

# STATE OF NEW YORK DEPARTMENT OF PUBLIC SERVICE

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May 1, 2003

Honorable Magalie R. Salas, Secretary  
Federal Energy Regulatory Commission  
888 First Street, N.E.  
Room 1-A209  
Washington, D.C. 20426

Re: Docket No. ER03-647-000 - New York Independent  
System Operator, Inc.

Dear Secretary Salas:

For filing, please find the Motion to File Answer and Answer of the New York State Public Service Commission in the above-entitled proceeding. Should you have any questions, please feel free to contact me at (518) 473-8178.

Very truly yours,

David G. Drexler  
Assistant Counsel

Attachment

UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION

New York Independent System                    ) Docket No. ER03-647-000  
Operator, Inc.                                    )

**MOTION TO FILE ANSWER AND ANSWER OF THE  
NEW YORK STATE PUBLIC SERVICE COMMISSION**

Pursuant to Rules 212 and 213 of the Federal Energy Regulatory Commission's (FERC or Commission) Rules of Practice and Procedure, the New York State Public Service Commission (NYPSC) hereby submits its Motion to File Answer and Answer in the above-captioned proceeding. Although Rule 213 does not permit answers to protests unless otherwise ordered by the Commission, the Commission has accepted pleadings for good cause, such as when the responsive pleading would assist in the Commission's analysis, provide useful and relevant information, or would otherwise facilitate a complete and accurate record upon which the Commission can base its decision.<sup>1</sup> Good cause exists to allow the NYPSC's Answer because it will contribute to the development of a complete and accurate record, provide

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<sup>1</sup> See, e.g., East Tennessee Natural Gas Co., 81 FERC ¶ 61,219 at n.4 (1997); National Gas Pipeline Co. of America, 81 FERC 61,216 at n.3 (1997); Pacific Interstate Transmission Co., 81 FERC ¶61,369 at n.2 (1997); Florida Gas Transmission Co., 79 FERC ¶61,147 at n.7 (1997).

useful information, and assist the Commission's understanding and deliberations on this matter.

### INTRODUCTION

On March 21, 2003, the New York Independent System Operator, Inc. (NYISO) submitted a filing with FERC requesting approval of a gradually sloped demand curve as a replacement for the existing vertical demand curve in the NYISO's capacity market. On March 25, 2003, the Commission issued a Notice of Filing (Notice) soliciting comments by April 11, 2003.

In response to the Commission's Notice, various parties submitted comments, including the NYPSC. In our comments, we supported implementation of the installed capacity demand curve (ICAP demand curve), which we indicated would moderate the "boom or bust" feature of the current market design, enhance reliability over the long term by providing a more effective economic signal for new investment, and moderate energy prices by providing more stable and predictable capacity prices.

Several parties submitted protests to the ICAP demand curve asking the Commission to reject the NYISO's March 21, 2003 filing. These protests raise various policy arguments, namely that the demand curve is inconsistent with competition, will not

yield new investment, and the cost impacts are unjustified.<sup>2</sup> The record in this proceeding adequately addresses these major policy arguments against the ICAP demand curve. Consequently, there is no reason to repeat the responses to those arguments. However, to ensure a more complete record, we respond to the arguments that the Commission cannot legally support approval of the ICAP demand curve and that it is inconsistent with the ongoing efforts to revise the ICAP markets in the Northeast. As discussed below, the ICAP demand curve is consistent with case law and with efforts to revise the ICAP market in the Northeast.

#### **DISCUSSION**

There is general consensus that the current ICAP market is dysfunctional at times and yields results that run counter to the goal of providing reliable service at reasonable prices. As such, the NYPSC supports the NYISO's filing to implement an ICAP demand curve, which will improve the way the market operates. Despite a consensus that the ICAP market needs to be improved, several parties oppose the NYISO's efforts to implement changes. The Commission should reject those arguments.

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<sup>2</sup> See Multi-Sector Comments (April 11, 2003).

**I. The ICAP Demand Curve Is Consistent With Case Law**

Several parties take the position that the NYISO's demand curve proposal is inconsistent with case law.<sup>3</sup> These parties argue that the ICAP demand curve does not satisfy the Federal Power Act's just and reasonable standard, and that it constitutes impermissible incentive ratemaking. Contrary to these arguments made by ELCON, Energy East, and RSA, the ICAP demand curve is consistent with case law.

Energy East cites Central Maine Power Company v. FERC, 252 F.3d 34 (1<sup>st</sup> Cir. 2001) (Central Maine) and Sithe New England Holdings, LLC v. FERC, 308 F.3d 71 (1<sup>st</sup> Cir. 2002) (Sithe), for the proposition that "generators are not entitled to receive some hypothetical rates based on someone else's cost of entry while continuing to receive market-based energy rates, which together provide more than either the market or cost of service regulation would allow."<sup>4</sup> Similarly, ELCON points to these cases as being inconsistent with the ICAP demand curve. However, these arguments misread the holdings in Central Maine and Sithe.

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<sup>3</sup> Electric Consumers Resource Council (ELCON) Comments (April 11, 2003) at pp. 4-6; Retail Suppliers Alliance Comments (April 11, 2003) at pp. 14-16; New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation (Energy East).

<sup>4</sup> Energy East Comments at 20.

Central Maine merely held that FERC must provide a reasoned explanation for its decision to impose an ICAP charge. Specifically, the Commission was required to explain "why, despite petitioner's various claims to the contrary, a substantial ICAP charge is still required to enforce reserve obligations; why, in light of petitioner's 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."<sup>5</sup> The record in this proceeding provides a sufficient basis for the Commission to make the determinations required by Central Maine. For example, the NYISO and other proponents of the ICAP demand curve have presented evidence why a substantial ICAP charge is needed, why the price levels of the bids for different zones throughout New York are appropriate, as reflected in the ICAP demand curve, and why the alternatives that were presented are inadequate and/or should not be considered at this time.<sup>6</sup>

As far as the court in Sithe was concerned, the issue was statutory entitlement to ICAP charges and whether FERC was

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<sup>5</sup> Central Maine at 48.

<sup>6</sup> See NYISO filing (March 21, 2003), NYPSC Comments (April 11, 2003), Independent Power Producers of New York, Inc. Comments (April 10, 2003).

required to make an increased ICAP charge effective retroactively. Here, the parties have not even suggested that they are statutorily entitled to receive ICAP demand curve payments or that the payments should be made retroactively.

ELCON reads Central Maine and Sithe even further for the proposition that ICAP "is appropriately treated as an incentive rate" and as such "is subject to special case law limiting the level of incentives to that necessary to achieve policy objectives."<sup>7</sup> Similarly, RSA points to incentive ratemaking requirements. Central Maine and Sithe *do not* stand for the proposition that ICAP falls under incentive ratemaking. Although the court in Sithe observed that the purposes of ICAP were "to give providers an extra incentive to construct new plants and...to impose a hefty penalty on those buyers who fail to acquire the reserve capacity that FERC has decreed they shall have,"<sup>8</sup> the court indicated that "FERC uses the 'just and reasonable' rubric in regulating them."<sup>9</sup> As a legal matter, the Demand Curve is not an incentive ratemaking tool but rather an approach to ensure resource availability. As such, the

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<sup>7</sup> ELCON Comments at 5-6.

<sup>8</sup> Sithe at 77.

<sup>9</sup> Id.

Commission is justified in approving the filing under its powers to ensure that rates are just and reasonable.

Assuming arguendo that the ICAP demand curve is considered incentive ratemaking, the arguments raised by ELCON and RSA also lack merit. ELCON and RSA rely on the general principle that there must be substantial evidence showing a connection between incentives and the desired purpose of the incentives.<sup>10</sup> The D.C. Circuit in NYPSC outlined a specific three-part test for upholding incentives. Namely,

[t]here must be substantial evidence showing a demonstrable connection between the funding in the program under scrutiny and the increased gas supply which it will allegedly produce. There must be some minimum level of the coordination of the program under scrutiny with national ratemaking and other programs so that they create no conflicting or unnecessarily duplicating incentives. Lastly, there must be evidence of producers' actual costs so that it can be determined whether the additional funding results in profits too huge to be reconcilable with legislative command.<sup>11</sup>

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<sup>10</sup> RSA Comments at 15 (citing NYPSC v. FERC, 589 F.2d 542 (D.C. Cir. 1978) (NYPSC); ELCON Comments at 7-11 (citing City of Charlottesville v. FERC, 661 F.2d 945 (D.C. Cir. 1981), Farmers Union Central Exchange Inc. v. FERC, 734 F.2d 1486 (D.C. Cir. 1984), NYPSC, and Mobil Oil Corp. v. FPC, 417 U.S. 283, 318 (1974)).

<sup>11</sup> NYPSC at 550 (citations omitted).

Applying the facts in this proceeding to the test in NYPSC demonstrates that the ICAP demand curve is a permissible exercise of FERC's discretion. First, there is a demonstrable connection between payments under the demand curve and its stated goal of procuring sufficient capacity to meet the capacity needs of the state.<sup>12</sup> In other words, generators will likely bring more new capacity to the state if the prices they receive are less volatile. Second, the ICAP demand curve will not create any conflicting or unnecessarily duplicative incentives. The ICAP demand curve would replace the existing ICAP program and would be the only payment generators receive for meeting installed reserve requirements. Third, the ICAP demand curve utilizes cost data for constructing a new gas turbine, offset by energy and ancillary services revenues, to yield a schedule of buy bids that are consistent with mandates of the Federal Power Act (FPA). It is unnecessary to look at the specific costs of each generator to meet the court's standard because to do so would make it impossible to implement any industry-wide program, including the existing FERC-approved ICAP program. Thus, the ICAP demand curve satisfies the standards for appropriate incentive ratemaking.

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<sup>12</sup> Underlying the approach is the recognition that capacity in excess of the minimum reserve required has value to the system as a whole because it is more reliable and the potential for market abuse is lessened.

Finally, Energy East's claim that the ICAP demand curve violates the FPA's just and reasonable standard is incorrect. Energy East claims that the ICAP demand curve cannot be supported under cost-of-service or market-based rates.<sup>13</sup> As the court in Alabama noted, while the Commission is not required to utilize a particular formula to determine whether rates are just and reasonable, it is "well established that electrical rates should be based on the costs of providing service to the utility's customers, plus a just and fair return on equity."<sup>14</sup> Alternatively, the Commission has allowed sales at market-based rates "if the seller and its affiliates do not have, or have adequately mitigated, market power in generation and transmission and cannot erect other barriers to entry."

Although the ICAP demand curve could be viewed as a cost-of-service or market-based approach, given that it contains aspects of both, the demand curve satisfies both standards. On one hand, the ICAP demand curve is based upon the cost of new

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<sup>13</sup> Energy East Comments at 16 (citing Alabama Elec. Cooperative v. FERC, 684 F.2d 20 (D.C. Cir. 1982) (Alabama), Anaheim, Riverside v. FERC, 669 F.2d 799 (9<sup>th</sup> Cir. 1981), Public Serv. Co. of New Mexico, 25 FERC ¶61,469 (1983), Allegheny Energy Supply Co., LLC, 101 FERC ¶61,278 (2002), Central and Southwest Services, Inc., 82 FERC ¶61,001 (1998), CSW Power Marketing, Inc., 79 FERC ¶61,308 (1997), Progress Power Marketing, Inc., 76 FERC ¶61,155 (1996), Heartland Energy Services, Inc., 68 FERC ¶61,223 (1994).

<sup>14</sup> Alabama at 27.

entry and sets the prices that buyers will pay for varying amounts of capacity. On the other hand, the demand curve allows the market to determine the amount of capacity that is available at these prices. Furthermore, market power is less likely to occur under this approach, and in any event, market power will be mitigated under the NYISO's Open Access Transmission Tariff market monitoring plan

Energy East further argues that the ICAP demand curve violates Commission precedent requiring that demand and energy charges be calculated in a consistent manner and that precedent precludes a wholesale power seller from selling capacity at cost-based rates and energy at market-based rates.<sup>15</sup> However, none of these cases involve valuing capacity through an ISO but were limited to off-system and coordination sales. Second, the cost of a combustion turbine is solely an input to the demand curve. However, the demand curve alone does not set the capacity price. Rather, the actual price of capacity is set by the market. Specifically, it is the voluntary bids of suppliers that form the supply curve for the market. This supply curve, interacting with the demand curve, sets the market price.

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<sup>15</sup> Energy East Comments at 17 (citing Detroit Edison Co., 78 FERC ¶61,149 (1997), Florida Power & Light Co., 66 FERC ¶61,227 (1994), reversed by Florida Power & Light Co. v. FERC, 85 F.3d 684 (D.C. Cir. 1996, Southern Co. Serv., Inc., 62 FERC ¶61,072 (1993), Indiana & Michigan Elec. Co., 10 FERC ¶61,295 (1980).

The record here demonstrates that the demand curve satisfies the just and reasonable standard.<sup>16</sup> As Central Maine and Sithe clearly demonstrate, ICAP charges are permissible, so long as the Commission provides a sufficient explanation. The record here provides such explanation.

**II. The Demand Curve Is Consistent With On-Going Efforts To Revise The ICAP Markets In Neighboring Regions**

Several parties suggest that the demand curve should await the findings of the Resource Adequacy Model (RAM) Group, which was established by NYISO, PJM and ISO-NE to harmonize the resource adequacy market rules in the Northeast.<sup>17</sup> While we support regional efforts, it is unclear how long it will take before the RAM Group presents a proposal to the Commission. The RAM Group's recent Request for Proposals contemplates the use of a demand curve as one approach to its centralized resource adequacy market model. While a proposal is tentatively scheduled to be presented to the Commission by 2004, such a filing is uncertain. Indeed, it may take several years before the RAM Group is able to reach consensus on a preferred approach, if at all. The three regions would then need to approve that approach through their stakeholder process and

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<sup>16</sup> NYPSC Comments (April 11, 2003) at 17-21.

<sup>17</sup> Multi-Sector Protest (April 11, 2003) at 14-16.

present the proposal for FERC approval. The Commission should not delay remedying the ICAP market in New York pending the outcome of such a potentially lengthy process. Moreover, assuming an approach different than the ICAP demand curve is ultimately selected by the RAM Group and adopted by the three Northeast ISOs, there will be an opportunity for the NYISO to transition to that mechanism should the Commission approve it.<sup>18</sup>

**CONCLUSION**

The Commission should grant the Motion and consider this Answer in its decision-making process. Furthermore, the Commission should approve the NYISO's March 21, 2003 filing.

Respectfully submitted,

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Dated: May 1, 2003  
Albany, New York

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<sup>18</sup> NYISO filing (March 21, 2003) at 7.

CERTIFICATE OF SERVICE

I, Jacquelynn Nash, do hereby certify that I will serve on May 1, 2003 the foregoing Motion to File Answer and Answer of the Public Service Commission of the State of New York by depositing a copy thereof, first class postage prepaid, in the United States mail, properly addressed to each of the parties of record, indicated on the official service list compiled by the Secretary in this proceeding.

Date: May 1, 2003  
Albany, New York

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Jacquelynn Nash