

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

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New York Independent System Operator, Inc.)	Docket No. ER03-647-000
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REQUEST FOR REHEARING OF
THE ELECTRICITY CONSUMERS COUNCIL,
THE NEPOOL INDUSTRIAL CUSTOMER COALITION, AND
THE PJM INDUSTRIAL CUSTOMER COALITION

Pursuant to 18 C.F.R. 713, the Electricity Consumers Resource Council (ELCON), the NEPOOL Industrial Customer Coalition (NICC), and the PJM Industrial Customer Coalition (PJMICC) (collectively, Industrial Consumers)¹ request rehearing of FERC’s May 20, 2003 decision conditionally accepting the New York ISO (“NYISO”) Demand Curve Proposal.

STATEMENT OF THE CASE

On March 21, 2003, NYISO filed revisions to its ISO Market Administration and Control Area Services Tariff to implement a new Demand Curve Proposal (DCP). The DCP revises the structure of the existing, competitive bid-based ICAP/UCAP market in New York. Currently, according to NYISO, each load serving entity (LSE) must procure resources equal to 118 percent of its peak load, and each LSE is assessed a fixed deficiency charge of three times the annualized cost of a new peaking unit per MW for each MW that it is deficient. Under NYISO's DCP, the ICAP requirement would no longer be fixed at 118 percent of peak load. Rather, it would vary depending on the market price for ICAP determined using a "Demand Curve for ICAP" in a

monthly “Spot Market Auction.” The proposal establishes an administratively set market-clearing price for capacity above the statewide installed reserve margin established by the New York State Reliability Council. NY PSC and the NYISO contended the ICAP Demand Curve is necessary to incent the continued operation of low-capacity-factor generating units and new generation investment.

On May 20, 2003, FERC issued a decision accepting for filing with modifications the NYISO demand curve proposal. (103 FERC ¶ 61, 201) The Commission found that the proposed modification to NYISO's ICAP market will benefit customers because it will provide better price signals to investors for the construction of new generation, encourage the formation of long-term bilateral transactions, and reduce incentives to withhold capacity. FERC agreed with the NYISO that the DCP will encourage greater investment in generation capacity and thus improve reliability, by reducing the volatility of ICAP revenues.

SUMMARY LISTING OF ERRORS

1. FERC’s May 20, 2003 rejects the comments of ELCON, Energy East, Multi-Sector Protestors, and the Retail Suppliers Group that the Demand Curve Proposal is inconsistent with just and reasonable (J&R) case law.

- FERC’s reasoning is internally inconsistent. FERC justifies the DCP as fostering new generation yet denies the applicability of case law applying the J&R standard in the context of incentives. FERC errs in its summary rejection of the legal argument ELCON and other intervenors presented. FERC disagrees with intervenors’ reading of Sithe New England Holdings, LLC v. FERC, 308 F.3d 71

¹ NICC and PJMICC were among the multisector protestors and the multi-ISO consumer groups in two

(1st Cir. 2002), because the Sithe court did not use the term “incentive ratemaking.” Contrary to FERC, the Sithe court precisely addressed ratemaking in the context of ICAP. A line of appellate cases requires that FERC demonstrate a connection between rates intended to stimulate new supplies and the described outcome and that the level of incentive is no more than needed. FERC’s flexibility in approving rates that are intended to increase supplies and promote reliability is bounded by this judicial precedent.

- When case law dealing with ICAP programs and incentives is applied, it is apparent that the DCP cannot be supported as just and reasonable. There is little basis to conclude that DCP will incentivize new supply in New York State. Rather there is a threat of “creamy returns” beyond the extent necessary to stimulate supply.

2. The record does not indicate that the DCP will yield new generation investment in New York, the fundamental rationale for the DCP. FERC gave little weight to intervenors’ comments that the DCP does not assure that revenues from DCP will be dedicated to the siting of generation in New York.

3. FERC predicates its conclusion that DCP will spur generation on a finding that the DCP will decrease the current volatility of NY ICAP. However, FERC does not adequately answer intervenors’ concerns that DCP will simply replace quantity volatility for price volatility.

4. FERC gave insufficient consideration to the extreme cost impact of DCP. The May 20, 2003 decision implicitly acknowledges that it is difficult for FERC to quantify the costs

of DCP. Given the significant cost impacts and tenuous future benefits, FERC erred in approving the DCP without a clear demonstration that these benefits justify the costs incurred and that new generation will result.

5. FERC summarily rejected intervenors' argument that the DCP represents a throw back to the horse-and-buggy days of implementation of administratively determined avoided costs. Long ago, the experience that FERC gained under PURPA led the Commission to recognize that a competitive market, rather than administrative determination, would more closely approximate "just and reasonable" rates. Here, too, competitive means to stimulate capacity are far superior to the complex and speculative derivation of administratively determined charges.

6. FERC's acceptance of the New York ISO DCP undermines the collaborative process underway in the RAM Working Group by approving in one region a single element of one approach to long-term resource adequacy. Unless the FERC reconsiders its May 20 Order, the FERC runs the risk of chilling the good faith efforts underway in the RAM Working Group, preempting further analysis by an independent consultant over the next few months of a comprehensive market-based approach to long-term resource adequacy, and institutionalizing a trade-altering seam among Northeast electricity markets.

ARGUMENT ON REHEARING

1. Given That FERC Justifies Approval Of DCP On The Basis That DCP Will Incent New Generation, FERC Erred In Determining That It Was Not Subject To Case Law Governing Incentive Rates

A. FERC's Rationale For Rejecting ELCON's Argument That ICAP Charges Are Appropriately Treated As Incentive Rates

The DCP is neither a cost-based rate nor a market-based rate. FERC rejected the argument of ELCON and other intervenors that the DCP is subject to case law requiring a showing that a proposed increase in rates is needed and that the incentive is no more than needed to achieve the desired outcome.

FERC disagrees with ELCON that the cases involving incentive ratemaking for oil and gas pipelines are controlling. “Those cases involved incremental rate increases levied upon all customers. ICAP charges are not automatically applied to every sale of power, and they can be avoided by self-supplying or procuring adequate capacity through bilateral contracts.” Further, FERC disagrees with protesters' understanding of Sithe; that case does not hold that ICAP is an incentive rate subject to incentive ratemaking standards. The court never used the term ‘incentive ratemaking,’ nor did it reference any of the cases cited by protesters.”

The Commission found that the ICAP Demand Curve is a just and reasonable proposal and that it will benefit customers by encouraging the construction of new generation and thus enhancing reliability. FERC asserts that it “need not find that the proposed cure for the flaws in the ICAP market is the best measure available. Even if some alternative proposal could be deemed reasonable, that would not detract from the reasonableness of this filing.”

B. Contrary To FERC's Decision, The DCP Must Be Tested Against The Incentive Case Law Because FERC Has Justified DCP As Necessary To Stimulate New Generation

i. FERC Approves The DCP On The Basis That It Will Incent New Generation

ELCON finds it difficult to connect the dots in the Commission's reasoning that judicial case law on incentive rate ratemaking is inapplicable. At several points in the decision, FERC explains that the fundamental purpose of the DCP is to incent new supplies:

13. We will accept the proposal, with the modification described below, to become effective May 21, 2003. We agree with the NYISO that the proposal will encourage greater investment in generation capacity and thus improve reliability, by reducing the volatility of ICAP revenues.

...

36. The NYISO has presented information indicating that the proposed Demand Curve will yield the price signals to suppliers and their investors to build more capacity in constrained areas. Although the potential costs and benefits cannot be known with certainty, we conclude that the NYISO's analyses adequately demonstrate that the proposal will benefit customers because it will encourage the construction of new generation, will encourage the formation of long-term bilateral transactions, and, as modified below, will reduce incentives to withhold capacity.

...

44. The ICAP Demand Curve proposal was crafted to elicit, among other things, additional generation. By signaling that reserves above the 118 percent level have value, the proposal should help develop adequate generation supply and thus provide long term benefits to NYISO markets and customers. The Commission finds it reasonable to assume that increased stability in ICAP revenues will contribute to, but not exclusively influence, the construction of new generation which over time should provide for savings and benefits that are difficult to quantify at the present time.

...

70. The Commission finds that, given the boom-bust nature of the current ICAP mechanism, the inclination for the region to respond

to capacity problems with small, incremental solutions is greater than would be under the proposed ICAP Demand Curve. Under the proposed ICAP Demand Curve, generation added after the 18 percent reserve margin has been satisfied will be recognized as adding value to the energy markets. The Commission believes that the incentive to add generation beyond 118 percent is greater under the proposed ICAP Demand Curve – under which this additional generation would receive ICAP revenues – than under the current mechanism, under which that potential supplier does not know if it will receive ICAP revenues.

...

80. As stated above, the Commission does not expect that ICAP revenues received under the proposed Demand Curve will alone result in more financing. However, the Commission does expect that more reliable and predictable ICAP revenues would contribute to a more reliable overall revenue structure for an ICAP supplier and thus play some role in improving that supplier's prospects for financing. By design, the Demand Curve will produce ICAP prices greater than zero above the minimum ICAP requirement, and thus the Commission believes that the proposal will provide greater incentive for investment than the current system. With an expectation of more stable and positive ICAP prices, new generation and demand response resources will have additional incentive to enter the New York market because of a more stable revenue stream. While the Commission notes that generation will not suddenly appear in New York and instead will take time to develop, we conclude that implementing the Demand Curve now will provide greater support for adding generation.

FERC's reliance on DCP as a spur to generation cannot be squared with its inconsistent position that incentive ratemaking case law does not apply.

ii. Incentive Rates Must Be Limited To Rates Necessary To Stimulate New Generation In New York

FERC's rejection of the Sithe case on the basis that the court never used the term incentive ratemaking is belied by the text of the decision. In Sithe, the First Circuit revisited the question of ISO-NE's ICAP charge and whether sellers could demand a higher charge than \$0.17 kw-mo. for a 13-month period. The court admonished that ICAP is not a statutory

entitlement to sellers, rather ICAP is justified as “an extra incentive to construct new plants” and a penalty on those buyers who fail to acquire reserve capacity. Petitioners:

. . . are fatally wrong in thinking that ICAP is any part of a supposed statutory entitlement. The classic just and reasonable rate -- which utilities were entitled to implement, cf. *Mkt. St. Ry. Co.*, 324 U.S. at 566-67 -- is a rate that allows for revenues that compensate carriers for their investment and expenses, not necessarily for the individual service but (taken together with revenues from all of their rates) for their services as a whole. See *Fed. Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591, 614-15, 88 L. Ed. 333, 64 S. Ct. 281 (1944). In this instance, the rates that perform this office are the rates that petitioners charge when they sell their surplus power or sell standby rights assuring access to that power.

Sithe New England Holdings, LLC v. FERC, 308 F.3d 71, 77 (1st Cir. 2002). The court concluded that ICAP is appropriately treated as an incentive rate:

The ICAP charge, by contrast, is not of this ilk. Rather, it is a payment to suppliers over and above the amount they charge for power sold to or reserved for buyers. Its aim is not private compensation for past investment; instead, it is designed to serve two different public purposes: one is to give providers an extra incentive to construct new plants and the other -- this time the stick rather than the carrot, see, e.g., *ISO New Eng., Inc.*, 96 FERC 61,234 at 61,942 (2001) -- is to impose a hefty penalty on those buyers who fail to acquire the reserve capacity that FERC has decreed they shall have.

It is true that ICAP charges are tariffed -- not by the sellers but by ISO-NE -- and that FERC uses the “just and reasonable” rubric in regulating them, but they are simply not part of the compensation to sellers required by the statute. If ICAP charges were abolished by FERC tomorrow, the sellers could object that FERC was behaving unreasonably in its “on and off” regulatory policies but not that they were deprived of a just and reasonable rate. Sellers can still charge the just and reasonable rate for whatever power they sell to buyers or reserve for them.

Id. (emphasis added).

FERC seems to argue that it is only subject to the incentive ratemaking case law where incremental rate increases are levied upon all customers. The FERC’s reasoning that the DCP is

not incentive ratemaking because it will not affect all ratepayers, however, cannot withstand scrutiny. Although bilateral contracts will continue under the DCP, as well monthly and six-month auctions, the results of the monthly Spot Market Auction, in which the demand curve is applied, will quickly be reflected in bilateral contracts and the other auctions. Once the results of the Spot Market Auctions are known, ICAP suppliers have no incentive to negotiate a lower price in a bilateral contract, or to bid a lower price in an earlier auction. Thus, the demand curve will establish an ICAP floor price that will drive up the price of electricity for all New York consumers, just sooner for some than for others. FERC's conclusion to the contrary is based on a misunderstanding of the broad impact of the DCP. Incentive ratemaking case law requires: (1) departures from cost based rates justified on the basis of stimulating supply must bear a demonstrable connection between the funding in the program and the increased supply expected to result, and (2) rates must not only be needed, they cannot be more than is needed for the purpose. As demonstrated below, had FERC applied these standards, the DCP would have failed.²

More importantly, refusal to follow clearly-established incentive ratemaking case law will reward existing generators without incenting new investment.

In City of Charlottesville v. FERC, 661 F.2d 945 (D.C. Cir. 1981), the D.C. Circuit struck down the Commission's consolidated tax policy for gas pipelines that gave shareholders, rather than ratepayers, the benefits of consolidated tax savings that come from production losses. The court insisted that a stricter standard of review would apply to Commission ratemaking endeavors that seek to encourage certain behaviors through increased rates to consumers: “[If]

² Clearly, the DCP is not justified as a cost-based rate or a market-based rate. Given this plus the fact that the stated purpose of the Demand Curve is to incent new generation, a review of the DCP as an incentive rate is clearly appropriate.

the Commission contemplates increasing rates for the purpose of encouraging exploration and development...it must see to it that the increase is in fact needed and is no more than is needed for the purpose. Further than this we think the Commission cannot go without additional authority from Congress.” *Id.* at 950 (emphasis added) (quoting City of Detroit v. FPC, 230 F.2d 810 (D.C. Cir. 1955)). The D.C. Circuit also held in City of Charlottesville that the Commission must demonstrate that the incentive is effective in achieving the desired outcome.³ The court found that the tax savings were not being used to expand exploration, but were being put to general corporate purposes. With respect to the NYISO DCP, there is no assurance that increased revenues will be directed to the siting of new generation in New York or indeed anywhere in the U.S.

In Farmers Union Central Exchange Inc. v. FERC, 734 F.2d 1486 (D.C. Cir.) *cert. denied*, 469 U.S. 1034 (1984), the Commission remanded to FERC a generic ratemaking methodology for oil pipelines intended to stimulate new capacity. The opinion sums up several cases that establish that incentive rates must be justified with findings that the particular incentive increment will result in the intended outcome:

In the absence of such a reasoned inquiry, we cannot countenance FERC’s approval of oil pipeline rates which, by FERC’s own admission, ensure “creamy returns” to the carriers, 21 FERC at 61,650, and are “far more generous than those [rates] that [FERC] or other regulators give elsewhere,” *id.* at 61,646. In a similar context, this court explained:

If the Commission contemplates increasing rates for the purpose of encouraging exploration and development . . . it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose. Further than this we think the

³ As FERC is well aware, the natural gas precedent is directly relevant to the electricity precedent since the FPA and the Natural Gas Act. *See, e.g., Kentucky Util. Co. v. FERC*, 760 F.2d 1321 (1985) (comparable provisions of Natural Gas Act and Federal Power Act are to be construed in *pari materia*).

Commission cannot go without additional authority from Congress.

Id. at 1503, citing City of Detroit v. FPC, 230 F.2d 817. Farmers Union concludes by reiterating the importance of carefully calibrated incentive rate mechanisms: “Departures from cost-based rates must be made, if at all, only when the non-cost factors are clearly identified and the substitute or supplemental ratemaking methods ensure that the resulting rate levels are justified by those factors.” Farmers Union, 734 F.2d at 1530. Here, too, there is a risk that the Demand Curve Proposal will be “too creamy” and offer rewards not calibrated to increase generation.

In Public Service Commission v. FERC, 589 F.2d 542 (D.C. Cir. 1978), the court remanded an order of the FPC that provided an “optional certificate program” for natural gas producers that was designed to increase exploration and development of new gas sources.

Where, as here, an agency has established national rates on an average cost basis, and individual exceptions escalating the price above the national rate are established in the interest of increasing supply, there must be a connection between such increased funding and the increased exploration and development of new gas sources alleged to result. This principle has been stated in a number of ways: that there must be a “Quid pro quo” for the extra funding; that there must be an “inquiry into the incremental increase in gas supply” attributable to the program; and that there must be “symmetry” between the funding and increase in production. In the Supreme Court’s words, the program must provide increased funding “while assuring that such increase would not be levied upon consumers unless accompanied by increased supplies of gas.” Mobil Oil Corp. v. FPC, 417 U.S. 283, 318, 94 S. Ct. 2328, 2350, 41 L. Ed. 2d 72 (1974)....

Id. at 552-54 (emphasis added) (footnotes omitted). It is arbitrary and capricious for FERC to approve the DCP on the grounds that it will give more money to *existing* suppliers of qualifying capacity without any evidence of a demonstrable connection between these additional funds and any additional investment in new capacity – the Commission’s stated goal in approving the DCP.

FERC's May 21, 2003 decision does not answer Intervenors' argument that under the Demand Curve the increased ICAP payments are not tied to actual incremental investment in New York. Indeed, suppliers receiving the increased payments would be free to simply pocket them. The Demand Curve looks more like a subsidy to current generators as opposed to an incentive for future generators. Generally, the ICAP program is not designed as an incentive for new generation, but all generation. Thus, contrary to the holding in Public Service Commission v. FERC, there is no direct connection between the increased funding and actual increased investment in New York by generators receiving this largesse.

In Central Maine Power Co. v. FERC, 252 F.3d 34 (1st Cir. 2001), the court considered FERC's rejection of ISO-NE's \$0.17 ICAP charge and its reinstatement of the \$8.75 charge previously in effect. FERC had defended the \$8.75 charge because it "represents an approximation of the cost to install a peaking unit and represents a reasonable basis for setting a level to incent the construction of new generation." *Id.* at 40. The court remanded for further explanation by FERC of the reason for the rejection of the \$0.17 charge. FERC "owed petitioners (and the public who will likely pay some of any ICAP charge through passed-on retail rate increases) some explanation as to why FERC was not persuaded by petitioners' efforts to discredit the notion of a substantial charge in general or the \$8.75 charge in particular." *Id.* at 43. FERC was "not entitled to ignore claims that the cost of peaking facilities is less than it was in the past." *Id.* at 44. The court observed that PJM's ICAP charge was \$5.25 per kw-month while NYISO's net charge was \$8.75 per kw-month for much of 2000.

The principal questions that FERC needs to answer more fully are these: why, despite petitioners' various claims to the contrary, a substantial ICAP charge is still required to enforce reserve obligations; why, in light of petitioners' claims of a lower present cost of peaking capacity, \$8.75 is the proper interim figure; and why any alternatives already proffered by opponents are inadequate or are otherwise not properly considered at this time.

Answers can be imagined, but it is FERC that must formulate and adopt them in the first instance.

Id. at 48.

The Central Maine case affirms that FERC tariffs may set an appropriate level of ICAP charges as a vehicle to “assure adequate energy supplies” and “to encourage suppliers to maintain marginal (*i.e.*, high cost) existing plant or to build new facilities for peak demand.” *Id.* at 48. However, the lesson of Central Maine is that excessive ICAP charges are not sustainable. Pre-demand curve NYISO capacity charges were in line with capacity charges in neighboring ISOs. Projections that the NYISO Demand Curve proposal will significantly increase these charges will raise a red flag to reviewing courts under Central Maine.

FERC also states that “the Commission need not find that the proposed case for the flaws in the ICAP market is the best measure available. Even if some alternative proposal could be deemed reasonable, that could not detract from the reasonableness of this filing.” *Id.* at ¶ 22. To the contrary, we believe that FERC’s failure to give meaningful consideration to alternatives renders the Commission vulnerable under the case law invalidating agency actions as “arbitrary and capricious” where there is insufficient consideration of alternatives. See Farmers Union Central Exchange, *supra*, 734 F.2d 1511; Central Maine, 252 F.3d at 48.⁴

⁴ Moreover, as New York Utilities pointed out in its answer, the Commission has consistently required a matching in the basis for capacity and energy charges in wholesale capacity and energy sales. See Detroit Edison Co., 78 FERC ¶ 61,149 at 61,629 (1997) (it is the Commission’s longstanding requirement that demand and energy charges be calculated in a consistent manner.) See also Florida Power & Light Co., 66 FERC ¶ 61,227 at 61,532 (1994). The Commission has well settled precedent that precludes a wholesale power seller from selling capacity at cost-based rates and energy at market-based rates. Southern Co. Serv., Inc., 62 FERC ¶ 61,072 at 61,347 (1993) (when energy is priced on the basis of incremental cost, the demand charge must reflect the costs of the units expected to participate in the transactions); Indiana & Michigan Elec. Co., 10 FERC ¶ 61,295 at 61,592 (1980) (capacity charges will not exceed the annualized costs of the units expected to be employed for the generation of energy, weighted on

More fundamentally, FERC is too conclusory in its finding that the “ICAP Demand Curve is a just and reasonable proposal and that it will benefit customers by encouraging the construction of new generation and thus enhancing reliability.” FERC needs to scrutinize proposals that will impose added costs on consumers even when such proposals are undertaken for purposes of improving reliability. More searching analysis is needed than simply concluding that a rate proposal is “just and reasonable” or “falls within the zone of reasonableness.” These words of art are legal conclusions (similar to a finding that a civil defendant is “negligent” or that a criminal defendant is “guilty”). FERC should give greater weight to appellate precedent that will govern judicial review of its approval of the DCP.

2. FERC Has Provided Insufficient Consideration To intervenors’ Argument That The DCP Will Not Incent New Generation

A. FERC’s Rationale For Rejecting intervenors’ Arguments That The DCP Will Not Incent New Generation

FERC summarized the arguments of intervenors that the ICAP Demand Curve proposal will not provide incentives for new entry and that indeed there is no assurance that revenues from ICAP will be used to site generation in New York. FERC states that the Commission does not expect that ICAP revenues received under the proposed Demand Curve will alone result in more financing. “However, the Commission does expect that more reliable and predictable ICAP revenues would contribute to a more reliable overall revenue structure for an ICAP supplier and thus play some role in improving that supplier's prospects for financing.” 103 FERC ¶ 61,201 at ¶ 80. With an expectation of more stable and positive ICAP prices, new generation and demand response resources will have additional incentive to enter the New York market because of a more stable revenue stream. “While the Commission notes that generation will not suddenly

the basis of the relative expected hours of use). The Commission has not allowed a fundamental mismatch on the basis for capacity and energy charges.

appear in New York and instead will take time to develop, we conclude that implementing the Demand Curve now will provide greater support for adding generation.” *Id.*

FERC’s response to these important arguments that DCP is unlikely to incent new generation are that “all capacity suppliers, regardless of the age of their resources, are entitled to the same treatment in the ICAP market. While the Commission understands that certain generators may realize greater profits than others, that is simply a fact of the marketplace.” *Id.* at ¶ 81.

B. FERC Gave Insufficient Weight To intervenors’ Argument That The DCP Will Not Incent New Generation

A number of intervenors contended that the ICAP Demand Curve proposal will not provide incentives for new entry as is postulated in NYISO’s proposal. These intervenors argued that the reluctance to build in New York is not due to the composition of the ICAP market. Energy East and others argued that new investment and entry is dependent on the willingness of lenders to extend capital for the construction of new generation projects. Energy East argued that three things are critical to engendering lender confidence and thus new entry: (1) long-term contracts with creditworthy counterparties; (2) a stable regulatory environment; and (3) a stable and streamlined siting process. NYC and others asserted that the revenues received from the ICAP markets are an incremental factor at best in inducing generation construction. NYC and Morgan Stanley Capital Group argued that the ICAP Demand Curve proposal is too blunt an instrument, which may confer a windfall on generators who are not at risk of retirement. They further argued that, while intended to promote new generation, the proposal offers an “indiscriminate subsidy” to all manner of generation regardless of their ability to address reliability needs. NYC argued the ICAP Demand Curve proposal’s benefits may well flow largely to existing generation sources rather than to new market entrants while many generators

are already adequately compensated under the current program. Strategic Energy argued that increasing ICAP payments will not solve the resource adequacy problems of New York. Strategic Energy submitted that there are problems to be addressed having to do with siting, scarcity pricing, out-of-merit dispatch and bilateral markets.

We believe that FERC's response ignores the key argument made by the intervenors. As Morgan Stanley Capital Group expressed in its comments: "...The proponents have not demonstrated that higher prices in the ICAP market are necessary to promote and retain generation in the NYCA." While higher prices "would certainly result in greater ICAP revenues for generators, the necessary link between this increase in revenues and the promotion of generation (new and existing) in the NYCA has not been demonstrated." FERC did not address the telling comment that if the crying reliability need is to increase the amount of generation available in New York City at the time of highest peak loads, the most cost effective approach would be to encourage the addition of peak generation in the areas of concern rather than indiscriminately subsidize all generation.

3. FERC Does Not Satisfactorily Rebut Intervenors' Comments That The DCP May Increase Volatility

A. FERC's Rationale For Finding That The DCP Will Incorrectly Increase Supply By Decreasing Volatility Currently Associated With ICAP

FERC found that the current ICAP mechanism promotes price volatility in the market. The prices that an LSE is willing to pay depend on the likelihood of the deficiency charges. Currently, the amount paid as deficiency charges moves from near \$0 to over \$200 per kW-year depending on whether a fixed ICAP requirement level is met. Even if the market does not clear at zero, the extreme volatility does not provide the right incentives. "The ICAP Demand Curve will help stabilize these prices and send better price signals to encourage the construction of

generation before a shortage occurs, by reducing the volatility in deficiency charges. Since the ICAP revenue stream will be more stable and predictable under the proposal, the risk to generation investors – and the cost of financing new investment – should be reduced. We expect that customers would share in this cost reduction. The argument about whether a capacity shortage already exists is not determinative, since better price signals that will result should help prevent future shortages.” 103 FERC ¶ 61,201 at ¶ 31.

B. FERC Failed to Give Reasoned Consideration To Intervenors’ Presentation On Volatility

Admitting that the DCP is not justified on the basis that it will directly lead to new supply, FERC justifies the DCP on the basis that it will reduce volatility. Several intervenors, however, argued that the DCP will only substitute quantity volatility for price volatility. Retail Suppliers Alliance, Energy East, Con Edison and PJM argue that the DCP exacerbates uncertainty in that the quantity of ICAP an LSE is required to purchase can fluctuate from month to month. The intervenors state that LSEs have no idea of their obligations until after the monthly ICAP auction establishes those obligations. Intervenors argue that unlike the current system, LSEs have no way to hedge against the uncertainty associated with the monthly-required quantity. Industrial Consumers submit that FERC has failed to give reasoned consideration to significant arguments that the DCP imposes great uncertainty in the quantity of ICAP that an LSE is required to purchase which will fluctuate from month to month. LSEs have no idea what their obligations will include after the monthly ICAP auction establishes those obligations. Unlike the current system, there will be no way to hedge against the monthly required quantity.

Con Edison argued that DCP creates an active disincentive to contract for capacity in advance, preventing LSEs from “locking-up” capacity obligations and creating a severe strain on their business operations while causing all capacity transactions to flow through the monthly

Demand Curve Spot Market Auction. Con Edison states that the lowest risk strategy available for LSEs would be to purchase all their requirements in the Spot Market Auction, avoiding the strip auctions and bilateral contracts. Con Edison and Morgan Stanley Capital Group commented that the process of adjusting the ICAP Demand Curve every three years will be subject to negotiations and fraught with uncertainty, which compromises the reliability of revenue streams and thus is unlikely to compel investors to commit funds over the long term. Morgan Stanley Capital Group urged that this uncertainty practically eliminates long-term liquidity in the markets. Similarly, Multi-Sector Intervenors indicate that the provision which allows NYISO to withdraw or revise the ICAP Demand Curve at any time, pursuant to the governing procedures, introduces regulatory uncertainty and thus will not reassure nervous investors.

The response that FERC provides in the May 20, 2003 decision again gives Intervenors' objections short shrift:

60. With regard to the potential for the quantity requirement to fluctuate from month to month, the Commission expects that over time, as parties gain more experience with the ICAP Demand Curve, those fluctuations will decrease. The Commission finds the potential for variation with regard to quantity required is less damaging than the potential for variation in price under the current ICAP mechanism, where an event affecting an incremental amount of capacity may tip the region into capacity deficiency and subject parties to the deficiency charge.

Since the reduction in volatility is the bedrock justification FERC offers for DCP – which will not directly incent generation -- FERC should have given more reasoned consideration to this serious concern.

4. FERC Has Given Insufficient Attention To The Significant Cost Impacts Of The Demand Curve

A. FERC's Rationale For Rejecting Intervenors' Comments That The Demand Curve Proposal Will Increase The Costs Of ICAP In New York Without Providing Commensurate Benefits

FERC asserts that the long-term benefits of the proposed ICAP Demand Curve will outweigh any short-term price impacts. The Commission admitted that it could not predict the level or range of savings (103 FERC ¶ 61,201 at ¶ 43) but found: “The ICAP Demand Curve proposal was crafted to elicit, among other things, additional generation. By signaling that reserves above the 118 percent level have value, the proposal should help develop adequate generation supply and thus provide long term benefits to NYISO markets and customers. The Commission finds it reasonable to assume that increased stability in ICAP revenues will contribute to, but not exclusively influence, the construction of new generation, which over time should provide for savings and benefits that are difficult to quantify at the present time. Further, the Commission finds it reasonable to assume that the sloped Demand Curve, which will be phased in over three years, will reduce incentives to withhold capacity, thus providing savings and benefits, relative to the current ICAP regime, over the long term.” *Id.* at ¶ 44.

B. It Is Arbitrary And Capricious To Implement DCP When The Costs Greatly Outweigh The Benefits

The DCP would result in significant increased costs to ratepayers. The NYISO Market Advisor estimates a cost increase of \$71 million to New York City ratepayers in the first year of the Demand Curve and an increase of \$84 million for consumers in the rest of state. This is not small change. And the analyses provided by Dr. Carl Pechman and by Strategic Energy are considerably higher (Dr. Pechman estimated costs of \$700 million over a three-year period; Strategic Energy asserts DCP could cost \$1 billion per year).

FERC acknowledges that the Commission cannot predict the level or range of those savings but finds that, relative to the current ICAP mechanism, where the deficiency price is three times the estimates of the localized peaker, this proposal would provide savings. However, it is inappropriate to justify the DCP by comparing it to the deficiency penalty which, as New York City pointed out, is an arbitrary number that is far in excess of the deficiency penalty in neighboring ISOs and, therefore, should be reduced regardless of the DCP.

While we appreciate the Commission's candor in acknowledging that it cannot predict "the level or range of cost savings," the magnitude of the acknowledged cost burden on consumers is so large that it was arbitrary and capricious for FERC to approve the DCP without a demonstration that the DCP could produce substantial benefits and accomplish the stated purpose of encourage new generation in areas where it is needed. In effect, FERC has approved a very expensive experiment that will raise electricity prices in New York, and even surrounding regions, in the hope that new plants will be built.

C. FERC Gave Insufficient Weight To Arguments That The Demand Curve Is Exorbitant For The Small Reliability Gains It Might Produce

Assuming the Demand Curve would induce any generation investment that would not otherwise occur, the Demand Curve establishes prices that are excessive for the very small increase in reliability that would be attributable to it. The cost of additional reliability under the Demand Curve Proposal is significantly greater than any increase in reliability attributable to having more capacity. In an affidavit in support of Energy East's filing, David Segal analyzes the costs and determines that the proposed demand curve "is flawed because it seriously distorts the price that consumers pay for reliability." (Segal Affidavit, ¶ 13.) The NYISO's calculation that a one-day in ten-year likelihood of lost load is achieved at a 17.5% reserve margin also shows that the loss of load expectation is exponential with respect to reserve margin, not linear.

Whatever the correct value of lost load is, it is naturally constant regardless of how likely it is to occur. An example shows how the proposed demand curve fails this test. Assume for the moment that the \$85/KW-yr figure proposed for the Rest-of-State market for an 18% reserve margin is correct. At 18% the ISO calculates the expected loss of load at 2 hours per year. This translates to a value of lost load of \$42.16 per kWh.

The same demand curve would establish the value of capacity at \$42.50/kWh if the reserve margin were 25%. At 25% the ISO calculates the expected loss of load at 0.1 hours per year. Consumers would in effect be required to pay \$443/kWh (\$443,000 per MWh), or ten times as much for this level of reliability.

Segal Affidavit ¶ 14-15.

5. The Demand Curve’s Administratively Determined Approach Is Inconsistent With Competitive Markets

A. FERC’s Rationale For Rejecting Intervenors’ Argument That The ICAP Demand Curve Proposal Represents An Administrative Intrusion Into The Marketplace

FERC found: “Although this proposal includes administrative setting of the demand for ICAP, both the current proposal and the existing ICAP proposals use ICAP demand levels and deficiency prices that are administratively determined. Hence, there is no reason to reject the proposal based strictly on whether it is set administratively. The issue is whether the proposed administrative approach (like the existing administrative approach) is ‘just and reasonable.’ FERC finds that it is.” 103 FERC ¶ 61,021 at ¶ 49.

B. FERC’s Defense of the Administratively Determined Approach Is Insufficient

ELCON and Multi-Sector Intervenors protested that the DCP replaces current bid-based competitive capacity markets with administratively determined prices at which LSEs would be required to purchase capacity. We pointed out that the history of PURPA administrative “avoided cost” determinations should give FERC pause about administratively-determined

prices. As the Multi-Sector Protestors pointed out in their April 11, 2003 protest, administrative determination of avoided costs is a tricky exercise, unlikely to yield an accurate calculation:

Properly setting a fair, administratively determined price requires many economic judgments, including the following:

- Which type of resource should set the price of new entry?
- What are expected electricity prices?
- What are future fuel prices?
- Which types of resources will be on the margin and over how many hours?
- How much will the new resource run?
- What energy market revenues will the unit earn?
- What ancillary service market revenues will the unit earn?
- What are the capital costs, financial structure and required returns?

The accurate calculation of the equilibrium point where supply equals 118% of the forecast peak load on the supply curve requires the “correct” answer to each of these questions, a near impossible task in an otherwise deregulated market.

FERC gave insufficient attention to Energy East’s April 11, 2003 protest claiming that the Demand Curve relies on erroneous estimates of capital costs (failing to consider the glut of turbines), fails to recognize any value in generators after a 15-year assumed useful life, and fails to reflect energy and ancillary market revenues. Taken together, these adjustments result in a 23.4% decrease in the real levelized cost of new entry in the Rest of State (“ROS,” the part of New York State outside of New York City) and a 16.7% decrease in New York City. In an April 28, 2003 filing, Energy East recalculated the Demand Curve Equilibrium Point using the Demand Curve supporters’ own data and estimates on energy and ancillary service revenues

filed in this docket. Energy East then provided a summary table setting forth estimates of the cost of entry or energy and ancillary service market revenues.

	<i>All Figures in \$ per KW-Year</i>		
	<i><u>Filed Demand Curve Equilibrium</u></i>	<i><u>Revised based on NYISO & PSC Data</u></i>	<i><u>Further Revised to Reflect Cost of Entry Adjustment</u></i>
<i>ROS Capital Zone</i>	<i>Yr. 1: 56.24/Yr. 2: 67.49</i>	<i>34.50</i>	<i>14.50</i>
<i>In-City</i>	<i>Yr. 1: 127.89/Yr. 2: 151.14</i>	<i>96.00</i>	<i>69.48</i>

Without endorsing the above estimates, Energy East made the point that the NYISO's Demand Curve is dependent on highly speculative, administrative guesses on many variables that the market must establish.

The factors reinforce the contention that the Demand Curve Filing is unworkable and must be rejected. There is just far too much speculation in even the NYISO's estimates to justify such an intrusion into the market, particularly when the current market structure has not been shown to produce unreasonable results.

6. FERC's Decision on DCP Will Interference With RAM Working Group Process

A. FERC's Rationale For Rejecting Intervenors' Arguments that the NYISO DCP Will Create Seams

FERC states that the NYISO Demand Curve proposal does not prevent implementation of any future actions recommended by the RAM WG. The Demand Curve only replaces the Deficiency Procurement Auction of the current ICAP markets and will allow longer-term solutions to operate. The Demand Curve has not been rejected by the RAM WG, and is still under review. FERC supports the objectives of a common resource adequacy market design and

encourage stakeholders to continue to develop a multi-regional proposal. “The Commission is also encouraged by the stated flexibility of the NYISO to adjust the Demand Curve as necessary to accommodate the results of the RAM WG process.” 103 FERC ¶ 61.2-1 at ¶ 86.

The Commission does not believe that the implementation of the ICAP Demand Curve will create seams with neighboring regions. According to FERC, potential sale of ICAP into New York is a market response, is not an example of a seam, and is something that is made possible or is allowed by the tariffs in PJM and ISO-NE. “If the sale of ICAP into New York will cause a capacity deficiency in PJM or ISO-NE, FERC would encourage the ISOs to explore and file proposed market solutions to retain capacity. Ultimately, the development of a common approach by the RAM WG will ensure that the markets for ICAP are similar throughout the multi-ISO region.” *Id.* at ¶ 87.

B. FERC’s Decision Affirming The NYISO DCP Will Create Seams

PJM’s protest of the DCP shows that the DCP is opposed by neighboring RTOs. Industrial Consumers believe that the DCP will increase regional disparities and erect a new obstacle to developing a regional approach to resource adequacy in the Northeast and interfere with the ongoing efforts to integrate these markets. The three Northeast ISOs have been working together for many months to try to develop a common approach to ensuring resource adequacy for the region. The imposition of the Demand Curve filing in New York will introduce seams and undermine the collective efforts pursued to date. In fact, many differences exist today in the capacity markets of the NYISO neighbors. It is no solution to this problem to pressure PJM and ISO-NE to adopt the NYISO DCP.

NOTICES AND COMMUNICATIONS

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CONCLUSION

For the foregoing reasons, Industrial Consumers' request for rehearing should be granted.

Respectfully submitted,

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Dated: June 19, 2003

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Motion for Rehearing of the Electricity Consumers Resource Council, the NEPOOL Industrial Customer Coalition and the PSM Industrial Customer Coalition was today mailed to parties on the service list of this proceeding by U.S. mail, postage prepaid.

Dated at Washington, D.C., this 19th day of June, 2003.

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