Independent Power Producers Of New York, Inc.

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Assembly Standing Committee on Energy

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Thank you for having me here today to discuss this important issue. The underlying purpose of today's hearing is to discuss legislation that, if enacted, would result in a series of significant and unwarranted changes to the way New York's energy markets operate. I strongly urge you to resist implementing these changes. Our state's energy markets, as currently structured, have brought real, tangible benefits to New York's energy system and infrastructure, and, as a result, its consumers. While there are a myriad of issues that could be addressed in this testimony, I will confine my remarks to the policies that are most relevant to this proceeding.

As the President and CEO of the Independent Power Producers of New York, or IPPNY, I represent generators, power marketers, and other participants in New York's competitive power markets. IPPNY's membership and board of directors is made up of just about every kind of generation commercially available today - gas, coal, nuclear, oil,

wind, hydro, landfill gas – you name a technology, we have a member who produces electricity using it.

Over the past 14 years, IPPNY's members have spent billions of dollars to purchase and to continue to operate the generating assets owned by the regulated utilities following the 1996 New York State Public Service Commission's seminal order setting forth its policy on competitive electricity markets and declaring its intent to encourage competition wherever feasible. It is IPPNY's members who have continued to build, improve, and invest in New York's energy supply infrastructure.

In fact, independent power producers have invested well over $10 billion in acquiring and building generation in New York State. As a result, not only do they provide the energy to the state's businesses and residents, they themselves employ over 10,000 individuals and pay hundreds of millions of dollars in taxes. Plus, considering the jobs retained or created by sectors that support electricity (railroad, fuel and equipment supply, etc), the direct benefit of these generators is enormous.

When the PSC made its policy decision regarding electricity competition, it believed that introducing competition to the electric industry in New York would inure benefits, such as reducing prices, spurring innovation and efficiency, encouraging economic growth, and increasing environmental protections. I am here to demonstrate that the results from introducing competition into New York's energy markets have justified making the transition.

One of the most important benefits of well functioning competitive markets is that they provide the appropriate incentives for efficient investment and operational decisions. The absence of a guaranteed regulated return, which is a central feature of competitive markets, is a strong motivator that drives innovation and dictates how generation resources are operated much more efficiently in New York today than they were as regulated assets.

Unlike the regulated, vertically integrated utility paradigm, competition provides price signals to promote an efficient level of investment in appropriate locations. Though roughly only a decade old, competitive markets in New York have bolstered system reliability, increased generator availability and efficiency, retained needed existing generating facilities and encouraged the development of some new generation. All of these benefits are critically important and show that New York's energy needs can continue to be satisfied by competitive electricity markets in the future.

In fact, generator availability has reached an all time high in New York under the competitive market design. Impressively, average generating facility availability increased from 87.5 percent through the years of 1992–1999 to 94.4 percent in the years 2000–2007. This increased availability of existing facilities is equivalent to adding 2,400 MW – four medium-sized generating facilities – to the grid. The importance of generator availability cannot be overstated, especially during times of peak demand. It is essential to note that in 2006, when electricity usage records were set three times in rapid

succession during a heat wave in the summer, independent power producers continued to operate their facilities with unprecedented efficiency and availability to meet the energy needs of consumers. In 2003, when a blow to the transmission system blacked out power for millions of people in the Northeast, it was the dependability, flexibility, and reliability of generators that played a critical role in bringing the system back on line.

Not only are consumers' electric energy needs being met reliably, but also the cost of that electricity, when adjusted for inflation, has trended lower. Steve Whitley earlier indicated that the percentage reduction is around 11% presently. Given today's economic picture, that is a strong indication that the private owners and operators of electric generating facilities are working hard to maximize output and compete with each other to serve consumers' needs without increasing costs.

Several studies on the impacts of competitive markets have been conducted and found that reduced outages, higher efficiencies, and better overall performance by today's generating facilities have resulted in savings in the hundreds of millions of dollars for New York's consumers. Dr. Sue Tierney, an expert on energy policy and economics and a former U.S. Department of Energy official under President Clinton, has authored some of these studies, as have prominent economists, former FERC commissioners, and other experts in the field. In fact, just this past October, following a long process with extensive stakeholder input, FERC issued a statement that said:

“Effective wholesale competition protects consumers by providing more supply options, encouraging new entry and innovation, spurring development of new technologies, promoting demand response and energy efficiency, and improving operating performance of market participants.”

A key component of competitive markets, including New York’s, is the uniform clearing price or UCP, and other witnesses today have provided an in-depth explanation of the merits of the UCP. It is important to note that the UCP auction process is the appropriate vehicle to encourage efficient operation of existing facilities and investment into new facilities with lower operating costs. In fact, this past Tuesday, the COMPETE Coalition, released two new studies supporting this statement. When a UCP auction is used, the lowest cost provider of electricity gets the largest contribution to its fixed costs. Therefore, those with lower operating costs, such as those that use a less expensive fuel, are able to secure needed dollars to meet their other costs. Bidders that have higher operating costs, such as those that use higher-cost fuels, receive a smaller contribution to fixed costs and, in turn, have a strong incentive to become more efficient.

Some say generators should be paid only their actual offers. The uniform-clearing-price market, it is said, pays too much for electricity because it sets a price for all equal to the highest-priced unit called on. Under the proposed alternative, the “pay-as-offered” market, when a generator’s offer is accepted, it would be paid only the price it offered. The expectation is that a pay-as-offered market would result in lower prices.

However, a pay-as-offered system does not result in lower prices than a uniform-clearing-price market. Economic theory, economic models and real world experience support this conclusion. The seeming benefit of a pay-as-offered system is based on the assumption that generators' bidding strategy would remain the same in a different market. However, that assumption is false. Under the pay-as-offered system, financial success depends more on producing the most accurate forecast of prices rather than on operating more efficiently. Pay-as-offered rewards the best forecasters. Smaller generators and new producers are disadvantaged because they may not have the resources needed to most accurately forecast prices.

Under the uniform-clearing-price system, financial success depends on efficient operations. New and efficient generators with lower costs have the opportunity to maximize their revenues. The lowest-cost, most efficient generators receive the greatest reward. As a result, the system encourages construction of efficient generation. Eventually the efficient new generation will displace more costly, less efficient generating units. If a generating company attempts to exercise market power and force prices higher than a competitive level, smaller market participants, which receive the same price, would be encouraged to build new generation and enter the market. The result would be less concentration and more competition.

These demonstrated results naturally occur when competition and the UCP are introduced into an industry that previously had little incentive to become more efficient and cost-effective. Indeed, under the old model where utilities were paid a return on their total

revenue requirement, they had the exact opposite incentive – increasing the revenue requirement meant increasing the return.

An equally compelling benefit of New York's energy markets is that it shifts the risk of poor investment and operational decisions from the consumer to the shareholders of IPPNY member companies. Under the regulated paradigm, investment decisions largely were rewarded with both a return of, and on, the investment. In the competitive arena, merchant companies internalize fully the risks associated with not only recovering their base investment but also securing any return on their investments. Now, if there exists poor investment decisions, consumers no longer are subjected to the excess costs of those decisions through utility rates.

Within just the past ten years, there are two stark examples of consumers being adversely impacted by regulated, rate-of-return projects. The Consolidated Edison East River project was constructed to supply steam and electricity at consumers' expense. The initial cost was projected to be $408 million, while the actual cost was some $788 million, almost double the initial estimate. The overrun was absorbed by Con Ed's consumers.

The Rochester Transmission Project also was funded by consumers and was ultimately constructed with a cost that was significantly over budget. The initial cost for this project was $75 million. The final price tag came in at approximately $125 million. As with the Con Ed project, this 67% increase is being absorbed by consumers. If these projects had

been built by merchant companies, the cost overruns would have been absorbed by stockholders, with no risk to consumers.

Independent power producers in New York clearly have been willing to accept the risk of making those investments. Merchant companies have spent billions of dollars to acquire generating facilities from the investor-owned utilities through auction protocols that were designed to maximize auction proceeds for the benefit of New York's consumers. In addition, new generation has been built in New York State since 2000, with more than 80 percent of it sited where demand is greatest. The trend experienced here in New York has mirrored the national trend. According to an October 2007 study by the Analysis Group between 1996 and 2004, roughly 74 percent of electricity capacity additions nationwide were made by non-utility entities who are not assured full cost recovery. A conservative estimate of the capital costs of the capacity added nationally between 2000 and 2007 is approximately $73 billion. That number is higher now for certain.

In any market structure, several factors affect the cost to produce electricity that are out of the control of the consumer, the utility, and the independent power producer. The price of fuel is the most prominent factor affecting energy prices across the country. As is true across the country, natural gas prices play a particularly important role in this state's energy market. According to the NYISO, "New York State's generation supply has been, and remains, heavily dependent on oil and natural gas. Over 60 percent of the state's installed capacity burns one or both of these fuels." As a result, and as reported by the NYISO, when fuel prices rose last year, the electric prices followed. Correspondingly,

also as reported by the NYISO, when natural gas prices declined 45% during the period from June to November of 2008, the statewide average cost of wholesale electricity dropped by 54%.

Beyond fuel input costs, environmental compliance is significantly increasing the cost of operation and construction, most notably for coal-fired facilities, and has become a driving factor with respect to the type of facilities that will be constructed as we go forward. Meeting existing clean air regulations is expected to cost an additional $2.7 billion a year in 2010 and $4.4 billion in 2015. This total is calculated before taking into account the recently adopted Regional Greenhouse Gas Initiative ("RGGI") and the potential federal carbon reduction requirement, which could be enacted in the next few years. Despite these challenges, independent power producers continue to own, operate, and develop generating facilities, and they are doing so better than ever before.

Generation divestiture combined with robust competition has led to operational improvements in existing facilities that in one way or another have reduced their operating costs. According to a study by the Economic Analysis Group ("EAG," located within the U.S. Department of Justice's Antitrust Division), "There is now substantial evidence that, in states that have restructured, generating firms have lowered their costs and improved their operating performance… Greater efficiency and lower operating costs enhance total economic welfare, provide investment incentives and save on scarce input resources."

These efficiencies also bode well for the environment. Adding newer, more efficient generating technology and dispatching the system more efficiently has led to reductions in emissions from generating facilities. In addition to the environmental benefits associated with efficiency, competitive markets also have allowed renewable energy to flourish. According to the American Wind Energy Association ("AWEA"), the development of renewable energy facilities is thriving under competition. In addition to the facilities already on line, eighty-three wind-powered generation projects are currently under construction nationally, totaling just over 8,500 MW. These projects are expected to be completed in early 2009.

According to AWEA, 93 percent (or 7,944 MW) of the wind generation projects currently under construction are being developed by competitive suppliers, with 92 percent of wind generation projects being constructed in regions that have organized wholesale electricity markets. Here in New York State, 1,000 MW of wind generation capacity has been interconnected to the grid, with over 7,000 MW of wind projects in the development queue. More renewable projects have been developed in Regional Transmission Organization ("RTO")-operated markets, due to the open access transmission policies that enable suppliers to obtain economical transmission service, the visibility of prices by location and time of day, and the ability to sell into spot markets and/or to multiple buyers.

Demand response programs have grown dramatically under the current market structure, with nearly 3,000 participants, including large manufacturing facilities, educational

institutions, and other power consumers aggregated by energy services companies, curtailing energy use at appropriate times. The potential electricity savings that can be realized from the programs have increased to about 2,100 MW – an amount equal to four medium-sized power plants. Indeed, when looking toward meeting future energy goals, demand response programs are a part of the solution, and competitive markets provide the best opportunity for them to thrive.

To conclude, competitive markets in general offer several positive benefits, and New York's markets specifically with their co-optimized structure designed to provide the most efficient, least cost dispatch of resources for the direct benefit of consumers are being heralded as a model for others to follow. As with any system, these markets are continuing to evolve. I implore the members of this committee and the Assembly as a whole to forego further consideration of these unwarranted extreme measures.