

Current Developments

Electric Industry

In New York State, as in much of the nation, segments of the electric, gas and telecommunications industries are moving toward open-market competition and deregulation. In May 1996, the NYS Public Service Commission (PSC or the Commission) issued its Opinion and Order in the Competitive Opportunities Case calling for competition in the wholesale power markets and the introduction of retail access for electric customers. Since then, the Commission has approved plans by each jurisdictional electric utility to open the state's electric industry to competition in the supply of electricity, which will allow customers the opportunity to choose their power supplier. These changes follow earlier Commission decisions to introduce competition in the telecommunications and gas industries. These actions, together with competitive market forces, will dramatically alter the structural make-up of the utility industry in NYS.

During 2000, each utility in New York allowed more customers to choose their supplier of electricity. To ensure that this change is made smoothly, the transition to a competitive market will occur in phases over the next few years. Staff has been actively involved in monitoring the progress of the retail access programs submitted by the utilities. By the end of the year 2001, all customers in NYS will have this opportunity.

Currently, nearly 100 electric generation plants have either been sold or are in the process of being sold by New York utilities. This process, called divestiture, has led to a competitive wholesale electricity market. After divestiture, the regulated portion of New York's utilities will be engaged primarily in the transmission and distribution of electricity.

Siting new generation in New York has been problematic and that coupled with a recovering economy has placed a strain on electricity price and reliability. In September 2000, Chairman Helmer established a task force to ensure that New York State will have reliable supplies of electricity at reasonable prices. The task force is composed of three specialized teams. One monitors the pricing of electricity by the New York Independent System Operator (NYISO). Another seeks to use conservation to reduce load or employ stop gap generation to increase output until new base load plants can be brought online. Finally, one facilitates the Article X process accelerating the time between an application is submitted and a worthy plant is built. The task force hopes to obtain the equivalent of 750 MW (500 MW in New York City) of reduced load/more generation in 2001 and another 600 MW (200 MW in New York City) in 2002. The major effort of the task force was in facilitating the siting of the New York Power Authority's eleven 44 MW gas turbines in the New York City area.

The New York ISO

During the late 1990's, interest in deregulating the wholesale market for electricity fueled the development of independent system operators (ISO). The ISO would be responsible for the operation of the bulk power system and would also manage a competitive wholesale market. Unlike power pools, which were run by and for utilities, independent system operators would

represent the interests of all market sectors and would be independent of control by any one sector of the marketplace.

In July 1998 the Federal Energy Regulatory Commission conditionally approved many of the critical aspects of New York's proposal for creation of an Independent System Operator and a Reliability Council to develop reliability standards to govern the operations of an ISO in New York. FERC recognized the Public Service Commission's role in ensuring system reliability by requiring the ISO to implement local reliability rules written by the PSC.

On September 30, 1999, the Public Service Commission approved the transfer of utility transmission assets and operational control over designated portions of utility transmission systems from the New York Power Pool to the New York State Independent System Operator (NYISO). The NYISO officially began operations on November 19, 1999. After several weeks of successful operations, NY Power Pool and NYISO officials signed final documents that permanently transferred control of New York's bulk power system to the NYISO. Initial results from the NYISO have been satisfactory. The NYISO was able to maintain power throughout the summer under difficult conditions. Combined with the actions of the Commission discussed below, the electricity needs of New Yorkers went uninterrupted throughout the year.

Capacity Requirements

The Commission set up a Demand and Supply Team with the responsibility to ensure that New York, and in particular New York City, has sufficient capacity reserves to satisfy customer demands until adequate new generating capacity can be brought online. The team had a goal of 750 MW for 2001. In terms of new generation, Staff, working with NYPA, supported the siting of eleven gas-fired generators by NYPA that will result in a capacity totaling 400 MW for New

York City. One unit was installed on Long Island. In addition, a subset of the Demand Supply Team, the Price Responsive Load Team, focused on implementing price responsive load programs. Price responsive load programs provide customers with price signals that are designed to encourage reductions and/or shift consumption during high price periods. Under the Emergency Demand Response Program (EDRP), when the NYISO activates an emergency, customers voluntarily curtail and are paid a predetermined price per MW. Under the Day Ahead Demand Response Program (DADRP), customers bid their demand reductions and bid prices into the NYISO's day-ahead market. If their bid is accepted by the NYISO, the customer is obligated to curtail. Acceptance of these bids is designed to reduce demand and moderate day-ahead price, thus providing savings to all customers. With regard to the Real Time Pricing Programs (RTP's), customers contract with their load serving entities to purchase commodity at hourly market prices.

In addition to the above programs, each of the utilities were provided public awareness plans to educate all customers on the price responsive load programs as well as other conservation measures. The utilities were further required to make interval metering available to commercial and industrial customers eligible to participate in price responsive load programs, to participate to the maximum extent possible in programs funded through NYSERDA's SBC funds for interval meters, and to coordinate activities with NYSERDA to have the greatest impact on peak reductions.

Specifically, for New York City, Con Edison was directed by the Commission to aggressively implement the NYISO's Price Responsive Load programs as well as participate in the NYSERDA programs. For the summer of 2001, a combination of 500 MWs of new capacity has been either installed (400 MWs / NYPA) or is anticipated to be curtailed (100 MWs). The

team will continue to make efforts to encourage greater participation that will result in greater reductions for the summer of 2002.

Mergers and Acquisitions

There were two mergers involving New York electrical companies in 2000. In September 2000, Niagara Mohawk Holdings, the parent of Niagara Mohawk Power Corporation, entered into a merger agreement with National Grid, whereby it would become a wholly owned subsidiary of National Grid. National Grid's principal subsidiary, The National Grid Company plc, owns and operates the high voltage transmission system in England and Wales. National Grid, through another subsidiary, National Grid USA, also has substantial transmission and distribution operations in the United States following its acquisitions of New England Electric System and Eastern Utilities Associates in early 2000. The combination of Niagara Mohawk and National Grid will more than double the size of National Grid's US operations with an electric customer base of approximately 3.3 million. The pending merger agreement is contingent on the sale of the nuclear assets or other satisfactory arrangements being reached. In December 2000, Niagara Mohawk announced an agreement to sell its nuclear assets to Constellation Nuclear, LLC, a subsidiary of Constellation Energy Group, Inc. The sale is targeted to close in late-2001.

On February 20, 2001, Energy East Corporation and RGS Energy Group, Inc. announced that their boards of directors have unanimously approved a definitive merger agreement, under which all of the outstanding shares of RGS Energy will be exchanged for a combination of cash and Energy East stock. The transaction will be accounted for as a purchase and is expected to be accretive to Energy East's earnings per share in the first full year after closing. The combined

company will be one of the largest, most diversified energy providers in the Northeast, serving nearly 3 million customers, including approximately 1.8 million electric customers, almost one million natural gas customers and approximately 200,000 other retail energy customers. The combined company will have annual revenues of approximately \$5 billion and nearly \$10 billion in assets. Together, Energy East and RGS Energy, through their operating subsidiaries, will serve half of upstate New York. By combining with RGS Energy, Energy East also strengthens their overall presence in the Northeast. The merger is expected to generate annual cost savings of approximately \$50 million. Savings are expected to come largely from the joint management of Energy East and RGS Energy subsidiaries in areas such as procurement, information systems, and other administrative and general areas. No layoffs are planned as a result of the combination. Both companies have on going cost reduction programs and, historically, have used reduced hiring and attrition to minimize any workforce effects.

Nuclear Plant Sales

As part of the Commission's goal of transitioning to a fully competitive electric market, New York electric utilities are in the process of divesting all their generating assets, including their nuclear plants. In November 2000, Con Edison announced the sale of its Indian Point 1 and 2 nuclear plants to Entergy Corporation through a competitive auction process. Indian Point 1 has been permanently shut down since 1974. Indian Point 2 is operational with a capacity of 951 MWs. The sale terms included, among other things, cash of \$600 million and approximately 3.5 years of purchase power agreements at prices expected to be below the market price of electricity.

The Commission in August 2000 approved this sale and the sale closed on September 6, 2001. The Commission made certain modifications to the proposed sales transaction to protect the public from the exercise of market power in the capacity markets and to assure that the public shares in any windfall profits that Entergy may realize if it does not immediately decommission the plant and restore the site to its initial greenfield state.

An auction process was conducted in November 2000, to sell the 609 MW Nine Mile 1 nuclear plant owned by Niagara Mohawk and the portion of the 1148 MW Nine Mile 2 nuclear plant owned by Niagara Mohawk, New York State Electric & Gas (NYSEG), Central Hudson, and Rochester Gas & Electric and the Long Island Power Authority. The Long Island Power Authority, which owns 18% of this plant, elected not to sell its interest. After these plant sales are completed, the only remaining nuclear plant in New York under the ownership of a fully regulated utility will be Rochester Gas & Electric's 485 MW Ginna plant. The only other nuclear plants in New York (762 MW Fitzpatrick and 965 MW Indian Point 3) are owned by the Entergy Corporation, which purchased them from the New York State Power Authority in November 2000.

In December 2000, the Nine Mile sellers announced Constellation Nuclear was the winning bidder for the plants. The sale terms included purchase prices of \$234 million and \$581 million for Nine Mile 1 and Nine Mile 2. Half the price would be paid in cash with the remainder paid in installments with interest over the next five years. The transaction also included a Purchased Power Agreement for the first ten years after closing and a Nine Mile 2 Revenue Sharing Agreement for years 11-20 (The Nine Mile 1 Operating License expires in 2009). Annual payments of up to \$10 million a year were required in the event Constellation did not immediately decommission the site.

All of the Sellers except NYSEG have entered into joint proposals with staff governing the regulatory treatment of the sale proceeds and any stranded cost and certain related rate issues. NYSEG has not yet entered into such an agreement and the timing of such an agreement, if any, with NYSEG is unknown. Commission action on this matter is expected in the Fall 2001. It is possible that the three remaining sellers may choose to close the sale without NYSEG once Commission approval is received.

Current Developments

Gas Industry

In 1998 the PSC issued a Policy Statement establishing its vision for the future of the natural gas industry in NY. The essence of that vision is that the most effective way to establish a competitive retail market in gas supply is for LDCs to cease selling gas. In this vision marketers would sell gas to customers and LDCs would deliver that gas to them. The Policy Statement requires LDCs to hold new upstream pipeline capacity contracts to the absolute minimum necessary for system operation and reliability purposes and eliminates the LDCs right to assign its capacity to migrating customers, except where specific operational and reliability requirements warrant. This encourages LDCs to relinquish capacity as contracts expire to make it available for marketers. A transition process consisting of three elements was established:

- Discussions with each LDC on an individualized rate and restructuring plan;
- collaboration among stakeholders on the key generic issues of system reliability and market power; and
- coordination of issues that are also faced by electric utilities, including provider-of-last-resort, and competition in areas such as metering, billing and information services.

Rate and restructuring plans have been approved for all but one of the utilities.

NYSEG just recently submitted its proposal for a multi-year restructuring plan. Generally, these plans freeze or reduce retail rates, establish back-out rates applicable when marketers replace certain LDC functions, establish or refine balancing services for marketers, incorporate gas capacity portfolio changes, and promote development of the competitive market through customer information programs. Several issues common to gas and electric that impact the

development of the competitive market are being addressed in a coordinated fashion. These issues include provider-of-last-resort, billing and metering, electronic data interface, uniform business practices, and unbundling costs.

Reliability

A Reliability Collaborative was established in December 1998 to implement the Policy Statement's goal of maintaining the reliability of gas deliveries. Specifically, the task of the group is how to assure that capacity continues to remain available to natural gas core markets. Based on recommendations developed through this collaborative, the Commission requires marketers serving firm loads to have firm, primary delivery point capacity for the months of November through March. A Natural Gas Reliability Advisory Group has recently been established to continue to address both short and longer-term reliability issues, such as the need for capacity requirements, the development of liquid trading points, and market power issues.

As capacity contracts have expired, upstate LDCs have been able to relinquish capacity on upstream pipelines. The reliability of the systems has been assured through retention of capacity on intermediate pipelines to liquid trading points. Purchasing at the liquid trading points instead of retaining capacity all the way back to the production regions has resulted in significant capacity cost savings.

Since the Commission Policy Statement was issued, the downstate capacity market has become tight, and currently marketers that acquire capacity at market prices cannot compete with the LDCs weighted-average cost of capacity. In response, the downstate LDCs have developed programs approved by the Commission under which they will acquire the resources

needed to meet market requirements on a year-to-year basis for the next three years and make capacity available to marketers at their average cost of capacity.

There are a number of pipeline projects in various stages that propose to add significant capacity to the New York City area. If several of these projects were ultimately built, the capacity situation would be relieved over the next several years. However, with the addition of significant numbers of gas-fired electric generators, the adequacy of pipeline capacity will continue to be an issue to be addressed, to assure reliability of gas deliveries.

Natural Gas Commodity Prices

Natural gas commodity prices soared to unprecedented levels during the 2000-01 winter. Several factors contributed to this increase. A sustained period of relatively low gas prices in the 1990's led to a substantial reduction in gas drilling, constraining domestic productive capacity. This set the stage for the price increase, but two factors that suppressed gas demand concealed the significance of the problem. First, low oil prices in 1998 and 1999 reduced gas demand through fuel switching to oil. Gas demand increased when those loads later switched back to gas as oil prices rose. Second, prior to last winter there were three warm winters in a row, masking the underlying level of gas demand. In summer 2000, gas prices started rising steadily in response to the increased summer demand for gas for electric generation and the competing need to fill gas storage. By the beginning of the 2000-01 heating season, prices were already at record high levels and storage inventories were relatively low. The sustained cold weather in early winter in combination with market nervousness due to low gas storage levels, caused gas prices to increase dramatically, to nearly ten dollars per DT. The balance of the 2000-01 winter was mild, drilling for gas increased in response to higher gas

prices, the national economy slowed, and in summer 2001 storage has been refilled at record levels. As a result, gas prices have returned to more familiar levels. However, gas prices will likely remain volatile.

To address price volatility, in 1998 the Commission issued a Policy Statement on LDC gas purchasing practices. While the Commission did not direct any particular mix of portfolio options, it stated that volatility of customer bills is one criterion along with other factors such as cost and reliability, that LDCs should consider in their gas supply portfolio strategies. The Commission stated that excessive reliance on any one gas pricing mechanism or strategy does not appear to reflect the best management of the gas portfolio and any LDC without a diversified gas pricing strategy will have to meet a heavy burden to demonstrate that its approach is reasonable.

Current Developments

Telephone Industry

Traditional Local Telephony

The 1980's and 1990's telecommunication market has been affected by a number of regulatory and technological changes most of which, if not all, spurred competition in a previously heavily regulated market. The New York State Public Service Commission has been at the forefront of these activities, being the first state in the nation to require Local Exchange Companies (LECs) to provide Central Office interconnection (1989), to require that LECs provide physical collocation for private lines (1991), and to authorize LEC competition through interconnection agreements (1993).

The 1996 Telecommunications Act (the Act) was designed to continue this pro-competitive agenda in local and long-distance markets. Under Section 271 of the Act, Regional Bell Operating Companies (RBOC's) were required to take steps to open their local market sufficiently to allow Competitive Local Exchange Companies (CLECs) a meaningful opportunity to compete locally, before an RBOC would be granted permission to compete in the long distance market. On December 24, 1999, Bell Atlantic-New York became the first RBOC in the country deemed to have opened its local market sufficiently to be granted permission by the FCC to participate in the New York long distance market.

Competition in the New York local market is the strongest in the nation. At the end of 2000, CLECs had captured 20% of the State's end user access lines, the greatest penetration rate in the nation. CLECs reported 2.8 million access lines in the State, compared to 1.2 million lines the prior year, an increase of over 130%. Moreover, the CLECs extended their reach into

the residential and small business markets - 63% of the lines they now serve are in these markets. Nationwide, the CLECs only have an 8% market share and focus primarily on large business customers, who comprise 59% of their total access lines.

Traditional Long Distance Telephony

The watershed event in Long Distance was the 1984 divestiture by AT&T of its local operations. As a consequence of divestiture, a process of access charges was set up whereby AT&T would compensate its divested subsidiaries for the costs of originating and terminating long distance calls on their lines. During the 1980s and 1990s access charge rates were reduced and replaced in part with fixed end-user charges, which spurred further growth in the long distance market.

Post-divestiture changes in the market have been dramatic: Since 1986 the number of long distance carriers has more than tripled. In 1984 AT&T's toll revenues accounted for 90% of revenues received by all long distance carriers. By 1999 AT&T's share of that market had fallen to 41%. In 1997 AT&T's core long distance business accounted for 80% of its revenues; by the end of 2002 some estimate a drop to 35%. Increased competition has reduced some residential long-distance calling rates to as low as 5 cents per minute, increasing the importance of ancillary services, and offering customers a bundled package of goods and services.

The 271 approval will not only affect local market shares as CLECs enter the market, but the entry of the former AT&T subsidiaries into long distance will impact market shares in that market. In just the first year following its receipt of permission to enter the interLATA market in New York, Verizon (the former Bell Atlantic-New York) has made significant inroads into the long distance market, capturing 1.4 million customers.

Emerging Telephony Providers

The New York State Public Service Commission's policies encourage competitor's to provide local telephone service by using their own facilities (facilities-based competition). However, the Telecommunication's Act of 1996 requires incumbent telephone companies to lease all or part of their network (unbundled network elements or UNEs) to competitors in order to provide service. The Commission envisions this as a transitional tool or bridge to its ultimate goal of facilities based competition.

The number of access lines in Verizon's service territory served by competitors has grown from 1.4 million in at December 31, 1999 to 3.3 million at April 30, 2001. The major entry means used by competitors to provide residential local service is by leasing all of Verizon UNEs needed to provide that service, referred to as UNE-Platform (UNE-P). The number of UNE-P has grown from 0.4 million at December 31, 1999 to 1.7 million at April 30, 2000.

The Commission originally approved UNE rates for Verizon in the 1996/1967 time period but initiated a proceeding in September 1998 to perform a comprehensive review of the those rates. A Recommended Decision was issued in that proceeding by the Administrative Law Judge in May 2001 that proposed substantially lowering Verizon's current rates. The Commission originally anticipated making its final decision in October 2001 but those plans have been delayed to consider what impacts, if any, the September 11, 2001 World Trade Center attack might have on Verizon's UNE rates.

The Commission has adopted the Total Element Long Run Incremental Cost (TELRIC) methodology mandated by the Federal Communications Commission in 1996 to set Verizon's UNE rates. Under the TELRIC method, UNE rates are based on costs that assume the most

current and efficient technology available given the current placement of the incumbent telephone company's wire centers.

Facilities-Based Competition

The underlying forces behind these regulatory changes are technological advances, which show no signs of slowing in the near future. Wireless and Cable technology are making inroads into the traditional telephony market fueling and being fueled by the Internet.

Recent estimates of the national wireless market reveal that this market generates in excess of \$63 billion annually, has over 101 million subscribers, and employs over 150,000 people. While first generation wireless analog technology is still prevalent, second-generation digital, and third generation digital broadband have and will spur future growth in this industry. Following the allocation of new spectrum for digital in 1994, total minutes of use by US wireless customers tripled, while the consumers' fully weighted average cost per minute dropped by nearly 50% from 1995 to 1999. The January 2001 auction of additional spectrum should also result in a substantial increase in New York customers, as Verizon Wireless paid an incredible \$4.1 billion for two 10 MHz licenses for the New York market.

The cable industry has begun its marketing of telecommunication services including local and high speed Internet service. By the middle of 1999 nearly 1 million cable modems had been deployed, up from 500,000 at the beginning of the year. According to the FCC's Report on Cable Industry Prices, system capacity and non-video services all showed growth in 1999, with 27% of cable operators offering Internet access service and 4% offering telephony service.

As new competitors enter traditional telephony markets, traditional telephony providers are entering new markets. AT&T has spent \$110 billion purchasing and modernizing US cable systems, while also exploring partnerships with other cable operators such as Time Warner. A goal being to provide bundled services that include digital television, voice telephony and high-speed Internet services.

Other technologies will also impact the market such as fixed wireless, Direct Broadcast Satellite, and Internet telephony. Market participants will need not only to deal with the complexities of these new technologies, and face new competitors, but will also have to obtain the necessary financial resources to do so. There are some early indications that this may not be an entirely smooth ride, as major carriers in Europe have found their credit ratings lowered following successful bids for third generation wireless licenses, and US firms have found their stock prices under pressure as they pursue acquisitions.

The first decade of the 21st century brings with it the promise of new services for customers, opportunities for market participants, and challenges for regulators to allow market forces to drive the outcome as much as possible.