# IPPNY Panel Discussion

## Confluence of Public Policy and Competitive Markets

Arif Y. Gangat

Arrowgrass Capital Partners

September 13, 2012

# INTRODUCTION

- **New York's electricity market is at a crossroads:**
  - The Energy Highway Initiative is an ambitious program to upgrade New York's transmission and generation infrastructure and bring jobs / economic development back to the state.
  - RFI Response May 2012: 85 Respondents identifying more than 130 proposals.
  - Over 25,000 MW of new and repowered capacity.
- **The challenge for New York is create a competitive, market-driven environment that will attract the required new investment:**
  - The goal: merchant generation projects financed with private investment.
  - Hurdles: Capacity prices must reflect the true cost of new entry and allow investors to earn a reasonable return.
  - Recognition that PPAs and other forms of public-sector subsidies cost ratepayers much more in the long run.
- **Public policy does not have to be at odds with competitive markets. Proper enforcement of the existing rules can effectively address the threat of both buyer-side and supplier-side market power and would attract investment in merchant generation.**

# NEW YORK'S ICAP MARKET – A HISTORY OF LITIGATION

- **Recent litigation at FERC (ER10-3043, EL11-42, EL11-50, EL12-98) relating to the implementation of the buyer-side mitigation rules has heightened investor concerns about New York's commitment to competitive electricity markets:**

  - The entry of uneconomic capacity from Astoria Energy II and Bayonne Energy Center caused capacity prices in Zone J to crash.

  - Incumbent merchant generators, whose capacity had been economic, have been forced to retire capacity.

  - Information obtained via the Freedom of Information Act confirms investors' worst fears – an apparently deliberate campaign to subsidize unnecessary capacity via an above-market PPA, with the goal of suppressing overall capacity prices.

  - Lack of transparency, use of dubious assumptions and the defense of flawed MET methodologies suggest that in New York, a project's mitigation status is driven by politics, not its unit economics.

  - FERC ruled on the EL11-42 complaint in June 2012, providing much-needed clarity on how the BSM Rules should be implemented on a prospective basis.

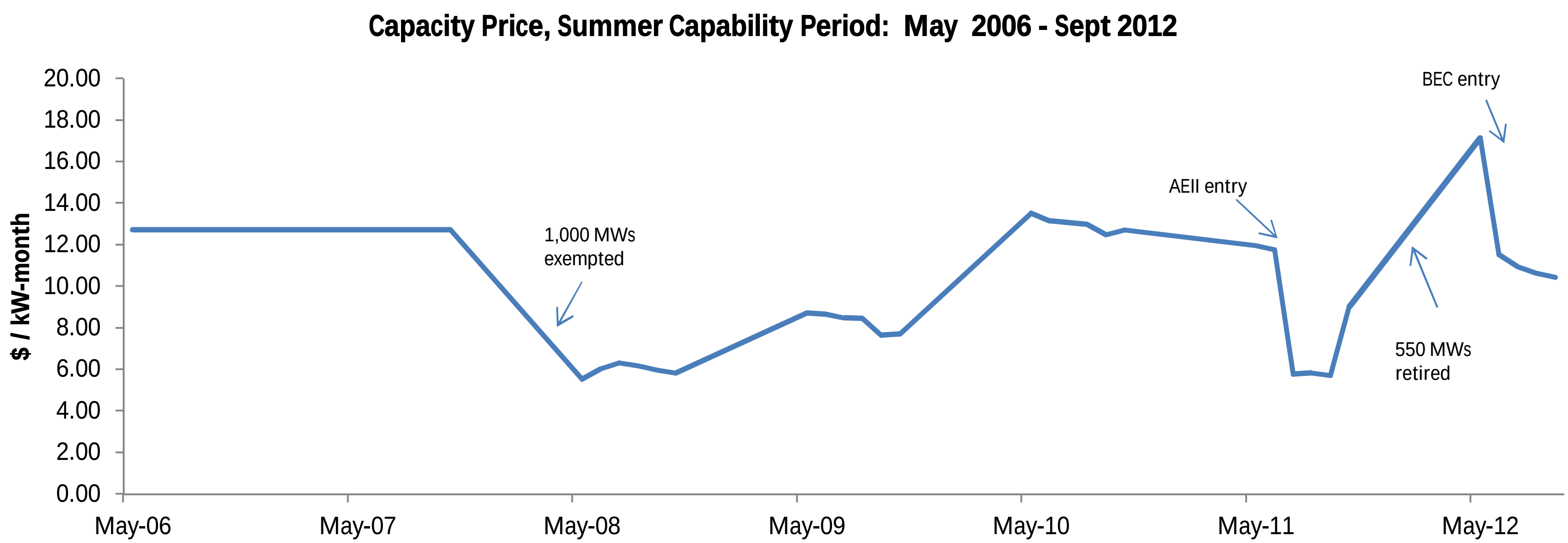
  - FERC ruled on the EL11-50 complaint on September 10, directing NYISO to re-test AEII and Bayonne. Proper and timely follow-through by NYISO in those re-tests (as well as HTP) is critical to addressing investor concerns about the New York market.

# NEW YORK'S ICAP MARKET – AN INVESTOR'S PERSPECTIVE

- **Key Requirements for investment in New Generation Capacity in New York:**
  - Transparency into MET process, with consistent and objective implementation of the BSM Rules.
  - Relative price stability to provide downside protection and afford reasonable rate of return over life of project.
  - Reasonable, unbiased load forecasts that do not perpetually overstate demand / load growth.
  - Price signals driven by increased demand / reduced supply, **<u>not</u>** RFPs, PPAs and subsidies.
- **The aforementioned criteria have not been present in New York, prompting the need for PPAs and other forms of subsidies that cost ratepayers much more in the long run:**
  - NYISO's annual Gold Book load forecast for 2012-2017 has been cut every year since 2007. 2012 peak demand in Zone J has been reduced by 1,145 MWs, or 9.1% since the 2007 Gold Book forecast.
  - More than 1,000 MWs of Zone J generation was exempted in 2008, and the exempted entry of AEII and BEC added another 1,000 MWs of uneconomic capacity to Zone J in 2011 and 2012, respectively.
  - With an estimated 11,500 MW of 2012 peak demand in Zone J, these actions have caused a severe suppression of capacity prices and made New York un-investible for merchant generators.

# New York's ICAP Market – An Investor's Perspective

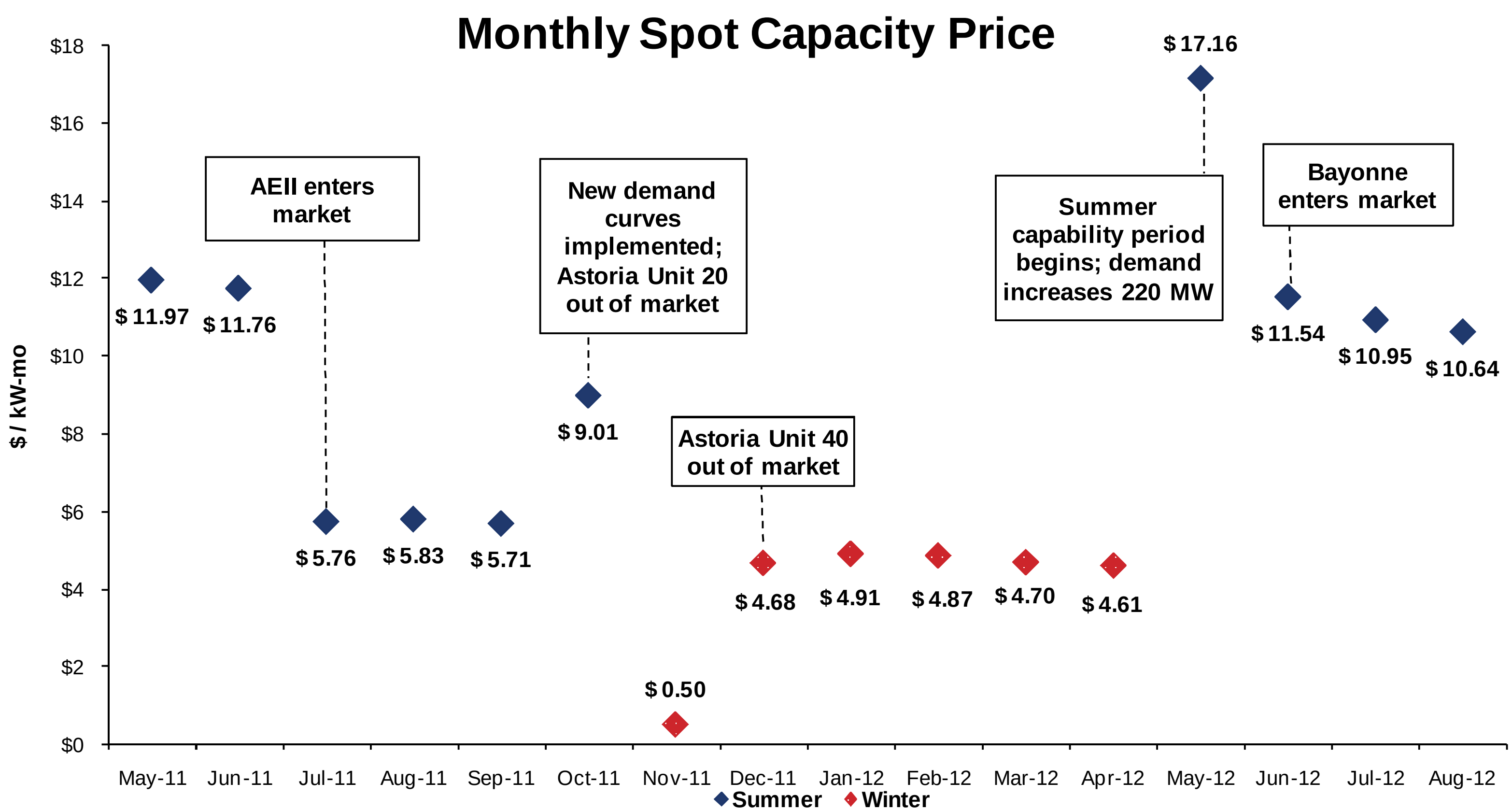
- **More than 2,000 MWs of new generation has been exempted in Zone J since 2008.**




- **Where are the Price Signals that warranted the AEII, Bayonne and HTP projects?**

# NEW YORK'S ICAP MARKET – AN INVESTOR'S PERSPECTIVE

- **If incumbent generators had not retired 550 MWs of capacity in early 2012, Summer 2012 capacity prices would be only $3-4 / kW-month.**



# Buyer-Side Mitigation Rules – Timeline of Events

| | |
|---|---|
| March 2008: | FERC issues order implementing the "Pre-Amendment" BSM Rules. NYISO proposes to apply the net buyer mitigation measures to all projects built subsequent to approval of these market rule revisions, thereby exempting the recently completed 1,000 MW of capacity from the NYPA and ConEd units from mitigation. |
| September 2010: | NYISO files proposed tariff revisions with FERC, seeking to implement "Post-Amendment" BSM Rules. |
| October 2010: | Although cost allocation process for Class Years 2009 and 2010 had not yet been completed, NYISO grants "final" exemptions to Astoria Energy II and Bayonne Energy Center, via application of the Pre-Amendment BSM Rules. No public disclosure was given. |
| November 2010: | FERC issues order in ER10-3043, implementing the Post-Amendment BSM Rules. |
| June 2011: | Astoria Generating, NRG and TC Ravenswood file EL11-42 complaint, raising concerns about NYISO's proposed application of the Post-Amendment BSM Rules. |
| July 2011: | Astoria Energy II enters the market; prices drop 51%, from $11.76/kW-month in June 2011 to $5.76/kW-month in July. |
| July 2011: | Astoria Generating and TC Ravenswood file EL11-50 complaint, citing improper exemptions of Astoria Energy II and Bayonne Energy Center. |

# Buyer-Side Mitigation Rules – Timeline of Events

October 2011: Astoria Generating and TC Ravenswood file Motion to Lodge in the EL11-50 docket, providing presentation materials obtained from AEII's developer via the Freedom of Information Act. This presentation stated that although it was uneconomic on a stand-alone basis, the Astoria Energy II project would nonetheless reduce NYPA's overall portfolio costs through the artificial suppression of market clearing prices.

November 2011: Cost allocation process for Class Years 2009 and 2010 concludes, 13 months **after** NYISO granted "final" exemptions to Astoria Energy II and Bayonne Energy Center.

June 2012: Bayonne Energy Center enters the market; prices drop 33%, from \$17.16 / kW-month in May 2012 to \$11.54 / kW-month in June.

June 2012: FERC issues order in EL11-42, providing much-needed clarity on how the Post-Amendment BSM Rules should be implemented. Importantly, FERC agrees with complainants on need for transparency in MET process. In addition, FERC recognizes that MET determinations that are made before closure of the relevant cost allocation process are **not final**, and directs NYISO to re-test any such projects.

September 2012: FERC issues order in EL11-50, directing NYISO to re-run the MET evaluations of AEII and Bayonne. In addition, FERC's comments regarding sunk costs, WACC, and "analysis reference date" suggest that upon re-test, at a minimum AEII will be mitigated. Lastly, FERC recognition that the AEII / NYPA PPA was discriminatory is encouraging, and should result in heightened scrutiny of projects supported by above-market PPAs.

# BSM Rules – Why They Matter to Investors

- **The EL11-50 complaint relates to the NYISO's MET evaluations of AEII and Bayonne under the Pre-Amendment BSM Rules, while the EL11-42 complaint relates to NYISO's implementation of the Post-Amendment BSM Rules.**

- **While FERC's orders in these cases are very helpful, proper and timely follow-through by NYISO in retesting AEII, Bayonne and HTP is critical to restoring investor confidence in the New York electricity market.**

- **The outcome of these cases will help answer a number of critical investor questions:**

  – Will NYISO, the MMU and other stakeholders recognize the importance of the BSM Rules as a key feature of a competitive ICAP Market?

  – Can investors rely upon fair, objective and transparent application of the BSM Rules to thwart uneconomic new entry and safeguard their investment?

  – Will NYISO's determination of a project's Unit Net CONE accurately reflect the actual project cost?

  – Will NYPA, politicians and stakeholders recognize the potential adverse impact that subsidies / PPAs have on capacity prices and the integrity of New York's ICAP market?

- **If the answer to these questions is "No", merchant generation financed with private investment will not play a role in New York's Energy Highway Initiative, and any new capacity built in New York will need to be subsidized.**

# Policy Considerations

- **Capacity Prices:**
  - Politicians and government officials have placed undue emphasis on capacity prices that they believe are "too high". In reality, capacity prices comprise less than 10% of a ratepayer's electric bill.
  - Capacity payments typically provide more than 80% of a merchant generator's revenues, and are a critical source of funds to maintain and invest in generation infrastructure.
  - Subsidization of uneconomic new generation projects premised on getting an exemption from mitigation creates a situation where ratepayers "pay twice" (if the unit is not exempt), or existing merchant capacity is forced to retire, thereby increasing capacity prices and potentially creating reliability issues.
- **FERC Oversight of Electricity Markets vs. States' Rights Issue:**
  - New York is free to pursue the goals of the Energy Highway Initiative and provide a boost to its economy. But in doing so, it must comply with the applicable rules mandated by FERC, including the BSM Rules. Further, quasi-governmental entities such as NYPA must be fully prepared to bear the full cost of subsidies, rather than seeking to push that cost onto merchant generators.
  - The EL11-50 Order does not restrict the authority state / local agencies may have to address reliability concerns; while recent Reliability Needs Assessment studies have confirmed no reliability issues in New York through 2018, if NYISO projects a capacity shortfall that threatens reliability, the BSM Rules exempt new capacity from mitigation.
  - NYISO and the MMU must recognize PPAs and other above-market subsidies for what they are, and closely scrutinize projects that are subsidized by net buyers of capacity.