

ORAL ARGUMENT IS SCHEDULED FOR APRIL 11, 2005

**IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT**

No. 03-1449

**ELECTRICITY CONSUMERS RESOURCE COUNCIL,
PETITIONER,**

v.

**FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.**

**ON PETITION FOR REVIEW OF ORDERS OF THE
FEDERAL ENERGY REGULATORY COMMISSION**

**BRIEF OF RESPONDENT
FEDERAL ENERGY REGULATORY COMMISSION**

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JANUARY 12, 2005

CIRCUIT RULE 28(a)(1) CERTIFICATE

A. Parties and Amici

The parties before this Court are identified in the brief of Petitioners.

B. Rulings Under Review

1. *New York Independent System Operator, Inc.*, 103 FERC ¶ 61,201 (2003); and
2. *New York Independent System Operator, Inc.*, 105 FERC ¶ 61,108 (2003).

C. Related Cases

This case has not previously been before this Court or any other court. Counsel is not aware of any other related cases pending before this or any other court.

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January 12, 2005

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GLOSSARY

ELCON	collectively petitioner Electricity Consumers Resource Council, and Intervenors PJM Industrial Customer Coalition and NEPOOL Industrial Customer Coalition
FERC	Federal Energy Regulatory Commission
FPA	Federal Power Act
LSE	Load Serving Entity
MW	megawatt
NYISO	New York Independent System Operator, Inc.
NYPSC	New York Public Service Commission
NYSRC	New York State Reliability Council
RAM Working Group	multi-ISO Resource Adequacy Markets Working Group
Rehearing Order	<i>New York Independent System Operator, Inc.</i> , 105 FERC ¶ 61,108 (2003)
RTO	Regional Transmission Organization
TAPS	<i>Transmission Access Policy Study Group v. FERC</i> , 225 F.3d 667 (D.C. Cir. 2000)
Tariff Order	<i>New York Independent System Operator, Inc.</i> , 103 FERC ¶ 61,201 (2003)

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**BRIEF OF RESPONDENT
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STATEMENT OF THE ISSUE

Whether the Commission reasonably approved the New York ISO's sloped demand curve methodology for determining the quantity and price of installed capacity that utilities must purchase for operating reserves, on the basis that (1) the current vertical demand curve caused significant price volatility and deterred investment in the installed capacity market, and (2) the sloped demand curve would reduce price volatility, increase incentives to invest in generation, and reduce incentives to withhold supply.

STATUTORY AND REGULATORY PROVISIONS

The pertinent statutes and regulations are contained in the Addendum to this brief.

STATEMENT OF THE CASE

I. Nature of the Case, Course of Proceedings, and Disposition Below

On March 21, 2003, the New York Independent System Operator, Inc. (“NYISO”) proposed to modify the requirement for load-serving entities (“LSEs”) in New York to procure installed capacity (“ICAP”), needed to meet each LSE’s operating reserves requirement. At the time, each LSE was required to procure capacity equal to 118 percent of its peak load, and was assessed a fixed charge for each megawatt (“MW”) that it was deficient. This resulted in a vertical demand curve for ICAP at 118 percent of peak load. When additional capacity entering the market exceeded the 118 percent requirement by even a modest amount, the price for ICAP collapsed, resulting in near zero prices. This price volatility in the ICAP market provided no incentive to invest in generation beyond the minimum ICAP requirement, drying up financing of new generating facilities as investors did not see a reasonably reliable stream of revenues.

The NYISO proposed to replace the vertical demand curve with a sloped demand curve, to determine both the amount of the ICAP requirement and the ICAP market price. The sloped curve sets the demand price at 118 percent of peak load at the annualized cost of a new peaking unit, with a gradual decline in price as capacity moves beyond 118 percent of peak load until it reaches a price of \$0 at 132 percent of peak load. The challenged orders accepted the proposal, finding that it would encourage greater investment in generation capacity, reduce the volatility of ICAP revenues, and reduce incentives to withhold ICAP capacity from the market. *New York Independent System Operator, Inc.*, 103 FERC ¶ 61,201 (“Tariff Order”), 105 FERC ¶ 61,108 (2003)

(“Rehearing Order”). Although petitioner Electricity Consumers Resource Council, and Intervenor PJM Industrial Customer Coalition and NEPOOL Industrial Customer Coalition (collectively “ELCON”), never questioned the need to change the NYISO’s existing vertical demand curve, ELCON objected to the adoption of the sloped demand curve proposed. This appeal followed.

II. Statement of Facts

A. The ICAP Mechanism

The demand for electricity can vary greatly, depending on such factors as weather and economic growth. *Central Maine Power Co. v. FERC*, 252 F.3d 34, 38 (1st Cir. 2001). Since electricity cannot be economically stored for future use in large quantities, the supply of electricity at any specific time is constrained by the time needed to build new generating plants and by unexpected breakdowns in generation or transmission facilities. *Id.* Accordingly, a prudent LSE must purchase enough standby (or reserve) capacity to assure that its peak demand can be met. *Sithe New England Holdings LLC v. FERC*, 308 F.3d 71, 73 (1st Cir. 2002). Because this standby capacity costs money and may never be used, without proper economic incentives, LSEs may “skimp” on its purchase, *id.*, particularly as there is no means to target only those LSEs that fail to procure adequate reserves when service is curtailed. R. 25, Attachment I, at 4 ¶ 15, JA 479. In an interconnected system, where the benefits of generation capacity are shared, each LSE has an incentive to “lean on” the capacity of the system, rather than procure sufficient reserve capacity. *Id.*

To reduce this incentive, utilities are required to purchase ICAP. The New York State Reliability Council (“NYSRC”) ¹ set the minimum capacity requirement for LSEs in New York State at 118 percent of the State’s peak load. ² The minimum capacity requirement is based upon an engineering estimate of the amount of capacity needed to assure service to loads will not be interrupted more than once in ten years due to insufficient generating capacity. R. 17, Attachment 1, Affidavit of Mark D. Younger (“Younger Aff.”), at 6 ¶ 19, JA 307.

At the time of the proposal at issue in this proceeding, LSEs were required each month to demonstrate that they met their reserve capacity obligation, and, if not, to bid into a deficiency auction for any shortfall. Younger Aff. at 7 ¶ 22, JA 308. Bids were priced at a deficiency rate, which was three times the annualized cost of installing a new gas turbine. R. 1, Attachment IV, Affidavit of Dr. David B. Patton (“Patton Aff.”), at 3 ¶ 10, JA 152. The NYISO estimated the annualized cost of a gas turbine at \$85 per kW-year statewide, resulting in a statewide deficiency rate of \$255 per kW-year. Younger Aff. at 8 ¶ 23, JA 309. If the market was deficient of capacity, the deficiency auction would clear at the deficiency charge. R. 17 at 7, JA 285. The deficiency charge was the

¹ The NYSRC is a limited liability company established to promote and preserve reliability in the New York Control Area for the benefit of the public and all market participants. The NYSRC is responsible for developing reliability standards including the annual state-wide installed capacity requirement for the New York Control Area that are implemented by the NYISO. R. 26 at 1, JA 508.

² In addition to the statewide minimum requirement, New York City and Long Island have separate locational minimum requirements. Tariff Order n. 1, JA 843.

highest price that a generator could receive in the NYISO auction, and was billed to each LSE for the amount of its requirement shortfall. Patton Aff. at 3 ¶ 10, JA 152.

This system essentially established an ICAP vertical demand curve at the minimum (118 percent) requirement level, with a single price at the deficiency charge level. *Id.* at 3 ¶ 11, JA 152. Because the ICAP requirements placed no value on reserve capacity above the required 118 percent of peak load, and the short-run cost of supplying capacity is very close to zero, even very small surpluses above the 118 percent level could cause the ICAP market to clear at extremely low prices. *Id.* at 5 ¶ 19, JA 154.

As the ICAP bid system was a single price auction, the bid of the last resource needed to satisfy the minimum requirement for all LSEs in that month set the Statewide price for all suppliers chosen in the auction. R. 10 at 4, JA 182. As those not chosen received no capacity payment, *id.*, capacity resources beyond the minimum requirement were valueless. *Id.* at 5, JA 183. In this system, when capacity exceeded the minimum requirement, suppliers sought to underbid each other, with bids far below their fixed operating costs. *Id.*

This strategy resulted from the cost structure related to reserve capacity. While short term, avoidable, variable operating costs for an existing generator approach zero, fixed operating expenses, such as taxes, backup and standby charges and labor charges, are substantial and cannot be avoided by either exiting the market for brief periods or putting the unit in standby status. Younger Aff. at 9 ¶ 26, JA 310. The only way to avoid such costs is to shut the facility down. *Id.* at 10, JA 311. This reality means, when available capacity exceeds what is needed to meet the minimum requirement, generators

will bid at prices well below their fixed operating expenses to improve their chances of sales, and thus some cost recovery. *Id.* ¶ 27, JA 311.

In months where available capacity exceeded the minimum requirement, suppliers received the deficiency charge (\$225/kW-year statewide) for all their capacity. Thus, suppliers in the ICAP market were faced with the antipodes of near zero prices when capacity exceeded the minimum requirement, and a deficiency charge set at three times the cost of a new gas turbine when capacity was deficient. R. 10 at 8-9, JA 186-87. This uncertainty was heightened because even a small amount of additional capacity made available during deficiency conditions would likely “catapult the entire market back down [from the deficiency charge] to near zero prices.” *Id.* at 9, JA 187. This created “an unreliable and unpredictable boom-bust cycle where ICAP prices are extremely low at times of any surplus capacity and extremely high during times of capacity deficiency.” R. 17 at 2, JA 280. It also created a perverse incentive to withhold capacity to cause the market to clear at the deficiency level. Patton Aff. at 8 ¶ 33, JA 157.

This boom-bust cycle led to extreme price volatility for customers as well as suppliers. Younger Aff. at 13 ¶ 37, JA 314. For example, the ICAP clearing price for the May, 2002 through April, 2003 period, during times of surplus capacity, translated to a charge of \$2.30/MWh for an upstate customer with a 70 percent load factor, while during deficiency conditions, the charge to that customer increased twenty-fold to \$49.10/MWh. *Id.*

B. Events Leading Up To The Commission Orders

To remedy this situation, in May 2002, the New York Public Service Commission (“NYPSC”), proposed that NYISO adopt a sloped ICAP demand curve. Tariff Order ¶ 15, JA 850. After more than 20 meetings of the NYISO ICAP Working Group,³ where flaws in the current ICAP markets were identified and market participants had the opportunity to propose solutions, the sloped demand curve was the sole proposal identified that would remedy the flaws. R. 17 at 3, JA 281.

On March 21, 2003, the NYISO proposed to revise its Tariff to incorporate the sloped demand curve. R. 1 at 3, JA 3. The proposal was supported by the NYPSC, as well as suppliers, customers, generators, consumer representatives, environmental parties, marketers, and three transmission owners. R. 10 at 7, JA 185.

The NYISO sloped demand curve proposal replaced the current vertical demand curve at the 118 percent ICAP requirement with one that varies with market price, and replaced the existing fixed deficiency charge with a variable charge equal to the price arising from the monthly ICAP auction. Tariff Order ¶ 14, JA 850. The NYISO proposal set the price for 118 percent of peak load capacity at the annualized cost of a new peaking unit. Tariff Order ¶ 5, JA 845. As capacity exceeds the minimum requirement, the demand price falls gradually below the cost of a new peaking unit until the price zeros out at 132 percent of peak load. *Id.* As capacity falls below the minimum requirement,

³ The NYISO’s ICAP Working Group is open to any market participant and is broadly attended by market participants in all five of NYISO’s governance sectors. Younger Aff. at 4 ¶ 10, JA 305.

the demand price rises above the annualized cost of a new peaking unit to a maximum of about two times the annualized cost of a new peaking unit. *Id.*

The sloped demand curve, along with the results of the monthly ICAP supply auction, define the amount of ICAP each LSE must obtain for the following month, except that it cannot be less than the 118 percent minimum requirement. Tariff Order ¶ 6, JA 846. The following month's ICAP requirement and ICAP price are thus established at the intersection where the supply curve of bids crosses the demand curve. *Id.* ¶ 7, JA 847. For example, if the ICAP auction in a given month clears at 120 percent, each LSE would be required to procure ICAP resources equal to 120 percent of its peak load in the following month. Any LSE that had procured less than 120 percent prior to the next auction would be required to purchase the shortfall at the monthly auction's ICAP price, and any LSE that had procured more than 120 percent would be paid the auction price for the excess. *Id.* n. 5, JA 847.

LSEs can continue to self-supply ICAP by procuring supply in advance (via forward auctions or bilateral contracts) and selling any excess into the spot auction, where the LSE will receive the auction clearing price for the sale. LSEs will be charged that same clearing price for any capacity needed to satisfy their reserve capacity obligation. R. 25, Attachment I, Affidavit of Dr. Thomas S. Paynter ("Paynter Aff.") at 13 ¶ 40, JA 488. All ICAP resources accepted in the auction, including those offered by LSEs, are paid the market-clearing ICAP price, which is the same price paid by LSEs for ICAP they purchase. Tariff Order ¶ 7, JA 847. The ICAP price thus effectively becomes the "deficiency charge" per MW for any ICAP shortfall that LSEs experience. *Id.*

The sloped demand curve is designed to produce price signals that more accurately reflect market conditions than the vertical demand curve. The sloped curve should yield lower prices when high levels of capacity are available, with prices trending gradually upward as capacity levels fall. R. 10 at 9, JA 187. Thus, the sloped demand curve would replace the boom-bust cycle between near zero prices when capacity exceeds the minimum requirement and the deficiency rate when capacity falls below the minimum requirement, with a more gradual and predictable relationship between the amount of available capacity in the market and the clearing prices. Younger Aff. at 19 ¶ 52, JA 320.

The sloped demand curve, by recognizing that capacity above the minimum requirement level has value to the system, reduces volatility, provides additional reliability, increases market competitiveness, and reduces the frequency of price spikes. Patton Aff. at 5 ¶ 20, JA 154. Additionally, the sloped demand curve reduces the perverse incentives for suppliers to withhold available capacity from the ICAP market as a way to cause the market to clear at the deficiency charge. *Id.* at 8 ¶ 33, JA 157. While under the vertical demand curve, the expected capacity price increase is dramatic as the market moves from non-deficiency to deficiency levels, and consequently creates an incentive to withhold capacity to create a deficiency, under the sloped demand curve, the price increase would be modest, thereby creating much less of an incentive to withhold. *Id.* at 9 ¶ 34, JA 158.

C. The Commission Orders

1. The Tariff Order

The Commission found that the sloped demand curve would provide net benefits, especially when compared to the existing vertical demand curve. Tariff Order ¶ 13, JA 850. The vertical demand curve created volatility, where the value of ICAP rises above \$200 per kW-year when aggregate ICAP supply is less than the 118 percent reserve requirements, and falls to near \$0 when aggregate ICAP supply exceeds 118 percent. *Id.* ¶ 4, JA 845. Such volatility increases risk and reduces the ability of new generation to obtain financing. *Id.* Financing for new generating facilities in New York had become scarce because investors did not perceive a reasonably reliable stream of revenues, causing the rate of capacity additions to fail to keep up with increasing power supply needs and creating the potential for a capacity deficiency. *Id.*

Offering a more reliable revenue stream, the sloped demand curve would provide better price signals to spur investment in new generation, encourage the formation of long-term bilateral transactions, and reduce incentives to withhold capacity. *Id.* ¶¶ 1, 13, JA 843, 850. This would enhance system and resource reliability, promote greater stability in the ICAP market, and reduce the frequency of price spikes in the energy and ancillary services markets. *Id.* ¶ 9, JA 848. The Commission found reasonable a price curve for ICAP with declining prices as the ICAP capacity increases because resources above the 118 percent minimum requirement provide additional reliability value to the market, and successive incremental resource additions above 118 percent provide declining, but not zero, reliability value. *Id.* ¶ 16, JA 850.

The Commission rejected arguments that the sloped demand curve would significantly increase ICAP costs without providing additional benefits. The proposal would provide savings relative to the vertical demand curve (where the deficiency price is three times the estimated cost of a localized peaker) in the short term by lowering the deficiency price. *Id.* ¶ 43, JA 859. Dr. David Patton, the Independent Market Advisor for the NYISO, estimated that the potential savings from lowering the deficiency charge would be between \$57 million and \$212 million for New York City for the summer capability period (May to October 2003). *Id.* n. 24, JA 859. In the long term, the sloped demand curve should benefit the NYISO markets and customers by increasing stability in ICAP revenues, contributing to the construction of new generation, and reducing incentives to withhold capacity. *Id.* ¶ 44, JA 859-60. Dr. Patton estimated that a one percent increase in capacity would yield savings of \$100 million from reduced price spikes. *Id.* n.23, JA 858.

As the sloped demand curve is a novel proposal, determining its optimum parameters involves some measure of judgment, until there is actual experience with the curve. *Id.* ¶ 17, JA 851. Accordingly, the Commission required ongoing evaluation and monitoring of the initial parameters as some experience is gained, and directed the NYISO to file a detailed evaluation of the sloped demand curve and its implementation by December 1, 2003, and annually for the following two years. *Id.*

The Commission disagreed with ELCON that approval of the sloped demand curve should be governed by incentive ratemaking cases. *Id.* ¶ 21, JA 853. Incentive ratemaking principles apply to incremental rate increases levied upon all customers,

whereas ICAP charges are not levied across all sales of power; rather, they can be avoided by self-supplying or procuring adequate capacity through bilateral contracts. *Id.* Further, *Sithe*, 308 F.3d 71, did not hold that ICAP is an incentive rate subject to incentive ratemaking standards. *Id.*

The Commission rejected the argument that the sloped demand curve replaced a competitive bid-based system with an administratively-determined demand curve, finding that both the sloped demand curve and the existing vertical demand curve use ICAP demand levels and deficiency prices that are administratively determined. *Id.* ¶ 49, JA 862. The issue is not whether aspects of the sloped demand curve are administratively determined, but whether the sloped demand curve is just and reasonable. *Id.*

The Commission found the administratively-determined parameters of the sloped demand curve just and reasonable. *Id.* While, absent actual market experience, all points on the curve cannot be known with precision, the NYISO, in collaboration with the NYPSC and market participants, chose a curve that appears to offer a reasonable result. *Id.* ¶ 53, JA 863. A focal point on the curve is the 118 percent minimum capacity reserves level; NYISO reasonably set a price at that level equal to the cost of constructing new capacity, because, if capacity were not available to meet that required level, it would have to be constructed. *Id.* When available capacity is below the required 118 percent level, the value of capacity rises along the curve until it approaches another set point, the deficiency charge of 200 percent of the cost of a peaking unit. *Id.* That point was set by the NYISO, in collaboration with the NYPSC and stakeholders, as a reasonable charge to

provide sufficient economic incentive for LSEs to obtain the required capacity reserve levels without relying on the auction market. *Id.*

The Commission rejected the contention that the sloped demand curve actually set an ICAP price floor, noting that its low point is \$0 (at 132 percent of forecast load) with a range up to a maximum of about two times the localized cost of a new peaker. *Id.* ¶ 52, JA 862.

Another aspect addressed in comments related to the ICAP monthly quantity requirement under the sloped demand curve. While the sloped demand curve may cause the quantity requirement to fluctuate from month to month, the Commission anticipated that, over time, as parties gain more experience with the sloped curve, the fluctuations will decrease. *Id.* ¶ 60, JA 865. In any event, the potential for quantity variation is less damaging than the potential price variation under the vertical demand curve, where even a slight change in the amount of capacity made available may tip the region into capacity deficiency and subject parties to the deficiency charge. *Id.* Further, the sloped demand curve will be adjusted every three years after stakeholder input. This provides a forum to raise issues regarding adjustments to the demand curve parameters based on actual experience. *Id.* ¶ 61, JA 865.

The Commission rejected the argument that the NYISO failed to consider alternatives to promoting construction of needed generation, such as promoting long-term contracts or demand response mechanisms. The sloped demand curve proposal does not preclude parties from entering into bilateral contracts or increasing demand responsiveness. *Id.* ¶ 75, JA 870. Indeed, the sloped demand curve can reasonably be

expected to foster long-term contracts through more reliable and stable long-term ICAP prices that can provide an appropriate baseline upon which to base long-term bilateral contract prices. *Id.*

While a number of commenters challenged the sloped demand curve's ability to increase new investment in generation, the Commission did not expect that ICAP revenues received under the sloped demand curve would, by themselves, result in more financing. *Id.* ¶ 80, JA 872. Rather, it was expected that more reliable and predictable ICAP revenues would contribute to a more reliable overall revenue structure for an ICAP supplier, and thus play some role in improving that supplier's prospects for financing. *Id.*

With regard to the argument that the sloped demand curve should distinguish between old and new generation, the Commission found that all capacity suppliers, regardless of the age of their generation facilities, are entitled to the same treatment in the ICAP market. *Id.* ¶ 81, JA 872. That certain generators may realize greater profits than others is a fact of the ICAP single price auction. *Id.* It is also difficult to fashion a pricing methodology that would pay fundamentally different revenues to more profitable and less profitable generator groups. Further, the market signals from such differentiated pricing would not be expected to encourage efficient generation additions. *Id.*

The Commission also found no conflict between approving adoption of the sloped demand curve and the regional approach being developed in the multi-ISO Resource Adequacy Markets Working Group ("RAM Working Group"), as adoption of the Demand Curve proposal does not preclude implementation of any future actions recommended by the RAM Working Group. *Id.* ¶ 86, JA 874. The NYISO specifically

stated that it would remain flexible to adjust the Demand Curve as necessary to accommodate the results of the RAM Working Group process. *Id.*

On rehearing, ELCON reiterated the arguments that the sloped demand curve: (1) fails the incentive ratemaking test, (2) fails to encourage new investment; (3) substitutes quantity volatility for price volatility; (4) results in significant increased costs without commensurate benefit; (5) replaces a competitive market with administratively-determined bids; and (6) interferes with the RAM Working Group process. *See* R. 54, JA 880-906. ELCON also argued that the Commission failed to give meaningful consideration to (unspecified) alternatives, and did not give the sloped demand curve proposal sufficient scrutiny. *Id.*

2. The Rehearing Order

On rehearing, the Commission again found incentive ratemaking cases inapposite. Rehearing Order ¶ 19, JA 935. Incentive ratemaking cases involve incremental commodity rate increases levied upon all customers, but ICAP charges will be incurred only by those LSEs that have not procured sufficient ICAP through bilateral purchases or through self-supply. *Id.* The LSEs can hedge against the ICAP charges by acquiring greater amounts of capacity, which would shield their customers from possible high ICAP charges. *Id.*

Even if incentive ratemaking standards applied, however, it would not change the result. *Id.* ¶ 20, JA 936. The sloped demand curve was found an innovative and appropriate means, in the Commission's judgment, as well as in the judgment of the NYPSC and the NYISO, to reduce volatility in the ICAP and energy markets, to provide

better prices signals for encouraging investment in new generation, and to reduce incentives to withhold capacity. No request for rehearing questioned that the ISO needed to change the existing vertical demand curve. *Id.*

The Commission did not fail adequately to consider alternatives. Most of the alternatives presented to the NYISO were not presented to the Commission. *Id.* ¶ 22, JA 937. The two alternatives that were presented to the Commission -- bilateral contracts and demand response -- were not precluded by the sloped demand curve. *Id.* Indeed, the expected price stability from the sloped demand curve could foster the formation of more long-term bilateral contracts. *Id.*

The Commission rejected ELCON's argument that paying increased revenues to existing suppliers under the sloped demand curve will not encourage new generation, finding that approval of the sloped demand curve was based both on encouraging new generation and retaining existing generation. *Id.* ¶¶ 24, 25, JA 937.

The Commission also rejected the claim that the sloped demand curve discourages LSEs from entering into long-term bilateral contracts by encouraging greater spot market purchases to keep prices low. The Commission disagreed, finding that LSEs could benefit from the price certainty offered by bilateral contracts to reduce their expected total ICAP costs. *Id.* ¶ 30, JA 939. Average long-term ICAP contract prices could be lower than average spot prices because contracts provide an assured revenue stream for generators. *Id.* As that stream lowers their risks and finance costs as compared to reliance on spot sales, they are more willing to take lower prices for contract sales.

The modest quantity uncertainty associated with the sloped demand curve was not grounds to reject the curve. *Id.* ¶ 28, JA 938. While LSEs would not know precisely their quantity of ICAP obligation in advance of the auction, any uncertainty would effectively lie between 118 percent (the minimum reserve capacity) and 132 percent (where the price goes to zero) of peak load. *Id.* ¶ 28, JA 938-39. This narrow (14 percent) range contrasts with the much wider price fluctuation under the vertical demand curve, where prices could fluctuate between \$0 and over \$200 per kW-year depending on whether the market was in surplus or deficit. *Id.* Further, while the monthly ICAP requirement varies under the sloped demand curve, LSEs can still hedge most of their ICAP obligations through bilateral contracts by estimating their needs between 118 percent and 132 percent of their peak load. *Id.* To the extent an LSE had more contract capacity than its ICAP obligation in a given month, it could sell the excess back into the ICAP spot market. *Id.* Additionally, the monthly quantity fluctuations are likely to decrease over time, as parties gain more experience with the sloped curve. *Id.*

While the benefits under and parameters of the sloped demand curve were well supported, *id.* ¶¶ 35, 39, JA 941, 942, the specific parameters, including slope and level of the curve, could be refined by actual experience. To allow for such adjustment, the Commission directed NYISO to file a detailed evaluation of the sloped demand curve and its implementation by December 1, 2003, and annually for the following two years. *Id.* Further, the NYISO proposed triennial review of the sloped demand curve, including stakeholder input, which may result in adjustments to the curve. *Id.*

The Commission also remained convinced that the adoption of the sloped demand curve would not prevent implementation of any future actions recommended by the RAM Working Group, and that the NYISO would be as flexible as necessary to accommodate the results of the working group process. *Id.* ¶ 44, JA 943.

For all the stated reasons, the Commission denied rehearing. The petition for review followed.

SUMMARY OF ARGUMENT

ELCON does not dispute that the existing vertical demand curve's boom-bust, volatile nature distorted market signals and deterred investment, and required correction. Rather, ELCON complains that the Commission failed to address adequately arguments that the remedy adopted, the sloped demand curve, was improperly set, would result in high costs, and would not produce the intended benefits. ELCON also argues that the Commission failed adequately to consider alternative remedies.

Each of these issues was fully and reasonably addressed in the challenged orders. The Commission determined that the sloped demand curve and its parameters had been adequately supported and it could be reasonably expected to improve reliability, as well as to promote greater stability in the New York ICAP and energy markets, with corresponding benefits to consumers. The Commission also found that adoption of the sloped demand curve did not preclude implementation of the alternative remedies presented to the Commission or later implementation of potential proposals devised by a multi-regional working group.

ELCON also contends that, notwithstanding the experimental nature of the sloped demand curve as an innovative remedy for a pressing problem, the Commission is not entitled to the deference ordinarily afforded in such situations. Rather, ELCON would apply the standard of review for incentive ratemaking cases where an award of "creamy returns" to encourage investment in new supply must be directly tied to increased investment.

To the contrary, the Commission is entitled to substantial deference in approving this innovative solution to the ICAP market distortions in the NYISO. The incentive ratemaking cases are inapposite as neither the purpose nor the result of the sloped demand curve is to provide creamy returns to ICAP suppliers. Rather, the sloped demand curve is designed to correct market signals so that both suppliers and customers in the NYISO ICAP market appropriately value ICAP supply. In any event, the benefits from correcting the market signals are well demonstrated, and, therefore, adoption of the sloped demand curve would meet the standard required in the incentive ratemaking cases.

ARGUMENT

I. STANDARD OF REVIEW

The Court reviews FERC orders under the arbitrary and capricious standard. *Florida Municipal Power Agency v. FERC*, 315 F.3d 362, 365 (D.C. Cir. 2003). Under that standard, the Commission’s decision must be reasoned and based upon substantial evidence in the record. The Commission’s factual findings are conclusive if supported by substantial evidence. FPA § 313(b), 16 U.S.C. § 825l(b). The substantial evidence standard “requires more than a scintilla, but can be satisfied by something less than a preponderance of the evidence.” *Florida Municipal*, 315 F.3d at 365 (quoting *FLP Energy Me. Hydro LLC v. FERC*, 287 F.3d 1151, 1160 (D.C. Cir. 2002)). Under the substantial evidence standard, the relevant question is not whether record evidence supports petitioners’ version of events, but whether it supports the Commission’s conclusions. *Id.* at 368. The Commission’s choice between “disputing expert witnesses” is entitled to deference. *Wisconsin Valley Improvement Co. v. FERC*, 236 F.3d 738, 746-47 (D.C. Cir. 2001).

“Because ‘issues of rate design are fairly technical, and, insofar as they are not technical, involve policy judgments that lie at the core of the regulatory mission,’ [the Court’s] review of whether a particular rate design is ‘just and reasonable’ is highly deferential.” *CPUC v. FERC*, 254 F.3d 250, 254 (D.C. Cir. 2001) (quoting *Sithe/Independence Power Partners, L.P. v. FERC*, 165 F.3d 944, 948 (D.C. Cir. 1999) and *Town of Norwood v. FERC*, 962 F.2d 20, 22 (D.C. Cir. 1992)).

Further, the sloped demand curve presents a novel, Tariff Order ¶ 17, JA 851, and “innovative way to address the deficiencies in the existing ICAP market,” Rehearing Order ¶ 20, JA 936. Notwithstanding this, ELCON contends that the Commission is not entitled to the deference usually afforded such experiments, Br. at 22-23, but would hold the Commission to the standard “that limits incentive rates to those reasonably calculated to stimulate new investment.” Br. at 14-21 (heading; initial caps deleted).

However, as this Court recognized in *Interstate Natural Gas Ass’n v. FERC*, 285 F.3d 18, 30 (D.C. Cir. 2002), “[f]or at least 30 years this Court has given special deference to agency development of [] experiments, precisely because of the advantages of data developed in the real world.” For, “[n]o matter how good the data suggesting that a regulatory change should be made, there is no substitute for reviewing the actual results of a regulatory action.” *Id.* Thus, even though it cannot be determined with certainty that the Commission’s policy will work, the record here clearly does not show that the Commission’s policy will *not* work. *See Public Serv. Comm’n v. FPA*, 463 F.2d 824, 828 (D.C. Cir. 1972). In such circumstances the court “must recognize that the formulation of such an experimental policy (where the probability of success is uncertain) is the type of activity that the [Commission] was created to perform, and we give great weight to the Commission’s determination regarding this policy.” *Id.*

Here, the Commission was confronted with a seriously malfunctioning ICAP mechanism, and was presented with one fully ventilated alternative that would promptly address the market distortions caused by the vertical demand curve. *See* R. 17 at 3, JA 281. The proposed sloped demand curve and its parameters had been developed in the

NYISO stakeholder process with input from market participants and the NYPSC. The sloped demand curve was well supported by expert evidence and appeared likely to address the problems at issue, as discussed below. Accordingly, the Commission determined that the sloped demand curve “is an appropriate and reasonable approach to resolving the problems encountered under the former ICAP methodology and would ensure adequate capacity and just and reasonable wholesale prices.” Rehearing Order ¶ 21, JA 936.

Thus, as required by *Maryland People’s Counsel v. FERC*, 761 F.2d 768, 778 (D.C. Cir. 1985), *see* Br. at 22-23, the Commission fully supported its determination that “more good than harm” will come from approving the sloped demand curve. Although the Commission could not be certain of exactly how this novel approach to the ICAP issue would function, the Commission should be afforded ample deference for its expectation that the proposed demand curve would work as designed based on the well supported and well-reasoned evidence presented. In addition, the Commission expressly provided for annual, formal review of the operation of the sloped demand curve to determine if refinement were needed based on actual experience. *See* Rehearing Order ¶ 20, JA 936. Under those circumstances, the Commission is entitled to the deference this Court normally affords to the development of experimental policy.

In contrast, the incentive ratemaking cases cited by ELCON, *see* Br. at 16-21, are inapposite. None of those cases addressed an innovative rate structure proposed to replace a mechanism that was no longer producing appropriate market signals. Rather, those cases apply a standard that is “even more particular” than the just and reasonable

standard, *City of Charlottesville v. FERC*, 661 F.2d 945, 950 (D.C. Cir. 1981), because the incentive rates are set above the “zone of reasonableness” to stimulate investment.⁴ *Farmers Union*, 734 F.2d at 1501 (D.C. Cir. 1984).

The incentive ratemaking cases concern a different type of ratemaking, with a different potential impact on ratepayers. Tariff Order ¶ 21, JA 853; Rehearing Order ¶ 19, JA 935. Those cases involved “incremental rate increases levied upon all customers,” Tariff Order ¶ 21, JA 853, *i.e.*, rate increases designed to give a premium above a utility’s cost-based rates as an incentive to increase investment or supply. Likewise, the Commission’s 1992 Policy Statement,⁵ *see* Br. at 20-21, concerned incentive rates that were alternatives to cost-of-service rate regulation for firms with market power. Tariff Order ¶ 21, JA 853.

In contrast, here, ICAP charges do not involve premiums above cost-based rates automatically applied to every sale of power. Tariff Order ¶ 21, JA 853; Rehearing Order ¶ 19, JA 935. ICAP charges can be avoided or hedged by self-supplying or procuring

⁴ *See, e.g., Public Serv. Comm’n. v. FPC*, 589 F.2d 542 (D.C. Cir. 1978) (considering an FPC “optional certification program,” designed to give gas producers “favorable rate procedures and standards” above the national rate for gas to encourage exploration and development of new gas supplies); *City of Charlottesville*, 661 F.2d 945 (considering decision allowing pipelines to include “stand-alone” tax component in rates, instead of accounting for the tax savings realized from filing a consolidated corporate tax return, with the higher cost recovery being used for exploration and development); *Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486 (D.C. Cir. 1984) (maximum rates for oil pipelines set at high levels to help alleviate underinvestment in oil pipelines); *Public Util. Comm’n v. FERC*, 367 F.3d 925 (D.C. Cir. 2004) (Commission approved a 200 basis point incentive on a utility’s return to alleviate longstanding transmission constraints in California).

⁵ *Incentive Ratemaking for Interstate Natural Gas Pipelines, Oil Pipelines, and Electric Utilities*, 61 FERC ¶ 61,168 (1992).

adequate capacity through bilateral contracts, and thus may not be paid by all customers. *Id.* ICAP charges, including the sloped demand curve, are designed to assure that the market appropriately values and compensates capacity resources within New York, and responds appropriately to deficiencies and to surpluses. Younger Aff. at 19-20 ¶¶ 53-55, JA 320-21. *See* Paynter Aff. at 7 ¶ 23, JA 482 (“under the sloped demand curve approach, the market will ultimately determine the price of capacity, since entry will drive the price toward the cost of new generation.”); *Central Maine*, 252 F.3d at 46 (the “core concept” of an ICAP charge is to match the charge with the cost of adding new peak load generating capacity).

It was necessary to revise the vertical demand curve because its boom-bust, volatile nature precluded proper operation of market signals. Paynter Aff. at 10-11 ¶ 33, JA 485-86. That volatility made investment decisions difficult, and thus capital more expensive, as suppliers could not anticipate predictable revenue streams. *Id.* at 11-12 ¶ 36, JA 486-87. Those higher costs ultimately flowed through to customers. *Id.* The vertical demand curve also provided a perverse incentive for large suppliers to withhold capacity, and thus drive the market toward the very high cost of a deficiency charge.⁶ *Id.* at 12 ¶ 38, JA 487.

⁶ The slope of the demand curve determines whether withholding will be profitable to the seller. With a vertical curve, and a deficiency charge equal to three times the cost of a localized peaker, the financial benefit to generation owners of withholding to induce a deficiency are huge. On the other hand, an appropriately graduated slope will keep any price rise small enough that the extra revenue the generator would receive by making capacity available would exceed any profits that might be gained by withholding capacity. *See* Paynter Aff. at 18 ¶¶ 48-51, JA 493.

The sloped demand curve was approved as a replacement for the vertical demand curve because it would “send better price signals to encourage the construction of generation before a shortage occurs, by reducing the volatility in deficiency charges.” Tariff Order ¶ 31, JA 855-56. A more stable and predictable revenue stream would reduce the risk to generation investors and the cost of financing new investment, and thus lower costs to customers. *Id.*

The purpose of the sloped demand curve was not, therefore, to provide above-cost premiums to suppliers of capacity, *see, e.g.*, R. 25 at 17 (“This proposal is not designed to overcompensate, or ‘bail out’ merchant generation. . . .”), but, rather, to “more realistically reflect the economic value of capacity reserves.” Tariff Order ¶ 35, JA 857. *See also* Rehearing Order ¶ 20, JA 936 (“the ICAP demand curve is clearly necessary in our judgment (as well as that of the NYPSC and the NYISO) to reduce volatility in the ICAP and energy markets, provide better price signals for investment in new generation, and reduce incentives to withhold capacity”).

Accordingly, the incentive rate standard does not apply.⁷ This Court has affirmed that “mitigating bias against capital investment and ensuring more accurate price

⁷ Contrary to ELCON’s contentions, *see* Br. at 25-26, *Sithe* did not hold that ICAP is an incentive rate subject to incentive ratemaking standards. Tariff Order ¶ 21, JA 853. The part of *Sithe* relied on by ELCON concerns whether a higher charge may be imposed retroactively, not the standard that the Commission must use when analyzing an ICAP proposal. Rehearing Order ¶ 19, JA 935 (citing *Sithe*, 308 F.3d at 76-77). “Indeed, the court indicated that the level of ICAP charges ‘is a perfect example of a choice with reasonable policy arguments on both sides, so that the agency’s choice easily controls so long as it adequately explains its position.’” *Id.*, JA 935-36. Thus, *Sithe* does not stand for the proposition that incentive ratemaking cases control ICAP charge review. *Id.*

signals,” as well as promoting rate stability, are valid FERC regulatory objectives. *Mid-Tex Elec. Coop., Inc. v. FERC*, 773 F.2d 327, 344 (D.C. Cir. 1985). The sloped demand curve is designed to produce just and reasonable ICAP charges that appropriately value and compensate capacity, creating an incentive for new entry to meet the need for additional capacity and infrastructure. Assuring more appropriate market signals and promoting rate stability are different than providing incentive “premiums” to encourage construction or supply. Thus any “incentives” produced by the sloped demand curve will not cause the ICAP charges to exceed the just and reasonable level, but will allow the market to respond with a more appropriate value to be placed on capacity.

In any event, application of the incentive ratemaking standard would not change the result here, as the sloped demand curve is directly connected to achievement of the Commission’s policy goals. Rehearing Order ¶ 20, JA 936. The sloped demand curve was necessary in FERC’s judgment, as well as that of the NYPSC and the NYISO, to reduce volatility in the ICAP and energy markets, provide better price signals for investment in new generation, and reduce incentives to withhold capacity. *Id.* The Commission reasonably expected substantial benefits from reduced price volatility in the ICAP market, which, by producing a more stable and predictable ICAP revenue stream, would reduce the risk to generation investors, and thus lower the cost of financing new generation to be passed on to customers. *Id.* ¶ 29, JA 939.

II. THE COMMISSION PROPERLY APPROVED THE DEMAND CURVE.

As ELCON concedes, *Central Maine* “affirm[s] that FERC tariffs may set an appropriate level of ICAP charges as a vehicle to ‘assure adequate energy supplies’ and

‘to encourage suppliers to maintain marginal (*i.e.* high cost) existing plant or to build new facilities for peak demand.’ Br. at 24-25 (quoting *Central Maine*, 252 F.3d at 48).

The NYISO’s existing vertical demand curve failed to serve those purposes, as it created extreme price volatility (between more than \$200 per kW-year when capacity is below the minimum requirement and \$0 when capacity exceeds the minimum requirement), which increased risk and reduced the ability of new generation to obtain financing. Tariff Order ¶ 4, JA 845. As a result, financing for new generating facilities in New York had become scarce, causing capacity additions to fail to keep up with need and creating the potential for a capacity deficiency. *Id.*

ELCON does not dispute that the boom-bust, volatile nature of the existing vertical demand curve distorted market signals and deterred investment, requiring that it be corrected. *See* Rehearing Order ¶ 20, JA 936 (“The requests for rehearing do not question that the NYISO needed to change its existing ICAP rules.”) Rather, ELCON complains about the choice of remedy, asserting that the Commission failed adequately to consider alternatives, Br. at 35-36, and failed to address arguments that the sloped demand curve was improperly set, Br. at 27-30, that it would result in high costs, Br. at 30-31, and that it would not produce the intended benefits, Br. 31-34, 36-38. None of these arguments has merit.

A. The Commission Properly Approved the Parameters of the Administratively-Determined Demand Curve.

To assure that reasonable amounts of capacity are supplied in the long run, the demand curve, in the vicinity of the minimum requirement level, should reflect the long-

run cost of capacity. Paynter Aff. at 22 ¶ 61, JA 497. An estimate of the cost of capacity is provided by the annual cost of a new peaking unit, offset by net revenues from energy and ancillary services. *Id.*

Accordingly, on the sloped demand curve, the demand price point for capacity at the 118 percent minimum capacity requirement is set at the annualized cost of a new peaking unit for each area, including New York City and the rest of New York State. Tariff Order ¶ 5, JA 845. Under the NYISO proposal, reflecting the consensus following completion of the stakeholder process, the cost of a new peaking unit to be used in the sloped demand curve was set at \$56.24/kW-yr and \$67.49/kW-yr statewide for years one and two respectively, and \$129.89/kW-yr and \$151.14/kW-yr for New York City.⁸ Tariff Order n. 4, JA 847. The Commission found it reasonable to set the price at the minimum requirement equal to the cost of a new peaker because, if capacity were not available to satisfy the 118 percent minimum capacity requirement, it would have to be constructed. Tariff Order ¶ 53, JA 862-63. ELCON does not contest setting the price point at the minimum capacity requirement at the cost of a new peaking unit. *See id.*, JA 863 (“No party has argued that it is inappropriate to use the cost of a peaker as one of the points on the proposed demand curve.”)

ELCON contends, however, that the Commission gave “insufficient attention” to the argument that the cost of a peaking unit was set too high, based on “recalculations” of the cost of a peaking unit performed by Energy East Companies’ expert David Segal. Br.

⁸ In the third year, the costs assigned to the minimum ICAP requirement will be defined by the results of the triennial independent review that NYISO proposed. *Id.*

at 27-28. *See* R. 37 at 9-12, JA 628-31. Segal opined that the NYISO proposal overstated the cost of a peaking unit and failed to account for net revenues received from the energy and ancillary services markets. Br. at 27 and n. 28. ELCON also challenges the slope of the demand curve resulting from the points chosen. *Id.* at 28-29.

As ELCON acknowledged in its request for rehearing -- but fails to acknowledge on brief -- the Energy East Companies themselves did not endorse their expert Segal's "recalculations," and did not offer Segal's adjustments to establish an alternative demand curve. Rather, the "recalculations" were offered solely as evidence of the difficulties of setting the demand price administratively. *See* ELCON Rehearing, R. 54 at 23, JA 902 ("Without endorsing the above estimates, Energy East made the point that the NYISO's Demand Curve is dependent on highly speculative, administrative guesses on many variables that the market must establish."); Energy East Companies' Protest, R. 37 at 12, JA 631 ("Once again, the Energy East Companies do not offer [Segal's] adjustments to establish a Demand Curve, but instead present them to demonstrate that the fundamental premise of the Demand Curve is flawed. Administrative price setting is bad policy in markets where competition is present.")

Contrary to ELCON's contention, *see* Br. at 30, the Commission considered and rejected Energy East Companies' argument regarding the viability of administrative price-setting in this case. *See* Tariff Order ¶ 45 and n. 27, JA 861; Rehearing Order ¶ 37, JA 941-42 (describing Energy East arguments). Both the sloped demand curve proposal and the existing vertical demand curve use ICAP demand levels and deficiency prices that are

administratively determined.⁹ Tariff Order ¶ 49, JA 862. Because the overall benefits of reserve capacity are largely socialized, the value of those benefits cannot be determined from the bids of individual LSEs, whose only concern in making a bid is to avoid a deficiency charge. Paynter Aff. at 9 ¶ 29, JA 484. The value to the system as a whole therefore must be estimated by other means. *Id.* Thus, as reliance on the energy market alone would not provide an appropriate level of necessary reserve capacity, any ICAP market, including both the existing vertical demand curve and the sloped demand curve, must be based on administrative policy. *See* R. 17 at 13, JA 291.

Accordingly, use of an administratively-set demand curve is not a reason to reject the NYISO's proposal. Tariff Order ¶ 49, JA 862. The issue is whether the administrative approach is just and reasonable. *Id.* ¶¶ 49, 51, JA 862. Here, ample substantiation in the record supports the points selected to define the sloped demand curve:

Although the points on the curve cannot be known with precision, the NYISO, in collaboration with the NYPSC and market participants have chosen a curve that they believe is reasonable. Because New York has required at least 118 percent capacity reserves, NYISO has set a price at that level equal to the cost of constructing new capacity. This is reasonable. If capacity were not available, it would have to be constructed. No party has argued that it is inappropriate to use the cost of a peaker as one of the points on the proposed demand curve. At levels below 118 percent, the value of capacity rises until it approaches the deficiency charge of 200 percent of the cost of a peaking unit. The proposed deficiency payment is an administratively determined amount that the NYISO, in

⁹ The existing vertical demand curve is established by the administratively-determined 118 percent minimum capacity requirement and the deficiency charge, which is set at three times the NYISO's estimate of the cost of a new peaking unit. Tariff Order ¶ 50, JA 862.

collaboration with the NYPSC and stakeholders determined to be necessary to provide sufficient economic incentive to ensure that LSE's would obtain the required capacity reserve levels.

Tariff Order ¶ 53, JA 862-63.

The sloped nature of the curve reasonably reflects prices for ICAP that decline as the available capacity level increases. *Id.* ¶ 16, JA 850-51. Capacity above the necessary 118 percent requirement provides additional, albeit declining, reliability value to the market, and it is reasonable for the price of ICAP to reflect this relationship. *Id.* The demand price reaches zero at 132 percent of peak load. *Id.* ¶ 5, JA 845. This point is set at 112 percent of the minimum capacity requirement (which is currently 118 percent of peak load). Younger Aff. at 15 ¶ 41, JA 316. Beyond 112 percent of the minimum capacity requirement, additional capacity is believed to offer no additional benefit to the system. Paynter Aff. at 14 ¶ 41, JA 489.

Thus, the Commission concluded that, because “[t]he proposed downward sloping demand curve reflects the decreasing but still positive value of additional reserves (while the existing vertical demand curve does not),” the sloped demand curve “rests on a more rational economic basis than” and “is a substantial improvement over” the existing demand curve. Tariff Order ¶ 35, JA 857. *See also* Rehearing Order ¶ 39, JA 942 (rejecting, *inter alia*, the challenge to the “pitch” of the sloped demand curve, finding that “the parameters of the ICAP Demand Curve, as proposed, are appropriate and reasonable”).

Because “determining specific parameters, including slope and level of the curve, requires some measure of experience,” Rehearing Order ¶ 39, JA 942, the Commission

determined that the operation of the sloped demand curve “demands close monitoring.” *Id.* See also Tariff Order ¶ 17, JA 851. Accordingly, the Commission directed the NYISO to file a detailed evaluation of the sloped demand curve and its implementation by December 1, 2003, and annually for the following two years. Rehearing Order ¶ 39, JA 942. Further, the NYISO proposal provided for a triennial review of the sloped demand curve that includes stakeholder input. *Id.* Adjustments to the curve are expected, as the mandated review would determine the then-current cost of gas turbines in each locality and the rest of the State. Tariff Order ¶ 61, JA 865 (quoting section 5.14.1(b) of the NYISO proposal, which provides that: “Among other criteria, the review will determine the current localized levelized embedded cost of gas turbines in each NYCA Locality and the Rest of the State and associated Energy and Ancillary Services revenues.”). With this review process in place the Commission found the proposal just and reasonable, as periodic reviews will allow participants to advocate for adjusting certain parameters of the curve based on actual experience. Rehearing Order ¶ 39, JA 942.

In any event, even if the Energy East Companies’ “recalculations” had been offered as an alternative calculation of the cost of a new peaking unit, the record amply supported the value selected by the NYISO. See Rehearing Order ¶ 39, JA 942 (rejecting argument that the sloped demand curve was based on flawed estimates). That value, as well as the other calculations supporting the sloped demand curve, were first subjected to extensive ICAP working group deliberations and stakeholder input, and were fully supported by expert testimony.

The consensus demand curve points for the 118 percent minimum requirement level following completion of the stakeholder process were \$56.24/kW-yr and \$67.49/kW-yr statewide, for years one and two respectively, and \$129.89/kW-yr and \$151.14/kW-yr for New York City. Tariff Order n. 4, JA 847. These figures were based on (i) an independent study showing actual entry costs in New England of \$73 and (ii) the estimated costs of \$220 incurred by the New York Power Authority to install LM 6000 gas turbines in New York City in 2001. R. 45, Attachment II, Supplemental Affidavit of Dr. David B. Patton (“Patton Supp. Aff.”) at 10 ¶ 33, JA 839. Following stakeholder input, the statewide value of \$73 was adjusted upward to \$85 per kW-year to reflect the higher applicable taxes in New York. *Id.* ¶¶ 33-34, JA 839. The New York City estimate of \$220 was adjusted downward to \$159 per kW-year to reflect the cost savings associated with installing a lower cost technology. *Id.*

Although estimated revenues from energy and ancillary services were \$42.50 per kW-year, Paynter Aff. at 23 n. 15, JA 498,¹⁰ the NYPSC proposed an offset to the cost of a new peaking unit of one-half of the value of the revenues, or \$21 per kW-year, as a conservative value. *Id.* This approach was prudent, from a resource adequacy standpoint, because to err on the side of overstatement of the capacity payment would help to assure

¹⁰ Dr. Patton estimated annual net revenues from energy and ancillary services for gas-fired combustion turbines based on data for the 12 months ending August 31, 2002 to be \$7.50 per kW-year for energy revenues and \$12 per kW-year for ancillary services revenues. Paynter Aff. at 23 n. 15, JA 498. Dr. Patton also estimated that prospective rules changes to more accurately price shortage periods in the energy markets would add \$13 per kW-year, and the NYPSC staff estimated that a reduction in capacity from the current 123 percent of peak load to the 118 percent minimum requirement would increase energy revenues by \$10 per kW-year. *Id.*

that new entry is economic. *Id.* at 21 ¶ 58, JA 496; Patton Supp. Aff. at 9 ¶¶ 28-29, JA 838.

Accordingly, contrary to the assertions of the Energy East Companies, espoused by ELCON here, Br. at 27, the consensus demand curve price levels set for the 118 percent minimum capacity requirement (1) were not in excess of the actual price of capacity but rather were well below the cost estimates of a new peaking unit, and (2) did not fail to account for energy and ancillary service market net revenues as the price levels were set based on an agreed level of offsets for those revenues. Patton Supp. Aff. at 9-10 ¶¶ 27, 34, JA 838, 839-40.

Thus, the figures employed in calculating the price level at the 118 percent minimum capacity requirement were the product of a lengthy stakeholder process and reviewed and supported by experts as a reasonable basis for setting the points on the curve. *See* Patton Supp. Aff. at 10 ¶ 31, JA 839; Paynter Aff. at 22-23 ¶¶ 61-65, JA 497-98. ELCON's challenge to those figures is based on "recalculations" that the Energy East Companies themselves would not endorse as a basis for setting an alternative demand curve. As a result, the record fully supported the finding that "the administratively determined parameters of the proposed ICAP Demand Curve are reasonable." Tariff Order ¶¶ 49, 51, JA 862. *See also* Rehearing Order ¶ 39, JA 942 (finding, in response to Energy East Companies' arguments, that "the parameters of the ICAP Demand Curve, as proposed, are appropriate and reasonable"); Tariff Order ¶ 35, JA 857 ("Based on our analysis, we conclude that the proposal has been adequately supported and that there is a

reasonable expectation that it will achieve the goal of improving reliability in New York, as well as promoting greater stability in the ICAP and energy markets.”).

Thus, here, unlike *Central Maine*, see Br. at 24 (quoting *Central Maine*, 252 F.3d at 43), the Commission fully explained why it was not persuaded by efforts to discredit the parameters set for the sloped demand curve. Under those circumstances, the Commission’s “expert judgments are entitled to deference, especially where safety concerns are on one side of the balance, as they are here [where ICAP is concerned].” *Central Maine*, 252 F.3d at 44.

B. The Commission Properly Evaluated the Costs of the Demand Curve As Compared to the Existing Curve.

ELCON charges that the Commission made “no effort to justify the size of the cost increase [from the Demand Curve] compared to the alleged benefit.” Br. at 31. As to the alleged cost increases, ELCON points to Dr. Pechman’s estimate that the sloped demand curve will result in an additional \$700 million paid to ICAP suppliers over a three-year period, and Strategic Energy’s contention that increases will be in excess of \$1 billion per year. *Id.* ELCON also points to Dr. Patton’s estimates that the sloped demand curve would result in first year transitional increased capacity costs of \$70 million in New York City and \$84 million statewide. Br. at 31.

The Commission noted the significant criticism of the \$700 million-\$1 billion estimates as unsupported and based upon flawed analysis, resulting in gross overstatement of potential price impacts. Tariff Order ¶ 38, JA 858. See R. 17 at 17-19, JA 295-97; Younger Aff. at 24-26 ¶¶ 70-76, JA 325-27. Dr. Patton testified that his own cost

estimates were overstated because they did not account for the short and intermediate term capacity contracts that would protect customers from price increases in the short run. Patton Aff. at 17 ¶¶ 60-61, JA 166. See R. 25 Attachment II, Affidavit of Harvey Arnett (“Arnett Aff.”) at 4 ¶ 9, JA 505 (estimating that flowing through all increased payments to generators to end-use customers would equate to a 1-1.5% increase in total electric bills, or, if certain customers have price protection, no more than 3% increase in the bills of non-protected consumers).

Additionally, any costs of the sloped demand curve are transitional and will be eliminated over time as the market moves toward a long-run equilibrium. Patton Aff. at 17 ¶ 61, JA 166. Since most types of generation can be built in two to four years, long-run equilibrium should be relatively rapidly achieved, and, once reached, consumers are likely to realize significant cost savings relative to the current capacity market system. *Id.*

Upon evaluating this evidence, the Commission concluded that, although it could not pinpoint the level or range of the savings that would result from the sloped demand curve proposal, the sloped demand curve would in fact provide savings relative to the existing vertical demand curve. Tariff Order ¶¶ 43, 44, JA 859-60. In the short term, the sloped demand curve would provide savings relative to the vertical demand curve where the deficiency price is set at three times the estimated cost of a localized peaker. *Id.* ¶ 43, JA 859.

For example, at the time of the challenged orders, New York City was projected to have a summer capacity deficiency. Younger Aff. at 11 ¶ 32, JA 312 (citing NYISO Locational Installed Capacity Requirements Study for the 2003-2004 Capability Year,

forecasting that New York City would have virtually no capacity beyond its minimum requirement). Because Dr. Patton's assumed prices for New York City, used in calculating the cost of the sloped demand curve as compared to the existing vertical demand curve, were not at the deficiency level, the transitional costs of the sloped demand curve to New York City load were likely overstated. Patton Aff. at 18 ¶ 65, JA 167. In fact, New York City loads would realize reductions in costs under the sloped demand curve, even in the short-run, if the capacity market cleared at the deficiency price. *Id.* See Tariff Order n. 24, JA 859. Dr. Patton estimated that those savings would be between \$57 and \$212 million for New York City for the summer capability period (May to October), as a result of reducing the deficiency charge from 3 times the localized peaker costs. Tariff Order n. 24, JA 859. See Rehearing Order ¶ 35, JA 941; Patton Aff. at 7-8, ¶¶ 30-32, JA 156-57. See also Arnett Aff. at 4 ¶ 11, JA 505 (estimating that the savings under the sloped demand curve, as compared to the existing vertical demand curve, assuming New York State is deficient, is in the order of several hundreds of millions of dollars).

Furthermore, when long-term equilibrium levels of capacity were reached, consumers could be expected to achieve significant savings over the current system. Tariff Order ¶ 9, JA 848. By signaling that reserves above 118 percent have value, the sloped demand curve should help develop adequate generation supply, and greater investment in generation capacity will improve reliability by reducing the volatility of ICAP revenues, reduce the incentive for suppliers to withhold ICAP capacity from the market and "provide net benefits especially compared with the existing vertical demand curve." Tariff Order ¶¶ 13, 44, JA 850, 859-60. Dr. Patton estimated that increasing

capacity in New York by 1 percent would result in average savings for consumers of \$100 million per year, as a result of less frequent price spikes. Tariff Order ¶ 9, JA 848. *See* Patton Aff. at 5 ¶ 22, JA 154. Further, the Commission pointed to the role of the NYPSC in developing the ICAP proposal to be an important factor in finding it will benefit customers. Tariff Order ¶ 15, JA 850; Rehearing Order ¶ 40, n. 25, JA 941, 942.

Of course, absent actual experience with the sloped demand curve, there was no way to demonstrate definitively the existence of these benefits. Rehearing Order ¶ 35, JA 941. Nonetheless, the Commission was persuaded that the sloped demand curve sends the right incentives to potential providers of ICAP resources, encouraging the construction of new generation that should result in substantial benefits. *Id.* Further, the requirement that the NYISO file detailed evaluations of the sloped demand curve and its implementation annually for three years will provide evidence of actual benefits. *Id.*

C. The Commission Properly Evaluated the Benefits of the Demand Curve As Compared to the Existing Curve.

The sloped demand curve was intended to address significant flaws in the NYISO's current capacity market design, in particular the extreme price volatility, the dearth of long-term contracting, and the inadequate market signals for new generation. *See* Younger Aff. at 3 ¶ 8, JA 304. The Commission approved the sloped demand curve because its more stable pricing would provide better price signals for the construction of new generation, encourage the formation of long-term bilateral contracts, and reduce incentives to withhold capacity. Tariff Order ¶ 1, JA 843. ELCON, however, disputes that the curve will reduce volatility, encourage bilateral contracts or encourage new

investment. ELCON also questions whether New York was suffering a capacity shortage that required adoption of the sloped curve. None of these contentions has merit.

ELCON contends that the sloped demand curve will not reduce volatility but merely substitute quantity volatility, which LSEs have no ability to hedge, for price volatility. Br. at 36-38. However, the Commission found that the potential quantity fluctuation under the sloped demand curve is in a narrow range (118 percent to 132 percent), and thus much less damaging than the price volatility under the vertical demand curve, where an event affecting an incremental amount of capacity could tip the region into capacity deficiency and subject parties to the deficiency charge. Tariff Order ¶ 60, JA 865; Rehearing Order ¶ 28, JA 938-39. *See, e.g.*, Paynter Aff. at 16-17, Table 1 and Figure 2, JA 941-42 (depicting the dramatic difference in price volatility under the NYISO's existing vertical demand curve and the sloped demand curve). Over time, as parties gain more experience with the sloped curve, quantity fluctuations will decrease. Tariff Order ¶ 60, JA 864-65; Rehearing Order ¶ 28, JA 939.

Thus, the Commission was not persuaded that the modest quantity uncertainty associated with the sloped demand curve warranted its rejection. Rehearing Order ¶ 28, JA 938. While LSEs would not know the precise quantity of their ICAP obligation in advance of the auction, it would effectively lie between 118 percent and 132 percent of peak load.¹¹ *Id.*, JA 938-39. By contrast, under the vertical demand curve, the ICAP

¹¹ The Commission noted that, in theory, the market could clear at a quantity either below 118 percent or above 132 percent. Rehearing Order n. 23, JA 939. However, if it fell below 118 percent the NYISO would attempt to purchase sufficient additional capacity outside the auction to reach 118 percent. *Id.* The costs of these additional

price could fluctuate widely -- between \$0 and over \$200 per kW-year -- depending on whether the market was in surplus or deficit. *Id.*

As to whether LSEs could hedge against this narrow quantity risk, “LSEs will have the opportunity to purchase any quantity of capacity they desire in the forward market and the spot market provides a means to sell back any excess capacity purchased forward.” Tariff Order ¶ 59, JA 864. Accordingly, while LSEs may not be able to match such purchases to their exact (and fluctuating) capacity obligation, they would be able to hedge most of it. Rehearing ¶ 28, JA 939. To the extent that an LSE purchased more capacity than needed to meet its obligation, it would be able to sell the excess back into the spot market. *Id.*

ELCON further argues that sloped demand curve’s alleged “unhedgeable” quantity risk, coupled with ELCON’s erroneous assertion that the sloped demand curve sets an ICAP floor price, “effectively eliminates” the incentive of LSEs to enter into bilateral contracts. Br. at 26-27. *See also id.* at 38. The Commission disagreed that the sloped demand curve would set a price floor, as the price of capacity will fluctuate between \$0 (at 132 percent of forecast load) and a maximum of about two times the localized cost of a new peaker. Tariff Order ¶ 52, JA 862. FERC also disagreed that the sloped curve would discourage LSEs from entering into bilateral contracts, because bilateral contracts can

purchases would be assigned to LSEs that had not previously acquired 118 percent, so acquiring capacity in advance equal to 118 percent of peak load would hedge against this possibility. *Id.* Conversely, if the auction were to clear at a quantity above 132 percent, the market price for capacity would be \$0, so there would be no financial risk to procuring only 132 percent in advance of the auction. *Id.*

reduce the uncertainty of ICAP costs to the extent they lock in a price for the contract quantity, and reduce total ICAP costs when the price specified in the contract is below the spot market price. Rehearing Order ¶ 30, JA 939. ICAP contract prices could be lower than average spot prices over the long run because contracts provide an assured revenue stream for generators with lower risks and finance costs as compared to reliance on the spot market. *Id.*

Further, the Commission agreed that, with the sloped demand curve in place, there will be a set of known payments from which the market-clearing price can be more accurately forecasted. Tariff Order ¶¶ 74-75, JA 870. This provides far greater price transparency and predictability than the vertical demand curve, which will allow investors and developers to better measure risks and incorporate future ICAP payments as a reliable source of revenue through long-term bilateral contracts. *Id.* This reduces the forecasting risk for buyers and sellers alike, by reducing the likely range of clearing prices and therefore reducing the bid/ask spread for long-term contracts. Younger Aff. at 21 ¶ 59, JA 322. Thus, the Commission found it reasonable to expect that “more reliable and stable ICAP prices over the long-term could provide participants with the appropriate baseline upon which to base long-term bilateral contracts.” Tariff Order ¶ 75, JA 870.

ELCON argues that the sloped demand curve will not encourage new generation, based on the arguments of other parties that reluctance to build new generation arises from issues other than the composition of the ICAP market. Br. at 34. The Commission did not, however, expect that ICAP revenues alone would result in more financing. Tariff Order ¶ 80, JA 872. It was expected that more reliable and predictable ICAP revenues

would contribute to a more reliable overall revenue structure for an ICAP supplier and thus play some role in improving that supplier's prospects for financing, which, in turn, provides additional incentive to enter the New York market. *Id.* While generation will not suddenly appear in New York, but, instead, will take time to develop, implementing the sloped demand curve now will provide greater support for adding generation. *Id.*

ELCON also argues that increased ICAP payments under the sloped demand curve are not targeted to increase new generation investment because the increased ICAP payments are not tied to incremental generation investment in New York, but are equally applicable to already constructed generation. Br. at 18, 21. All capacity suppliers, regardless of the age of their resources, are entitled to the same treatment in the ICAP market. Tariff Order ¶ 81, JA 872. Due to its design as a single price market, every MW of capacity that meets the reliability needs of the system is providing the same service. R. 18 at 18, JA 368. While certain generators may realize greater profits than others, that is a fact of the marketplace, and the Commission failed to see how those generators could receive ICAP revenues that were fundamentally different from those paid to less profitable generators. Tariff Order ¶ 81, JA 872.

Moreover, treating all suppliers in the ICAP market the same sends market signals that the Commission expects to encourage both building new generation and retaining existing generation. Rehearing Order ¶ 25, JA 937.

Ultimately, it is the cost of entrance that determines overall price levels and it is the amount of new entry, and exit, that determines the reliability of service seen by a buyer in the marketplace. If prices are high relative to the cost of new entry, then new entrants will be attracted into the market place and prices will be pulled back down. If prices are low compared to the cost

of new entry, then there will be little or no new entry, exit may occur due to the inability to make a reasonable profit, and prices will be pushed up. The process of prices affecting entry, and entry affecting prices, yields an equilibrium price that is tied to the cost of entry.

Paynter Aff. at 2-3 ¶ 9, JA 477-78. Thus, reaching an equilibrium market price that approximates the cost of new entry is necessary not only to encourage new entry but also to discourage exit from the market (as occurred when suppliers withheld capacity due to the old ICAP pricing).

Although ELCON now disputes that supply conditions in New York were critical at the time, Br. at 23, its Rehearing Request failed to raise this argument. R. 54. Thus, this argument cannot be considered on review. FPA § 313(b) (“[n]o objection to the Order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure to do so”).¹²

In any event, the NYISO presented evidence that New York was already in serious capacity deficiency. Tariff Order ¶ 30, JA 855. *See* R. 45 at 3 and n.7, JA 795 (discussing findings of the Locational Installed Capacity Requirements Study as evidence that “New York is already approaching a serious deficiency in Capacity.”) Further, the Commission found that, whether or not there was an already-existing capacity shortage,

¹² *See, e.g., City of Orrville, Ohio v. FERC*, 147 F.3d 979, 990 (D.C. Cir. 1998) (court lacks jurisdiction to hear arguments not made on rehearing); *Platte River Whooping Crane Critical Habitat Trust v. FERC*, 876 F.2d 109, 113 (D.C. Cir. 1989) (parties seeking review must themselves raise on rehearing all objections urged on appeal).

the better price signals generated by the sloped demand curve should help prevent future shortages. *Id.*

D. FERC Properly Considered All Alternatives Raised Before It.

ELCON now contends that FERC failed adequately to consider alternatives to adoption of the sloped demand curve, specifically, Strategic Energy's proposal to use long-term contracts and demand response mechanisms, a NYISO market participants' proposal to enhance the existing ICAP market mechanism, and Energy East Companies' proposal to delay modification of the ICAP mechanism awaiting the RAM Working Group's recommendation. Br. at 35-36. On rehearing, however, while ELCON made one general allegation that FERC "fail[ed] to give meaningful consideration to alternatives," R. 54 at 13, JA 892, ELCON did not identify any specific alternatives that FERC allegedly failed to consider, let alone proffer any reasons why those alternatives should be adopted.

Thus ELCON should not now be heard to criticize the Commission's failure to adopt particular alternatives raised by other parties but not by ELCON below. This court strictly construes the jurisdictional requirement that objections on rehearing must be specific. *Wisconsin Power & Light Co. v. FERC*, 363 F.3d 453, 459-60 (D.C. Cir. 2004). The fact that other parties to the proceeding may have raised specific alternatives for consideration does not permit ELCON to appeal the Commission's failure to adopt those alternatives, when ELCON never even identified, let alone supported, before the Commission the alternatives it now endorses. *ASARCO, Inc. v. FERC*, 777 F.2d 764, 773-74 (D.C. Cir. 1985).

In any event, the Commission did not fail to consider those alternatives. *See* Tariff Order ¶¶ 72-74, JA 869-70 (describing alternatives). Most of those alternatives had been brought before the NYISO during the stakeholder process, but were not presented to the Commission. Rehearing Order ¶ 22, JA 937. The two specific alternative proposals made to the Commission, bilateral contracts and demand response, were considered but did not foreclose adopting the sloped demand curve, as it and they could coexist. *Id.* For example stable pricing under the curve could foster the formation of long-term bilateral contracts. *Id.* *See also* Tariff Order ¶ 75, JA 870. Accordingly, the sloped demand curve would not preclude parties from entering into bilateral contracts or increasing demand responsiveness. Tariff Order ¶ 75, JA 870.

As for the RAM Working Group, *see* Br. at 35, it had not yet made any proposal at the time the sloped demand curve was approved, and it had not rejected use of the demand curve. Tariff Order ¶ 85, JA 873-74. The NYPSC urged the Commission not to delay remedying the ICAP market pending a RAM Working Group proposal, which may cause a lengthy delay. *Id.* *See, e.g.,* Younger Aff. at 30 ¶ 94, JA 331 (“Based upon my participation in the RAM group I expect this process to take at least a couple of years. The capacity market problem in New York is too critical to wait until the RAM process concludes before moving to implement a solution.”)

Under these circumstances, the Commission found approval of the sloped demand curve appropriate, and noted that approval did not prevent implementation of any future actions recommended by RAM Working Group. Tariff Order ¶ 86, JA 874; Rehearing Order ¶ 44, JA 943. The sloped demand curve only replaced the current ICAP market

auctions and will allow longer-term solutions to operate. Tariff Order ¶ 86, JA 874. Moreover, the RAM Working Group still had the sloped demand curve under review. *Id.* Thus, FERC approval of the sloped demand curve did not undermine a broader solution. *See, e.g., Central Maine*, 252 F.3d at 44 (“the sense that agencies should address alternatives before acting is not hard and fast: if prompt action is necessary and delay would be harmful, agencies sometimes do need to take interim action, deferring to further proceedings other facets of the problem or alternative solutions that may take more time to develop”).

The Commission supports adoption of a common resource adequacy market design, and therefore encouraged stakeholders to continue to develop a multi-regional proposal, noting with approval the stated flexibility of the NYISO to adjust the sloped demand curve as necessary to accommodate possible results of the RAM Working Group process. Tariff Order ¶ 86, JA 874. Thus, while the sloped demand curve would benefit New York immediately, the multi-regional approach was not foreclosed. Indeed, as the RAM Working Group was intending to file a proposal by 2004, the Commission directed the NYISO to file a compliance report by February 28, 2004 that describes the status of the RAM Working Group process. *Id.* ¶ 88, JA 874-75.

CONCLUSION

For the reasons stated, the Commission's orders should be affirmed in all respects.

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CERTIFICATE OF COMPLIANCE

In accordance with Circuit Rule 28(d)(1), I hereby certify that this brief contains 12,976 words, not including the tables of contents and authorities, the certificate of counsel, this certificate and the addendum.

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