

LEONARD
STREET
AND
DEINARD

THE ARMY AND NAVY CLUB BUILDING
1627 EYE STREET NW SUITE 610
WASHINGTON, DC 20006
202-974-6100 MAIN
202-974-6101 FAX

ROBERT C. FALLON
202-974-6110 DIRECT
fallonr@leonard.com

June 25, 2007

Hon. Jaclyn A. Brillling
Secretary
New York State Public Service Commission
Three Empire State Plaza
Albany, New York 12223-1350

Re: Case 06-M-1017 – Proceeding on Motion of the Commission as to Policies, Practices and Procedures for Utility Commodity Supply Service to Residential and Small Commercial and Industrial Customers

Dear Secretary Brillling:

Pursuant to the New York State Public Service Commission's *Order Requiring Development of Utility-Specific Guidelines for Electric Commodity Supply Portfolios and Instituting a Phase II to Address Longer-Term Issues*, issued April 19, 2007, the NRG Companies (NRG Power Marketing Inc., Arthur Kill Power LLC, Astoria Gas Turbine Power LLC, Dunkirk Power LLC, Huntley Power LLC, and Oswego Harbor Power LLC) hereby submit to the Commission an original and ten copies of their reply comments.

Thank you for your cooperation in this matter. Please do not hesitate to contact me if you have any questions or concerns.

Respectfully submitted,

NRG Companies

By _____
Robert C. Fallon
Attorney for the NRG Companies

cc: Service List

**NEW YORK STATE
PUBLIC SERVICE COMMISSION**

Case 06-M-1017 - Proceeding on Motion of the Commission as to Policies, Practices and Procedures for Utility Commodity Supply Service to Residential and Small Commercial and Industrial Customers.

REPLY COMMENTS OF THE NRG COMPANIES

Christopher C. O'Hara
Assistant General Counsel - Regulatory
NRG Energy, Inc.
211 Carnegie Center
Princeton, NJ 08540
609-524-4601
chris.ohara@nrgenergy.com

Robert C. Fallon
Leonard Street and Deinard
1627 Eye Street, NW, Suite 610
Washington, DC 20006
202-974-6110
fallonr@leonard.com

Dated: June 25, 2007
Albany, New York

**NEW YORK STATE
PUBLIC SERVICE COMMISSION**

Case 06-M-1017 - Proceeding on Motion of the Commission as to
Policies, Practices and Procedures for Utility
Commodity Supply Service to Residential and
Small Commercial and Industrial Customers.

REPLY COMMENTS OF THE NRG COMPANIES

In this reply, the NRG Companies (“NRG”) recommend that the Commission not (i) permit regulated load-serving entities (“LSEs” or “LSE”) to construct rate-base generation or (ii) abandon or distort the New York City market by relying on Reliability Must Run (“RMR”) Agreements.¹

I. The Commission Should Not Permit Regulated Load-Serving Entities to Construct Rate-Based Generation But Rather Should Ensure That Needed Resources Are Obtained Through Competitive Procurement Processes In Which All Entities Compete Under the Same Terms and Conditions.

Several commenters suggested that the best way to get new generation constructed in New York is to abandon not only markets, but also competitive procurement, and return to traditional rate-base generation.² To the contrary, adopting

¹ For purposes of this proceeding, the NRG Companies include NRG Power Marketing Inc., Arthur Kill Power LLC, Astoria Gas Turbine Power LLC, Dunkirk Power LLC, Huntley Power LLC and Oswego Harbor Power LLC.

² For example, Con Edison wants the Commission to “make clear ... that a utility built facility will be allowed as an alternative to entering into long-term contracts.” *Initial Comments of Consolidated Edison Company of New York, Inc. and Orange and Rockland Utilities Concerning Long-Term Contracts* at 11. Con Edison says, “there may well be opportunities to re-power facilities to provide for both steam and electric needs, as well as regional benefits.” *Id.* But the Commission gave Con Edison the opportunity to re-power its East River facility and that opportunity cost consumers almost double the amount it was supposed to cost. *NRG Initial Comments* at 6. Con Edison also suggests that “[a] utility built facility can be a better option than a long-term contract because there would be increased operational flexibility as conditions change, *i.e.* no need to amend a contract, and the increased stability and reliability that comes from the actual owner being a creditworthy entity.” *Id.* Avoiding changing a contract does not justify giving Con Edison a blank check at ratepayer expense. In any event, one reason Con Edison has superior credit is that ratepayers backstop its obligations. Central Hudson Gas & Electric (“Central Hudson”) even goes so far to say that “the regulated utility option may be the only choice...” *Phase II Initial Comments on Behalf of Central Hudson Gas & Electric Corporation*, at 13. But as set forth below in fn. 6, competitive suppliers competed vigorously in responding to the New York Power Authority’s (“NYPA”) Request for Proposals (“RFPs”) (as well as the divestiture RFPs) and will continue to compete vigorously if the Commission puts in place open and transparent processes.

competitive procurement processes should be the foundation of any Commission decision in this proceeding.³ First, competitive procurement is consistent with the clear public policy directives of the state.⁴ Second, competitive procurement will result in a more efficient outcome.⁵ Numerous suppliers will compete to provide the requested resource (by size, type, and location) and thus the resulting contract price will be, with certainty, the lowest cost solution for the desired resource.⁶ Rate-based generation, by contrast, delivers no such assurance but rather creates an incentive to increase costs so as to increase the return to the utility. Third, competitive procurement will capture a significant amount of the efficiency benefits of a competitive wholesale market and can be conducted in a manner that does not distort the market.⁷ At the same time, the

³ At the very minimum, the Commission should adopt a “competition first” policy, *i.e.*, only in the unlikely event that a competitive procurement process has tried and failed to produce the needed resources would it be appropriate to consider other methods, such as utility build.

⁴ Title 9 Part 250, Section 250.9 of the New York Code requires state agencies to select a formal competitive procurement process in accordance with guidelines established by the State Procurement Council. The procurement process shall include, but is not limited to, “...a reasonable process for ensuring a competitive field, a fair and equal opportunity for offerors to submit responsive offers; and a balanced and fair method of award.”

⁵ The PSC Staff agrees. *Staff Initial Comments* at 14 (“Staff Comments”) (pointing out the process of RFP approval, followed by an auction and the approval of contracts entered into with the winner of the auction, has developed into a reasonably effective mechanism). As the PSC Staff concluded, “[t]he lessons learned in conducting the divestiture RFPs, and in approving the contracts for the sale of the generating facilities, can be readily adapted to an RFP process for the procurement of electric infrastructure and resources through long-term contracts.” *Id.* The Federal Energy Regulatory Commission (“FERC”), on the other hand, recently said that “[c]ompetitive solicitation is a sound vehicle to support to long-term contracts in regions with or without organized markets,” noting that “[c]ompetitive forward power contracting allows many sellers to compete to provide electric service.” *Wholesale Competition in Regions with Organized Electric Markets*, Docket No. RM07-19-000, issued June 22, 2007 at ¶ 83, 85. (“ANOPR”).

⁶ For example, more than thirty bids were received in 2005 to serve NYPA’s governmental customers in 2008. *N.Y. Power Authority Approves Selection of Electricity Suppliers for New York City Governmental Customers*, February 23, 2005, available at <http://www.nypa.gov/press/2005/050223bpr.htm> Similarly, NYPA’s recent solicitation for 500 MW of capacity attracted diverse bids from fourteen different generation and transmission developers. *Comments by the City of New York* at 10. The results from the NYPA RFPs and divestitures RFPs show that competitive suppliers will step forward when open and transparent procurement processes are being used.

⁷ The NYISO Market Monitor recently referred to the NYISO’s markets as the “most complete and efficient set of electricity markets in the United States.” *2006 State of the Market Report New York Electricity Markets*, May 2007 at 2.

contracts resulting from such procurement will provide the certainty needed to support investment in new facilities – thereby ensuring resource adequacy and rate stability – without ratepayers bearing all the investment risk.

In order to obtain the most efficient outcome, the Commission should adopt the processes identified in NRG’s original comments which rely on competitive procurement, a robust and functional capacity market, and the establishment of resource adequacy requirements for all LSEs. As part of this process, the Commission should adopt a statewide resource planning process that is both flexible and coordinated with the NYISO planning process.⁸ Such planning must not, however, result in a return to command-and-control regulation. Rather the Commission should set portfolio targets for each LSE and then allow competitive suppliers to meet those targets.⁹ In exercising its oversight of the procurement of long-term resources and the development of a state-wide resource plan, the Commission should identify the optimum long-term resource needs (considering all resources – transmission, generation, and demand-side resources), and then competitively procure the identified resources through Commission-administered procurement processes.

The planning process must require all LSEs to procure a portfolio of assets, not only to serve load in the near term, but to provide their pro-rata share of the long-term

⁸ The Commission Staff agrees that any planning process can be coordinated with the NYISO. *Staff Comments* at 3, 7, 9-10.

⁹ NRG proposes a more flexible process than Staff’s Integrated Resource Plan. NRG would build off the NYISO CRP process by identifying, through annual filings with the Commission, the desired resources (or needed solution) and then procuring such resources from competitive suppliers either bilaterally or through a forward capacity market. Near-term resources (1-3 years) would be procured through BGS style auctions and intermediate-term resources (3-10 years) procured bilaterally or through an improved NYISO capacity market that provides for more forward contracting. In contrast, Staff’s Dynamic Energy Planning Process contemplates a top down resource planning procurement process that would dictate the specific resources to be procured in all circumstances. The Commission should dictate the resources to be procured only when long-term resources (10 to 20 years) are procured.

resource adequacy of the state, including contracts greater than 10 years. NRG agrees with Niagara Mohawk that energy service companies (“ESCOs”) benefit from improved reliability and thus should not be exempted from bearing their pro rata responsibility.¹⁰ Any arguments to the contrary can best be described as “they should not have to support resource adequacy.”¹¹

Competitive procurement should be conducted under the oversight of the Commission or other state governmental agency.¹² Moreover, the Commission should pre-approve the prudence of any contract and provide a recovery mechanism, in order to minimize any costs associated with such risks.¹³

All market participants, including existing suppliers, must be eligible to compete on a level playing field – lest the efficient market outcome be distorted. As in any competitive business, existing electric suppliers seek to develop economies of scale in order to be more efficient. The benefit of achieving such economies of scale dictates operating a fleet of generation facilities in a region, rather than a single asset. In addition, existing suppliers may have the best sites to respond to a particular procurement and utilizing existing sites may allow the existing infrastructure (*i.e.*, transmission interconnection facilities, fuel delivery mechanisms) to be utilized, resulting in greater

¹⁰ *Comments of Niagara Mohawk Power Corporation D/B/A National Grid on Phase II Issues* at 13 (Niagara Mohawk Comments). Any supplier of any product that is only obligated to provide the product for a short-term, will be able to undercut a supplier with a longer-term obligation to provide the product. The Commission must ensure a level playing field and thus require that all LSEs bear their share of resource adequacy.

¹¹ *Comments of the City of New York* at 8 (ESCOs’ portfolios are generally too small and too volatile to include utility-scale long-term resource commitments); *Initial Comments of the Retail Energy Supply Association and Small Customer Marketer Coalition* at 15-16 (stating that retailers should not have to support resource adequacy because their supply portfolios are tied to customers’ preferences).

¹² Staff agrees. *Staff Comments* at 13, 16. Moreover, NRG agrees with Staff that in the annual process the Commission should monitor the progress towards acquiring previously-identified resources. *Staff Comments* at 6.

¹³ Staff agrees. *Staff Comments* at 17-21.

efficiencies and lower costs to consumers. Such efficiencies should not be overlooked in the procurement process, particularly when a purchase power agreement that provides for the sale of both capacity and energy will mitigate any market power.

Finally, the competitive procurement process must include conditions to ensure that the competitive market outcome is not distorted if the Commission is inclined to permit LSEs, with regulated rates, to develop, own, and operate generation. The Commission must (i) require those utilities to offer their projects on the same terms and conditions as other market participants, with the same obligations and risks, and (ii) adopt protections to ensure that an affiliate preference does not distort the procurement and result in an inefficient outcome. For example, the Commission will need to ensure that there is no cross-subsidization occurring between the regulated LSE and its competitive generation affiliate. LSEs should not be permitted to incur development costs at ratepayer expense in order to gain an advantage in the competitive procurement, because these advantages will distort the efficient market and cause ratepayers to incur expenses that may never result in a used or useful project. Nor should such LSEs be permitted to pledge or encumber the LSE or its balance sheet for the benefit of its competitive generation affiliate. Equally, NRG rejects the suggestion that the utility develop proposed sites for use for new generation and then auction those sites (presumably with a PPA) over to merchant developers to build new generation.¹⁴ This process would create a bias towards a utility self-build option without consideration of alternative sites developed by competitive suppliers.

¹⁴ *Staff Comments* at 26.

II. The In-City Market Should Not Be Abandoned Or Distorted by Placing All In-City Units Under RMR Agreements but Rather the Commission Should Support a Forward Capacity Market.

Many reasons can be fostered on why there has only been a limited amount of market-based entry in the New York City generation zone.¹⁵ But certainly such limited entry should not be used to effectively abandon the In-City wholesale market as proposed by the Staff.¹⁶

Under the Staff's proposed plan, new units would receive contracts (possibly without using the beneficial procurement processes described above) without any consideration of the impact of the contracts on the wholesale market, while the existing In-City units would receive essentially the equivalent of RMR Agreements.

Rather than adopt Staff's flawed plan, the Commission should embrace the portfolio approach of NRG including that of a forward capacity market discussed herein, a form of which has been adopted by both ISO New England Inc. ("ISO-NE") and PJM Interconnection, L.L.C. A locational, forward capacity market cleared centrally and administered by the New York Independent System Operator ("NYISO"), in combination with a robust and competitive procurement process, is the most effective way to ensure long-term reliability in New York at the lowest possible cost.¹⁷ Such a market design would move the In-City market towards achieving the desired resource adequacy margin

¹⁵ NRG would submit, though, that the principal reasons have been prices inadequate to recover the cost of a new unit, and significant regulatory uncertainty – as evidenced by the multitude of on-going proceedings impacting the In-City capacity market.

¹⁶ *Staff Comments* at 21-25.

¹⁷ Large LSEs in New York, for example, support a forward capacity market. *See e.g., Niagara Mohawk's Comments* at 20. As Niagara Mohawk concludes, "an FCM [forward capacity market]-type mechanism is the most optimal method for addressing the Commission's goals." *Id.*, at 33. Similarly, the City of New York favors a forward capacity market. *A Greener, Greater New York PLANYC* at 106 ("PLANYC").

in a simpler, more straightforward and reliable way than any competing design.¹⁸ A forward capacity market would complement and enhance, but not replace competitive procurement, and bilateral contracts and a capacity market are not mutually exclusive.

The objective of a capacity market should be to support the right amount of competitive investment in generation resources by sending price signals that induce investment when supplies are less than the established Installed Reserve Margin (“IRM”), but not do so when supplies are greater than the IRM. To that end, the Commission should support the development of a forward capacity market (at least three years forward) that includes a long-term commitment period (at least five years). The best way for the Commission to support the development of such a market, is to, as set forth in NRG’s comments, require LSEs to procure a portfolio of resources, with a certain amount of that portfolio representing forward obligations designed to ensure the future resource adequacy of the state.¹⁹ If the Commission were to impose such a requirement, the NYISO – driven by stakeholder participation incentivized by the regulatory mandate – would certainly respond and market forces would ensure that the forward market is a robust market.

A locational, forward capacity market would ensure that (i) through an open and transparent auction process, the value of capacity is accurately reflected through competition between both new and existing resources, and (ii) the resulting price signal

¹⁸ Staff’s suggestion that the FCM is “complex” and may not “prompt the new investment needed to resolve reliability concerns” is belied by ISO-NE’s recent analysis. *Staff Comments at 24*. ISO-NE said that adopting FCM “brings the ISO closer to a long-standing objective – a complete set of wholesale markets that ensures power system reliability in New England by attracting investment in new and existing power resources.” *Annual Markets Report of ISO-NE at 6*.

¹⁹ FERC recently said it is “important for buyers and sellers in organized markets to be able to choose a portfolio of short-term, intermediate-term, and long-term power supplies. Having portfolio choice allows market participants to manage the risk that comes from uncertainty.” *ANOPR at ¶ 85*.

causes more efficient resources to displace the less efficient, and often times older, resources.

Long-term bilateral contracting will likely be an enduring feature of the New York regulatory framework, but that feature can and should be complemented by a robust capacity market. NRG does not view its proposed forward capacity market as a substitute for long-term bilateral contracting. Rather, bilateral contracts and an efficient wholesale market are not mutually exclusive, and indeed can be integrated partners in achieving the most efficient outcome, and thus the lowest achievable rates for In-City ratepayers.

Importantly, such a forward capacity auction would provide an accurate and transparent price signal so that LSEs could efficiently forward contract and demand-response providers could efficiently sell their capacity. A properly structured forward capacity market will create the correct incentive for LSEs to enter into long-term contracts to manage their forward exposure – including some component of their energy costs – thereby resulting in lower overall costs. Moreover, transparent pricing of capacity would also provide an important reference point for bilateral procurement decision-making, and should lead to increased efficiency in procurement decisions. Importantly, the forward capacity market will provide LSEs with the opportunity to sell excess capacity (and buy when short), thereby reducing the risk of the long-term commitment. The ability to sell excess capacity and purchase capacity when short will also allow LSEs the flexibility to manage load changes so that they retain only the amount of capacity needed to serve load.²⁰

²⁰ As Niagara Mohawk recognizes, forward capacity markets include mechanisms to accommodate the load shifts associated with retail access on a monthly basis. *Niagara Mohawk Comments* at 22.

As discussed briefly above, NRG’s proposal for a centralized capacity market will create transparent pricing of capacity that will facilitate negotiations of equitable long-term bilateral contracts. Many LSEs express concern with Commission *mandated* long-term contracts. But with properly structured capacity and energy markets, LSEs will have incentives to enter into long-term contracts to manage the risk of capacity shortages in load pockets and hedge energy costs by supporting more capital-intensive projects through bilateral contracts. Accordingly, the need for Commission *mandated* utility long-term procurement would be reduced and eventually replaced by market-driven incentives for long-term contracting.

In contrast, Staff proposes to place all existing In-City units under RMR contracts – not just individual units that want to retire, for economic reasons, but cannot for reliability reasons.²¹ Staff’s proposal would rely heavily on administrative determinations of what to contract for, at what price, but would not send a price signal to the market, trigger a market response, or discipline the bilateral contracting and likely result in inefficient bilateral contracting and higher costs for consumers.

The RMR agreements which the Staff encourages that the Commission pursue have faced opposition from regulators elsewhere, including state commissions, because such RMR agreements pay old and inefficient units their full cost of service, including a rate of return based upon the original investment cost, to keep these inefficient units operating. RMR payments end up *exceeding* the market revenues that would otherwise be available to these units.²² RMR contracts for existing resources will, in the long term,

²¹ RMR Agreements are appropriate in such limited situations.

²² Indeed, the underlying reason for the RMR contract is that the market does not provide a unit, needed for reliability, with sufficient revenues to stay in operation for economic reasons.

cost the consumer more dollars than relying on market forces such as a forward capacity market together with bilateral procurement.

Staff's proposal to willfully utilize out-of-market mechanisms such as RMR agreements to continue operating old and inefficient units would be bad public policy and inconsistent with (i) increasing energy efficiency and (ii) reducing the environmental impact of producing electricity, at a time when such issues are at the forefront of U.S. and world energy policy.²³ Specifically, using RMR agreements would forestall the entry of cleaner, more efficient generation – generation that can best increase energy efficiency and reduce environmental impacts – because (i) there is no incentive to retire units and re-power the existing sites, and (ii) the continued operation of the old and inefficient resources underestimates the true need for new resources.²⁴ Moreover, it would reduce reliability by relying on units that are over thirty years old, which have high failure rates and an unavailability of replacement parts. In sum, the end result of RMR Agreements is higher costs for consumers through reliance on outside-the-market mechanisms, rather than a least-cost solution resulting from competition from market participants based upon accurate price signals.²⁵

²³ The City of New York is part of this effort. It recently proposed to reduce carbon emissions by seven million tons by 2015 and greenhouse gases by 30% by 2030. The City also supported greater energy efficiency, noting that the existing plants “guzzle” 62% more fuel. *PLANYC* at 103, 108.

²⁴ As the Federal Energy Regulatory Commission (“FERC”) has repeatedly recognized, out-of-market RMR payments “distort market clearing prices in a way that understates the value of resources necessary to reliably serve load,” thereby discouraging new entry. *Richard Blumenthal, Attorney General for the State of Connecticut, et. al. v. ISO New England, Inc.*, 117 FERC ¶ 61,038 at P 58 (2006) *reh'g denied*, 118 FERC ¶ 61,205 (2007) (order denying complaint of Connecticut Attorney General seeking to require all Connecticut generators to be paid through RMR agreements); *Devon Power LLC*, 103 FERC ¶ 61,082 at P 29 (2003) (“RMR contracts suppress market-clearing prices, increase uplift payments, and make it difficult for new generators to profitably enter the market”).

²⁵ Not surprisingly, the FERC has repeatedly asserted that it disfavors RMR agreements. See, e.g. *Devon Power LLC*, 119 FERC ¶ 61,150 at P 5 (2006) (explaining that the Commission has rejected RMR agreements in the past “out of concern about the effect of widespread use of such contracts could have on the competitive market”); *PPL Wallingford Energy LLC*, 103 FERC ¶ 61,185 at P 13 (2003) (“an RMR

As such, the Commission's objective should be to minimize reliance on RMR contracts – not increase them – and support competitive markets, by supporting NRG's proposal for a portfolio approach to resource acquisition, including a locational, forward capacity markets. Such markets would provide for logical investment and retirement decisions through accurate forward price signals that vary by location. An open and transparent auction process would result in the selection of the best combination of existing and new resources to meet resource needs, with enough time for needed resources to be developed. An accurate forward price signal would result from competition between both new and existing resources, ultimately leading to lower costs for consumers.

In closing, the Commission should not embark on a course of action that would disregard federal jurisdiction over the wholesale market and distort the efficient wholesale market outcome, thereby forcing a jurisdictional conflict with the FERC.²⁶ The Commission need not embark on such a course given the benefits associated with the forward capacity markets adopted in ISO-NE and PJM and the ability of such a market to

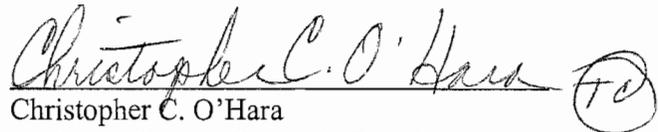
agreement should be a last resort and that proliferation of these agreements is not in the best interest of the competitive market as they affect other suppliers in the market").

²⁶ NRG supports the reply comments of the Independent Power Producers of New York filed on this issue.

coexist with robust bilateral contracting, together resulting in the most efficient outcome and lowest achievable rates for ratepayers.

Respectfully submitted,

THE NRG COMPANIES

Handwritten signature of Christopher C. O'Hara in cursive, with a circled 'FO' to the right.

Christopher C. O'Hara

Assistant General Counsel - Regulatory

NRG Energy, Inc.

211 Carnegie Center

Princeton, NJ 08540

609-524-4601

chris.ohara@nrgenergy.com

Dated: June 25, 2007

3907165