

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a session of the Public Service
Commission held in the City of
Albany on April 24, 1998

COMMISSIONER PRESENT:

Maureen O. Helmer, Chairman

CASE 96-E-0891 - In the Matter of New York State Electric & Gas
Corporation's Plans For Electric
Rate/Restructuring Pursuant to Opinion No. 96-
12. AUCTION PLAN FILING.

ORDER AUTHORIZING THE PROCESS FOR
AUCTIONING OF GENERATION PLANT

(Issued and Effective April 24, 1998)

BACKGROUND

In an Order Adopting Terms of Settlement Subject to Modifications and Conditions (Settlement Order) issued January 27, 1998 in this proceeding, we conditionally approved a Settlement Agreement between New York State Electric & Gas Corporation (NYSEG) and other parties, resolving issues affecting NYSEG's rates and its restructuring into a framework consistent with the opening of retail electricity markets to competition.^{1/} The Settlement provides for the auctioning of NYSEG's coal-fired generation stations. Under the Settlement, proposed protocols for the auction were to be developed in consultation among the utility, staff, and other parties, and would be submitted for our approval. After conducting the consultations, NYSEG filed draft generation asset auction protocols on February 11, 1998. After further consultation with staff and the parties, the utility filed revised protocols on February 24, 1998. The protocols set

^{1/} See also, Case 96-E-0891, New York State Electric & Gas Corporation, Opinion and Order Adopting Terms of Settlement Subject to Modifications and Conditions, Opinion No. 98-6 (Issued March 5, 1998).

forth the terms and conditions for the auctioning of the coal facilities. On March 18, 1998, parties filed comments in response to the revised protocols.

As established in the Settlement, NYSEG will not share in the proceeds from the auction. Auction proceeds in excess of book value, however, are applied to the write-down of NYSEG's investment in its portion of the Nine Mile II Nuclear Station. Although the Settlement permitted NYSEG to participate in the auction through an unregulated subsidiary, the utility, by letter dated March 18, 1998, offers to withdraw from participation in return for rapid approval of the protocols with the modifications proposed in the letter. The protocols, and the comments of the parties in response, are analyzed below.

NYSEG'S AUCTION PROTOCOLS

Plants Offered For Auction

NYSEG plans to auction its coal facilities. The utility is the sole owner of the Kintigh, Milliken, Goudey, Greenidge, Hickling, and Jennison Stations located in New York. The operational units at those sites total 1,282 MW in size. NYSEG also owns the Homer City Station jointly with the Pennsylvania Electric Company (Penelec),^{1/} which operates the facility. NYSEG's 50% share of the station amounts to 944 MW. The cumulative total of the generation NYSEG will offer at auction is 2,226 MW, with a book value of approximately \$1.1 billion.^{2/} Penelec has agreed to auction its share of Homer City at the same time as NYSEG.

As the Settlement Agreement provides, NYSEG does not propose to auction its generation assets other than the coal facilities. These other generation assets consist of NYSEG's 18% share of Nine Mile II, approximately 50 MW in small hydro electric plants, divided among widely-scattered locations, and

^{1/} Penelec is a subsidiary of General Public Utilities.

^{2/} Settlement Order, Appendix D to Settlement Agreement.

the independent power producer (IPP) contracts the utility entered into in compliance with the Public Utilities Regulatory Policies Act of 1978 and PSL §66-c. Nine Mile II and other New York utility-owned nuclear stations are the subject of a separate proceeding, and so could be divested outside this auction.^{1/}

Auction Process

In the protocols, NYSEG proposes an aggressive schedule. It would circulate a notification letter to potential bidders on March 2, 1998, soliciting participation in a Phase I of the auction.^{2/} Bidders that successfully qualify would be provided with an Offering Memorandum on April 9, 1998, and then would submit initial non-binding bids. The utility would review those bids, and select satisfactory bidders for participation in Phase II, which would commence on May 11, 1998.

The Phase II bidders would participate in additional due diligence activities, would submit detailed comments on the transaction contracts accompanying the sale of the plants, and would submit binding bids on a date selected by the utility. After evaluations of these bids, NYSEG would decide if an additional ascending bid round were necessary, and then would proceed to choose a winning bidder. The utility plans to announce its choice on July 31, 1998.

NYSEG has retained a financial advisor, Goldman, Sachs & Co. (Goldman), to manage the auction. Goldman would mail the notification letter, respond to inquiries, and organize the bidding.

Phase I of the process is intended to attract as many qualified participants as possible and NYSEG will consider statements of interest from prospective bidders up to the date of the submission of the Phase I bids. The Phase I bidders will be

^{1/} Case 98-E-0405, Opinion and Order Instituting Further Inquiry, Opinion No. 98-7 (issued March 20, 1998).

^{2/} NYSEG reports that the letter was mailed, after consultation with staff.

required to execute a Confidentiality Agreement. Following execution, they will receive initial due diligence information and the Offering Memorandum, which will include term sheets for contracts the winning bidders would enter into and detailed plant data. The Phase I bidders will then submit initial non-binding bids with a price or prices for the unit or units each bidder desires to purchase, a description of any conditions precedent it must satisfy, and a description of the financial underwriting supporting its bid price. Phase I bidders would also submit two purchase prices, one assuming entry into a transition power purchase contract,^{1/} and the other assuming that no such contract will be required.

After evaluation of the Phase I bids, the best-qualified bidders will be selected for participation in Phase II. These bidders will be furnished with additional information on the units, and may visit and inspect them. The Phase II bidders will also comment on the utilities' proposed auction transaction agreements. These contracts, besides the transition contracts, consist of an asset purchase agreement, an interconnection agreement, and a call contract for the Ithaca load pocket surrounding the Milliken unit. After receipt of the comments, NYSEG will review the contracts and revise them to reflect changes it finds acceptable.

In the protocols as originally filed, NYSEG divides the units into two bundles, one consisting of all the units located in New York and the other consisting of Homer City. Homer City, it emphasizes, must be priced separately whatever bundling is adopted, since it is jointly owned with Penelec and a station-specific price is needed as a prerequisite to dividing the purchase proceeds. NYSEG and Penelec have agreed to auction the Homer City facility at the same time as NYSEG's other units, and to divide the proceeds between them, in the same proportion as

^{1/} The transition contracts are options instruments, allowing NYSEG to make purchases at a call price, and the new generation owner to make sales at a put price.

their 50% ownership share. The auction protocols for the two shares in Homer City are substantially the same.

NYSEG also announced an alternative preference for the combination of the central area stations -- Goudey, Greenidge, Hickling and Jennison -- into one package. According to the utility, there are locational, operational and environmental compliance synergies among these stations.

NYSEG, however, would permit a Phase I bidder to submit an initial bid for all, any, or any combination of the New York units. Once Phase I bids are received, NYSEG will reevaluate the packaging of the units into bundles, and announce the bundles that will be available for bidding during Phase II.

The binding Phase II bids will then be submitted, and NYSEG will select the winner with the objective of maximizing the value of the facilities. Selected Phase II bidders, however, may be required to participate in a multiple round ascending bid process that would be conducted over a short timeframe, with the goal of maximizing auction value. Following selection of the winner, the transaction agreements will be signed and filed with the appropriate regulatory agencies and other prerequisites to closing will be satisfied.

Regulatory approvals are also addressed in protocols. NYSEG would inform us promptly if it decides to cancel the auction or reject bids, and concedes that course of action would be subject to our review and approval. Moreover, the Asset Purchase Agreement will assign the risk of failure to close due to regulatory disapproval premised upon market power concerns to the winning bidder.

Market Power

According to NYSEG, horizontal market power concerns are unlikely to affect its auction, because the outcome will likely reduce the concentration of electric generation ownership in the relevant geographic markets. The utility, however, would require the purchaser to satisfy any market power concerns that

regulatory agencies might raise in their review of the auction transactions.

NYSEG originally identified two load pockets on its system,^{1/} in the Oneonta and Ithaca areas. Subsequently, NYSEG informed staff that it had eliminated the Oneonta pocket by installing transmission upgrades in November 1997, leaving only the Ithaca load pocket as a concern.

That load pocket is currently served by the Milliken Station, a plant with two 150 MW units. NYSEG says that when load in the Ithaca area exceeds 135 MW, at least one of the Milliken units must be operated at or above its minimum generation level of 70 MW. This situation occurs during approximately 100-175 hours, or 1 - 2%, of the year.

Because Milliken's running costs are comparatively low, it is typically expected to run, especially at times of peak load. It is possible, however, that a new owner of Milliken could price the segment of generation serving local load above the price that would occur if Milliken faced local competition during the constrained hours. As a result, the owner of Milliken could exercise market power when load exceeded 135 MW in the Ithaca area.

To address this concern, NYSEG proposes that the purchaser of the Milliken plant enter into a call contract with the utility to ensure that market power will not be exercised within the load pocket to the detriment of ratepayers located there, and that electricity supply in the pocket will be adequate. NYSEG has outlined its approach to such a contract in its protocols and in discussions with staff.

A call contract would allow NYSEG to order Milliken to operate if it is otherwise scheduled off-line, and the utility

^{1/} A "load pocket" is a small portion of a utility service territory in which load levels, at certain times, will exceed the transfer capability into the area, and so local generators must serve some of the load. Depending on the specific circumstances present in a load pocket, the local generators may or may not possess market power.

forecasts that the next day's load in the pocket will exceed 135 MW. The contract would specify call prices, provide for an appropriate term, and for renewal rights. Lack of performance by the new owner would trigger specified penalty payments.

The Transition Contracts

NYSEG proposes transition contracts between the winning bidders and the utility's regulated subsidiary, which will provide transmission, distribution and provider of last resort services. The transition contracts would allow the utility to exercise a call option, or permit new owners of the plants to exercise a put option. Strike prices for the two options, amounts of capacity subject to the options, and other terms and conditions affecting the options would be set forth in a detailed transition contracts. NYSEG, however, would reconsider the terms of its proposed transition contracts if the results of the preliminary Phase I bids, made with and without assuming the transition contract obligation, indicate the contracts are depressing the prices offered in the auction.

Labor And Environmental Provisions

NYSEG would provide prospective bidders with a copy of the current collective bargaining agreements, including work rules, for union employees at the units. The contract for New York employees extends through June 30, 2000, and the contract for Penelec employees at Homer City extends through May 14, 1998. The utility intends that the winning bidder will assume and honor the provisions of the labor contracts. It advises bidders that work rules at the units may be modified only in accordance with the terms and conditions of the labor agreement.

NYSEG would also supply bidders with additional information on salaried employees, and any other information pertinent to employee matters. The utility also seeks to recover incremental employee transition costs from the auction proceeds.

A consultant will be retained to prepare environmental audit reports on the units, and NYSEG intends to identify and

disclose past and present environmental liabilities. All past, present and future liabilities would be transferred to the winning bidder, and the bidder would be required to indemnify NYSEG on any environmental liability. The utility will also transfer to the new owner all sulfur dioxide and nitrogen oxide allowances attributable to each generation unit, and would include in the sale operating ash disposal sites located both on and off generation station sites.

NYSEG says it will perform any needed environmental remediation uncovered as a result of the environmental audits. It plans to recover the costs of any remediation completed prior to transfer of the facilities from the auction proceeds.

Confidentiality Requirements

NYSEG would also require Phase I bidders to execute a Confidentiality Agreement. This Agreement would require bidders to keep confidential any information they received from the utility on the generation units, and also to preserve the confidentiality of any documents they prepare using that information.

The Confidentiality Agreement would prohibit bidders from soliciting NYSEG employees during the pendency of the auction and one year thereafter, but would permit a bidder to employ persons who contact it on their own initiative and to conduct generalized solicitations for employees not specifically targeted at NYSEG. Moreover, the utility would permit the winning bidder to identify those individuals it would like to employ after its acquisition of the generation unit. NYSEG would also require waiver of the right to challenge the auction, and would prohibit bidders from seeking to acquire NYSEG or influence or control its management or policies.

Supplemental Filings

On February 26, 1998, NYSEG reported errata to its protocols. The errata include a further justification for its transition contract proposal, with the utility maintaining that the transition contracts might be needed because the installed capacity market may not be liquid immediately.

In a letter dated March 18, 1998, NYSEG reported interested parties have objected to its participation in the auction, and a proposal in the protocols to require liquidated damages of a winning bidder in the event of its failure to close as a result of inability to obtain market power regulatory approvals. In response to those criticisms, NYSEG says it will release its eligibility and forgo participation in the auction, and eliminate the liquidated damages condition, if the protocols as so modified are approved at the April 8, 1998 Session without changes or conditions adverse to NYSEG. This would include approval of appropriate environmental and labor transition cost proposals.

ANALYSIS OF COMMENTS

CPB

The Consumer Protection Board (CPB) says it supports approval of NYSEG's auction protocols, with modification. CPB believes that revision of the protocols to reflect NYSEG's release of eligibility to participate in the auction and elimination of the liquidated damages provision are laudable. CPB, however, is concerned that the protocols allow the utility to recover employee transition costs as auction transaction costs. CPB contends that the Settlement Agreement does not provide for that recovery. It notes that the Niagara Mohawk and O&R Agreements explicitly limit recovery for those costs, and that the absence of an explicit provision providing for recovery in the NYSEG Settlement Agreement indicates that NYSEG should not recover those costs from the auction proceeds.

Joint Supporters

The Joint Supporters^{1/} generally favor the divestiture principle, but question the large-scale aggregation approach the utilities have taken to bundling of the generation units offered for sale. As a result, Joint Supporters advocate an auction solicitation where discrete prices would be bid for each utility site or unit. Joint Supporters would also retain the single-site bidding feature throughout the auction process, and would require bidders to identify the increments above their initial bids for each site in each phase of the auction. Joint Supporters assert this approach would make comparison of bids more transparent, reduce prudence review risk, and facilitate proper property tax valuation.

The Joint Supporters also question the utilities' contentions that a speedy process is necessary to ensure maximum value is obtained for the auctioned units. Joint Supporters believe that delay might permit niche markets to develop, and would encourage more bidders to participate, thereby boosting value. Joint Supporters also see advantages in multiple ownership of the generation properties formerly owned by utilities alone.

MI

Multiple Intervenors (MI) says it supports approval of the auction protocols, upon NYSEG's agreement to release its eligibility to participate in the auction and eliminate the liquidated damages clause. MI also comments on the Environmental Assessment Form (EAF) NYSEG submitted on March 6, 1998. According to MI, the EAF justifies the conclusion that no further State Environmental Quality Review Act (SEQRA) action is necessary. MI believes that NYSEG's EAF, although providing a new level of detail of the potential impacts associated with

^{1/} The Joint Supporters are a consortium of energy and energy services providers, including the E Cubed Company and CNG Energy Services Corporation.

divestiture, does not identify any impacts that were not adequately addressed in the previous Final Generic Environmental Impact Statement issued in conjunction with Opinion No. 96-12.^{1/} There, says MI, the requisite "hard look" required under SEQRA was focused at topics of environmental concern.

Moreover, MI references the EAF filed upon the approval of the Settlement Agreement. That EAF, it continues, when combined with the EAF NYSEG filed here, justifies the conclusion that no further SEQRA proceedings are necessary.

Pace

Pace Energy Project and the Natural Resources Defense Council (Pace) report three areas of concern upon their evaluation of the auction protocols and the EAF. Pace believes that use of long-term contracts to resolve load pocket problems, premised upon the purchase of generation from the incumbent generation station located in the pocket, may needlessly encourage continued air pollutant emissions.

Alternative mitigation efforts, Pace asserts, may reduce reliance on call contracts in the future, and so those contracts should be limited to a short term, such as one year. That approach, it continues, would permit flexibility to arrive at alternative solutions to load pocket problems, such as distributed generation, load control, demand side management, or other programs. Pace also believes interruptible rates should be offered within load pockets, because, if appropriately priced, cost-effective opportunities for radio-controlled load management could arise.

Pace also relates that existing utility property is frequently used by the public for recreational purposes. Some of these arrangements, it reports, are informal, and should be formalized upon divestiture. Pace would also explore sale of

^{1/} Case 94-E-0952, Opinion and Order Regarding Competitive Opportunities For Electric Service, Opinion No. 96-12 (Issued May 20, 1996).

vacant land adjacent to utility plant for recreational or environmental preservation purposes. Pace also believes that monitoring of aquatic life may be needed, to prevent harm arising from use of cooling water in thermal generation facilities and from management of dam flows at hydroelectric facilities.^{1/}

DISCUSSION

Auction Process

Although NYSEG's draft protocols differ from the auction process envisioned in its Settlement Agreement, the differences have been satisfactorily explained. The Settlement Agreement presumed that the auction would be conducted on the basis of a simultaneous multiple round ascending bid open process. NYSEG reports, however, that the two-phase auction process it now favors is the most widely-accepted format in the industry. The utility maintains the process has worked well for other utilities, and is the most likely to produce the maximum value for the plants.

Moreover, NYSEG explains that it will extend Phase II of the auction and conduct ascending bid rounds if more than one bidder clusters around a particular price at the end of Phase II. The clustered bidders would then compete against each other, thereby arriving at the maximum possible price when the highest bids are achieved. The auction would then end and NYSEG would negotiate contract terms with winners.

The Settlement Agreement also provided for a minimum bid. In the protocols, a preliminary round of initial bids is substituted for the minimum bid requirement. NYSEG believes that the preliminary round process is more likely to identify qualified bidders than imposing a minimum bid requirement. That requirement, it asserts, could inappropriately signal a low price to the market.

^{1/} This comment is not relevant to NYSEG, because it is not selling its hydro units.

NYSEG has adequately justified its departures from the Settlement Agreement. Auctions in California and New England have been conducted successfully using the two-phase approach. That and the minimum bid modification made in the protocols to the auction procedures adumbrated in the Settlement Agreement are accepted.

The auction process NYSEG describes in its protocols generally appears intended to maximize plant value. NYSEG, however, did not initially address the bundling of its plants adequately. While the utility's proposal to require a separate price for Homer City from New York plants or bundles is appropriate, given that it must split the proceeds for Homer City with Penelec, the remainder of its bundling proposals underwent further developed in consultation with staff.

NYSEG will evaluate Phase I bids for units or bundles with the goal of selecting the bundling or individual unit sales that will best maximize auction proceeds in Phase II. NYSEG will consult with staff before arriving at the final bundling of units or individual unit sales that will be offered in Phase II. With these revisions, the utility's approach to bundling of units in the auctions is acceptable, and the further revisions proposed by Joint Supporters are rejected.

As a result, bids for the individual units and bundles as the bidders themselves opt to offer will be assessed and evaluated. Instead of stating preferences for bundles, a bundle consisting of all the New York units and a bundle consisting of the central area stations -- Goudey, Greenidge, Hickling and Jennison -- will be offered. For the information of the bidders, it will be reported that the central area stations are currently managed as a group and that there were locational, operational and environmental compliance synergies among those units.

Consequently, instead of statements of preferences for bundles, information useful to bidders will be provided. With these changes, NYSEG should attract broad participation in its auction, and bidders will be encouraged to provide bids on the individual facilities, bundles and other combinations of their

choosing. As a result, the Phase I bids should result in Phase II offerings that achieve the maximum price for the individual plants.

NYSEG and Penelec have agreed to jointly auction the Homer City Station. The two utilities have arranged for the equitable distribution of any proceeds from the auction, at their 50% proportionate share of ownership of the station. The two utilities also bear an equitable proportion of the responsibility for the auction. As a result, NYSEG has properly effectuated the auction of the jointly-owned station, and protected the interests of its ratepayers.

NYSEG proposed other revisions to the initially-filed protocols. The utility released its eligibility to participate in the auction and withdrew its proposal to impose liquidated damages, in the event that a winning bidder fails to obtain needed regulatory approvals because it cannot satisfy market power concerns. The other parties laud these concessions, which are satisfactory improvements to the protocols. In particular, the utility's withdrawal from the auction eliminates concerns its subsidiaries would receive preferential treatment.

Labor and Environmental Issues

The employee transition cost and ash site remediation cost provisions also require clarification. NYSEG reports it could experience employee transition costs upon the sale of the coal plants, if the new owners decide not to retain former NYSEG employees. Recovery of up to \$10 million in such costs is acceptable, if costs are limited to incremental costs and NYSEG makes every effort to minimize the costs below the \$10 million cap. This cost should be treated as a regulatory ratepayer responsibility, and added to the Category 2 costs recoverable

under the Settlement Agreement for the remainder of the price cap period.^{1/}

NYSEG also proposes to sell, with the coal generation facilities, coal ash disposal sites located both on and off generation unit sites, including some that have been dormant for decades. Sale of operating and disposal sites, wherever located, is appropriate, because those sites are directly connected to operation of the plants. We direct, however, that NYSEG retain closed disposal sites not located on plant property.

Forcing potential bidders to acquire these closed ash disposal sites, which are not useful to them, could artificially depress auction prices. These closed sites are more appropriately retained by the T&D utility, which can fund remediation measures, if any are needed. NYSEG is currently unaware of any environmental liabilities at the sites it must retain. If any are experienced, we permit the utility to recover prudently-incurred expenses as a Category 2 cost under the Settlement Agreement for the remainder of the price cap period.^{2/}

CPB questions NYSEG's proposal to recover employee transition costs. The employee transition cost, however, has been limited to \$10 million, and conditioned upon utility efforts to constrain the cost. The effect on the auction of this cost is also dampened by providing for Category 2 recovery. As a result, CPB's concern has been satisfied.

MI and Pace raised a number of environmental issues. These issues are addressed in the Draft Supplemental Generic Environmental Impact Statement, issued on April 15, 1998 in this proceeding.

^{1/} The Category 2 monetary target, establishing the level of utility obligation to fund costs incurred under this category would be set at zero, enabling the utility to pursue recovery of the incremental employee cost as defined above.

^{2/} Again, the Category 2 monetary target, establishing the level of utility obligation to fund costs incurred under this category, would be set at zero.

Market Power

The auctioning of NYSEG's coal-fired generation raises potential market power issues. Broad horizontal market power could be exercised if a winning bidder combines its purchase of NYSEG units with other units located in the state. More geographically-limited horizontal market power could be exercised in the Milliken load pocket. Vertical market power concerns will exist so long as the utility owns generation and sells generation to retail customers, while also providing monopoly transmission and delivery services within its service territory.

A. Horizontal Market Power Guidelines

Horizontal power occurs if one, or a small number, of generation entities owned a percentage share of generation supply large enough to improperly raise prices above competitive market levels. Just and reasonable rates cannot be based on competitive market prices if the effective functioning of the competitive market place is distorted by horizontal market power. On the other hand, the potential efficiencies inherent in single ownership of multiple generation stations could foster, in the short run, higher bids in the auctions, and in the long-run, lower costs of production and lower prices. Accordingly, a balance must be reached between the obligation to protect against undue market power concentration and the realization of the potential benefits which large-scale ownership may provide to ratepayers.

The Federal Energy Regulatory Commission (FERC) and the Department of Justice (DOJ) have already issued market power guidelines and sophisticated bidders are aware of these requirements. To avoid uncertainties associated with our regulatory review on market power issues, we adopt guidelines on horizontal market power.^{1/}

The guidelines track FERC's electric industry merger guidelines. Those guidelines in turn follow DOJ's guidelines for

^{1/} The guidelines are set forth in Appendix A.

general commerce, while adding considerations that are specific to the electric industry and its unique characteristics. Utilities shall employ the methods outlined in FERC's guidelines for evaluating the potential market power bidders in their auctions might exercise, and for selecting a winner that can survive market power scrutiny. Taking this approach will lend consistency to the analyses applied at the federal and state levels.

NYSEG shall provide auction participants with the market power guidelines we have promulgated. The utility shall inform bidders that they must comply with the guidelines, and the utility must certify to us that the winning bidder has satisfied the guidelines, or proposed satisfactory mitigation measures. The utility's certification will be reviewed and verified upon final approval of the sale to the winner. Compliance with the guidelines will be deemed sufficient to demonstrate the absence of unwarranted horizontal market power; however, we retain the jurisdiction necessary to arrive at just and reasonable rates upon final review of the auction results.

B. Vertical Market Power

Vertical market power occurs when an entity that exercises monopoly power in one stage of a production process leverages that power to gain advantage over its competitors in a different stage of the production process. Monopoly control of transmission and distribution (T&D) in the electric industry could result in the exercise of vertical market power in the electric generation market. A utility could make decisions in the operation and construction of the T&D systems that would advantage its generators in the generation market.

The potential for vertical market power is ameliorated with the creation of an Independent System Operator (ISO). The ISO will retain day-to-day control over the bulk transmission system and over the flow of power dispatched to meet load. This

fundamental feature of electric industry restructuring is specifically designed to address vertical market power.^{1/}

Another important factor ameliorating vertical market power is the divestiture of generation assets. If the owners of the T&D utilities possess little or no generation, vertical market power issues are reduced or eliminated. NYSEG agreed to sell the bulk of its generation, retaining only a small number of hydro sites, and its proportionate ownership of the Nine Mile II nuclear station. It has released its eligibility, under the Settlement Agreement, to participate in its auction as a bidder through an unregulated subsidiary. Other upstate utilities that have presented auction plans also will not participate in their auctions. The resulting divestiture avoids most of the potential for vertical market power after the auctions are complete. We do not expect that New York utilities will bid in each other's upcoming auctions or, if they do, that they will bid on generation in locations where the potential for vertical market power could exist.

Moreover, NYSEG has agreed, in the Settlement, to affiliate transaction rules and a code of conduct. These provisions provide some degree of protection against vertical market power. The combination of the ISO, the divestiture of assets, and the settlement restructuring provisions should provide sufficient protection against the exercise of vertical market power.

C. The Milliken-Ithaca Load Pocket

The proposal to mitigate the potential market power in the Ithaca load pocket with a call contract for the Milliken unit appears reasonable. Eliminating the load pocket with transmission upgrades now would be a significant expenditure, at about \$35 - 40 million. While the transmission investment will be required eventually, the contract appears a less expensive

^{1/} An ISO for New York, to replace the New York Power Pool, is awaiting approval at FERC.

alternative in the interim. Further, the contract will enable the utility to satisfy local reliability concerns within the framework of expected forthcoming ISO rules and procedures.

The call contract would require the new owner of Milliken to support local reliability when load pocket circumstances exist, to the extent Milliken is not already producing energy during those hours. The pricing of the call contract will prevent the new owner from exercising market power and charging excessive rates at times when generation is critically needed to serve in the load pocket, and any attempt by the owner to withdraw generation during those times will trigger contractual penalties.

The terms and conditions of the call contract have not been fully specified. The utility is directed to consult with staff to ensure that the contract is reasonable. Moreover, the utility will provide Phase II bidders an opportunity to comment on the contract, and will negotiate final terms with the winning bidder. NYSEG must also file any executed contract for our approval.

While call contracts are a form of price control that could be inconsistent with a fully competitive marketplace, a contract for the Milliken load pocket is a cost-effective transition measure during the movement from a fully regulated environment to a fully competitive environment, and provides for reliability of service during that period.^{1/} Since NYSEG intends to perform the transmission reinforcement into the load pockets within ten years, and our approval is needed for an extension of the term of the call contract, in the long run the load pocket will be subject to the same market forces as the rest of NYSEG's service territory. NYSEG should proceed with the negotiation of the call contract, subject to the process described above.

^{1/} These considerations outweigh the objections Pace raises against use of these contracts, and most of those objections are based on speculative assumptions in any event.

Pace has not demonstrated its alternatives to a call contract for load pocket mitigation are feasible. While Pace's suggestions should be explored where they might prove cost-effective without adversely reducing reliability, a call contract is still needed to ensure the availability of sufficient generation to preserve reliability within the Milliken pocket. A long term for the contract is also required, to dovetail with the future plans for building transmission reinforcements. Pace's arguments are therefore rejected.

The Transition Contracts

NYSEG will be permitted to continue with development of transition price contracts. Niagara Mohawk's entry into this type of contract has been approved, and NYSEG could be disadvantaged in the competitive marketplace if it is denied the same opportunity. Moreover, transition contracts will assist in ensuring that adequate supplies are available to meet the utility's provider of last resort (POLR) responsibilities to ratepayers that do not select competitive alternatives.

NYSEG has consulted with staff on the terms and conditions appropriate for this type of contract, and will also negotiate with Phase II and winning bidders further. So long as the pricing in the contracts does not distort either the workings of the competitive marketplace or the price offered in the auction, and the volume of unit output subject to the contract is appropriate in relation to the utility's POLR load, negotiations of the contracts should proceed. As with the call contract, consultation with staff will continue, and the contracts must be filed with us for our review after execution.

The Confidentiality Agreement

Revisions should be made to NYSEG's Confidentiality Agreement. The utility would compel participating bidders to forgo any effort to influence NYSEG management, or to acquire NYSEG assets outside the context of the auction. It is appropriate to prevent efforts to interfere with NYSEG's

management during the course of the auction process, because these efforts could interfere with the effective implementation of the auction. A requirement of excessive duration, however, could harm ratepayers by chilling otherwise meritorious merger proposals or take-over efforts.

A proper time duration for the non-interference requirement is up to the date of closing with the winning bidder or bidders, or August 1, 1999, whichever is earlier. The August 1, 1999 date is derived from the Settlement Agreement as the latest closing date for the auction. If the auction in fact closes earlier, prevention of interference into utility management efforts to conduct the auction no longer exists as a reason to foreclose takeover efforts, and so the time period as revised is appropriate.

The waiver of right to seek review of auction outcomes that NYSEG proposes is too extreme. While it is appropriate to limit challenges to the auction process,^{1/} NYSEG's language could chill participation in the auction. As a result, the utility is directed to revise its requirement, replacing the existing provisions with the language provided at Appendix B.^{2/}

Regulatory Approvals

NYSEG proposed to retain the right to withdraw the protocols entirely, if any regulatory agency, including this Commission, imposed requirements unacceptable to the utility. This reservation of right must be modified, to provide that NYSEG will be deemed to have accepted any regulatory modifications, conditions or restrictions if it does not provide written notice to the contrary within 10 business days following issuance of the regulatory agency's decision. This revision tracks our existing

^{1/} We will limit challenges as well, as described below.

^{2/} The revisions would adhere equally to NYSEG's share in Homer City as well as to its New York plants; while GPU need not conform to New York requirements for limitations of liability in auctioning its share of Homer City, NYSEG is obligated to meet our requirements applicable to its share at the plant.

procedures for approval of proposals like the auction plan, and is acceptable.

Alignment of Interests

With the revisions made after consultation with Staff, the interests of NYSEG and its ratepayers in the success of the auction are reasonably aligned. The auction process, as modified, appears intended to benefit both ratepayers, in the form of lower rates, and shareholders, in enhanced viability of NYSEG in the competitive marketplace. Moreover, if the proceeds of the auction exceed the book value of the coal facilities (after recognition of tax impacts and auction costs), the excess can be used to write down Nine Mile II costs. Again, both ratepayers and shareholders would benefit from that accelerated depreciation.^{1/}

Moreover, NYSEG has also agreed to consult with Staff on bundling and other auction issues that might affect value maximization. While the utility will not share in the auction proceeds as an incentive, the provisions of its Settlement Agreement and its protocols, as revised, result in an acceptable auction process and sufficient protection of ratepayer interests.

Further Procedures

The outcome of the auctions will be reviewed in a subsequent filing. This approach is appropriate because many of the details attending the sales transactions to the winning bidders are not yet final. The specific conditions of the transaction contracts must still be negotiated with the bidders. Utilities must also evaluate the ability of the purchaser to survive market power review, under the market power guidelines. New issues may also arise once a purchaser has been selected. As a result, NYSEG is required to file for approval of the sales

^{1/} Under the Settlement Agreement, any remaining excess would be allocated as we direct, another benefit to ratepayers.

transactions after any purchaser has executed the relevant transaction agreements.

To facilitate efficient auction procedures, and avoid onerous duplication of regulatory requirements, several other steps will be taken. NYSEG is directed to consult with staff on the important auction decisions, such as the contents of the offering memorandum provided to prospective bidders; Phase I bid evaluation, including asset bundling; Phase II bid evaluation, including bid clustering and the need for further rounds; and, negotiating the terms and conditions of the various transaction contracts. This consultation will smooth the subsequent approval process. Moreover, parties are advised that decisions on the approval of the auction protocols are subject to rehearing only under PSL §22 and 16 NYCRR §3.7, and the approval will not be reheard further upon the sales transaction filing. Review of that filing will assess adequacy of compliance with the approved protocols and conformance of the transfers with the public interest. Losing bidders are informed that consideration of demands for monetary relief peculiar to a loser's pecuniary interest would be inconsistent with those purposes.

NYSEG is also directed to inform bidders that the owners' electric generation stations are electric corporations subject to regulation of the Public Service Law.^{1/} Competitive providers of wholesale electric generation, however, have been regulated lightly in the past.^{2/}

There are two natural gas issues that might affect the auctioning of generation plant. If a new owner of a generation plant builds pipeline to connect directly to an interstate gas supplier instead of to the local gas distribution company, the

^{1/} New owners are not required to apply for a Certificate of Public Convenience and Necessity under PSL §68 at previously-certified facilities, unless the new owner desires to obtain a municipal franchise and sell at retail within the confines of the franchised territory.

^{2/} See Case 91-E-0350, Wallkill Generating Co. L.P., Order Establishing Regulatory Regime (issued April 11, 1994).

new owner becomes responsible for the construction, maintenance, inspection and repair of the pipeline, under regulations set forth at 16 NYCRR Part 255. Moreover, we have instituted a proceeding to consider the pricing of gas transportation for electric generation.^{1/} NYSEG should provide bidders with this information on these regulatory requirements.

CONCLUSION

NYSEG's auction protocols satisfy the requirements of its Settlement Agreement. The process as revised should lead to a fair and open competitive auction, and should maximize plant sales value.

It is ordered:

1. New York State Electric & Gas Corporation is authorized to auction generation plant in conformance with the discussion in the body of this Order.
2. The Order Adopting Terms of Settlement Subject to Modifications and Conditions issued January 27, 1998 in this proceeding is modified, to permit recovery of employee transition and ash site environmental remediation costs as Category 2 costs, to the extent discussed in the body of this Order.
3. New York State Electric & Gas Corporation must submit a written statement of unconditional acceptance of the modifications and conditions contained in this Order, signed and acknowledged by a duly authorized officer of the utility, within

^{1/} Case 98-G-0122 - Proceeding on Motion of the Commission to Review the By-Pass Policy Relating to the Pricing of Gas Transportation from Electric Generation.

ten business days of the date of this Order. This statement shall be filed with the Secretary of the Commission and served on all parties to this proceeding.

4. This proceeding is continued.

Commissioner

MARKET POWER GUIDELINES

In Opinion No. 96-12, it was decided that moving towards competitive markets for the provision of wholesale and retail electric services was in the ratepayers' best interests.^{1/} It was further determined that the divestiture by each utility of its generation assets was an appropriate means towards accomplishing that goal.^{2/} During this transition to competition, our responsibility to ensure just and reasonable rates for electric service continues. One facet of this responsibility is to prevent generation suppliers from exerting undue influence over prices through the exercise of horizontal market power.^{3/}

An overly restrictive view of large-sized generation owners, however, could adversely affect ratepayer interests. We recognize the potential efficiencies inherent in single ownership of multiple generation stations that could foster, in the short run, higher bids in the auctions, and in the long run, lower costs of production and lower rates. Moreover, participation in the auctions of the largest and most diverse field of potential bidders should be encouraged. Accordingly, a balance must be reached between the obligation to protect against undue market power concentration and the realization of the potential benefits large scale ownership provides to ratepayers through higher auction prices and lower generation production costs.

^{1/} Case 9-E-0952, Opinion and Order Regarding Competitive Opportunities for Electric Service, Opinion No. 96-12 (issued May 20, 1996), pp. 24-31.

^{2/} Utility divestiture of generation assets was strongly encouraged in Opinion No. 96-12, as critical to the movement towards a competitive marketplace for the provision of electric services. Opinion No. 96-12, pp. 59-60.

^{3/} These guidelines pertain only to broad markets and apply generally across the State. Issues associated with load pockets unique to each utility are analyzed elsewhere.

After scrutiny of the market power provisions in the Federal Energy Regulatory Commission's (FERC) Merger Guidelines,^{1/} and review of FERC decisions on the role of market share in evaluating requests for permission to charge market-based wholesale rates, we conclude that those rulings furnish a reasonable analytical approach to examine market power issues.^{2/} Therefore, we will require that the prospective purchaser(s) in each utility's auction satisfy the FERC Guidelines.

To prevent any market power problems from arising during our review of the auctions and approvals of the sales, we direct each utility to analyze the potential for the winning bidder(s) to exercise market power. To conduct this analysis, in each defined market the ownership concentration resulting from the auctions shall be compared to the existing concentration based on ownership by the regulated utilities. The FERC Guidelines and the markets as defined below should be used to perform this analysis:

- 1) the baseline to be used in the analysis shall incorporate the following parameters:
 - a) the relevant markets, reflecting geographic, product, and time dimensions, are those defined in the New York Power Pool member utilities' FERC ISO filings;^{3/}

^{1/} Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement, Order 592, 77 FERC Paragraph 61,263 (December 18, 1996).

^{2/} Louisville Gas and Electric Company, 62 FERC, 61,016 (1993); Southern Co. Services, Inc., 72 FERC, 61,324 (1995); Southwestern Public Service Company, 72 FERC, 61,208 (1995); New England Power Company, et al., 82 FERC, 61,179 (1998).

^{3/} August 15, 1997 filing of the eight Member Systems of the New York Power Pool, Docket No. ER 97-4234-000 (also referred to as Docket Nos. ER97-1523 and OA97-470), Central Hudson Gas & Electric Corporation, et al.; see especially Attachment D.

- b) the IPP ownership assignments for Niagara Mohawk's IPPs shall employ the "Restructured IPP Contracts" scenario Niagara Mohawk presented in its August 15, 1997 FERC filing, reflecting separate ownership of the Independent Power Producer facilities subject to Niagara Mohawk's Master Restructuring Agreement; and
 - c) market power screens shall assume 100% retail access penetration in New York, in order to reflect the policy of full retail and wholesale competition adopted in Opinion No. 96-12;^{1/}
- 2) for purposes of calculating market shares, the generators sold in each auction shall be assigned to the winning bidder(s), irrespective of any transition contracts that may exist between the utility and the winning bidder(s);
 - 3) market power screens shall be performed for all markets defined in (1) above; and
 - 4) the concentration resulting from acquisition by the winning bidder(s) shall be compared against the baseline defined in (1), above.

We expect that the utilities will require auction participants to comply with the above guidelines as part of their overall procedures for determining the viability of bidders.

To demonstrate compliance, the utilities must include in their post-auction filings a certification that they have reviewed the documentation and evidence submitted by the winning bidder(s) and believe the winner(s) either satisfy the above guidelines or propose appropriate mitigation. Additionally, we require that the winning bidder(s) maintain compliance with the guidelines up to the time all needed regulatory approvals are obtained and the transactions are closed.

^{1/} This scenario was used by Niagara Mohawk in its "Available Economic Capacity" definition.

APPENDIX B

You further acknowledge that, in order to ensure the integrity of the Auction and provide persons participating in the Auction process with fair assurance that if they are the chosen successful bidder they will not become involved in a legal dispute, the conduct of the Auction as determined by the Company in its sole discretion must be final. In consideration of the collective benefit to all persons participating in the Auction process of finality in the Auction process and of the Company providing you with access to its Proposed Acquisition pursuant to this letter agreement, the sufficiency of such consideration which is hereby acknowledged, you further agree not to bring, in any regulatory, judicial or other forum, including any proceeding before the NYPSC prior to proceedings on approval of the transfer of the Facilities to new owners but not including timely rehearing of NYPSC's approval of the Protocols, any petition, action or proceeding regarding or related to the conduct of the Asset divestiture process conducted pursuant to the NYPSC-approved Protocols. You further agree, on or after proceedings on approval of the transfer of the Facilities are instituted at the NYPSC, not to bring any petition, action or proceeding in any judicial forum challenging a definitive agreement upon a ground other than (a) that the Company erred in calculating the price, terms and conditions of your final bid or the final bid of the designated successful bidder, or (b) the Company conducted the Auction other than in substantial compliance with the Protocols. Nothing in this Agreement shall be construed as limiting the Bidder's right to participate and request relief in proceedings before the NYPSC on rehearing of its approval of the Protocols or related to the approval of the transfer of the Facilities to new owners, subject to such requirements and limitations as the NYPSC may establish.