

**ADDITIONAL COMMENTS OF THE TRANSMISSION OWNERS SECTOR AND LIPA  
REGARDING THE DEVELOPMENT OF ICAP DEMAND CURVES**

September 15, 2004

The members of the Transmission Owners Sector (Central Hudson, Con Edison, New York State Electric & Gas, Niagara Mohawk, Orange & Rockland, and Rochester Gas & Electric) and LIPA hereby submit the following additional comments regarding the development of demand curves for installed capacity (ICAP).

**Development Cost Estimates**

In comments we have submitted previously, we have emphasized the importance of basing development cost estimates on actual development experience. The difference between the ROS development cost estimates that originally appeared in the report prepared for the NYISO by Levitan & Associates, which was not based on ROS development experience, and the revised ROS development cost Levitan submitted on September 1, which was partially based on actual development experience in an area where Levitan believed development costs would be similar to development costs in ROS, illustrates this importance.

As John Charlton correctly pointed out during the September 14 ICAP WG meeting, however, the ROS development cost estimate that he used to develop the preliminary demand curves was not fully based on actual experience. Rather, only two components of development cost—construction materials and labor—were based on actual costs. We have concerns that have been expressed in previous comments that some other categories—notably the balance of plant (BOP) and shipment line items—are overstated. These costs apparently are not based on actual experience, and so we fear that they may be overstated just as the construction materials and labor costs were overstated. We have not been able to assess these cost estimates in greater detail because a more detailed breakdown of these costs has not been provided to market participants, but we encourage the NYISO to endeavor to review these costs based on actual experience. If the NYISO is unable to do so, the NYISO should bear in mind that the resulting estimate of development costs is likely biased upward.

As we stated in our September 3, 2004 Recommendations, the NYISO should continue to look to other locations with similar development costs, such as PJM and ISO-New England. Levitan's September 1 update is consistent with ISO-New England's August 31 filing with FERC (See Exhibit ISO-8). When the PJM analysis can be obtained by the NYISO, or when it is made public, it should receive consideration before the NYISO makes its filing at FERC. The NYISO should also give fair consideration to the PSC Staff's detailed and impartial analysis of the Jamestown construction and to publicly available data regarding Athens.

Other market participants have indicated the desire to submit cost data to the NYISO in the wake of Levitan's revision of its ROS cost estimates. While we certainly have no objection to the NYISO gathering as much data as it can in order to inform its decision, the ISO must remain cognizant that a self-selected sample is unlikely to be a representative sample. Consequently, even if data the NYISO receives indicate that the NYISO's cost estimates are too low, one should not jump to the conclusion that the NYISO should increase its cost estimates, because other market participants in possession of data indicating that the NYISO may have overestimated costs have no incentive to release those data. Certainly, the failure of these market participants to submit these data previously buttresses this point, as it was not in their interests to release those data at that time. The NYISO should treat these data with the appropriate degree of skepticism, and it certainly should not accord any weight to cost estimates or projections that do not reflect actual development experience. In addition, it should not accord any weight to partial cost estimates—i.e., estimates provided by developers that reflect only some components of a plant's cost. Differences in accounting conventions used by different developers may cause some cost categories to be depressed below the NYISO's estimates while other categories are increased above

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those estimates, even though the total development cost is consistent with the NYISO's estimates. If the NYISO allows data that has been provided for only some cost categories to influence its estimates, it may overstate costs as a result. Additionally, accepting partial cost estimates will encourage the selective data release that we warned against above.

### **Energy and Ancillary Services Margins**

David Patton, the NYISO's independent market advisor, has prepared estimates of the margins above variable cost that entrants using the technologies specified in the Levitan study could expect to earn in the future, based on past historical performance. Generator representatives have taken issue with certain aspects of Dr. Patton's findings and have suggested that a better approach would be to use data produced by the model used by Levitan for its study. The plain truth of the matter is that, if one was considering developing a peaking unit, one would not use models to estimate its future margins because these models do not accurately model peaker revenues. They fail to do so because they fail to dispatch peakers with anything approaching the frequency with which they operate in real life. Developers of modeling software will freely admit this—the software was not intended for this purpose. The results that these models produce are not only inconsistent with past performance, but they are also inconsistent with future expectations, as the comparison of the future price curve to the prices that Levitan had forecast for 2005-06 (described in our September 3 comments) demonstrates.

There is no reason why the NYISO should base its estimates of peaker margins solely on the results produced by these models, given their inappropriateness for the task at hand and the evident disconnect between their output and reality. Instead, the NYISO must ensure that these results are consistent with actual historical experience. Dr. Patton's analysis is one such approach. Alternatively, modeling results could be used to adjust the historical results to reflect differences between the past and the future, and Con Edison has proposed a method for performing such adjustments.

In addition, we note that some of the criticisms of Dr. Patton's analysis included the assumed production cost recovery period for start-up costs in the Upstate region. As discussed in the September 14 ICAP WG meeting with Dr. Patton, a two-hour recovery time was used in the Upstate region and a one and one-half hour recovery time was used in the NYC/LI region. These adjustments are made to reflect a one-time supplier cost that becomes averaged into a typical unit run time, which can result in inappropriate estimated net revenues for the occasions that the GT operates longer or shorter than the assumed run time. Without actual data, it cannot be determined if the assumed run times are appropriate. It was unclear from the ICAP WG meeting if Dr. Patton reviewed actual data before making the run time assumptions. It would be appropriate for Dr. Patton or the NYISO to perform that review before the NYISO completes its study. An additional concern is that when the NYC run time is compared to the Upstate run time, the NYC run time seems to be too short. Since the NYC entry units are LM6000 GTs, they have heat rates comparable to the majority of the baseload steam units in NYC and are therefore likely to run much longer than 1½ hours after they are started. This assumption could significantly understate the net revenues from these units and can simply be verified by the NYISO through a review of GTs installed by NYPA in the NYC region. Upon this review, the NYISO should make the appropriate adjustments.

### **Multiple Conservatism**

During the meetings of the ICAP WG, a number of participants have indicated a desire to base the demand curves on estimates of the net cost of entry that are conservative—i.e., which tend to overstate the revenues that would be required to induce entry, given the error inherent in estimating the net cost of entry. We are concerned, however, that different elements of this calculation, if all calculated in a conservative manner, will give rise to an estimate of the net cost of entry that is unreasonably conservative and a demand curve overpriced for NYS loads.

For example, as noted above, if additional detail cannot be garnered regarding ROS development costs, we believe the resulting estimate will be conservative. Similarly, Dr. Patton has indicated that he views his estimates of energy and ancillary services margins during non-shortage conditions as an upper bound, because of his preference for conservatism. However, the \$10/kW adder (reflecting margins of \$500/MWh during shortage conditions) that he has suggested (although not endorsed) assumes only 20 shortage hours a year, a figure that seems to be less than would be implied by the 118% statewide ICAP requirement, so use of this adder is conservative.

During the September 14 meeting, Dr. Patton indicated that if his margins were to be the basis for the margin calculations used in the demand curves, he had a number of modifications in mind that he would have made. If there is time, we suggest trying to make those adjustments, which would eliminate the perceived need to reduce the margin estimate significantly to account for certain problems in Dr. Patton's estimates whose magnitude is unknown. If not, the ISO should be mindful that the cumulative impact of multiple conservatisms (including a development cost estimate that is on the high side, a margin estimate that is on the low side, and estimates of margins during shortage conditions that are also on the low side) may produce an estimate of the net cost of entry that is profoundly conservative.

### **Demand Curve Length**

Finally, we reiterate our previous statements that the demand curve length that the NYISO proposes must be justified on the basis that it best fulfills the objectives of the market, not on the basis that it was the length previously adopted and there is no particular reason to change it. In our September 3 comments, we proposed a methodology for determining that slope and no market participant, to our knowledge, has taken exception to that approach.