STATE OF NEW YORK
EXECUTIVE DEPARTMENT
STATE CONSUMER PROTECTION BOARD

George E. Pataki **Teresa A. Santiago**
Governor Chairperson and Executive Director

October 22, 2004

John W. Boston
Chairman, New York Independent
System Operator Board of Directors
c/o Robert E. Fernandez
NYISO General Counsel
290 Washington Ave. Ext.
Albany, NY 12065

Re: Responsive Supplemental Information and Request for Oral Argument of the New York State Consumer Protection Board for NYISO Board Consideration of New ICAP Demand Curves for 2005/06, 2006/07 and 2007/08 Capability Years.

Dear Chairman Boston:

In accordance with the Procedures for Submitting Supplemental Information, the New York State Consumer Protection Board ("CPB") respectfully submits this Responsive Supplemental Information regarding the Initial Supplemental Information provided by other market participants. As required, the CPB is providing its written submission in triplicate with an additional copy by electronic mail to:rfernandez@nyiso.com. Additionally, CPB requests an opportunity to present oral argument before the NYISO Board or the relevant subcommittee.

Thank you for the opportunity to provide this additional information. In case of any questions or clarifications, please don't hesitate to contact me at (518) 486-3932.

Sincerely

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Responsive Supplemental Information of the New York State Consumer Protection Board Regarding the NYISO Staff's Proposed New Demand Curves.

1. Summary

On September 22, 2004, NYISO Staff issued its proposed demand curves for 2005–2007. Nothing in the Initial Supplemental Information filed by other parties on October 15, 2004 either substantially contradicts or casts doubt upon the NYISO Staff recommendations. The CPB continues to support the demand curves proposed by the NYISO Staff. We recommend that the NYISO Board file that proposal with the Federal Energy Regulatory Commission ("FERC") as soon as possible.

The process to establish the new demand curves began in March 2004 with the NYISO's hiring of an independent consultant, Levitan & Associates Inc. ("Levitan"), and concluded approximately seven months later with issuance of the NYISO Staff's proposed demand curves. Over this fairly extended period, there were numerous meetings of the Installed Capacity Working Group in which market participants provided information to the NYISO and questioned or supported the approach taken by NYISO Staff and its consultant in developing the new demand curves. Levitan provided an initial and draft final report to market participants identifying the proposed demand curve parameters. In each case, market participants were provided an opportunity to submit further information to correct or supplement the NYISO's findings. Several market participants took advantage of this opportunity and Levitan responded in many cases by making substantial changes to its proposal. After the release of Levitan's final report, the NYISO Staff issued its proposed demand curves in draft form, and provided market participants an additional opportunity to submit more information and comments on that proposal.

NYISO Staff used a balanced and exhaustive approach that provided all parties ample opportunity to submit information and any comments to guide the development of the demand curves. Further, NYISO Staff considered the views of all parties and reflected that input in a manner that balances the need of investors to have a fair opportunity to recover their costs with the need to prevent unnecessary burdens on consumers.

In its Initial Supplemental Information, the Independent Power Producers of New York, Inc. ("IPPNY") accepted the NYISO Staff's capital cost estimate of $87/kW-yr for the Rest of the State ("ROS"), but questioned the $20/kW-yr estimate for net revenue offsets. We disagree with that approach. Both capital cost and net revenue offsets must be considered together. In contrast, as stated earlier, the NYISO Staff carefully balanced its estimates of both capital cost and net energy revenues to arrive at reference values that would provide potential investors a fair opportunity to recover their cost without unnecessarily burdening consumers.

IPPNY and the New York Suppliers[1] contend that the net energy revenue forecasts for the demand curves should be set conservatively.[2] It appears that these parties want to have it both ways. They support the quasi-regulatory approach employed to set the demand curve since it provides them with a secure stream of revenues to justify investment in generation capacity. However they are apparently unwilling to accept a balanced approach to estimating the earnings potential of their generation investment. The CPB opposes the approach taken by IPPNY and the New York Suppliers, under which consumers would pay an established price for capacity while suppliers could retain earnings from higher energy revenues above what is required as fair compensation for potential investments.

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[1] Separate comments were filed by Entergy Corporation, the Mirant Companies and Sithe Energies, Inc. (collectively the "New York Suppliers"), pp. 8-9.

[2] IPPNY Initial Supplemental Information, October 15, 2004, pp. 3-4.

2. <u>The NYISO Board Should Take a Balanced Approach in Setting the New Demand Curves</u>

The NYISO Staff proposed capital costs of $87/kW-yr for the ROS and net energy offsets of $20/kW-yr resulting in a reference value of $67/kW-yr. IPPNY accepts the NYISO Staff's estimate of capital costs of $87/kW-yr for the ROS. However, it recommends that net revenue offsets for the ROS be reduced from $20/kW-yr to $10/kW-yr, resulting in a reference value for the demand curve of $77/kW-yr.

We disagree with this piecemeal approach. Capital costs and net energy savings must be considered together. IPPNY and the New York Suppliers claim that NYISO Staff used the higher end of the range of estimates for energy offsets,[3] but ignore the fact that the NYISO also used the higher end of the range of estimates for capital costs. NYISO Staff reviewed several estimates of capital and fixed operating costs for the ROS, including a DPS Staff estimate for Jamestown at $523/kW, an ISO-NE estimate for a General Electric Frame 7FA peaker in Maine at $560/kW, and a Levitan estimate at $599/kW. Estimates from PJM's territory indicated that capital costs should be between $369/kW and $447/kW. The NYISO Staff's proposal reflects the highest available estimate of capital cost. If IPPNY and the New York Suppliers object to the NYISO choosing the high end of the range of estimates for net energy offsets, they should be consistent and also apply the same criteria to the NYISO Staff's selection of capital costs. Contrary to the pick-and-choose approach of IPPNY and the New York Suppliers, NYISO Staff did a commendable job in considering all relevant information, including arguments made by IPPNY and other parties regarding both capital cost and net

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[3] IPPNY, pp. 2 and 8; New York Suppliers, p. 8.

energy offsets. The resulting NYISO Staff proposal balances the interests of both suppliers and consumers.

The $20/kW-yr net revenue offset consists of two components: $15/kW-yr for energy and ancillary service revenues that a peaking unit is expected to earn on average in the ROS, and an additional $5/kW-yr for the winter revenue benefit from reductions in capacity offers during the winter capability period. New York Suppliers and IPPNY assert that both components are overstated. They believe that the $15/kW-yr component for energy and ancillary service revenues is at the higher end of the range of available estimates. That contention is erroneous. Dr. Patton, the NYISO's market advisor, estimated net energy offsets of $18.52/kW-yr. In his letter dated October 1, 2004 to NYISO President and CEO William Museler, Dr. Patton stated:

> In my opinion, the NYISO's proposed new ICAP Demand Curve parameters are both reasonable and consistent with the underlying objectives for which the Demand Curves were originally implemented. In particular, the NYISO has proposed an offset value of $15 per MWh, which is lower than my historical estimate of $18 per MWh and consistent with my recommendations.

IPPNY and the New York Suppliers also contend that the $5/kW-yr estimate for winter revenue benefit is not justified and should be eliminated.[4] Their opinion is also inconsistent with Dr. Patton's finding on this issue. Dr. Patton stated that the winter revenue benefit reflecting reductions in capacity offers have occurred over the past two winter capability periods. He further explained that the $5/kW-yr adjustment is reasonable if these reductions are expected to occur in the future.

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[4] New York Suppliers, Initial Supplemental Information, pp. 5-7; IPPNY, p. 8.

It is also noteworthy that some market participants have estimated energy offsets that are higher than the $20/kW-yr recommended by the NYISO Staff. For example, the Transmission Owners ("TO") recommend that the energy offsets for the ROS be increased to $22/kW-yr instead of the $15/kW-yr used by the NYISO Staff.[5] These recommendations further demonstrate the reasonableness of the NYISO Staff proposal.

3. <u>Net Revenue Offsets Should Not be Set Artificially High as Advocated by the Suppliers</u>

IPPNY and the New York Suppliers contend that the reference values for the demand curve should be set conservatively.[6] These parties are apparently not concerned if demand curves are set too high and consumers have to pay higher prices; however, they assert that the risks of setting them too low, are unacceptable. We disagree. The suppliers want to have it both ways. They support the quasi-regulatory process employed to set the demand curve because it assures them a stable source of revenues. At the same time they want to err on the side of earning more than they need, by advocating a conservative approach in setting the demand curve. However, a balanced approach does not work that way. In return for a stable stream of revenues, a limit could be placed on suppliers' earning potential above what is necessary. If suppliers believe that it is not possible to forecast net revenues with sufficient confidence, a reconciliation process might need to be established. Under that process, if suppliers earn more than the forecasted target, the excess would be returned to customers. We are not necessarily proposing that such a mechanism be established. However, such an

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[5] Initial Supplemental Information filed on behalf on Central Hudson Gas & Electric, LIPA, New York State Electric & Gas, Niagara Mohawk Power Corporation and Rochester Gas & Electric, p. 5-7.

[6] IPPNY, p. 3; New York Suppliers, p. 9.

approach would appropriately balance investor and consumer interests, unlike the proposals by IPPNY and the New York Suppliers.

We believe that the demand curve should not be set artificially high or low. IPPNY and the New York Suppliers seem to ignore the fact that setting the demand curve artificially high will burden consumers and may erode the public's confidence in restructured energy markets, thereby leading to additional regulation or oversight of electric generators.

The New York Suppliers claim that the NYISO Staff has unilaterally attempted to continue a phase-in of demand curves. They criticize the NYISO Staff in concluding the following in their September 22, 2004 issuance of the new demand curves:

> The new Demand Curve parameters proposed here should continue to provide the efficient price signals that the Demand Curves were designed to provide at a reasonable cost to consumers.

The New York Suppliers misconstrue the NYISO's attempt to balance the need for efficient price signals without unnecessarily burdening consumers with high cost, as an attempt to incorporate cost impact considerations in setting the demand curve. We believe that the NYISO Staff should to be commended for balancing the need for efficient price signals with reasonable costs to consumers. As explained above, the NYISO Staff looked at a range of estimates for both capital costs and energy revenues and made recommendations that we believe will provide appropriate price signals to potential investors without burdening consumers with unnecessary costs. Setting the demand curve above what is necessary to provide efficient price signals would be bad public policy and an unnecessary burden on consumers.

Both IPPNY and the New York Suppliers also contend that regulatory intervention may be necessary if the demand curve is set too low and does not spur investment. We believe that the burden is on suppliers to show that there is no reason for regulatory intervention. Capacity must be added to the system to maintain reliability. As the NYISO points out in its September 22, 2004 issuance of the demand curves:

> The original Demand Curves provided significant revenue increases to ICAP suppliers when compared to market prices at the time they were introduced.

ICAP demand curves were established two years ago and it is time for the suppliers to respond to these significant additional revenues by increasing investment in New York.

4. Conclusion

For the reasons explained above, the CPB urges the NYISO Board of Directors to approve the demand curves recommended by the NYISO Staff on September 22, 2004 and file them with the Federal Energy Regulatory Commission for regulatory approval. The arguments by IPPNY and the New York Suppliers in opposition to the NYISO Staff proposal should be rejected.

Respectfully Submitted,

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