it should not be artificially supported for an indefinite period by a Demand Curve that would inappropriately treat all facilities equally.

## III. Conclusion

For all the above reasons, the Signatories hereto urge the Management Committee to reject the appeal of IPPNY.

Dated: January 6, 2003

Respectfully submitted,

Michael J. Delaney, Esq.
Energy Policy Advocate
City of New York
110 William Street, 4th Floor
New York, NY 10038
Ph. 212-312-3787
mdelaney@nycedc.com

[22] Reeder n. 19 *supra* at p. 4, referring to the Oswego generation facility

Catherine Luthin, Principal
Luthin Associates
15 Walling Place
Avon-By-The-Sea, NJ 07717
732-774-0005\
cluthin@luthinassociates.com
Consumer Power Advocates

Neil H. Butterklee, Esq.
Attorney for Consolidated Edison
Company of New York, Inc.
4 Irving Place
Room 1815-S
New York, N.Y. 10003
(212) 460-1089
butterkleen@coned.com

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

John Watzka
Central Hudson Gas & Electric Corp.
284 South Avenue
Poughkeepsie, N.Y. 12601
845-486-5495
jwatzka@cenhud.com

Raymond B. Wuslich, Esq.
Winston & Strawn
1400 L Street, N.W.
Washington, D.C. 20005
202-371-5700
rwuslich@winston.com
Central Hudson Gas & Electric Corp.

Judith L. Mondre
Executive Director
New York Energy Buyers Forum
c/o Mondre Energy, Inc.

1601 Market Street, Suite 1750
Philadelphia, PA 19103
215-988-0577 Phone
215-988-0579 Fax
judith.mondre@nyebf.org