STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

Case 94-E-0136 - Sithe/Independence Power Partners L.P. - Petition For An Original Certificate of Public Convenience and Necessity Authorizing Independence's Proposed Independence Generating Station to Provide Electric Service to Alcan Rolled Products Company and Liberty Paperboard L.P.

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PRELIMINARY STATEMENT

On February 22, 1994, Sithe/Independence Power Partners L.P. (Independence) filed an application for a Certificate of Public Convenience and Necessity (Certificate) under PSL §68, authorizing Independence's 1040 MW cogeneration facility to make approximately 40 MW of electric retail sales to Alcan Rolled Products Company (Alcan), and approximately 15 MW to Liberty Paperboard L.P. (Liberty). Alcan is an existing aluminum products manufacturer located adjacent to the Independence site, while Liberty is a proposed paper-recycling mill that would be built on the Independence site.

Independence filed the petition in response to the Independence Ruling, where the Commission decided the Independence cogeneration facility would be an electric corporation if it made the retail sales.[1] As described in the Ruling, Independence is constructing a 1040 MW natural gas-fueled cogeneration plant that will be a qualifying facility (QF) under the Public Utility Regulatory Policies Act of 1978 (PURPA)

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[1]Case 93-E-0272, Niagara Mohawk Power Corporation, Declaratory Ruling on Regulation of Sithe/Independence Power Partners (Issued February 9, 1994).

regulations. It will sell approximately 740 MW of capacity at wholesale to Consolidated Edison Company of New York, Inc. (Con Edison) and approximately 300 MW of capacity at wholesale to Niagara Mohawk Power Corporation (Niagara Mohawk).[1] In addition to wholesale sales, however, Independence also proposes the retail electric sales to Alcan and Liberty.

Since PURPA explicitly provides that retail electric sales are subject to state jurisdiction, and Independence's retail sales would be within the ambit of regulation under the Public Service Law, Independence was required to obtain a Certificate before the sales were made.

In the Independence Regulation Order, the Commission established guidelines for regulating Independence as an electric corporation, and provided guidance to this proceeding.[2] Although noting that competition itself is generally desirable, the Commission emphasized the purpose of certification is to review competition questions and that consideration of "conditions needed to ameliorate any adverse ratepayer impact" was appropriate in a certification proceeding.[3] The Commission further explained that the transition from monopoly service

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[1]Consolidated Edison Company of New York, Inc. and Lakeview, Inc., Contract No. 403 (Filed May 20, 1991), Supp. No. 1 (Filed December 9, 1992); Niagara Mohawk Power Corporation and Sithe/Independence Power Partners L.P., Contract No. 729 (Filed August 4, 1992).

[2]Case 93-E-0272, Niagara Mohawk Power Corporation, Order Establishing Regulatory Regime For Sithe/Independence Power Partners (Issued April 19, 1994).

[3]Independence Regulation Order, p. 9.

provided by a utility like Niagara Mohawk to retail competition could, unless carefully managed, result in "price shocks, ratepayer subsidies for unregulated enterprises, and declines in service quality."[1]

The Commission added that a demonstration that the competition between Niagara Mohawk and Independence over Alcan and Liberty had been unfair could bar certification, but that parties opposing certification would bear a heavy burden in proving that unfair competitive practices justified a denial of certification rather than imposition of conditions necessary to assure fairness.[2] Finally, the Commission expedited consideration of this proceeding, directing that it be submitted for review at their August 31, 1994 Session. The date of that Session was later postponed to September 8, 1994.

After this proceeding was instituted upon the filing of Independence's petition, Pre-hearing Conferences were held on April 11 and April 21, 1994. Hearings were conducted for five days -- on July 6, 7, 13, 14, and 15, 1994. 1,596 pages of transcript were taken, and 66 exhibits were propounded. This record justifies imposition of a fee on Independence, as a condition imposed upon certification of the retail sales, if certification is otherwise justified.[3] The fee is needed both

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[1]Independence Regulation Order, p. 9.

[2]Independence Regulation Order, p. 11.

[3]Staff takes no position on the issue of whether a Certificate should be granted, because it is Independence's burden to justify certification (SM 1542).

to ameliorate the unfair competitive disadvantages Niagara Mohawk faced that were inherent in this competition, and to shield ratepayers against the impacts of that competition.

Independence was unfairly advantaged, while Niagara Mohawk was unfairly disadvantaged, in the competition over retail sales to Alcan and Liberty.[1] Most importantly, to maintain QF status under PURPA, Independence is compelled to maintain deliveries of thermal energy to a steam host, and Alcan and Liberty serve that role. It is reasonable to assume this requirement, enforced through penalties in the wholesale contracts with Con Edison and Niagara Mohawk, enabled Alcan to leverage a lower price for electricity out of Independence than the generator would otherwise have offered.

Moreover, regulatory impediments inherent in Niagara Mohawk's status, as an electric utility subject to the full panoply of the Public Service Law, hampered its efforts to compete effectively. The utility could make only those offers authorized under its tariffs, or otherwise approved by the Commission. And its cost structure was established through the ratemaking process, where its rates are not quickly or readily changed. While Niagara Mohawk may not have managed the regulatory process as aggressively as it could have, that process constrained its ability to match Independence's offers.

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[1]Staff believes these customer's retail contracts are priced similarly, and the customers are otherwise analogous; at least one independent financial analyst apparently holds the same view (Exh. 36, p. 23).

Even if competition had been equal, a certification fee would still be justified. If Independence supplants Niagara Mohawk as the supplier of electricity to Alcan and Liberty, the contributions Alcan made, and Liberty would have made, towards common system costs would be lost. Captive ratepayers could then find themselves burdened with those transferred costs. Since Independence is responsible for so burdening captive ratepayers, it should be responsible as well for alleviating that burden.

Understandably reluctant to focus attention on the advantages Alcan and Independence enjoyed in negotiating a retail electric service contract with each other, the two raise a host of questionable complaints against imposition of a certification fee. They argue PURPA benefits ratepayers -- a position belied by New York's experience and the enormous overpayments Independence and its parent, Sithe Energies, Inc. (Sithe), extract from New York's ratepayers through contracts obtained under PURPA. They claim reliance on the Empire Ruling, when there is little factual and no legal basis for that reliance. They criticize Niagara Mohawk's negotiating efforts, rather than focus on the nature of their relationship.

Independence/Alcan maintain further that the 1040 MW Independence "PURPA machine" (SM 186) is analogous to self-generation -- the equivalent of disguising an elephant as a mouse. They point to alternatives other than Independence Alcan might have turned to for electricity supply, but the fact is that Independence was the alternative selected. Finally, they argue Public Service Law regulation benefits Niagara Mohawk, while at

the same time criticizing the rate-setting process applied to the utility under that regulatory regime.

These positions, and the attendant host of other, less important questions Independence and Alcan have raised, should be disregarded, to focus on the more important issues -- the nature of the competition over retail sales to Alcan and Liberty and the impact of that competition on ratepayers. Those factors justify a fee as a condition of certification, tied to the contribution to common costs Niagara Mohawk's ratepayers lose as a result of the diversion of Alcan and Liberty revenues from the utility to Independence.

ARGUMENT

I. The Competitive Framework

The competition over Alcan and Liberty, as retail electric customers, was unfairly tilted towards Independence and away from Niagara Mohawk. PURPA favored Independence while traditional regulation hampered Niagara Mohawk.

A. The Independence/Alcan PURPA Advantage

In order to obtain its wholesale contracts with Con Edison and Niagara Mohawk, Independence was required to establish it would be a QF under the PURPA regulations. A cogeneration facility seeking to qualify under those regulations must show it will deliver useful thermal energy to entities like Alcan or Liberty. The quantum of that thermal energy must be no less than 5% of the total output of the QF facility (SM 1457-63).[1]

[1] 18 C.F.R. §292.205(a).

Independence sized its electric production plant as near as possible to the maximum feasible, given the steam load it could expect from Alcan standing alone (SM 1462-63). In doing so, it became one of the largest QFs in the United States and placed itself squarely within the ambit of the definition of a "PURPA machine" (SM 168).

Independence's wholesale contracts, however, are dependent upon QF status, which, in turn, is dependent upon thermal energy deliveries (SM 1322). If the magnitude of those deliveries fails to satisfy the 5% criterion, and Independence loses its QF status, its wholesale price with Con Edison will be reduced by 10%, and with Niagara Mohawk by 15% (SM 1462). Since the Con Edison contract alone will provide Independence with payments of $170 million per year beyond actual energy-only avoided costs, these rate reductions are a powerful incentive for Independence to meet demands Alcan might make (SM 1159). Moreover, this relationship between thermal deliveries and wholesale contracts demonstrate that it is the wholesale contracts -- especially the Con Edison contract -- that is the real purpose motivating development of this project, not retail electric sales to Alcan (SM 1156-63).

Competition implies that there is no collusion between any of the parties to the competition (SM 543, 1465). Alcan and Independence, however, trumpet the close connection between the two that arises out of the QF relationship between steam supplier and steam host (566-68). Independence was in a position where it had to meet the needs of Alcan, and Liberty for insurance

purposes (SM 1168-69, 1171-73, 1465), to act as its thermal hosts, and, as a result, Alcan clearly had an advantage in negotiating with Independence rather than Niagara Mohawk for electricity supplies (SM 1465). Therefore, Independence's exercise of its PURPA entitlements resulted in competitive disadvantage to any other supplier competing for Alcan's load.

B. The Independence/Alcan Contract

That Alcan did not obtain everything it desired in the negotiations is not proof that the competition was fair and equal (SM 1483-87). There is a limit to the benefits a thermal host can extract from its QF supplier. Moreover, Independence could have built its own thermal host, albeit at expense to itself and delay to the project, to reduce Alcan's leverage, and Liberty is the apparent result of that sort of consideration (SM 1173).

That said, the contract between Independence and Alcan, and its price,[1] is sufficient proof of a cooperative link between these two parties that Niagara Mohawk could not be expected to break. If that were not sufficient proof, the contract is replete with examples of the leverage Alcan exercised. Independence is solely responsible for the design and cost of all electric and steam interconnection facilities needed to supply Alcan (Exh. 39, pp. 21, 28). Independence is responsible for the design and cost of installing any equipment Alcan needs, even within Alcan's own plant, to use Independence's electricity and steam (Exh. 39, p. 22). Independence is

[1]That price is 40% below Niagara Mohawk's current tariff rates (SM 584).

responsible for the design and cost of all monitoring equipment Alcan might desire to supervise the delivery of electricity and steam (Exh. 22, p. 26). Independence must obtain all permits and approvals it needs at its expense, and must also pay for any permits Alcan must obtain (Exh. 39, pp. 30-31). Independence must pay for any defective metering equipment (Exh. 39, p. 33). Independence must pay for all standby or back-up service Alcan might need (Exh. 39, p. 37).

The indemnification clause adds to this list demonstrating the competitive advantage inherent in the Independence/Alcan relationship (SM 1163-68). As set forth at Exhibit 39, pp. 44-45, that clause requires Independence to reimburse Alcan for any amount it might pay for electricity in excess of the contractual rate established between the parties (SM 137). Despite the efforts of Independence and Alcan to argue that this clause is ambiguous (SM 1253-59, 1266-67), Independence may escape its obligation only if Alcan breaches the contract, there is a challenge to or change in law or regulation adopted after the "financing closing date," or Independence is able to make changes to the configuration or ownership of the project which would comply with the challenged or changed law or regulation. Of course, in opposing any such challenge or change in law or regulation, Independence must pay not only its own costs, but also Alcan's costs (Exh. 39, pp. 43-44).

Another example of Alcan's advantages, and the cooperative link between Alcan and Independence that Niagara Mohawk faced in this competition, is the extension of the

indemnification clause. Since the closing date for financing occurred in January 1993, before the issue of regulation of Independence was resolved in the Independence Ruling, Independence willingly extended the indemnification clause to a time sufficient to obtain a decision in both that and this proceeding (SM 572, 1253-56, 1266-67, Exh. 14, sch. 2).

Standing alone, the contract between Independence and Alcan demonstrates that, even if Niagara Mohawk competed more effectively, it is unlikely it would have been able to break the link between these two parties. As a result, there were clearly competitive inequities under these circumstances, and a certification fee is required to rectify those inequities.

C. Flexible Rate Tariffs and Niagara Mohawk's Competitive Disadvantage

Restrictions on Niagara Mohawk's ability to compete with Independence add to the inequities in the competition over Alcan and Liberty.[1] Niagara Mohawk may sell electricity to Alcan only under an approved tariff -- it would be illegal for the utility to offer Alcan a rate that did not comply with its tariff terms and conditions.[2] As a result, any rate it were to offer Alcan would be subject to regulatory approval, either

[1]Even though a prospective customer rather than an existing one, the loss of Liberty as a customer harms Niagara Mohawk to the same extent as loss of Alcan, because the utility bases its planning on the appearance of future customers (SM 1324).

[2]PSL §65, 66; Purcell v. N.Y. Central R.R. Co., 268 N.Y. 164 (1935); In Re City Ice & Fuel Co., 260 A.D. 537 (1940).

directly or indirectly.[1] The relatively recent development of flexible rate tariffs has eased the utility's burden somewhat, but both the timing and conditions of those tariff offerings would not have enabled Niagara Mohawk to compete with Independence, given the Independence/Alcan relationship.

1. Development of the Flexible Rate Tariff

Independence and Alcan misinterpret the chronology and effect of the Orders establishing the flexible rate tariffs. As Alcan concedes, it signed a letter of intent with Independence for electricity and steam deliveries in March 1992 (SM 1349), and finalized its relationship in the contract presented at Exhibit 39, executed on November 18, 1992 (SM 571). Contrary to Alcan witness Lawrence's contention (SM 559), these dates both occurred long after Independence secured its wholesale contract with Con Edison, executed in May 1991.[2] During this period, Niagara Mohawk was realistically precluded from competing with Independence over Alcan (SM 1463-64). While flexible rate tariffs have evolved since then, they still do not necessarily permit Niagara Mohawk to compete effectively with Independence.

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[1]The utility could sign a contract without assurance of rate recovery (SM 1464), and subsequently request permission to implement it, but implementation would have to await such permission.

[2]It is this contract, not the sale of electricity to Alcan, which is the foundation for the Independence project (SM 1156-64).

The first flexible rate tariff was not filed until September 18, 1992, and was not approved until January 12, 1993[1] -- after the Alcan/Independence deal was finalized. Following that approval, Niagara Mohawk promptly moved to implement a similar tariff offering, which was approved on June 30, 1993.[2] In both cases, however, the term of the contract the utility could offer was limited to three years -- even though NYSEG had asked for a period of up to ten years. Therefore, during 1992, when Alcan and Independence finalized their agreement, no utility was permitted to offer an individually-priced tariff contract of more than three years -- a term Alcan concedes it would not accept (SM 581-83).

Over time, the Commission liberalized the requirements of the tariff offerings. In December 1993, NYSEG was permitted to offer a contract term of up to seven years, and RG&E was granted the same permission in February 1994.[3] In neither case, however, was the utility assured cost recovery for more than a three-year period.

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[1]Case 92-E-0893, New York State Electric & Gas Corporation, Order Approving Tariff Filing Subject to Conditions (Issued January 12, 1993).

[2]Case 93-E-0208, Niagara Mohawk Power Corporation, Order Approving Tariff Filing Subject to Conditions and Denying Petition (Issued June 30, 1993).

[3]Case 93-E-0976, New York State Electric & Gas Corporation, Order (Issued December 22, 1993); Case 93-E-0672, Rochester Gas & Electric Corporation (RG&E), Opinion and Order Remanding Proposed Settlement, Opinion No. 94-4 (Issued February 16, 1994).

Most recently, in Opinion No. 94-15, the Commission further liberalized the tariff contract flexible rate offerings.[1] Even there, the Commission continued to limit the term of any agreement to no more than seven years.[2] Moreover, the Commission also established a floor price for any offering of at least 1¢ per kWh above the utility's marginal cost. In doing so, the Commission emphasized that utilities should seek to negotiate prices in flexible rate contracts which result in substantial contributions to common costs from the customer, for the benefit of captive ratepayers.[3]

Only with the issuance of Opinion No. 94-15 -- two weeks ago -- was Niagara Mohawk perhaps no longer completely precluded from competing with Independence (SM 1492, 1535).[4] By that time, however, Independence and Alcan had established their relationship and tightened it to the point where breaking it would be unlikely, albeit that Alcan retains the flexibility to move to another electricity supplier (yet another benefit the steam host extracted from Independence)(SM 565-66). Moreover, even under Opinion No. 94-15, Niagara Mohawk remains at a competitive disadvantage.

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[1]Case 93-M-0229, Opinion and Order Regarding Flexible Rates, Opinion No. 94-15 (Issued July 11, 1994).

[2]Opinion No. 94-15, p. 26.

[3]Opinion No. 94-15, pp. 23-24.

[4]Independence witness Bidwell faults Staff for not reflecting the Commission's decision in its testimony (SM 280), but Staff preferred to await issuance of the Order, rather than proceeding on the basis of a press release, as witness Bidwell did (SM 452).

2. The Remaining Competitive Disadvantage

Under the Independence contract, Alcan obtains fixed electricity prices for 15 years at its option (SM 565). While Alcan complains that Niagara Mohawk never made an adequate long-term offer to it (SM 561-66), it nowhere states that it would have accepted a seven-year offer, as eventually permitted by the Commission (SM 1377).

In addition, cost recovery is still not assured for more than three years. And the utility must still show that whatever price it offers to a customer is prudent (SM 1497). That prudence review would include analysis of the question of whether it obtained sufficient contribution towards common costs from its flexible rate offer. Given the leverage Alcan had exercised in obtaining its low price for electricity from Independence, it might be imprudent for the utility to match that price, because it would not obtain sufficient contribution for its ratepayers (SM 1041-42, 1396).

There is also no proof that Independence would not have simply lowered its price, if Niagara Mohawk had made an offer that bettered the current price in the Alcan/Independence contract. Indeed, Independence has not promised to forego any future competition with Niagara Mohawk, or not to match a price that is 1¢ plus Niagara Mohawk's marginal cost. As a result, there is no proof that, even if the criteria enunciated in Opinion No. 94-15 were present in 1992 or 1993 -- and they were not -- that Niagara Mohawk would have been able to compete any

more effectively than it did. Again, a certification fee is required to correct and balance this competitive inequity.

II. Ratepayer Protection and the Transition to Competition

A certification fee is also necessary as a measure to protect ratepayers in the transition from monopoly service to competition. As the Staff Panel testified, if the transition from monopoly to competition is not properly managed, ratepayers can be disadvantaged (SM 1468-71). The Commission has emphasized, in the context of telephone and natural gas service, that rate shock to captive customer classes must be avoided, and that affordable service to those customers must be maintained. Deregulation is not beneficial if the result is a near-monopolistic or an uncompetitive market,[1] especially if the disadvantages fall most heavily on captive, residential customers -- as they probably would here.

While, for electric customers, these considerations will be reviewed further in the Competitive Opportunities and Bypass (COB) proceeding,[2] the Commission, in the Independence Order, directed that they be addressed here as well. In fact, this proceeding is being conducted for Independence's benefit, instead of requiring it to wait for certification until these issues are decided in the COB proceeding (SM 1590).

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[1]See Case 93-G-0932, Order Instituting Proceeding (Issued October 28, 1993); Case 29469, Opinion and Order Concerning Regulatory Response to Competition, Opinion No. 89-12 (Issued May 16, 1989).

[2]See Opinion No. 94-15, pp. 32-37.

The testimony of other witnesses also supports imposition of a fee. Dr. Willig presents cogent reasons for collecting the cost of regulatory requirements from Independence (SM 788-819, Exh. 19). Even Independence witness Bidwell concedes a fee might be appropriate in some circumstances (SM 259-65). Since, as discussed above, Independence is a competitor dependent on and deriving benefits from its wholesale contract with Con Edison, and must cooperate with Alcan (the only customer who benefits from this "competition"), a fee is appropriate under these circumstances.

As Staff concluded, a competition fee is justified by the need to minimize rate impacts on captive customers, ensure access to affordable electric service at reasonable usage levels, and promote fair competition among competitors (SM 1471). This proceeding certainly raises those transition principles (SM 987-89), and Independence has not demonstrated that it should escape paying its fair share to fund the transition. As a result, Independence should be required, as a condition of certification, to compensate Niagara Mohawk, on behalf of its remaining ratepayers, for the net loss of revenues incurred as a result of Alcan and Liberty's bypass of the Niagara Mohawk system, through purchases from Independence (SM 1471).

III. <u>The Independence/Alcan Arguments</u>

Disregarding the nature and characteristics of the QF relationship between Independence and Alcan, Independence and Alcan raise a host of arguments that are irrelevant, or wrong, or self-serving. While Staff believes that it has adequately

demonstrated the need for a certification fee, and so does not need to address every questionable argument Independence and Alcan present, it responds to the most important ones.

A. PURPA and the Ratepayer

In opposing the certification fee, Independence argues that PURPA benefits ratepayers, and, as a creature of PURPA, it will, too (SM 164-67, 284-302). Independence and its Sithe parent, however, have found in PURPA the opportunity to extract subsidies from ratepayers. This record evidences the extent to which PURPA, and Sithe's actions under it, have harmed ratepayers.

1. The Independence - Con Edison Wholesale Contract

The Independence wholesale contract with Con Edison demonstrates that PURPA allowed QFs to extract subsidies from utilities and their ratepayers. Under the first five years of this wholesale arrangement, Independence earns $170 million per year more than the avoided cost its electricity is actually worth. Indeed, the actual value of the electricity is the base price, and a 2.6¢ per kWh adder is applied to the purchases Con Edison makes (SM 1158-60).

This arrangement had its genesis in the original negotiation of the contract, where Independence sought to price its contract at long-run avoided cost (LRAC) estimates. At some point in 1990, Independence apparently realized both that the 1990 LRAC estimates and the predecessor 1989 LRAC estimates were

stale and overstated,[1] and that it could obtain even greater overpayments under the LRAC estimate schedules if its project were priced at the stalest estimates possible, under the standard PURPA format then available. That is, an LRAC schedule provides estimates for a 20-year period, and the further the year of estimation is from the year of calculation, the more likely the estimate is overstated.[2] By bringing a project on-line in 1995 or 1996, based on estimates calculated in 1989 or 1990, the developer could realize some of these higher, excessive prices through 1999 or 2000.[3]

Independence was able to obtain its PURPA LRAC contract just before other developers and the Commission became aware of how severely overstated the 1989 and 1990 LRAC estimates were. In fact, Independence secured a Ruling that it was entitled to the 1990 LRAC estimates in its contract at the same Session where the Commission found that those estimates were overstated,[4] and precluded their use for pricing in any other QF contracts (sized

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[1]Case 89-E-127, Order Adopting Long-Run Avoided Cost Updates (Issued November 20, 1990); Case 88-E-093, Order Adopting Long-Run Avoided Cost Updates (Issued May 17, 1990)(1990 and 1989 Update Orders).

[2]See Case 92-E-0175, Order Adopting Long-Run Avoided Cost Update (Issued November 24, 1993), p. 3; Case 93-E-0912, Recommended Decision (Issued June 1, 1994), p. 20.

[3]See Case 91-E-0237, Order Withdrawing Long-Run Avoided Cost Estimates On a Permanent Basis (Issued February 10, 1992).

[4]Case 91-E-0402, Sithe Energies U.S.A., Inc., Declaratory Ruling (Issued September 25, 1991). Sithe had sought to price the contract at the even more overstated 1989 estimates.

over 2 MW).[1] The wholesale contract overpayments based on those LRAC estimates were so excessive that, to Con Edison, agreeing to a contract with the 2.6¢ adder was preferable.[2] There can be no doubt, however, PURPA enabled Independence to obtain overpayments.

2. The Sithe Subsidiaries

Beyond the Con Edison wholesale contract overpayments, Independence's Sithe parent has other contracts which severely disadvantage ratepayers. These are the four "tracking account" contracts (and one 6¢ contract for a smaller facility), that Sithe entered into with Niagara Mohawk prior to 1990, priced at LRAC estimates (except for the 6¢ contract)(SM 1151-52). In the four tracking account contracts, the excess of the contract price over the actual avoided cost value of the electricity is accumulated in a tracking account. Independent financial analysts concede that the tracking account amounts will accumulate to the point where, by year 15 of the contracts, Sithe will default, and cede ownership of the facilities to Niagara Mohawk (Exh. 34, SYT 11-12; Exh. 36, pp. 7, 41-43). By that time, as Niagara Mohawk witness Nadeau points out, Niagara Mohawk's ratepayers will, in effect, have paid amounts in the range of $500-$700 million, beyond the actual value of the

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[1]Case 91-E-0237, Order Withdrawing 1990 Long-Run Avoided Cost Estimates and Requesting Comments (Issued September 18, 1991).

[2]Con Edison is responsible for justifying the prudence of this decision.

electricity purchased, for facilities that were worth somewhere around $80 million new (SM 1216).

3. Conclusion

Whatever PURPA's design, the result in New York has been to burden ratepayers and Niagara Mohawk with excess costs, and Sithe has been one of the primary beneficiaries of that PURPA process. Therefore, Independence's PURPA status is certainly no reason to exempt it from a certification fee.

B. The Empire Ruling

Independence/Alcan assert that regulation over Alcan's purchase of electricity from Independence should be eschewed, because they relied on the Empire Ruling in structuring the transaction (SM 122, 588-89).[1] There, a 200 MW facility was exempted from most regulation under the Public Service Law. The Empire Ruling, however, was explicitly limited to the factual circumstances addressed in the Ruling,[2] and the Commission has already found in the Independence Ruling that the Empire Ruling is not dispositive of the issues here.[3] Moreover, factual distinctions between the Empire Ruling and these circumstances were known or should have been known to both Independence and

[1]Case 91-M-0031, Empire Energy Niagara L.P., Declaratory Ruling (Issued March 13, 1991).

[2]Empire Ruling, pp. 7-8; SM 1555-57.

[3]Independence Ruling, pp. 10-11.

Alcan,[1] and so grandfathering them based on the Ruling would be inappropriate.

1. Factual Distinctions Between Empire and Independence

Empire stated it would construct its plant on a 15 acre parcel of land within the 515 acre industrial complex owned by its steam host, General Motors (GM).[2] Here, Independence purchased 78 acres from Alcan, but found that insufficient for its needs, and instead expanded its site to a total of 330 acres. While a QF developer that truly sought to integrate its operations into its host would, of course, limit its land use to the smallest amount possible (to keep costs down), Independence purchased a far larger parcel than it required to site its plant. Indeed, it only used 78 acres to site its plant (Exh. 40, B-5), and could have clearly fit its facility within the 78 acres purchased from Alcan with little difficulty (see Exh. 60).

The answer is that Independence desired additional property to both expand the size of its generation facility (Exh. 34, SYT 10; Exh. 35, p. 9; Exh. 36, pp. 24-25) and to add steam hosts (Exh. 60). In other words, rather than seeking integration of its operations with Alcan, the developer was more concerned with additional profits from additional wholesale sales and

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[1]Given that Alcan and Independence added the indemnity clause to their November 18, 1992 contract near the end of negotiations (SM 131-32) -- after Niagara Mohawk warned them it would challenge the sale (SM 1372-73), it may be presumed the two were aware the Ruling might not adhere to them, and took that possibiilty seriously.

[2]Empire Ruling, p. 2.

whatever retail customers it could reach through direct interconnection in its privately-held industrial park. Indeed, as shown in Exhibit 60, Independence explicitly planned the addition of another steam host at its industrial park. This sort of aggressive wholesale and retail sales activity distinguishes Independence from the Empire facility, which always emphasized its integration into the operations of its General Motors (GM) steam host.

Empire fully integrated itself into GM's internal operations, providing all of the host's electricity and thermal supplies. Those thermal needs included steam for both industrial-process and heating purposes.[1] In contrast, Alcan admits its use of thermal energy from Independence is currently restricted to building space heating. The manufacturer concedes it could use more thermal energy in its operations, but has not reconfigured those operations to do so (SM 600-02, 1572). And Empire will provide a yearly average of 97,000 lbs./hr. of steam to GM,[2] while Independence -- a generation station five times the size of Empire -- will provide only 195,000 lbs./hr. to Alcan.

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[1]Case 91-M-0031, Petition of Lockport Energy Associates L.P. (Successor to Empire)(Dated January 11, 1991)(Lockport Petition), p.3; Case 88-E-216, Empire Energy Niagara L.P., Order Denying Petitions and Directing Further Negotiations (Issued April 3, 1989), Petition of Empire Energy Niagara L.P. (Dated January 17, 1988 and Filed January 19, 1988), p. 7.

[2]Project No. UPA9-2926-00016-0001-0, Empire Energy Niagara Cogeneration Facility, State Environmental Quality Review Act Statement of Findings (Undated), p. 1.

Moreover, the difference in size between Independence and Empire is significant. While Empire, at the time the Empire Ruling was issued, was considered a large facility because sized at 200 MW, the Commission had considered a facility in that size range previously.[1] Empire also explained that the 200 MW size was needed to insure adequacy of steam supply during periods of GM's peak steam need -- up to 315,800 lbs./hr.[2] And Empire expressly promised to limit its sales to GM and NYSEG, and no one else.[3] In contrast, Independence, at 1040 MW, is by far the largest cogeneration facility ever built in New York and is one of the largest in the nation (SM 974); the conclusion it fully intends to serve whatever customers, wholesale and retail, it can find is warranted.

Therefore, the Commission viewed Empire as fully integrated into General Motors' operations, and so somewhat resembling the smaller, state-qualifying facilities it was familiar with under PSL §2(2-a). Independence is not so integrated, does not resemble state QFs or self-generation (as discussed below), and is not similar to Empire. In other words, Empire is primarily a cogeneration facility while Independence appears intent upon acting as a mini-utility. These factual

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[1]Case 28848, Inter-Power of N.Y., Inc., Declaratory Ruling (Issued June 15, 1984). Inter-Power, a 200 MW cogeneration facility, proposed to sell steam, but not electricity, to its host.

[2]Lockport Petition, p. 3 n. 3.

[3]Lockport Petition, p. 4 n. 5.

distinctions preclude Independence and Alcan from claiming reliance on the Empire Ruling.

2. The Claim of Reliance on Empire and the Law

The Empire Ruling relied on the view of PURPA, expressed at SM 1559, as establishing an integrated QF concept, where the QF consists of producing and consuming components, with the whole entitled to all PURPA benefits. That view of PURPA is also set forth in Dr. Shanker's testimony (SM 171), and has been enunciated both by FERC (Exh. 2) and by the courts.[1]

As those same courts have made clear, however, the PURPA statute itself establishes one exception from that view.[2] The statute states that the exemptions from state regulation and entitlements generally available to QFs do not extend to QF sales of electricity "for purposes other than resale"[3] -- that is, retail electric sales remain subject to the full panoply of state regulation. As discussed in the Independence Ruling, that explicit statutory directive was not adequately considered in the Empire Ruling, and it overrides the general PURPA view of a QF as integrating both a consuming and a producing component. In claiming that retail sales are subsumed within the QF (SM 172), Dr. Shanker disregards the plain language of the statute and the

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[1] Gulf States Utilities Co. v. FERC, 922 F.2d 873 (D.C. Cir. 1991); Puerto Rico Electric Power Auth. v. FERC, 848 F.2d 243 (D.C. Cir. 1988).

[2] 848 F.2d at 249; 922 F.2d at 574, n. 1.

[3] 16 U.S.C.A. §824a-3(a).

language in the court decisions. Therefore, his interpretation is legally questionable.

Even beyond these considerations, there are other reasons Alcan was not entitled to rely on the Empire Ruling. Contrary to the belief of Independence and Alcan (SM 1558), not everyone interpreted the Empire Ruling as exempting all facilities sized above 80 MW from Commission regulation. While facilities sized below that level are, of course, exempted from regulation through PSL §§2(2-a) and 2(4), the developer of the 120 MW cogeneration facility built at JFK Airport thought it prudent to otain a statutory exemption from regulation for its facility, through amendment of PSL §2(2-a)[1] after the Empire Ruling was issued.

Alcan's claim it is entitled to grandfathering is legally deficient for other reasons as well. Alcan had no legal right to rely on the Empire Ruling, even if the factual circumstances were similar. It is well-settled that an administrative agency may reverse a prior declaratory ruling prospectively, even if a prior declaratory ruling on the same facts came to a diametrically opposed conclusion.[2]

Moreover, New York courts have soundly and repeatedly rejected the contention that agencies may be estopped from carrying out their duties, or may waive their statutory

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[1]Laws of 1991, c.651, §1, effective July 26, 1991.

[2]National Elevator Industry, Inc. v. New York State Tax Commission, 49 N.Y.2d 585 (1980).

authority.[1] Even where an entity obtained a permit from a governmental agency, the agency is not estopped from revoking the permit upon discovering that it was issued in error, notwithstanding a result harsh to the permittee. This is especially true where, as here, diligent investigation by a sophisticated party could have uncovered the error or distinction. As the Court of Appeals has concluded "it would be naive to suppose that the knowledge of these [sophisticated] applicants and their experienced counsel did not include an awareness of at least the probable inapplicability of any doctrine of estoppel."[2]

Therefore, whatever the contents of the Empire Ruling, Alcan had no legal right to rely on it. Given the factual distinctions between the Empire circumstances and these circumstances, Alcan had no equitable basis for such a position either. Its argument that it should be grandfathered under the ambit of the Empire Ruling is consequently without foundation.

C. Independence and Self-Generation

Independence seeks to tailor itself in the clothes of a self-generation facility. Self-generation, of course, has long been exempt from regulation in this state and other states as well.[3] But Independence's 1040 MW PURPA machine in no way

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[1]Parkview Associates v. City of New York, 71 N.Y.2d 274 (1988). See also Scruggs-Leftwich v. River Cross Tenants Corp., 70 N.Y.2d 849 (1987).

[2]Matter of Hamptons Hospital and Medical Center, Inc. v. Moore, 52 N.Y.2d 88, 95 (1982).

[3]See PSL §2(13).

resembles self-generation alternatives, which are generally sized to meet all or part of a customer's load.

Contrary to Independence's insinuation (SM 1513-18), there is nothing pernicious in exempting some forms of electric service from regulation, while regulating others. Indeed, it is the legislative judgment of this state that QFs sized at 80 MW or less shall be exempt from regulation, just as self-generation is.[1] As discussed above, the legislative judgment is also that one particular 120 MW facility shall also be exempt from regulation. That these legislative judgments leave Independence's 1040 MW behemoth subject to regulation is both reasonable and rational.

The experience of Florida is instructive. That state, upon implementing PURPA in 1983, immediately found that the statutes §824a-3(a) exception allowed it to regulate all sales of electricity from a QF to its steam host.[2] Similar to New York, Florida has a statute which exempts from regulation self-generation, but otherwise broadly regulates all electricity sales.[3] Finding that PURPA was intended to create a wholesale market for QF power, Florida also ruled that PURPA left retail

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[1]PSL §§2(2-a), 2(4) and 2(13).

[2]In Re Amendments of Rules Relating to Congeneration, Order No. 12634 (Fla. PSC, October 27, 1983)(1983 Fla. PUC Lexis 178).

[3]See PW Ventures, Inc. v. Nichols, 533 So. 281 (Fla. 1988). Despite Dr. Shanker's interpretation (SM 183-84), Staff believes this decision demonstrates that the state's right to regulate an intra-QF sale of electricity was so clear the developer despaired of winning on federal law, and pursued state law grounds instead. See In Re PW Ventures, Inc., Order No. 18302-A (Fla. PSC, October 22, 1987).

sales to state regulation, and did not "effect a back-door deregulation of the electric utility industry."[1]

According to Florida, its authority to supervise retail competition was intended to prevent uneconomic duplication of services and to protect utilities and ratepayers from potentially harmful effects of unbridled competition. Although conceding that retail sales from a QF might benefit a few customers, Florida decided:

> The ultimate impact of the repetition [of QF retail sales] occurring many times in an extensive system-wide operation could be extremely harmful and expensive to the utility, its stockholders and the great mass of its customers.[2]

Florida thereafter implemented its interpretation of PURPA through requiring QFs that sold electricity at retail to their hosts to demonstrate that they were, in fact, self-generation arrangements. Under Florida law, the steam host seeking retail electric service, to secure status as a self-generator, must show that it will maintain control over the ownership and operation of the QF electric generation facility.[3] Florida carefully analyzes proposed transactions to determine if, in fact, that control remains with the alleged self-generator, or

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[1]1983 Fla. PUC Lexis 178, p. 23.

[2]1983 Fla. PUC Lexis 178, p. 22.

[3]See e.g., In Re Seminole Fertilizer Corp., Order No. 23729 (Fla. PSC, November 7, 1990).

has been ceded to some other entity, whereupon a retail sale that must be regulated would occur.[1]

So distinguishing between self-generation and a retail sale is a line-drawing function that is the province of the states, and is a feature of every state regulatory regime. That Independence is on a side of the line it dislikes is its own fault, not the fault of regulation generally. Instead of constructing an 80 MW facility, or seeking a statutory exemption, it structured an arrangement which bears no relationship to self-generation. The economies of scale that allow Independence to construct its facility for a lower per unit cost than even the other New York QFs it constructed entirely changed the economics and impact of its generation station (cf. Exh. 34, SYT 6 and Exh. 40, p. 16), and this distinguishes it from self-generation as well. Since there is no resemblance between Independence and self-generation, or other generation exempt from regulation, its efforts to analogize itself to such arrangements should be rejected.

[1]Since Dr. Shanker, in arguing the regulation of Independence would deviate from both the intent and history of PURPA (SM 172), ignores these Florida decisions, and he was not aware of the 1983 decision at all (SM 181-86), his testimony is flawed.

D. Criticisms of Niagara Mohawk

In an effort to avoid the certification fee, Independence and Alcan level a number of criticisms against Niagara Mohawk. They argue the utility charges excessive rates, was imprudent in its handling of the negotiations over a tariff contract with Alcan, and that it benefits from regulation. These arguments are for the most part irrelevant, because it is Independence's competitive advantages and the restrictions on Niagara Mohawk's ability to negotiate tariff contracts that are at issue in this proceeding.

1. Niagara Mohawk's Rates and RRC

Whatever might be wrong with Niagara Mohawk's rates, those matters are addressed in rate cases. Independence's efforts to transmogrify this proceeding into a prudence review of Niagara Mohawk's rates is clearly beyond the scope of this proceeding. The rates are established under the Public Service Law, and must be assumed just and reasonable (SM 426, 1518). To the extent that competition would lower rates, the transition issues Staff raises above must be addressed.

To the extent relevant, however, Niagara Mohawk rates do raise an issue related to the Raising Rivals' Costs (RRC) concept Independence presented in cross-examination (SM 893-99). RRC is a form of economic predation, where one competitor seeks to harm another by raising the latter's costs. To some extent, that has occurred here, with Sithe raising Niagara Mohawk's costs through forcing on it the excessively-priced purchases from the five Sithe subsidiaries (SM 1152). In fact, the QFs generally

vigorously sought adoption of higher LRAC estimates in the 1989 and 1990 LRAC Orders, and in the 1988 LRAC proceeding.[1] Once they drove up Niagara Mohawk's rates and costs through power purchase contracts based on those LRAC estimates (SM 989), it was much easier for Independence to price its electricity below Niagara Mohawk's. Therefore, to the extent that the RRC form of competitive predation exists here, it is Sithe that is the predator, not Niagara Mohawk.

2. The Failure to Petition

Alcan faults Niagara Mohawk for not petitioning for more flexibility in offering tariff rate contracts (SM 562-63, 581). To the extent this issue is relevant, Niagara Mohawk has given its reasons for not petitioning sooner (SM 1363-87). While the utility did lag behind NYSEG and RG&E, there is no proof that, even if Niagara Mohawk had acted quicker, the Independence/Alcan transaction would have been materially affected.

3. Benefits of Regulation

Alcan also asserts that regulation benefits utilities (SM 1579-81). But it in no way demonstrates how this benefit assisted Niagara Mohawk in its competition with Independence over Alcan. Given the regulatory framework in which it operates, these benefits did not enhance Niagara Mohawk's ability to offer a lower price to Alcan, while the PURPA regulatory framework in

[1]Case 28962, Opinion and Order Adopting Long-Run Avoided Cost Estimates, Opinion No. 88-13 (Issued May 10, 1988).

which Independence operates encouraged just that sort of lower price offer.

E. Offsets and Alternatives

Independence and Alcan also hypothesize that offsets to the proposed competition fee might exist (SM 216-20, 574). Most of those offsets, however, take the form of compensation to Niagara Mohawk for services rendered to either Independence, or Alcan, or both. Moreover, the alleged offsets exist whether or not Niagara Mohawk serves Alcan, because Independence must still pay them in order to deliver its wholesale electricity (SM 409, 1173-75). Therefore, these hypothesized offsets are not, in fact, relevant to this proceeding.

Again seeking to divert attention from the transaction that actually occurred, Independence and Alcan theorize that other alternatives were available to Alcan for electricity supply beyond Niagara Mohawk and Independence (SM 1504, 1508). Of course, Independence was the alternative selected, necessitating this proceeding.[1] While Alcan has asserted it might have moved out-of-state (SM 575), it has not, in fact, taken any steps to do so. It also asserts it would explore self-generation (SM 1417), but the cost of that alternative is more expensive than electricity purchased from Independence (cf. SM 502-04 and Exh. 9). It is the alternative Alcan selected, not the choices potentially available to it, that is at issue here. Finally, it

[1]Independence argues demand-side management (DSM) programs also result in lost margin -- but the Commission has addressed that issue and allocated those costs, which are not analogous to the lost margin in this proceeding (SM 1520-21, 1528-29).

should be remembered that the indemnification clause guarantees Alcan the electricity prices it needs to remain viable.

F. Impact of the Lost Customer Margin on Rates

Independence and Alcan argue that the rate impact of the lost margin attributable to Alcan's leaving the system is not significant. As Alcan's witness Rosenberg admitted, however, the approximately $10.4 million size of the lost margin that Niagara Mohawk postulates would certainly be pursued in a rate proceeding (SM 745). Since Dr. Rosenberg is an expert on ratemaking (SM 649-50), his position on this point is credible.[1] There is a cognizable rate impact, and the Commission may correct it.

IV. The Certification Fee

Imposing a certification fee in this proceeding is justified. Conceptually, Staff and Niagara Mohawk approach the calculation of the size of the fee for the first year similarly (SM 996-1000, 1471-72). Adjustments of the fee in subsequent years, however, are more problematic. While Staff assumes the issue of certification and competition fees would be addressed generically in the COB proceeding, and that the COB proceeding would be decided in time to address the fee in years after 1995, there is no guarantee that this will occur (SM 1568-69).

As a result, Staff proposes a cap on the fee. As Independence and Alcan postulate, it would be technically

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[1]As to the remainder of Dr. Rosenberg's testimony, it is either rate case testimony directed towards prudence, or parrots the testimony of Independence witnesses Shanker and Bidwell. As a result, Staff does not see it necessary to address Dr. Rosenberg's testimony in more detail.

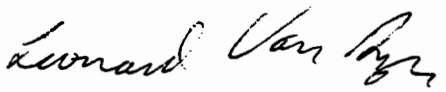
feasible to construct a self-generation unit on Alcan's property. The price for such a unit, however, would be approximately $1,000 per kW, or $40 million.[1] Assuming that Liberty is a 15 MW load, the price for constructing self-generation would be about $15 million. These amounts may be used as caps on the size of the certification fee, subject to adjustment depending on the outcome of the COB proceeding. Once the fee or part of the fee, as imposed on a yearly basis, reaches those amounts, it would cease.

This recommendation balances the interests of all parties. Ratepayers are compensated, but are not guaranteed revenues for an indeterminate period. Alcan and Sithe are required to pay for the benefits they garnered through the advantages they wielded in the competition, but the amount of their payment is capped. Consequently, imposing such a cap is consistent with the purposes of this proceeding.

CONCLUSION

For the reasons discussed above, Staff's proposed certification fee should be adopted, if it is decided to certify the retail sales from Independence to Alcan and Liberty.

Respectfully submitted,



Leonard Van Ryn
Staff Counsel

Dated: July 25, 1994
Albany, New York

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[1]Independent financial analysis of Sithe's New York cogeneration projects indicate it costs the developer about $1000 per kW to build a plant (Exh. 34, SYT 6).