

New York’s “Perfect Storm”

An Industry in Crisis:

*The Financial Condition of
Electric Generating Companies
in New York State*

A Report

by

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Executive Summary

New York faces an energy crisis the scope of which has not been seen since the oil shocks of the 1970's. A capital crisis has shattered the merchant generator industry, which supplies over half of the electricity in New York, leaving many companies with severely depressed equity values and bond ratings below investment grade. Major companies are in danger of bankruptcy. A predicted rise in natural gas and petroleum prices may deepen the crisis by draining the operational resources of the companies. While it has been documented by the California State Attorney General, the Federal Energy Regulation Commission (FERC) and other agencies that the California crisis of 2000 was a case of manipulation and collusion rather than a shortage of electricity, this capital crisis may lead to devastating shortages for electric consumers. Despite this crisis being national in scope, the PSC's radical deregulation policy, which encouraged divestiture (separation of the transmission and distribution functions of a traditional utility from the generating function), has left New Yorkers in unique peril.

Moreover, in the state's most populous utility territory, Consolidated Edison, the PSC's rate structure has discouraged the use of long-term contracts, which are necessary not only to provide financing for new projects, but to provide the "revenue assurance" to keep existing generation online. Over the past seven years, the Assembly Majority has introduced comprehensive legislation that provided a cautious, incremental approach toward restructuring. However, our legislative proposals have been ignored by the Senate and Governor. In fact, a bill that overwhelmingly passed the Assembly last year to encourage contracts between utilities and generators died in the Senate. While the current crisis in the capital markets has both a national and international reach, the PSC's restructuring policy has placed many of New York's electric

consumers at greater risk than those consumers in other states. As the chart below illustrates, the capital crisis broadly impacts New York's electrical generating industry.

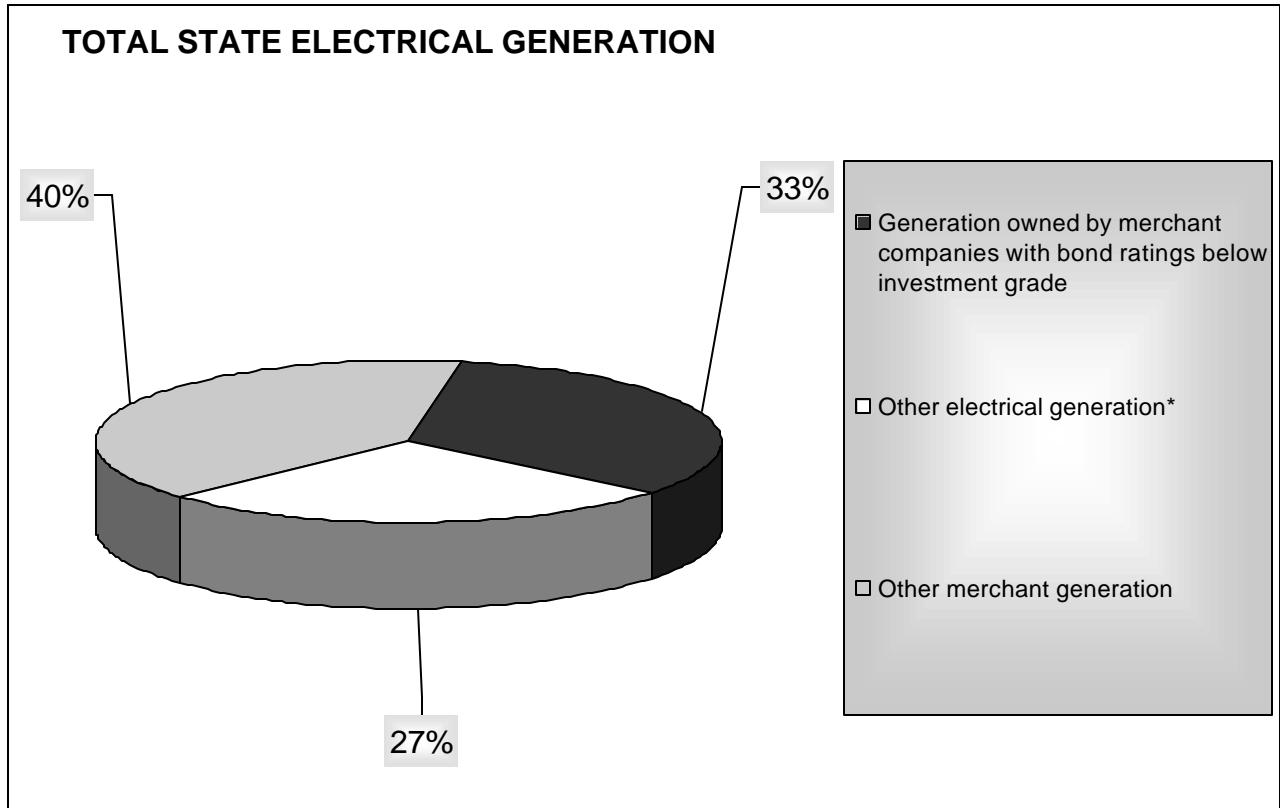


Chart represents total state summer generating capability. Credit information compiled from Standard and Poor's and Moody's

*Other generation includes the New York State Power Authority, generation located within the Long Island Power Authority service territory and generating capacity owned by utilities.

Because of the vital importance of electricity, State government needs to address this critical situation. The first step is to have an honest dialogue among policymakers, the industry and all

stakeholders to effectively respond to this crisis. The following recommendations should be considered:

- The PSC should abandon its philosophical aversion to long term contracts and implement one of the cornerstones of the Assembly's comprehensive energy policy, which requires utilities to act as "purchasing agents" on behalf of ratepayers.
- The state should overhaul its Energy Planning functions to ensure adequate analysis and planning for the reliability of the electric system.
- The State should be vigilant in overseeing the actions of the ISO in its efforts to eliminate market power, collusion and round-trip trades.
- The State must define an appropriate role for the Power Authority in the new deregulated environment.
- The Power Authority, to the extent it participates in the deregulated electric markets, must make its participation transparent.
- As the long-term power contracts between the Power Authority and government entities expire, the contracts should be put out to competitive bid.
- On a case-by-case basis, where appropriate and when the reliability of the electric system is threatened, the Power Authority could provide the role of lender of last resort.
- If the worse-case scenario plays out and generators go bankrupt, the PSC could order local distribution companies to procure capacity, build plants or potentially repurchase plants.
- The PSC should proceed very prudently with any recommendation to divest the assets of Rochester Gas and Electric until the crisis subsides.

- The PSC should remove barriers to the utilization of Combined Heat and Power and onsite generation and invest in the new technologies that will provide new opportunities for real consumer choice

Introduction

Like the meteorological event referenced in the title, New York's crisis is a convergence of factors, coming together with great force. What makes this convergence a potential crisis is the course on which Governor Pataki has put us – a course which sets us sailing straight in the midst of this convergence. That course on which the Governor put us was a full-steam ahead course of divestiture of power plants from utility companies as the means to initiate a deregulated market for electricity generation. The three storms converging are the “persistent crisis” in capacity in the downstate New York markets, the prolonged upstate New York economy that weakens the industry in state, and the emergent capital crisis in the merchant generation sector. The confluence of these factors coupled with the administration's lack of responses, or more accurately, lack of response to these issues, could hit us like a hurricane and place New York's fragile economy in further peril.

Earlier this year, the New York Independent System Operator (ISO) – the entity created by the PSC and FERC charged with overseeing the operation of the state's deregulated electricity markets – declared the New York electric system in “persistent crisis” because of inadequate generating capacity and potentially higher prices in New York City and Long Island. In the Spring and Summer following the release of the ISO's “Industry in Crisis” Report, the State Energy Planning Board issued its Energy Plan, which reiterated the tightening of the downstate

markets, but assured us that adequate margins for system reliability were in place, even if adequate margins for a competitive market were still in the distant future. The reality is that New York City and Long Island suffer from a lack of generating capacity as well as a lack of transmission capacity that inhibits the importing of electricity, including from upstate where plentiful capacity currently exists.

Although the Energy Plan contains analyses primarily done on a statewide basis, different regions of the state have faced different conditions. Downstate has been starved for capacity while upstate has had more than adequate supplies. Unfortunately, the upstate capacity situation seems to be imploding in on itself. The weakness in the upstate economy has resulted in a weakness in demand for electricity. This has placed a downward pressure on electricity prices. In isolation, lower prices could be a bonus, but when combined with the financial stress felt by the electric generating companies, they create additional problems – such as generating enough cash flow to meet both capital and operating needs. If such a condition continues, weak demand and low prices, future investment in both the generation and transmission (T&D) sectors could flee the region, fearing increased risk in recovery of such investment.

Converging with New York's specific conditions, is the current outlook of the capital markets towards the merchant generation sector. Whether the result of reduced economic activity nationwide due to the recession of 2001, or the strong taint of scandal and questionable practices that is spreading across the country and the industry, the financial community is running away from the sector on a scale not seen since the Great Depression according to the October 15th, 2002 *Wall Street Journal*. This jeopardizes the ability of the sector to build new plants. This

also jeopardizes the ability of the power plant owners to maintain operations of the plants we rely on right now. As was recently stated:

... you can't have reliable energy if you don't have a strong capital raising ability. You just can't pay your bills. You can't operate your plants and certainly you can't build new ones..." (Dan Scotto, independent electric industry analyst, from a CNBC interview, October 9, 2002)

While predicting what this capital crisis could mean for both upstate and downstate is a complex and uncertain exercise, Scotto's and other analyst's views suggest the possibility of some generating plants closing down due to eroding financial conditions and potential bankruptcies. Furthermore, the ISO and regulators must scrutinize plant closings by owners who may reduce capacity to raise prices.

Moreover, Scotto noted that

Those [states] that sold power plants in the initial stages of deregulation...are in difficulty because they are facing the need and reliance on ... merchant power producers...So certainly, states like New York, the Northeast regions, parts of the West are in great jeopardy of seeing spikes in energy prices...

Thus, the convergence of New York's unique vulnerabilities with the possible ultimate consequences of the state's divestiture policy jeopardizes the future of a deregulated energy sector in New York, and the economic recovery, which the State is so assiduously trying to achieve.

Charting a Course to Crisis

At the outset of electric industry restructuring, the New York State Public Service Commission (“PSC”) effectuated the deregulation of the electric generation sector. While the PSC claimed existing statutory authority to deregulate the industry, no new State laws were specifically enacted addressing this complicated issue. The PSC, as an administrative body, formulated, adopted and implemented the policy to transform an industry that had sales in excess of \$14.2 billion in 1994 (New York Power Pool Load and Capacity Data, 1995).

Beginning in September 1997, the PSC issued a series of decisions, approving deals with six of New York’s seven major electric utilities.¹ Each of the utility deals was different, depending on the state of affairs of the particular utility company, or the demands of the parties involved in each of the individual cases. Generally, the settlements established rates to be effective over a four to five year period and permitted the utilities to change their corporate structure. The settlements set a schedule for the implementation of "retail access," at which time customers would be able to choose their electricity supplier. In most cases, the settlements also provided for the separation or sale of generating plants from the regulated utility, either by requiring divestiture of generation assets from the transmission and distribution (T&D) utility, or by providing “incentives” or rewards for utilities that effectuated a degree of divestiture, without being under orders to do so. By so doing, the PSC facilitated an industry model wherein generation would be deregulated, but the T&D portion of the utility would remain regulated.

¹ The seventh utility, Long Island Lighting Company, was taken over by the Long Island Power Authority, a state agency. At the time, the LIPA takeover represented the largest public debt issuance in U.S. history.

Among the PSC's goals, as stated in their Competitive Opportunities decision, the restructuring and deregulation of generation was intended to bring competition and lower prices to New York's electricity markets, all while maintaining high system reliability. Since then, as deregulation progressed, New Yorkers' electricity prices increased and grew faster than prices in the rest of the country. The most recent statistics published by the Energy Information Administration, estimate that the New York average electric cost per kilowatt-hour (kwh) in December 2000 was 11.3 cents, 70 percent higher than the national average – as compared to the 50% figure in 1994. In fact, New York's electric rates remain the second highest in the nation, behind only the Hawaiian Islands. Price spikes witnessed by New York City in the Summer of 2000 contributed substantially to this increase. Prices in the Consolidated Edison and Orange & Rockland service territories remained at these inflated levels in 2001.²

Customer migration, that is, customers choosing an electric power supplier other than their local utility, also appears stymied throughout the state. According to the most recent data, slightly over 5 percent of customers have switched with larger proportion of industrial and commercial switching compared to residential customers. This is a reflection in part of the relative treatment of business and residential customer classes in the negotiated rate settlements. Much of the switching occurred when the utilities offered cash incentives to get their customers to choose a new provider. Thus far the experiment of decreased prices from greater choice seems to have swerved greatly off-course though continuing to tack into a coming maelstrom.

² Recent figures suggest that had the state itself not undertaken certain actions such as the LILCO takeover which lowered rates on Long Island by over 20 percent, electricity costs in New York would exceed those prior to

Vulnerabilities in New York’s Electric Supply System

New York was among the first states in the nation to decide to divest utilities of generation, and deregulate the energy generation sector. The theory was that market forces represented by higher prices would lead to merchant generation being built to meet growing electric demand. In the words of the Public Service Commission Chair at a public hearing on the prices spikes experienced in New York City in the summer of 2000, “We **hope** that power plants will get built so that prices will go down.” (Testimony before a State Assembly hearing, August 2, 2000, emphasis added.)

Despite this hope and the flurry of proposals by private developers to build power plants filed under Article X, the state’s power plant siting law, only Con Edison and KeySpan, two of the state’s financially stable utilities, are constructing their facilities along with PSEG’s repowering project near Albany. Most recently, PGE, builder of a plant at Athens, New York, has joined the list of companies stopping construction or canceling their projects. However, all these projects add up to relatively modest increases in capacity, nothing close to approaching what is needed in according to the ISO.

The State has also been able to construct new power plants. The Power Authority of the State of New York is proceeding with its plans for expansion at its Poletti power plant site, although it will result in an overall net decrease in capacity upon closure of the old facility. Also, the Power Authority added nearly 450 MW of capacity in and around New York City in 2001. Finally, the Long Island Power Authority, by providing long-term purchase contracts has had success in inducing plant construction on Long Island.

deregulation relative to the rest of the country.

Generation is not the only problem. New York has witnessed no major expansions of the transmission system, and by and large the interstate and intrastate constraints and bottlenecks remain in place, as they did when restructuring was begun. While the Power Authority is to be commended for its experimental approach to system expansion at the Marcy station, the impact is relatively minor, and comes at a rather high cost. Thus, it is unclear whether this approach to system expansion is sustainable. That being said, constructing new transmission lines is a daunting process, even for relatively small projects, as witnessed by the controversy surrounding the Cross Sound Cable. Yet it is not impossible. The Pennsylvania-New Jersey-Maryland system (PJM), just next door, has invested over \$700 million – representing an 11 percent increase in transmission assets – over the past two years. Phase three of its regional transmission expansion plan has already been approved for implementation. This represented forward thinking and careful planning by the PJM Board of Managers and is something New Yorkers have not witnessed from the Pataki administration nor from the New York ISO, which should have made more efforts to strengthen the transmission system prior to deregulation.

The New York system appears to be developing into somewhat of a regional pariah. Hopes to merge with PJM appear to have floundered and opposition in New England for the merger with that system has begun to grow. Any merger of the New York and New England grids will more likely be the result of a strong resolve at the Federal Energy Regulatory Commission to bring about a Northeast regional transmission operator, rather than from a natural coming together of the two systems. Unfortunately for New York, those in other states can see that its system was

not appropriately or adequately set up for competition, and they do not want their energy prices to increase merely as a result of having to do business with New York.

Economic Weakness and Rough Sailing for Merchant Generators

Despite the fact that demand is continually growing, markets for capacity and energy are relatively flat to lower. In fact, recent pricing signals suggest that the market for capacity may be on the verge of collapse. Ironically, retail customers have not experienced price relief due to the embedded costs (stranded cost recovery, etc.) of the T&D system.

The New York ISO holds auctions that result in payments to merchant generators for committing capacity to New York. Since it began operation in November 1999, prices for capacity have dropped precipitously in both the upstate and downstate markets. In fact, in the recent Upstate capacity auction, generators were only able to get pennies on the dollar for capacity. Weakness in the day-ahead and spot markets, reflecting the sluggish State economy, has depressed energy prices below those forecast in the past, squeezing the ability of generators to meet operating costs. As a result, there has emerged a severe liquidity crisis for the generation sector in New York. At their recent fall meeting, power producers indicated they were being “squeezed” by prices in New York and losing money. This liquidity crisis, in concert with trends throughout the country, has become a large part of the negative rating agency activities of the recent past. The spiral of reduced credit ratings, rendering the continued operation of plants more expensive, thus further squeezing the merchant generation sector is discussed further below.

Actions by the administration may have aggravated problems. Although it has ostensibly placed its faith in the private sector, the administration has intervened in the markets. Arguably, the State was shocked into action by the price spikes that occurred in New York City in Summer 2000. The outrage over these elevated energy prices, coupled with concerns over reliability of supply, prompted an end to the laissez-faire approach to the market barely one year after the onset of the market pricing operations of the ISO.

While the PSC appeared ready to stay on course in testimony the Commission Chairman made on August 2nd, 2000 before committees of the State Assembly, there was an auguring of things to come when she stated: "...I would prefer the market to respond to this as opposed to the Power Authority.. the power authority should only do what the market can't do or where it's clearly better for public power to deal with.." Only two months later, the State Department of Public Service sent a letter to the New York Power Authority describing an "urgent and compelling need for at least 315 MW of additional electric generation capacity in New York City." The letter also quoted the PSC chair that "the cushion between our existing supply of electric generation capacity and demand for electricity is shrinking. *This situation puts upward pressure on prices* (emphasis added) and threatens the reliability..." The impact of the resulting state intervention in the market will also be discussed further below.

Despite having to turn to the Power Authority for new generation, the PSC still proceeded with divestiture and deregulation of the generation sector without ensuring that adequate capacity was available for the reliability of the system let alone sufficient capacity to stabilize prices in a competitive market. The State Energy Plan projects that by 2003 the state reserve margin will be

21.3%, barely enough to meet reserve requirements, and certainly a far cry from the ISO's recommendations for the amount of capacity required for the proper functioning of competitive markets. As it may turn out, price stabilization may not just mean protecting consumers from skyrocketing prices due to capacity constraint, but also to preserve the market in order to sustain the state's ability to attract capital to keep the generation market viable.

Tempest in the Credit Markets

Looming in the distance was the specter of the crisis in the merchant generator industry in California. Many of the same companies that were welcomed into New York through the purchase of former utility generation assets, were now being mentioned in the growing number of reports of corporate scandals. While companies in industries made new negative headlines daily, the utility industry – or rather the merchant generator industry – was seemingly the hardest hit. Although the Enron story led the parade of negative headlines, other firms in the industry were accused of a variety of actions ranging from questionable “wash trades” to inflate sales and revenues on their balance sheets to outright manipulation of the market. The latter appears to have taken several forms including artificially creating congestion on transmission lines to withholding capacity. Whether or not the practices were illegal, most companies have paid the price in the equity and bond markets. Investors and lenders simply do not appear to trust what most of these companies tell them about their businesses and fear the companies have financial exposure because of their possibly illegitimate practices.

The impact of scandal opened the books on the entire operations of the merchant generator sector, exposing a highly leveraged industry now subject to a weak economic outlook, coupled with the possibility of massive civil penalties. The new merchant generator industry, given birth as a result of the divestiture policies of New York and a handful of other states, had been the darling of the financial world and great sums of money were placed in power plant refinancing and market trading activities. Only a year ago, stocks of companies that build and operate electric generating plants were doing well and lenders were making loans available to invest in new plants.

However, the trust of the financial industry has been broken. This erosion of trust has impacted the entire industry, and the capital once available for plant purchasing and plant construction has quickly dissipated. Compounding the pain has been the economic “recession” which has had a large impact on electricity demand and prices. The severely reduced prices in both the capacity and energy markets have impaired the ability to meet fixed and operating costs. These ever-deepening pressures on the power plant owners are discouraging new construction, as well as threatening the operation of plants owned by those with the most critical financial problems.

As the following table indicates, many of New York’s merchant generators have paid the price in their bond ratings.

Credit Ratings of Power Generators in New York

	Summer Capability	% State Total	S&P Rating	Moody's Rating
<i>AES Corp.</i>	<i>1,287</i>	<i>3</i>	<i>BB-/Neg</i>	<i>Ba3</i>
<i>Calpine Energy Service</i>	<i>166</i>	<i>0</i>	<i>B+/Stable</i>	<i>Ba3</i>
<i>NRG Power Inc.</i>	<i>4,529</i>	<i>12</i>	<i>CC/Neg</i>	<i>Caa3</i>
<i>Dynegy Power Inc.</i>	<i>1,691</i>	<i>4</i>	<i>B-/Neg</i>	<i>Caa2</i>
<i>Mirant Corp.</i>	<i>1,710</i>	<i>4</i>	<i>BBB-/Stable</i>	<i>B1</i>
<i>Reliant Energy</i>	<i>2,652</i>	<i>7</i>	<i>BB+/Neg</i>	<i>Baa3</i>
Constellation Power Source	1,871	5	No Listing	Baa1
Entergy Nuclear, Inc.	2,841	7	BBB/Stable	No Listing
KeySpan (w/out LIPA)	2,210	6	A/Stable	A3
PSEG Power	377	1	BBB/Stable	Baa1
Sithe Energies Inc.	1,180	3	No Listing	No Listing
Other IPP Generators	1,430	4	Various	Various
Other State Generation	14,398	44	Various	Various
Total State Generation	36,342	100	Total	Total

Note: Companies in italics are considered by one or both rating agencies as below investment grade.

The downgrading of merchant generator industry securities will likely only result in higher capital costs for the generators, thus requiring an increase in prices solely to cover these costs. Considering that downstate is dependent on virtually all the generation to meet current need and has significant limitations with its transmission system, an economic upturn will result in higher prices that could stifle a recovery. Even upstate could face similar problems if operators choose to close plants to reduce capacity and raise prices. A worst-case scenario places the reliability of the system in jeopardy.

One can only conclude that the electric system in New York could be on the brink of a crisis worse than that anticipated by the ISO. What has precipitated the crisis was the Governor's overly simplistic policy toward the electric industry: deregulate the industry as quickly as

possible and hope the markets solve any problems. As stated above, the construct was built only on “hopes” – perhaps there were merely “dreams” that the construct would work.

Convergence

As noted earlier, in March 2002, the New York Independent System Operator released a report that characterized New York’s power supply markets as in “persistent crisis.” The problem according to the ISO was continuing growth in the demand for electricity with too little addition to generating capacity that provides supply. As supply relative to demand tightens, the result would be higher prices for consumers and lower reliability. In other words, New York consumers could pay more for the privilege of having their lights going out.

While there were scattered outages this summer, wholesale prices have declined due to a sluggish economy. Resumption of economic growth can tighten the electricity markets considerably.

In concert with the above industry trends, New York has aggravated the situation through short-sighted, reactionary measures rather than by careful planning. During the PSC’s prolonged negotiating and utility-by-utility deal brokering to set up competition, the administration neglected to address the changing conditions in New York. The lack of transmission capacity allowed a severe shortage to develop in the Downstate economy that was becoming more reliant on plentiful and reliable electricity, while Upstate capacity become underutilized as that region’s

economy continued to suffer its depression-like slump. Energy Planning, as evidenced in the State Energy Plan, became little more than a self-congratulatory exercise, and failed to fully address what was happening. Deregulation and divestiture were pursued with no analytical attempt to assess their impacts in the face of a near-decade-long failure to invest in the generation and transmission sectors.

As noted previously, at the first sign of a price signal resulting from a capacity shortage, the signal that those in charge of deregulation hailed as the necessary driver for new power plant construction, it became evident that the political ramifications of unmitigated price spikes would be untenable. Almost as quickly as prices rose, the administration acted – by having the state step in and resolve the advertised capacity shortfall. The Power Authority’s decision to purchase, construct and operate the 10 In-City turbines is a textbook example of the advantages that the state holds over other private market participants, and how state intervention will distort markets and disrupt the development of that market. To get the plants built, the state was able to win a loophole in the state siting law, avoid local regulatory process and review, and have access to low-cost capital. It is very much debatable whether any one private market participant would have been able to achieve the same measure of success in such a short time period. The specter of competing with a tax-free entity that has these other advantages must be daunting for any private company, especially in the face of a capital crisis that limits investment opportunities.

The presence of the Power Authority’s generators provided reliability and lowered prices in New York City, although critics still maintain they were not truly necessary and their siting raised community concerns that have never been adequately addressed. All that having been said, the

role of the Power Authority has become the big “wild card” in the state’s energy picture. The intervention in markets by the authority represents a threat to private sector developers who, at the least, need to be allowed to understand the role the authority will play and the ground rules under which it will operate.

The question emerges: what will these various converging factors, a credit crunch, an uncertain economy, inconsistent policies, and neglected planning mean for the state? The situation is apt to vary depending on which section of the State is in question, but the forecast in each part of the state is stormy.

Downstate. If a plant were to go off-line, in a cost-cutting measure by a generator, such a move could have ramifications to reliability. Two companies facing the most severe capital constraints, NRG and Reliant, are primary owners of capacity in the New York City, and their base load and peaking units are essential for maintaining the reliability of the In-City grid. Considering that Con Edison set an all-time high for electricity output this past summer, in a time of considerably reduced economic activity, the loss of a relatively small amount of capacity could jeopardize the economic recovery, because of the importance of businesses in the city, which require the 99.999 percent reliability of electric supply for their operations.

Reliability is not the whole story. The removal of small amounts of generation could threaten price spikes, and spur further intrusions by the public sector into the market to keep prices stable for consumers. This would continue the vicious cycle that New York City seems to have entered. KeySpan and Con Edison, two holding companies which maintain stable credit ratings, are

continuing their respective construction projects, and will add new capacity, but only in amounts that keep the City skirting the margins of the 80% reserve requirement. The Power Authority just won approval for its 500-megawatt proposal, which will likely proceed. However, the net decrease of 300 megawatts from the system is problematic, even despite promises for widespread energy efficiency to make up some of the difference. These are the only capacity additions which seem likely to occur in the next two to three years. This is far below the ISO's recommended capacity additions needed to preserve reliability margins, let alone the development of the competitive market. As noted above, the fact that this new capacity also comes from a state agency may dampen the private sector's participation in the market's development.

Long Island. The conversion of a private utility system to a state utility has impeded the development of a "competitive" market. The proposed merchant facilities, which do not have direct ties to LIPA, have run into trouble at every step of the siting process. In contrast, LIPA is effectively on a building binge – adding 400 megawatts this year and announced plans for another 200 megawatts next year. This has been accomplished by LIPA entering into firm contracts to purchase output from new plants. As the LIPA chairman has recently stated: "If we don't enter into power-purchase agreements, then no plants are going to be built and the lights are going to go out. LIPA will own none of the power plants but will basically have all the risks associated with ownership... That's not good for us or our customers, but it's the current climate." Though LIPA must cope with real potential power shortages, it appears to have taken almost an ad hoc approach, lacking a detailed plan on how it can best serve Long Islanders. Furthermore, the impacts of these contracts on costs and what they mean for competition on the

Island have never had a full public discussion. Perhaps the LIPA chairman said it best: “We’re kind of in a trapped situation.”

Upstate. Upstater potentially face an even worse scenario far different in its origins from those on Long Island or in New York City. For the generators, the current collapse in the capacity markets may not even be the bottom. The reliability of the system can tolerate some plants coming off line without the threat of chronic failures. If some generating capacity finds itself subject to sale in the current market, or in an even worse circumstance, a liquidation order from a bankruptcy judge, prices based on the current capacity markets will reset the entire market, thus threatening the value of all generation in the region. This would likely also carry the ripple effect in the form of property tax adjustments, thus threatening local communities. Recent studies are showing that transmission system expansions will likely have the effect of increasing prices in the region. The Governor’s proposed clean air regulations, while they will have beneficial impacts on natural gas generation in the area, will likely result in increased prices in the region. However, increases in capacity and energy prices, while perhaps beneficial to the health of the energy generation sector, will likely have overall negative impacts on this economically fragile region. As with the Downstate markets, the administration has provided no plan on how to alleviate or temper what bodes to be a possible drastic situation.

Charting a course to safe harbor

The original Assembly comprehensive electric energy plan, Competition Plus, phased in competition by calling for the PSC to exercise judgment in a step-by-step process that started

with demonstration projects and required a wholesale market to be functioning before instituting retail competition. Other safeguards included only going forward with the divestiture of a generating plant by a utility when divestiture was in the public interest and to provide regulatory protections to consumers in load pockets until a competitive market developed. Since 1995, the administration has ignored nearly all of the Assembly's comprehensive energy initiatives.

Now, unfortunately, the PSC's headlong rush to divestiture offers the State limited options in dealing with this crisis. However, there are some specific proposals that should be implemented immediately to restore investor confidence and mitigate the impacts of the capital crisis.

The first thing we should do is have an honest dialogue among policymakers, the industry and all stakeholders to effectively respond to this crisis.

Second, the PSC should abandon its aversion to long-term contracts. The PSC's rate structures have discouraged the use of long-term contracts in an apparent attempt to volatilize the market and relieve the regulated local distribution companies from actively managing a portfolio of electricity supplies on behalf of captive ratepayers. Moreover, in the state's most populous utility territory, Con Edison's, the PSC's rate structure specifically discourages the use of long-term contracts, which are necessary not only to provide financing for new projects, but to provide the "revenue assurance" to keep existing generation online. The theory held that the new electric markets would send price signals to investors and generation would be built in response.

Unfortunately, due to supply inelasticity (the relatively long period of time it takes to site and construct electric generation) and the administration's sluggish implementation of Article X, price signals came and went without the PSC's desired result.

To remedy this situation, the PSC should implement the cornerstone of the Assembly's NYSTEP proposal, which required utilities to act as "purchasing agents" for ratepayers by utilizing a portfolio of short-, medium- and long-term contracts. Certainly there is always a risk inherent in long-term contracting and critics of this approach can point to the ill-conceived six-cent law of the 80's. However, with the collapse of the market, this is an ideal time for utilities to take advantage of depressed wholesale electric prices. More evidence of the need for certainty in obtaining finances is that even companies with strong finances are requiring long-term contracts to be signed committing a local distributor to purchase all or most of the output of a plant. According to reports in Newsday, this is precisely what has happened on Long Island where the Long Island Power Authority (LIPA), which serves virtually all Long Island electric customers, finds itself facing potentially severe capacity shortages unless new plants get built. Locking LIPA into these contracts provides the developers with a guaranteed revenue stream that they can take to their lenders.

Third, the State should take an active role in overseeing the actions of the ISO in its efforts to eliminate market power, collusion and round-trip trades. Emphasizing long-term contracting, utilities would limit the use of spot markets to the very margins of electricity purchases and could reduce the opportunity for market manipulation.

Fourth, the state should overhaul its Energy Planning functions to ensure adequate analysis and planning to provide a foundation for the future reliability of the electric system. The State should implement the initiatives contained in the Assembly's proposed extension of the Energy Planning statute. The State must adequately provide for the planning and monitoring of the system to ensure that necessary investments in transmission, distribution and generation are being made.

Fifth, the State must define an appropriate role for the Power Authority in the new deregulated environment. This role can include several possible functions listed below as separate proposals for consideration.

Sixth, to the extent it participates in the deregulated electric markets, the Power Authority must make its participation “transparent.” The perception of subsidy is distorting the price of electricity in the downstate region and could have both drastic short- and long-term consequences for consumers and the reliability of the system. As the people’s utility, the Power Authority has a higher obligation for transparency.

Seventh, as long-term power contracts between the Power Authority and government entities expire, the contracts should be put out to competitive bid. A competitive bidding process could help provide the liquidity the market requires to reduce the likelihood of generators going off-line and spurring approved plants to be built in the Downstate Metropolitan region.

Eighth, on a case-by-case basis and where appropriate to ensure the reliability of the electric system, the Power Authority could provide the role of lender of last resort.

Ninth, if the worse-case scenario plays out and generators go bankrupt, the PSC should consider ordering financially stable local distribution companies to procure capacity, build plants or potentially repurchase plants.

Tenth, at this time the PSC should proceed very prudently with any recommendation to divest until the crisis subsides. With the merger of Energy East and Rochester Gas and Electric (RGE)

completed, the PSC is recommending the divestiture of RGE. RGE is the one utility that remained vertically integrated – forgoing the recommendations of the PSC – and did not divest their generation. The utility has the second lowest rates in the State and its ratepayers will be somewhat shielded from the crisis by retaining its current corporate structure.

Eleventh, the PSC should remove barriers to the utilization of CHP and onsite generation and invest in the new technologies that will provide new opportunities for real consumer choice. The Senate should pass and the Governor should sign into law A8976, the energy efficiency and investment act.

Conclusion

Unfortunately, there is no turning back from the course that the PSC has set us on. However, there are real, concrete steps that the State can implement to mitigate the impacts of a potential crisis that threatens the integrity of the New York's electric system.

Over the past seven years, the Assembly Majority has introduced comprehensive legislation that provided a cautious, incremental approach toward restructuring. However, our legislative proposals for industry restructuring have been rejected by the Senate and Governor. In fact, a bill that overwhelmingly passed the Assembly last year to encourage contracts between utilities and generators died in the Senate. While the crisis has both a national and international reach, the PSC's restructuring policy has placed many of New York's electric consumers at greater risk than those consumers in other states. The reality is that the capital crisis and a market

development crisis hang heavily over the industry. A crisis that requires immediate action by State government.

CHART-1

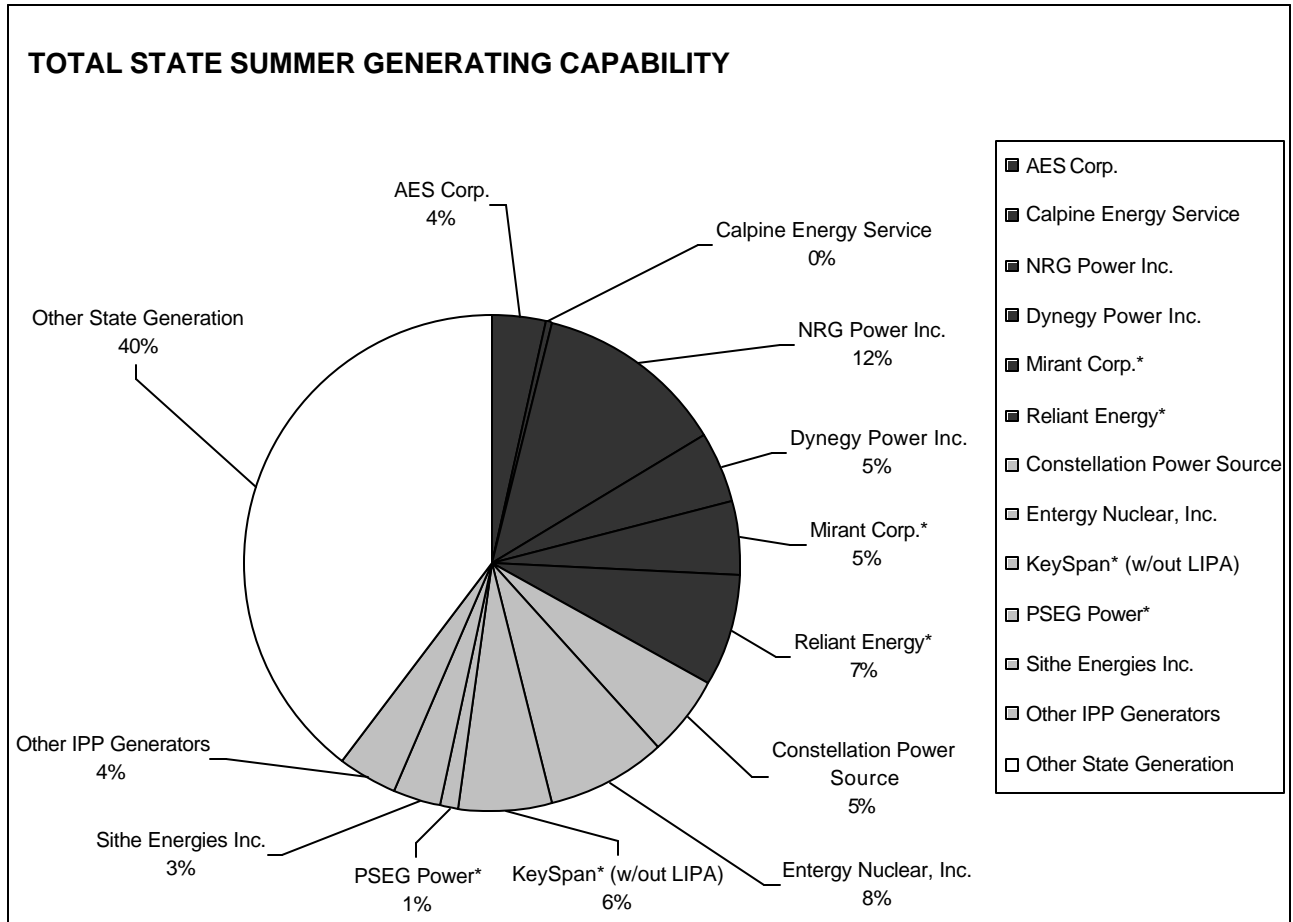


CHART-2

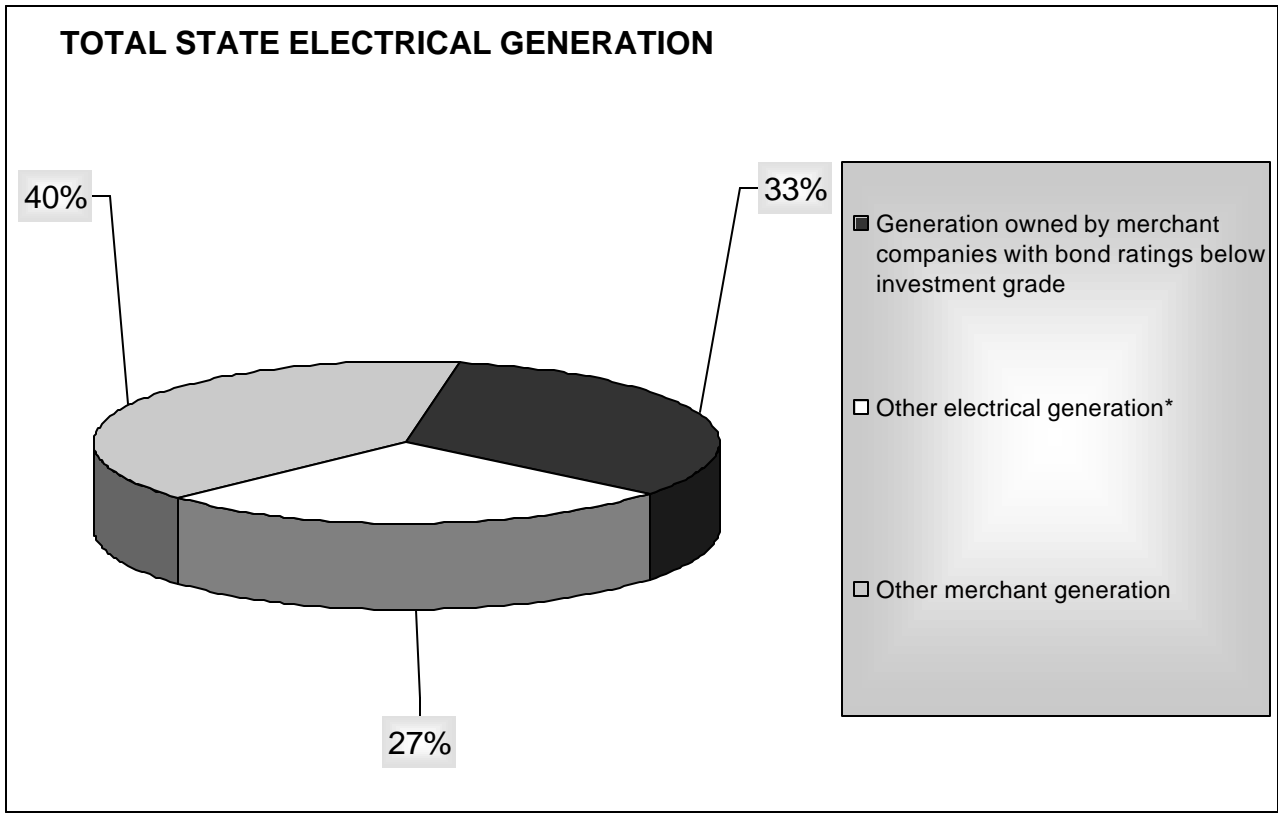


TABLE-1

<i>Credit Ratings of Power Generators in New York</i>				
	Summer Capability	% State Total	S&P Rating	Moodys Rating
AES Corp.	1,287	3	BB-/Neg	Ba3
Calpine Energy Service	166	0	B+/Stable	Ba3
NRG Power Inc.	4,529	12	CC/Neg	Caa3
Dynegy Power Inc.	1,691	4	B-/Neg	Caa2
Mirant Corp.*	1,710	4	BBB-/Stable	B1
Reliant Energy*	2,652	7	BB+/Neg	Baa3
Constellation Power Source	1,871	5	No Listing	Baa1
Entergy Nuclear, Inc.	2,841	7	BBB/Stable	No Listing
KeySpan* (w/out LIPA)	2,210	6	A/Stable	A3
PSEG Power*	377	1	BBB/Stable	Baa1
Sithe Energies Inc.	1,180	3	No Listing	No Listing
Other merchant generators	1,430	4	Various	Various
Other Generation	14,398	44	Various	Various
<i>Total generation</i>	36,342	100		

TABLE-2

Proposed Generators			
American National Power	1680 (Ramapo and Brookhaven)	No Listing	No Listing
Besicorp	505	No Listing	No Listing
ConEd	360	A/Stable	A2
Duke Energy	520	A/Stable	Aa3
KeySpan	500 (Ravenswood and Spagnoli Road)	A/Stable	A3
Mirant	750	BBB-/Stable	Ba1
PG&E Energy	1,080	No Rating	Ba1
PPL Power	300	BBB/Neg	Baa1
PSEG	750 (350 net increase)	BBB/Stable	Baa1
Reliant	1,842 (500 net increase)	BBB-/Neg	Baa2
SCS Energy	1,000	No Listing	No Listing
Total proposed generation	4,515		

CHART-3

