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July 20, 2009

Mr. Stu Nachmias
Business Issues Committee Chairman for the NYISO
Consolidated Edison Company of New York, Inc.
4 Irving Place—Room 1138
New York, NY 10033

Re: Comments of Financial Marketers on Disaggregated Virtual Trading Concept Design

Dear Mr. Nachmias:

In connection with the planned discussion of the Disaggregated Virtual Trading Concept Design ("DVTC") proposal at the meeting of the NYISO Business Issues Committee scheduled for July 22, 2009, the undersigned Financial Marketers submit the enclosed comments on that proposal. While the Financial Marketers applaud the goal of expanding virtual trading opportunities in the NYISO, the DVTC proposal proceeds from the mistaken assumption that a rapid increase in virtual trading is something to be avoided, rather than encouraged. As a result, the DVTC proposal contains a number of elements—limitation of virtual trading to 40 nodes in New York City, imposition of an anticompetitive and unjustifiable bid fee, and adoption of schedule limitations and a soft bid cap—that would seriously undermine the goal of building a robust virtual trading market in the NYISO.


Financial Marketers have set forth their most serious concerns with the DVTC proposal in the enclosed comments and ask that you and the Committee give them your careful consideration.

Consumers in the NYISO footprint has been deprived of the benefits that a vibrant virtual trading sector can bring for far too long. Instead of focusing on ways to control the number of virtual bids, the NYISO should be installing the necessary computer upgrades and systems that would allow unlimited virtual trading at all nodes across the NYISO.

If you would like to discuss the DVTC proposal or the enclosed comments with us, please let us know.

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Very truly yours,



Carol A. Smoots *NT*
Glenn S. Benson

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Energy Endeavors, LP
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MAG Energy Solutions, Inc.
Pure Energy, Inc.

Enclosure

cc: NYISO President
NYISO Business Issues Committee Members

**COMMENTS OF FINANCIAL MARKETERS ON
NEW YORK INDEPENDENT SYSTEM OPERATOR
DISAGGREGATED VIRTUAL TRADING CONCEPT DESIGN
(July 20, 2009)**

On June 26, 2009, Michelle Gerry submitted a draft presentation entitled "Disaggregated Virtual Trading Concept Design" to the New York Independent System Operator's ("NYISO") Market Issues Working Group ("DVT Concept Design"). The draft presentation proposes a number of changes to the NYISO market rules that would begin a process of gradually expanding virtual trading opportunities in the NYISO. While the undersigned Financial Marketers applaud the goal of expanding virtual trading opportunities in NYISO, we believe that the proposals are far too limited and restrictive. Opening up of the entire NYISO market to virtual trading is long overdue. There is no basis for continuing to deprive consumers in the NYISO footprint of the many benefits that virtual trading provides and that other organized markets have long enjoyed. We call on the NYISO to rework the DVT Concept Design to expeditiously put in place the computer upgrades and systems needed to open up all nodes in the NYISO to virtual trading, remove all unnecessary limitations on the expansion of virtual trading in the NYISO, and reject proposed rules and bid charges that would impede development of a vibrant trading sector.

The DVT Concept Design is based on a mistaken assumption that significantly increasing virtual trading in the NYISO would pose unacceptable risks.¹ That simply is not the case, as demonstrated by the experiences with virtual trading in other markets, including PJM, ISO New England, and the Midwest ISO. The independent market monitors for these markets recognize that virtual trading is critical to a well-functioning market for energy. *See California Independent System Operator Corp.*, 112 FERC ¶ 61,013 at par. 175 (2005). A robust virtual trading sector greatly reduces opportunities for the exercise of market power and provides numerous benefits to the market and consumers.² On the other hand, limitations on virtual trading opportunities deprive the market of liquidity, price convergence and price discovery benefits and facilitate the exercise of market power.

PJM, ISO New England, and the Midwest ISO have long benefited from vibrant virtual trading sectors. As the Federal Energy Regulatory Commission ("Commission") has recognized, virtual trading in these markets has provided a variety of public benefits, including enhanced reliability of electric supply, reductions in the exercise of market power, lowering incentives for buyers and sellers to forego bidding physical schedules in day-ahead markets in expectation of better prices in the real-time markets, improving day-ahead and real-time price convergence, and providing price discovery and liquidity to the market. *See, e.g., Wholesale Competition in Regions with Organized Electric Markets*, Order No. 719, 125 FERC ¶ 61,071 at par. 122

¹ See Draft Presentation at 4 ("How can we maximize benefits while minimizing risks?").

² As Andrew Ott, PJM's Senior Vice President of Markets, was recently quoted as saying, "[I]f we did not have financial participation, we might as well shut [the PJM day-ahead market] down. Essentially, the market could not function without financial participation, period." *Platts Megawatt Daily* at 7 (Nov. 14, 2008). In addition, PJM's Independent Market Monitor, Joe Bowring, was quoted as saying that "it would be difficult to imagine" day-ahead markets operating effectively without participation by financial players. *Platts Megawatt Daily* at 7 (Nov. 14, 2008)

(2008); *California Independent System Operator Corp.*, 116 FERC ¶ 61,274 at pars. 450-451 (2006); *ISO New England, Inc.*, 113 FERC ¶ 61,055 at par. 30 (2005).

Thus, the Commission has ordered the California ISO to rapidly implement virtual trading, which it has found would promote competition and produce other significant benefits for the market and consumers. *California Independent System Operator Corp.*, 112 FERC ¶ 61,103 at par. 175 (2005); *California Independent System Operator Corp* 107 FERC ¶ 61,274 at pars. 157-59 (2004). When the California ISO claimed that it was unable to promptly implement virtual trading, the Commission ordered it to establish interim rules to counter the incentive that load serving entities have to underschedule load until virtual trading could be implemented. *California Independent System Operator Corp.*, 116 FERC ¶ 61,274 (2006). The Commission explained why prompt implementation of virtual trading is essential to a healthy energy market and is not something that should be deferred:

As discussed in previous orders, convergence bidding improves market performance in several ways. Convergence bidding has the effect of expanding the number of competitors and the number of bids into the day-ahead market. By expanding the number of offers to buy and sell in the day-ahead market, convergence bidding helps to prevent the exercise of market power. Without convergence bidding, participants with market power may have the ability to price discriminate between the day-ahead and real-time markets, resulting in a forward price that is systematically different than the expected real-time price.

Convergence bidding reduces the price differences between the real-time and the day-ahead markets, thus reducing the incentive for buyers or sellers to forego bidding physical schedules in day-ahead markets in expectation of better prices in the real-time markets. Additionally, incorporating convergence bidding into the CAISO's tariff will facilitate the CAISO's management of grid operations by allowing it to distinguish clearly between physical bids and bids submitted for financial purposes.

Convergence bidding has proven to be a valuable market design feature in other LMP-based electricity markets. If included in the CAISO's market, convergence bidding could provide such benefits as improving day-ahead and real-time price convergence, as well as reducing the exercise of market power.

Id. at pars. 449-51.

Even in the NYISO, the experience with virtual trading has been highly favorable. Specifically, the NYISO has reported that virtual trading has provided the following benefits for its market and consumers:

- Increased LBMP convergence;
- Increased TCC revenue convergence;

- Provides more degrees of freedom in finding an optimum solution to the security-constrained unit commitment ("SCUC") and dispatch problems and therefore more certainty of converging to a solution;
- Provides a better day-ahead commitment;
- Allows physical load/generation to hedge positions between the day-ahead and real-time markets; and
- Increases liquidity because more participants are in the day-ahead energy market.³

These benefits will only increase if the NYISO market is opened up to virtual trading at all nodes, as has been amply demonstrated in other ISO markets. Thus, the DVT Concept Design is based on the wrong premise. The way to achieve the maximum benefit for consumers in the NYISO footprint at the minimum cost and with the minimum amount risk is not by gradually phasing in virtual trading; it is by opening up the entire NYISO market to virtual trading and fostering a vibrant virtual trading sector that will enhance competition, improve liquidity and price discovery, increase convergence, and provide other benefits. We therefore urge that the NYISO make the following modifications to the DVT Concept Design so that it promotes a rapid expansion of virtual trading in the NYISO.

Node Limitations

Under the DVT Concept Design, virtual trading would be limited to 40 nodes in New York City at this time. This is unacceptable and contrary to FERC precedent. Virtual trading at all nodes has long been in place in PJM, ISO New England, and the Midwest ISO. These ISOs implemented virtual trading with little or no additional costs, delay, or operational problems. And, as noted above, those markets have seen significant benefits from robust virtual trading.

All customers in the NYISO footprint are entitled to the benefits and protection from market power abuses that virtual trading brings. Further delay in opening up the entire NYISO market to virtual trading will only serve to distort the market, invite market manipulation and the exercise of market power by existing utilities, and subject consumers to unnecessarily high energy costs. The NYISO should therefore move as expeditiously as possible to open up virtual trading at all nodes, not just those within New York City. This means putting in place now whatever computer upgrades or systems are necessary for processing such bids. There is no basis for limiting virtual trading to New York City nodes and depriving the rest of the State of benefits that such trading provides. Opening up the entire market to virtual trading is too important to be delayed any longer.

We also would note that the costs of the computer upgrades and systems needed for implementation of virtual trading across all nodes should be allocated through a per-MWh charge to all load, "given the benefits that virtual trading can bring to the marketplace as a whole." *ISO New England, Inc.*, 109 FERC ¶ 61,383 at par. 35 (2004). To allocate the costs

³ See Presentation of NYISO entitled "Virtual Bidding in the NYISO" at slides 7, 15 (Sept. 6, 2006).

exclusively to virtual transactions would discourage virtual bidding, resulting in a greater cost to load. *See id.* The following testimony of Dr. Peter Cramton with respect to the virtual bid charge that PJM once proposed is instructive here:

The proposed per-bid charge would introduce a transaction cost that would undermine the profitability of this and other arbitrage strategies. These strategies have real and positive impacts in the PJM market; hence, the strategies should not be discouraged. Thus, FERC should reject the proposed charge.

The major impact of this and other arbitrage strategies is to increase both supply and demand response in the real-time market. This is highly desirable. One of the greatest difficulties of electricity markets is the absence of both supply and demand response in real time. Since electricity is not storable, both the supply and demand curves are nearly vertical at real time. This makes the real-time market highly volatile, vulnerable to the exercise of market power, and vulnerable to market failure.

Elaborate schemes for monitoring and mitigating the exercise of market power have been and are being established in every functioning electricity market. These schemes are far from perfect, yet are an essential response to the absence of demand and supply response in real time. Arbitrage strategies like the ones employed by Outback provide supply and demand response in the real time market. These strategies lessen PJM's reliance on inefficient and costly automatic mitigation procedures to address market power concerns. The strategies, by increasing supply and demand response in real time, reduce price volatility and reduce the markets vulnerability to the exercise of market power. The strategies are pro-competitive and should not be discouraged.

Although it is true that Outback benefits from its strategy, Outback only is able to capture a fraction of the value its strategy brings to the market. Like most arbitrageurs, much of the value Outback creates is captured by other market participants that benefit from the improved real-time liquidity, reduced price volatility, and more efficient dispatch. Outback's strategy and related arbitrage strategies do impose costs on the PJM eMarket system. These costs necessitate some form of cost recovery. Efficient pricing for the PJM eMarket system should be based on PJM's marginal cost. This marginal cost is clearly zero, once the software and servers are in place. This dictates that PJM should set the per-bid charge at 0. The question then is how best can PJM recover the fixed cost of the eMarket system. These fixed costs should be allocated in a way to minimize the economic distortion caused by the charges. The best practical way for PJM to do this is through a per-MWh charge to all load. This socializes the costs across the greatest possible base, minimizing any economic distortion.

It is tempting for market makers like PJM to allocate fixed costs through per-bid charges. The Federal Communications Commission did a similar thing in some of its early spectrum auctions. The FCC charged bidders a per-minute connection fee to use its auction system, which bidders access through a 900 number. This

resulted in substantial fees on small bidders, thus discouraging participation by such bidders. Of course, it is the presence of such bidders that makes the auction competitive, resulting in an efficient assignment of the spectrum licenses and a fair return to taxpayers for the valuable spectrum resource. Hence, the FCC abandoned its per-minute connection charge, once decision makers recognized the negative effect of the per-minute charge.⁴

Bid Fees

The DVT Concept Design's proposed bid fee must be rejected. It is based on the faulty assumption that the NYISO should be seeking ways to control the volume of virtual bids. The bid fee would serve no other purpose. Unlike any bid fee or similar charge that has been adopted in other markets, the bid fee proposed in the DVT Concept Design is not intended to be a mechanism for the ISO to recover costs. The bid fee is not designed to allocate costs to those who cause them or to those who derive benefits from virtual trading. It is a barrier to entry that has no basis in cost allocation principles. The very idea of a bid charge that *increases* as the volume of bids increases runs counter to all established Commission policies with respect to cost allocation and rate design.

Under the DVT Concept Design, each virtual bid would initially be subject to a fee of \$0.10. The amount of the fee would be ratcheted upwards or downwards as bid volumes increase or decrease, subject to a minimum fee of \$0.03 and a maximum fee of \$1.00. The bid fee has been proposed as means of ensuring that the NYISO has the ability to post the Day-Ahead Market in a timely manner by managing bid volume. By increasing the bid fee as bid volumes increase, the NYISO would severely inhibit the growth of virtual bidding and limit the benefits that it provides. High volumes of bids are something that market rules should encourage, not discourage, as FERC Commissioners Wood and Kelliher have noted:

High volumes of bids and transactions increase the efficiency of the market and contribute to price convergence between real time, day ahead, and bilateral markets. Markets with high price convergence have price signals that are clear, accurate, and transparent and guide efficient short and long term behavior.⁵

Because the nature of virtual trading is to make markets by bidding at multiple trading points or nodes for most hours of the day, and often for small potential financial gains, any per bid charge will have a very serious adverse effect on virtual trading. In addition, such charges greatly increase both trade risk and market risk. Thus, the proposed bid charge could render much virtual trading activity uneconomic.

If the NYISO is seeking to provide the maximum benefit for its consumers at the lowest cost and with the least amount of risk, then the NYISO should be looking for ways to invite more virtual trading, not for ways to control the volume of bids. A high volume of virtual bids

⁴ Affidavit of Dr. Peter Cramton at ¶¶ 11-16, submitted with the Motion to Intervene and Protest of Outback Power Marketing, Inc. and SESCO Enterprises, L.L.C., Docket No. ER04-121-000 (Nov. 28, 2003).

⁵ *ISO New England, Inc.*, Docket No. ER04-121-000, Concurring Opinion of Commissioners Wood and Kelliher (Jan. 15, 2004).

indicates that load likely submitted bids in the Day-Ahead market at a location that reflected demand less than or greater than "could be considered reasonable based on weather and other data." *ISO New England, Inc.*, 113 FERC ¶ 61,055 at par. 30. In such instances, the virtual bids bring the Day-Ahead price into closer convergence with the Real-Time price, stabilizing the market. *Id.* at par. 38 & n.33. What is needed is not bid fees to control virtual bid volumes, but software improvements so that the NYISO can process all virtual bids. That is what will provide the maximum benefit and minimum risk to the market.

Thus, the NYISO should be moving forward as expeditiously as possible to put in place the software needed to ensure that all virtual bids can be timely processed. The cost of such software improvements should be borne by all load on a per-MWh basis because all load benefits from virtual trading for the reasons discussed above with respect to the costs of opening all nodes to trading. Not only would the DVT Concept Design's proposed bid fee act as a barrier to entry and severely limit the benefits that virtual trading can bring to the market, but it would unduly discriminate against those placing virtual bids because it (i) would be imposed exclusively on them, (ii) is neither cost-based nor based on assigning the costs to those who receive benefits, and (iii) would violate every cost allocation and rate design policy of the Commission by ratcheting *up* as volumes increase.

Schedule Limitations

While the NYISO should avoid adopting any restrictions on the amount of virtual trading that can occur, the NYISO should be especially wary of those restrictions that market participants cannot account for *before* placing their bids. Such restrictions are contrary to FERC policy and can severely limit the ability of participants to effectively hedge their market positions and to pursue arbitrage opportunities that benefit the market. One such limitation is the DVT Concept Design's proposal to limit the net sum of virtual schedules at each node to double the amount of combined generation at the node.

No limitation on the net sum of virtual schedules at any node should be adopted or applied unless it is clearly necessary to cure a specific operational problem that has arisen. Even then, the NYISO should be careful to ensure that the limitation is narrowly tailored to address the specific operational problem at issue and that it does not go beyond what is necessary.

The DVT Concept Design's proposal to limit the sum of virtual schedules at each node to double the combined capabilities of generation resources at that location is tantamount to taking a hatchet to address something better handled with a scalpel. It would place needless restrictions on virtual trading, introduce unnecessary uncertainty, increase risk, distort prices, and discourage the development of a vibrant virtual trading sector in the NYISO. To the extent operational circumstances require that any limitations be placed on virtual schedules at a particular node, such limitations should be adopted on as-needed basis to address the specific operational problem at that node with as little disruption to the market as possible.

Soft Bid Volume Cap

The proposed Soft Bid Volume Cap ("SBVC") must be rejected because it is contrary to FERC policy and would discourage virtual trading, distort pricing, introduce unnecessary risks,

and limit the benefits that virtual trading can provide. Under the DVT Concept Design, the SBVC would be determined by the volume of bids that the NYISO can process and still post the Day-Ahead market in a timely manner. When the SBVC is invoked, each market participant who submitted virtual bids would be allowed an equal number of bids for that market day. The SBVC would purportedly provide the following benefits: (i) allow the NYISO to open up virtual bidding at more nodes; (ii) ensure that SCUC can reach solution; (iii) ensure timely Day-Ahead posting; (iv) maximize benefits while minimizing costs; and (v) eliminate the need for a hard bid volume cap.

The SBVC, like the other aspects of the DVT Concept Design discussed above, is based on a faulty assumption: that a high volume of virtual bids is an evil that must be prevented. That assumption has been proven wrong time and time again in PJM, ISO New England, the Midwest ISO, and even with the limited virtual trading that the NYISO has already permitted. In each of these markets, virtual trading has produced numerous benefits and caused no significant operational problems. In fact, one of the benefits that the SBVC would ostensibly provide—ensuring that SCUC can reach solution—is something the NYISO has previously acknowledged can be accomplished through *more* virtual trading, not less. See Presentation of NYISO entitled "Virtual Bidding in the NYISO" at slides 7, 15 (Sept. 6, 2006).

The way to maximize benefits while minimizing costs to the market is not to place caps and limitations on virtual trading, but to embrace virtual trading at all nodes in a way that encourages robust participation by arbitrageurs. To do so, the NYISO should be focused on putting in place the computer upgrades and systems needed to ensure that a high volume of virtual bids can be processed. Putting those systems in place as soon as possible and opening the entire NYISO to virtual trading at all nodes will achieve each of the benefits (i) through (v) that the SBVC would purportedly provide, while also providing the numerous other benefits to the market that virtual trading alone can bring.

Timely Posting of Uplift Charges

The DVT Concept Design fails to propose any improvements with respect to how the NYISO posts uplift charges. To foster a more vibrant virtual trading sector, it is important that market participants be given complete and accurate information on uplift charges on a timely basis. The current failure to timely post such information imposes costs on the market in the form of lost transparency, reduced volumes of virtual bids, and more limited opportunities to effectively hedge market positions. Both PJM and MISO post the amount of uplift charge per MWh within one week of the market day. The NYISO should do the same.

Currently, the uplift charge assessed on each market participant is essentially a black box charge. Posting the uplift charge per MWh within one week of the market day would allow market participants to ensure that they are being allocated uplift charges on a comparable basis and to dispute the calculation of their uplift charge where appropriate. The availability of this information would enhance price discovery and allow all market participants to more effectively hedge their market positions. It also would bring greater efficiency and other benefits to the market, as market participants would be able to base their bids on a more complete and accurate view of the charges to which they would be subject.

Respectfully submitted,

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