



VIA ELECTRONIC MAIL

Mr. Joseph Oates
Chairman of the NYISO Board of Directors
c/o Mr. Richard J. Dewey
President and CEO
New York Independent System Operator, Inc.
10 Krey Boulevard
Rensselaer, New York 12144

Re: NRDC Comments Regarding the 2025-2029 Demand Curve Reset

October 9, 2024

Dear Chairman Oates:

In accordance with Section 5.14.1.2.1.9 of the New York Independent System Operator, Inc. (NYISO) Market Administration and Control Area Services Tariff, enclosed please find the comments of Natural Resources Defense Council in response to NYISO staff's final recommendations regarding the 2025- 2029 demand curve reset process.

If you have any questions regarding this matter, please feel free to contact me directly.

Respectfully submitted,

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Comments on “Proposed NYISO Installed Capacity Demand Curves for the 2025-2026 Capability Year and Annual Update Methodology and Inputs for the 2026-2027, 2027-2028, 2028-2029 Capability Years”

Submitted by the Natural Resources Defense Council

October 9, 2024

Natural Resources Defense Council (NRDC) respectfully submits the following comments to the New York Independent System Operator, Inc. (NYISO) Board of Directors (Board) on the NYISO Staff’s Report, *Proposed NYISO Installed Capacity Demand Curves for the 2021-2022 Capability Year and Annual Update Methodology and Inputs for the 2022-2023, 2023-2024, and 2024-2025 Capability Years* (Staff Final Report).¹ The Staff Final Report covers Staff’s recommendations for the proposed ICAP Demand Curves, which has been informed by the work performed by the independent consultants, Analysis Group Inc. and 1898 & Co. (collectively “Consultant”), as summarized in their report, *Independent Consultant Study to Establish New York ICAP Demand Curve Parameters for the 2025-2026 through 2028-2029 Capability Years* (Consultant Final Report).² In its Final Report, NYISO Staff generally accepts the conclusions, assumptions and recommendations of the Consultant including the recommended selection of a two-hour, lithium-ion battery energy storage system (BESS) as the appropriate peaking plant technology underlying each ICAP Demand Curve for the 2025- 2029 reset period (“Demand Curve Reset” or “DCR”).³

¹ NYISO Staff, *Proposed NYISO Installed Capacity Demand Curves for the 2025-2026 Capability Year and Annual Update Methodology and Inputs for the 2026-2027, 2027-2028, 2028-2029 Capability Years* (Updated October 2024) (hereinafter, “Staff Final Report”, available at <https://www.nyiso.com/documents/20142/47366127/NYISO-Staff-DCR-Final-Report-Updated.pdf/513a05d5-800e-e022-f248-9406d65f6395>).

² Analysis Group, Inc. and 1898 & Co., *Independent Consultant Study to Establish New York ICAP Demand Curve Parameters for the 2025-2026 through 2028-2029 Capability Years*, Final Report (Updated October 2, 2024), (hereinafter “Consultant Final Report”) available at, <https://www.nyiso.com/documents/20142/47366127/Analysis-Group-2025-2029-DCR-Final-Report-Updated.pdf/08c7f632-c0f9-d821-cc9d-a9cfe18178a1>.

³ Staff Final Report at 4.

NRDC supports many aspects of the Staff and Consultant Final Reports, including the recommendation to adopt a two-hour lithium-ion BESS as the appropriate peaking plant technology for the 2025-2029 DCR. However, we submit these comments to express concern that both the Staff and Consultant Final Reports rely on financial data only through August 2024 and do not account for the significant monetary policy shift that began with the Federal Reserve's interest rate cut in September 2024.⁴ This rate cut, which Chair Powell described as a "recalibration of our policy," marked a broader shift from a restrictive stance aimed at combating inflation to a more accommodative approach that is expected to continue influencing financial markets over the next few years, affecting key financial parameters of peaking plants such as the cost of debt and equity.⁵

As a result, the Consultant and Staff Final Reports' financial assumptions, particularly the weighted average cost of capital (WACC), may be overstated, potentially distorting reference prices for the ICAP Demand Curve. Given the evolving economic conditions, including the September 2024 rate reduction, it is crucial for the WACC assumptions in the DCR to be revised. We urge the Board to direct NYISO and the Consultant to update the WACC to reflect the recent interest rate cut as well as any additional reductions that may occur during the Federal Reserve's Federal Open Market Committee meeting on November 6-7, 2024, before filing the DCR at FERC. Making these adjustments will ensure that the demand curves more accurately reflect current financial conditions and the true cost of new capacity.

⁴ See Federal Reserve, *Federal Reserve issues FOMC statement*, (September 18, 2024), available at <https://www.federalreserve.gov/newsevents/pressreleases/monetary20240918a1.htm>.

⁵ See Federal Reserve, *Transcript of Chair Powell's Press Conference*, (September 18, 2024), available at <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20240918.pdf>; see Federal Reserve, *Summary of Economic Projections*, (September 18, 2024), available at <https://www.federalreserve.gov/monetarypolicy/files/fomcproptabl20240918.pdf>.

I. The Board Should Direct NYISO Staff and the Consultant to Update Financial Parameters to Reflect the Federal Reserve’s “Recalibration” of Monetary Policy Before Filing at FERC

a. The WACC plays a critical in determining accurate ICAP demand curve parameters and cost estimate

The weighted average cost of capital (WACC) plays a crucial role in the both the Consultant and Staff Final Reports (collectively “Final Reports”) because it serves as a key financial parameter in estimating the Gross Cost of New Entry (CONE) for the selected peaking plant technology. WACC reflects the average rate of return required by investors (both debt and equity holders) to finance a new peaking plant, accounting for the proportion of debt and equity in the plant’s capital structure. It is used to levelize the fixed annual costs associated with capital investments over the economic life of the asset, ensuring that all financing costs, including interest payments on debt and expected returns for equity investors, are adequately recovered.

In setting the ICAP Demand Curve parameters, WACC plays a critical role because it directly affects the Gross CONE calculation. A higher WACC indicates elevated financing costs, which increases the estimated Gross CONE, while a lower WACC decreases these estimated costs, potentially resulting in lower reference prices for the ICAP Demand Curve. Notably, in the previous DCR, the process for annual updates was revised to include adjustments to capital costs for constructing peaking plants and calculating the composite escalation factor; however, the WACC is determined at the outset of the DCR and remains fixed for the entire 2025-2029 reset period, without being subject to the annual update process.⁶ Therefore, accurately setting the WACC at the outset is crucial to ensure that the demand curves reflect realistic economic

⁶ See Staff Final Report at 6.

conditions for the reset period, avoiding overestimation or underestimation of the costs associated with providing new capacity.

Given the potential for interest rate fluctuations and changes in financial market conditions, the assumption for WACC must align with the current economic environment to maintain the integrity of the cost estimates. If WACC is overestimated due to outdated data, it can distort the demand curves, leading to higher capacity payments than necessary and impacting the economic signals provided to investors and developers in New York’s capacity market.

b. The Consult’s analyses establishing the cost of equity and the cost of debt are sensitive to Federal Reserve interest rate changes

The Staff Final Report adopted the WACC recommended by the Consultant,⁷ who developed it by analyzing the components of the cost of capital for new peaking plant investments, including the cost of debt and the cost of equity.⁸ This analysis was based on a mix of financing sources and assumed a specific capital structure (debt-to-equity ratio) that aligns with typical financing practices in the power sector.

The cost of debt was determined by evaluating a project developer’s ability to raise funds in debt markets.⁹ The Consultant calculated the after-tax cost of debt using average bond yields from a “Proxy Group” of comparable independent power producers (IPPs) and data on the generic cost of corporate debt, relying on data from June 2, 2024 through August 31, 2024.¹⁰ The Consultant’s Final Report emphasizes that fluctuations in the cost of debt for corporate entities

⁷ *Id.* at 25-27.

⁸ *See* Consultant Report at 62-70.

⁹ *Id.* at 65.

¹⁰ *Id.*

with credit ratings similar to the proxy IPPs closely tracked changes in Federal Reserve interest rates, highlighting the sensitivity of borrowing costs to monetary policy.¹¹

For the cost of equity, which compensates equity investors for their required return on investment (ROE), the Consultant used the Capital Asset Pricing Model (CAPM).¹² This model calculates the cost of equity by adding a risk-free rate of return—usually represented by the yield on long-term government bonds—to an equity risk premium, which accounts for the additional return investors require for taking on market risk.¹³ Specifically, the Consultant employed a 90-day average of the 20-year Treasury rate from June 2, 2024, to August 31, 2024, to determine the risk-free rate,¹⁴ which fails to account for the “recalibration” of monetary policy that began with the Federal Reserve’s interest rate cut in September 2024. Because the risk-free rate is directly influenced by the Federal Reserve’s interest rate policy, changes in the Fed’s rates, such as rate cuts, can significantly impact the CAPM calculation. When the Fed lowers interest rates, yields on government bonds typically decrease, which reduces the risk-free rate used in the CAPM formula. This, in turn, lowers the overall cost of equity. Thus, the CAPM is sensitive to shifts in monetary policy, as these changes affect the baseline rate of return used to evaluate equity investments.

Accordingly, the WACC adopted in the Staff Final Report relies heavily on financial assumptions that are sensitive to shifts in monetary policy, such as changes in Federal Reserve interest rates. The components of the WACC, including both the cost of debt and the cost of equity, are influenced by bond yields and the risk-free rate, which fluctuate with Fed policy actions. Therefore, accurately reflecting current economic conditions in the WACC calculation is essential

¹¹ *Id.* at 65-66.

¹² *Id.* at 67.

¹³ *See* Consultant Final Report, Appendix B, at 2.

¹⁴ *Id.*

to ensure that the financing costs for new peaking plant investments are not overstated, thereby providing a more realistic basis for setting ICAP Demand Curve parameters.

c. The Staff Final Report does not account for the recalibration of monetary policy marked by the Federal Reserve’s interest rate cut in September 2024

The Consultant Final Report asserts that “the appropriate WACC for use in the DCR needs to reflect the project-specific risks associated with the development of a new peaking plant by a merchant developer within the NYCA in the timeframe of interest in this DCR (i.e., 2025-2029).”¹⁵ However, the WACC analysis relied on financial data only through August 2024—i.e., the period just prior to the Federal Reserve’s significant shift in monetary policy. As a result, both the Consultant and Staff Final Report’s WACC calculations do not account for the subsequent reduction in borrowing costs that occurred with the September 2024 interest rate decrease, potentially leading to an overestimation of the financing costs for new peaking plant projects for the entire reset period.

Indeed, prior to September 2024, the Federal Reserve maintained a restrictive policy stance, characterized by higher interest rates aimed at curbing inflation, which had been running significantly above the 2% target. Throughout much of 2022 and 2023, the Fed aggressively raised rates to address inflationary pressures, leading to the federal funds rate reaching a range of 5% to 5.25% by mid-2024. This approach was intended to temper economic growth and reduce demand in the labor market, with the goal of bringing inflation under control.

However, in September 2024, the Federal Reserve took significant monetary policy action by lowering the federal funds rate by 0.5 percentage points, bringing the target range to 4.75% to

¹⁵ Consultant Final Report at 62.

5%.¹⁶ This decision was driven by signs of easing inflation, which had declined from a peak of 7% to 2.2% by August, along with a cooling labor market.¹⁷ Chair Powell described this rate cut as a “recalibration of our policy” aimed at reducing the degree of policy restraint after an extended period of higher interest rates intended to combat inflation.¹⁸ The recalibration reflects the Fed's growing confidence that inflation was moving sustainably toward its 2% target, and it sought to balance the risks of maintaining economic strength while preventing any resurgence in inflation.

Of note, in September 2024, Federal Reserve policymakers also projected the benchmark interest rate would fall by another half of a percentage point by the end of this year, a full percentage point next year, and half of a percentage point in 2026, though they cautioned that the outlook that far into the future is necessarily uncertain.¹⁹ The prospect of further rate reductions was reinforced last week when Chair Jerome Powell indicated the Federal Reserve would likely stick with quarter-percentage-point interest rate cuts at its November meeting²⁰ and again this week when Federal Reserve Bank of New York President John Williams said that he “personally expect[s] that it will be appropriate again to bring interest rates down over time.”²¹ These projections demonstrate a shift toward a more accommodative monetary stance over the coming

¹⁶ Federal Reserve, *Federal Reserve issues FOMC statement*, (September 18, 2024), available at <https://www.federalreserve.gov/monetarypolicy/files/monetary20240918a1.pdf>.

¹⁷ *See id.*

¹⁸ Federal Reserve, *Transcript of Chair Powell's Press Conference*, (September 18, 2024), available at <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20240918.pdf>.

¹⁹ *See* Federal Reserve, *Summary of Economic Projections*, (September 18, 2024), available at <https://www.federalreserve.gov/monetarypolicy/files/fomcprojtab120240918.pdf>.

²⁰ Reuters, *Fed's Powell says rates will, over time, reach 'neutral' level, not on preset course*, (September 30, 2024), available at <https://www.reuters.com/markets/rates-bonds/feds-powell-says-rates-will-over-time-reach-neutral-level-not-preset-course-2024-09-30/>.

²¹ Reuters, *Fed's Williams says interest rate should be cut over time, FT reports*, (October 8, 2024) available at <https://www.reuters.com/markets/rates-bonds/feds-williams-says-interest-rate-should-be-cut-over-time-ft-reports-2024-10-08/>.

years, reflecting expectations of sustained moderation in inflation and the need to support economic growth.

This shift in monetary policy has important implications for the WACC used in the 2025-2029 DCR. By lowering interest rates, the Federal Reserve effectively reduced borrowing costs, which are a key component of the cost of debt. Additionally, as the rate cut influenced the yields on government bonds, it also affected the risk-free rate used in calculating the cost of equity through models like the CAPM. Consequently, the September 2024 rate cut, and the prospect of further monetary easing suggest that the initial WACC estimates in the DCR is overstated, potentially leading to inflated cost projections for new peaking plant projects if not adjusted to reflect the current financial environment.

II. Conclusion and Recommendation for revising WACC assumptions

NRDC urges the Board to take proactive steps to ensure the ICAP Demand Curve accurately reflects the current financial landscape and does not unreasonably burden electricity consumers with inflated market prices. Specifically, we request that the Board direct NYISO and the Consultant to revise the WACC assumptions in the 2025-2029 Demand Curve Reset (DCR) before submitting it to FERC. The adjustments should incorporate the effects of the September 2024 interest rate cut, as well as any subsequent reductions that may occur during the Federal Reserve's Federal Open Market Committee meeting in November 2024. By updating these financial parameters to align with the ongoing monetary easing, the revised WACC will more accurately represent the true cost of capital for new peaking capacity, preventing overestimated costs and ensuring fair and efficient market signals for investors and developers in New York's capacity market.