

City of New York

August 6, 2004

Via E-mail and U.S. Mail

Mr. John Charlton
New York Independent System Operator
3890 Carmen Road
Schenectady, NY 12303

Re: Levitan Draft Report

Dear John:

The City of New York (City) hereby submits its initial comments in response to the July 2004 Draft of Levitan & Associates' Independent Study to Establish Parameters of the ICAP Demand Curves for the NYISO.

1. The City's first issue is with the methodological approach taken by Levitan at the direction of the NYISO in estimating GT net operating revenues for the reference point on the curve. While Levitan should have estimated net revenues in a market at the 80% requirement and therefore not exhibiting a surplus or deficiency, the NYISO instructed Levitan to model the in-City market assuming certain near-term generation additions. The effect of this change is to create a surplus in the City, thereby depressing the net revenues expected to be realized by GTs relative to the market were it at 80%. This in turn results in an overestimation of the reference value, defined as GT capital cost less net revenues realized.

I understand that at the ICAP Working Group meeting of August 2, you acknowledged this problem, but declined to have Levitan change its modeling, instead suggesting that the Working Group itself use data from Levitan to make the appropriate adjustments. Such a post-hoc process in the Working Group does not appear to be a reasonable course to follow, and accordingly the City urges that Levitan re-run the model in question with an assumption of no near-term additions or retirements, and permitting the model to install generic new capacity as needed to satisfy the 80% minimum requirement.

2. Levitan has inconsistently assumed degradation of plant output and efficiency over time. While Levitan assumed such degradation for a new GT in its modeling of operating costs and performance, it made no parallel assumption for either existing plants or for new generic additions when forecasting the market price of energy and spinning

reserves. Were such degradation to be assumed in the modeling of market prices, the forecasted market prices would then be higher than those predicted by Levitan – as would the revenues received by the new GT. This lack of symmetry in methodological approach should be corrected in Levitan’s Final Study.

3. The Study’s analysis of withholding potential and the possible costs associated therewith in the City is of limited value. As was acknowledged at the August 2 meeting, the analysis posited a hypothetical supplier of a portfolio size significantly smaller than those of the principal unregulated suppliers in the City. In addition, the Levitan analysis did not take into account the bid caps on these suppliers, or the fact that a withholding supplier could profit were the NYISO to purchase withheld capacity out-of-market in order to relieve a spot auction deficiency.

This is a particular concern for the City, as Levitan recognizes in its Draft Study, stating at page 51 that “the incentive to withhold is more pronounced” in Zone J, and moreover, that suppliers have “an economic incentive to increase withholding practices as the regional surplus increase[s].” Zone J has a negative slope in Cases I, II and IIa ranging from -9.96% to -7.03%, and unlike Zone K is not characterized by the extensive use of long-term contracts as a check on the ability to withhold. Against this backdrop, it is critical that the Study modeling closely conform to the realities of the New York City market.

4. The 12.5% value for ROE is appropriate for the stochastic case, and is if anything too high for the deterministic case. In assuming on-balance sheet financing by credit-worthy entities, with balance sheet debt and equity funds that reasonably reflect project risks, Levitan asserted that its best judgment was that the 12.5% value was appropriate. It thus represents a reasonable estimate of the return expected by investors recognizing assumed revenue risks. While the stochastic case is inherently riskier than is the deterministic, it does not follow that the projected ROE associated with it should exceed 12.5%. Rather, the differential should run in the other direction, with the more predictable deterministic case requiring a somewhat lower ROE to spur investor interest.

5. The distinction in net revenues between the stochastic and deterministic cases is not simply a function of deviations from expected load in the real time market. Rather, the stochastic model attempts to capture the inherent uncertainty in the long term load forecasts assumed in the analysis, particularly as that uncertainty is revealed through the differences between the long term load forecast and the day-ahead forecast. This is important because of the contention by some that the new GT being modeled would be fully scheduled day-ahead, and therefore not in a position to capture any additional revenues resulting from deviations from expected load in the real-time market. Even were this contention correct, it does not follow that the higher assumed stochastic estimate of net revenues is inappropriate for such a GT.

6. Finally, the City notes its objection to the lack of comparability associated with the \$/kW-yr estimates in the three Levitan cases with the tariff values established for the 2004 demand curve. The Draft Study results are expressed in plant capacity as

measured at 59° F, while the 2004 demand curve reference value is expressed in terms of the lower capacity typically experienced in summer ambient temperatures. Thus, the Study reports a reference value for Case IIa (GT capital cost net of deterministically estimated net operating revenues) of \$139/kW-yr, which is seemingly some 8% below the 2004 tariff value of \$151/kW-yr. In reality, however, restating the Levitan result using the Levitan estimate of capacity rating at 90° F increases the Case IIa result almost 15%, and yielding a value of \$159/kW-yr for Zone J.

We understand that in the Final Report all results will be restated using the capacity rating at 90 degrees. Doing so would be helpful in clarifying the true effects of the demand curve calculation, particularly if the 2004 curve numbers are restated to allow an assessment based on truly uniform criteria.

Very truly yours,

/s/ Michael J. Delaney

Michael Delaney, Esq.
Energy Policy Advocate