

**ANSWER OF NEW YORK UTILITIES
IN OPPOSITION TO APPEAL OF IPPNY**

New York's investor-owned utilities, Central Hudson Gas and Electric Corporation, the Consolidated Edison Company of New York, Inc. ("Con Edison"), New York State Electric & Gas Corporation, Niagara Mohawk Power Corporation, a National Grid Company ("Niagara Mohawk"), and Rochester Gas and Electric Corporation ("New York Utilities") submit this response to the appeal to the Management Committee ("MC") of the New York Independent System Operator, Inc. ("the NYISO") taken by the Independent Power Producers of New York, Inc. ("IPPNY") challenging the rejection by the Business Issues Committee ("BIC") of a proposal to replace the current Installed Capacity ("ICAP")¹ Deficiency Auction with the administratively-determined ICAP Demand Curve presented by the NYISO staff on December 13, 2002 ("DC Proposal").

SUMMARY OF POSITION

Pursuant to requirements established by the New York State Reliability Council ("the NYSRC"), all Load Serving Entities ("LSEs") in the New York Control Area are presently required to maintain sufficient ICAP to cover their forecasted peak demands, plus a reserve margin, currently set at 18 percent. LSEs failing to comply with this requirement are subject to an ICAP deficiency charge ("ICAP Deficiency Charge") that is presently set equal to three times the levelized carrying cost of a gas turbine. LSEs that do not own sufficient generation to meet their ICAP obligations may purchase ICAP in bilateral transactions with generators or in periodic auctions administered by the NYISO. If the NYISO is unable to obtain sufficient ICAP to meet the demands of purchasers in

¹ As used in this Answer, the term "ICAP" includes both "Installed Capacity" as defined in section 2.74 of the NYISO's Control Area and Market Services Tariff and "Unforced Capacity" as defined in section 2.194a of that tariff.

any auction, the price of all ICAP sold in that auction is set equal to the ICAP Deficiency Charge.

The DC Proposal would modify these rules by replacing the ICAP Deficiency Auction with an administratively-determined “demand curve” for ICAP, which would establish a range of minimum prices at which LSEs would be required to purchase not only those amounts of ICAP needed to meet NYSRC requirements, but also additional quantities of ICAP above and beyond that level, whenever ICAP suppliers were willing to offer such additional supplies of ICAP at the prices established by that demand curve. Because the shape of this demand curve would be known in advance by all market participants, it would effectively act as a price floor on all ICAP transactions, including bilaterals. Thus, the DC Proposal would replace the free interplay of supply and demand in one of the unregulated markets for generation services which the NYISO was established to promote with a new system of mandated purchases of ICAP at administratively-determined prices.

These changes are likely to impose hundreds of millions of dollars in additional costs every year on New York’s already heavily burdened consumers. The PSC estimates that these charges will increase the cost of serving load in New York City by over \$ 400 million per year² and Niagara Mohawk estimates that these changes will increase its total payments for ICAP by approximately \$125 million per year. For the reasons noted below, IPPNY has failed to justify this enormous expenditure. IPPNY has made no attempt to demonstrate that the DC Proposal was the product of any comprehensive analysis of the needs of the ICAP, energy and ancillary service markets administered by the NYISO, and has failed to adequately address the potentially negative

² 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).

impacts of the DC Proposal on load across New York. Moreover, contrary to IPPNY's claim in its Appeal, alternative proposals were discussed and IPPNY has not proven that its proposal is better than those alternatives.

ARGUMENT

I. IPPNY HAS FAILED TO ESTABLISH A NEED FOR THE DC PROPOSAL

IPPNY claims in its Appeal that the NYISO's ICAP markets are inherently flawed because the present system ascribes no value whatsoever to any quantities of ICAP in excess of the level required to satisfy the NYSRC's ICAP requirement. As a result, IPPNY claims, ICAP prices "have spiraled towards zero" in times of even slight excess supply. Moreover, IPPNY asserts, ICAP prices will have to spike up to the level of the ICAP Deficiency Charge "once every three or four years." In such circumstances, IPPNY asserts that generators will be unable to finance the construction of new facilities, because the unstable nature of their ICAP revenues will make their projects appear unduly risky to banks and other financial backers.

This analysis suffers from several serious flaws. First and foremost, ICAP revenues are simply one part of a larger issue of generator revenue adequacy that neither IPPNY nor the NYISO staff have undertaken any effort to examine on a comprehensive basis. Generators also earn substantial additional revenues from the sale of energy and ancillary services. Since the NYISO's markets for energy and most ancillary services clear at the price set by the highest bid required to meet demand, generators can frequently earn significant net revenues from such sales. Generators may also bid to provide spinning or non-spinning reserves, for which they are similarly compensated. Because neither IPPNY nor the NYISO staff has presented a comprehensive analysis of generator earnings under current NYISO market conditions, there is no way to ascertain whether

the DC Proposal would appropriately compensate or overcompensate generators. In attempting to assess whether generators are receiving adequate revenues under the NYISO's current market structure, the NYISO must consider the generally adequate level of installed capacity in upstate New York and must analyze the numerous changes to the NYISO's markets that have been made in recent months and therefore would not yet appear in any comprehensive analysis of generator revenues. These changes include the following NYISO initiatives:

- The NYISO has modified the demand response program and adopted scarcity pricing rules that can be expected to substantially increase Real-Time Market energy 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 depress Real-Time Market energy prices;
- The NYISO continues to work to increase convergence between the Balancing Market Evaluation software used to run the Hour-Ahead Market and the Security Constrained Dispatch software used to run the Real-Time Market which may result in higher, but more efficient, price signals.

The NYISO must also include in its analysis the fact that other projects are now being developed or will be developed in the future to further enhance the efficiency of the NYISO's markets. For example, the NYISO is considering a scarcity pricing proposal that would set energy prices at \$ 1,000 per MWH during shortages of ten-minute reserves. This proposal is scheduled for implementation prior to the commencement of the Summer Capability Period of 2003.

To the extent that any market flaws remain which may inappropriately reduce the total revenues earned by generators below competitive levels, the NYISO should consider whether it would be more productive to address those concerns directly through market-based solutions in order to avoid the need to provide any offsetting subsidy payments through its ICAP program. In addition, the NYISO must also recognize that some existing generating facilities that claim to be experiencing financial difficulty may well be profitable to operate once they have restructured their current debt obligations and that other existing generators may be candidates for retirement.

Any proposal to displace competition and market mechanisms simply to protect existing generators from financial reorganization must be rejected.³ Generators have freely accepted the risks of participating in New York markets in the expectation that they would reap unregulated profits and, hence, are only entitled to recover those revenues allowed to them by the marketplace.

The notion that ICAP payments must be set at a level high enough to ensure that all existing generators continue to operate is similarly flawed. With actual installed capacity well above 118 percent of peak load, some plant closures or moth balling is to be expected in a properly functioning market. This is particularly true in upstate New York, where the capacity surplus is significantly above the state-wide average. One of the fundamental justifications for establishment of a competitive market for generation services was to ensure that those generating facilities that are unable to recover their going forward costs from TOTAL market revenues would be forced to shut down. Other more efficient units with short-run marginal costs that allow them to earn a margin on energy sales in some hours would be expected to continue to operate or to be maintained

in a state so that they could be made ready to operate upon a perceived impending shortfall in capacity.

The mere fact that some generators may be forced to reorganize and/or close their plants under current market conditions is therefore no indication that the NYISO must take action to administratively bolster generator revenues. In competitive markets, plants continue to operate when they are capable of recovering their going forward costs from TOTAL market revenues. Even if they are not capable of recovering all of their fixed costs, including debt service, it is rational to run the plants as long as they make a positive contribution to fixed costs. Scare tactics on plant closures are not a rational basis to administratively intervene and bolster plant revenues.

Moreover, the facts simply do not support IPPNY's claims. Despite generally adequate levels of installed capacity in upstate New York, prices for ICAP have not "spiraled towards zero," and have instead fluctuated as one would expect in unregulated markets. For example, the upstate New York Six-Month Strip Auction prices for ICAP since NYISO start-up are presented below:

\$1.50/kW-Month	May 1, 2000 – October 31, 2000
\$1.04/kW-Month	November 1, 2000 – April 30, 2001
\$1.90/kW-Month	May 1, 2001 – October 31, 2001
\$2.00/kW-Month	November 1, 2001 – April 30, 2002
\$1.75/kW-Month	May 1, 2002 – October 31, 2002
\$.65/kW-Month	November 1, 2002 – April 30, 2003

ICAP prices in New York City have remained high throughout this period.

In light of the fact that upstate New York had a surplus of energy throughout this period – and actually exported significant quantities of energy to other control areas even

³ In Sithe New England Holdings v. FERC, 308 F.3d 71, 78 (1st Cir. 2002), the court explained that "ICAP is not devised to compensate past investment but to spur sellers to make new investment and buyers to meet their reserve capacity obligations."

during peak hours in the Summer Capability Period of 2002⁴ -- these spot-market prices do not appear unreasonable on their face. While the ICAP price for the Winter Capability Period of 2002-03 is at the low end of the range of prices seen to date, that one data point does not establish a trend. These prices certainly do not support IPPNY's claims of a dysfunctional market characterized by price spikes every third year. Instead, these figures suggest that current ICAP payments, coupled with the other revenues earned by generators, have been sufficient to incent generators to provide the amounts of ICAP needed to satisfy NYSRC requirements.

IPPNY's analysis is also flawed because it completely ignores the fact that substantial amounts of ICAP are sold in long-term bilateral transactions or are hedged through contracts for differences. Many New York Utilities purchase substantial quantities of ICAP through such transactions, and the payments made to generators under these agreements generally exceed the spot-market prices set out above. When these existing bilateral arrangements expire or additional supplies of ICAP are required, these LSEs can be expected to anticipate their capacity needs and, as a result, to enter into additional bilateral contracts for new capacity at prices that are acceptable to both the buyer and the seller.⁵ This is entirely appropriate, since the purpose of these long-term arrangements is to protect both parties from the extreme prices that can be expected to result from time to time in even a perfectly competitive marketplace.

⁴ See D. Patton, Summer 2002 Review of the New York Electricity Markets at 71 (Oct. 15, 2002). This document may be found on the NYISO's web site at the following address: <http://www.nyiso.com/IndependentMarketReviewofSummer2002>.

⁵ Where the existence of market power precludes the negotiation of reasonable bilateral supply arrangements, bilateral transactions are not allowed. In such circumstances, the NYISO's Market Mitigation Measures require that existing generators sell all of their ICAP supplies through the NYISO's ICAP auctions.

In short, without even addressing the need for a new form of pricing for ICAP, such as a demand curve, it is apparent that there are numerous unanswered questions about whether this particular demand curve is appropriately shaped and set at levels that will ensure adequate resources without unduly subsidizing generators. In such circumstances, the BIC correctly concluded that the DC Proposal should not be accepted.

II. IPPNY HAS FAILED TO DEMONSTRATE THAT ITS PROPOSAL WILL ASSIST GENERATORS SEEKING TO FINANCE NEW PROJECTS

Even if IPPNY were correct in claiming that the NYISO's current ICAP rules create a flawed or dysfunctional market that interferes with the ability of developers to finance new generating facilities, there would be no point in adopting its proposal unless that action could be expected to cure that problem. It is therefore highly significant that IPPNY has offered no explanation of how its proposal would permit generators to finance new projects without entering into long term arrangements with LSEs. It is highly unlikely that any bank would finance a new generating facility on the basis of artificial above-market payments for ICAP that may be revoked at any time by amending the NYISO's tariffs, as artificially high rates for mandated purchases of energy and capacity from PURPA QFs were revoked by the New York State Public Service Commission once the full extent of the harm created by those prices became evident. Moreover, developers will generally need to enter into long-term arrangements to hedge the risks created by the other still unregulated markets in which they must sell all of the other generation services which their plants would produce.

Thus, it is likely that banks would continue to require developers who lack the resources to finance their own projects to secure a long-term commitment from a financially responsible purchaser even if the DC Proposal were adopted. Since, as previously noted, generators are already able to enter into such agreements to obtain an

assured source of ICAP revenues over the long term and thus insulate them from the ebb and flow of prices in unregulated markets, IPPNY has failed to demonstrate a need for its costly DC Proposal.

Moreover, an artificially high demand curve may stimulate substantial investment in situations where new entry is inefficient – for example, in circumstances when existing resources exceed projected load and reserve requirements. The costs of any excess capacity constructed in response to any such incorrect incentives will be borne by all consumers in New York in the form of higher prices for the services they receive from their LSEs. As previously noted, these increased costs could amount to hundreds of millions of dollars every year. The MC should be particularly cautious in reviewing any such proposal in light of the fact that consumers in New York State are still paying off the costs incurred as a result of the last regulatory program to mandate purchases from generators at administratively determined prices under PURPA and New York’s Six Cent Law.

CONCLUSION

In sum, IPPNY has failed to establish the need for the radical administrative intervention in the NYISO’s capacity market which it now proposes. Were some form of intervention required to aid in the financing of new generating capacity, IPPNY has not established that its proposal will achieve this objective. In such circumstances, it would be irresponsible to adopt such a costly proposal. Accordingly, Central Hudson Gas and Electric Corporation, the Consolidated Edison Company of New York, Inc, New York State Electric & Gas Corporation, Niagara Mohawk Power Corporation, a National Grid Company, Orange & Rockland Utilities, Inc., and Rochester Gas and Electric

Corporation urge the Management Committee to reject IPPNY's appeal of the Business Issues Committee's rejection of the DC Proposal.

Respectfully submitted,

Neil H. Butterklee, Esq.
Consolidated Edison Company of New York, Inc.
4 Irving Place, Room 1815-S
New York, NY 12207
212.460.1089 (tel.)
butterklee@coned.com

Attorney for Consolidated Edison Company of
New York, Inc.

George M. Pond, Esq.
Hiscock & Barclay, LLP
50 Beaver Street
Albany, NY 12207
518.429.4232 (tel.)
gpond@hiscockbarclay.com

Attorney for Niagara Mohawk Power
Corporation, a National Grid Company

John Watzka, Section Engineer – Transmission
Planning and Design
Central Hudson Gas & Electric Corporation
284 South Avenue
Poughkeepsie, NY 12601
845.486.5495 (tel.)
jwatzka@cenhud.com

Stuart Caplan, Esq.
Huber Lawrence & Abell
605 Third Avenue
New York, NY 10158
212.682.6200 (tel.)
Scaplan@huberlaw.com

Attorney for New York State Electric & Gas
Corporation and Rochester Gas & Electric
Corporation

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