NOTICE OF APPEAL OF KEYSPAN-RAVENSWOOD, LLC TO THE BOARD OF DIRECTORS FROM THE MANAGEMENT COMMITTEE'S DECISION AT ITS JUNE 18, 2003 MEETING

I. SUMMARY STATEMENT

KeySpan-Ravenswood, LLC ("Ravenswood") appeals the decision of the Management Committee on June 18, 2003 approving revisions to the Demand Curve (Motion #3). The Management Committee's decision is based upon the New York Independent System Operator, Inc. ("NYISO") Staff and Counsel misinterpretation of the Federal Energy Regulatory Commission's ("Commission's") May 20, 2003 Order approving the Demand Curve ("May Order").[1] The NYISO's interpretation and proposed revisions to the Demand Curve are in conflict with the New York State Reliability Council's ("NYSRC's") reliability rules. The NYISO's interpretation and proposed revisions to the Demand Curve could jeopardize reliability. This misinterpretation of the May Order and choice to ignore the NYSRC rules and requirements will result in potential unnecessary reliability deficiencies and service interruptions. Specifically, the NYISO's misinterpretation and the proposed revisions to the Demand Curve fail to comply with the detailed requirement of the NYISO's tariff that it comply with the NYSRC requirements. Accordingly, Ravenswood respectfully requests the NYISO Board of Directors ("Board") to reject the revisions proposed by the Management Committee on June 18, 2003, and leave the NYISO's June 19, 2003 compliance filing as is.

II. BACKGROUND

A. May 20, 2003, Order

On May 20, 2003, the Commission issued an order approving the implementation of a Demand Curve for the New York Independent System Operator Inc.'s ("NYISO's") installed capacity spot market. The Commission found that the Demand Curve would provide better price signals, encourage long-term bilateral transactions and reduce incentives to withhold capacity. (May Order at 1). In addition, the May Order recognized the critical reliability needs that the installed capacity market

[1] *New York Independent System Operator, Inc.*, 103 FERC &61,201 ("May Order").

serves in New York, as well as the establishment of minimum statewide and locational installed capacity requirements by the New York State Reliability Council ("NYSRC").[2] The Commission specifically noted that with respect to short- and long-term reliability, the New York Public Service Commission ("NYPSC") and the NYISO, pursuant to rules established by the NYSRC, were the appropriate entities to establish the quantity of capacity required to serve customers reliably. (May Order at 8 paragraph 15).

Notwithstanding these long-term improvements and reliability benefits, the Commission recognized there was a transition period in the short term. For example, the Commission understood that the Demand Curve in the first two years reflects a cost less than the cost of entry. (May Order at 5 paragraph 6). It is only in the third year that the Demand Curve will attempt to incorporate the actual cost of entry, thereby providing the efficient price signal the Commission determined was required by the market.

Furthermore, the Commission agreed with the NYISO that "the removal of the "boom-bust" nature of the ICAP market will significantly reduce the incentive to withhold when ICAP supply and demand are relatively close."[3] However, the Commission was still concerned with the potential for capacity withholding when the system would not clear to meet the 118 percent minimum, notwithstanding the NYISO's confidence that it could monitor and control withholding with its

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[2] *See generally*, May Order, ("each load serving entity (LSE) must procure resources equal to 118 percent of its peak load . . ."), at 1 paragraph 2; ("the rate of capacity additions has not kept up with needs and there is the potential for capacity deficiency."), at 3 paragraph 4; ("The NYISO would use the ICAP Demand Curve and the results of the monthly ICAP supply (or bid) auction to define the amount of Installed Capacity each LSE must obtain for the following month (which can be no less than the 118 percent minimum capacity reserve requirement)."), at 4 paragraph 6; ("The potential benefits include: enhancing system and resource reliability;"), at 6 paragraph 9; ("We agree with the NYISO that the proposal will encourage greater investment in generation capacity and thus improve reliability, . . ."), at 8 paragraph 13; and ("we conclude that the proposal has been adequately supported and that there is a reasonable expectation that it will achieve the goal of improving reliability in New York . . ."), at 15 paragraph 35.

[3] May Order at 25 paragraph 67.

existing market monitoring and mitigation measures. Accordingly, the Commission ordered the NYISO to eliminate the Supplemental Supply Fee.[4] (May Order at 25 paragraph 67).

Even though the Supplemental Supply Fee was rejected, the Commission understood that the proposed deficiency charge provides an incentive to ensure an LSE obtains the required minimum installed capacity reserves.[5] In a footnote, the Commission also recognized that eliminating the Supplemental Supply Fee removes some of this incentive for LSEs to ensure that they procure at least the minimum reserve requirement. (May Order at 25 footnote 37). Therefore, the Commission noted its willingness to entertain new proposals to address its concerns about withholding (May Order at 25 paragraph 67) and the possible need for higher capacity payments for capacity purchases when minimum reserve requirements are not met by the Demand Curve spot auction (May Order at 25 footnote 37). On June 19, 2003, the NYISO made a compliance filing to eliminate the Supplemental Supply Fee as required by the Commission.

B. New York State Reliability Requirements

Each year, the NYSRC establishes the minimum installed capacity reserve margin for New York State in order to achieve a loss of load expectation of one day in ten years. The NYSRC performs a study based on various assumptions to determine the statewide installed reserve margin ("IRM"). Two of the assumptions and inputs to this study are the locational installed reserve requirements in New York City and Long Island. Currently, the locational requirement in New York

[4] The Supplemental Supply Fee is a charge to LSEs equal to the localized levelized embedded cost of a gas turbine multiplied by one and one half (1.5), divided by twelve (12), and multiplied by the number of MWs the LSE needs to meet its share of the Locational Minimum Installed Capacity Requirement. NYISO Tariff Third Revised Sheet No. 158, Section 5.14.1(c).

[5] "At levels below 118 percent, the value of capacity rises until it approaches the deficiency charge of 200 percent of the cost of a peaking unit. The proposed deficiency payment is an administratively determined amount that the NYISO, in collaboration with the NYPSC and stakeholders determined to be necessary to provide sufficient incentive to ensure that LSE's would obtain the required capacity reserve levels." (May Order at 21 paragraph 53).

City is 80% and on Long Island it is 93%. Based on these locational requirements and other assumptions, the NYSRC determined that the statewide IRM should be 118%. Accordingly, because at a minimum the NYISO is obligated to meet the NYSRC's minimum IRM, the NYISO must ensure both the minimum locational and statewide requirements are met. Without achieving each of these minimum requirements, the loss of load expectation of one day in ten years would not be achieved, and the NYISO would be in violation of NYSRC rules and reliability would be compromised.

III. ARGUMENT

A. The May Order Is Not Intended To Allow The NYISO To Run Afoul Of The Requirements Of The New York State Reliability Council.

Although the Commission approved the Demand Curve filed by the NYISO, it did so with the requirement that the Supplemental Supply Fee be eliminated.[6] The Commission was concerned that the Supplemental Supply Fee, which was to be set at 1.5 times the cost of entry, would create an incentive for suppliers to withhold capacity notwithstanding the NYISO's confidence that its existing market monitoring and mitigation measures could monitor and control potential withholding. The Commission stated, "the Supplemental Supply Fee may create the potential for capacity withholding when the system does not clear to meet the 118 percent minimum."[7] Next, the Commission added in a footnote that "suppliers accepted in the auction (other than those subject to bid or price limitations due to market power mitigation) must be paid the same price as that paid by LSEs in the auction. Our concern with the Supplemental Supply Fee is that sellers accepted in the auction would receive a lower amount than the Supplemental Supply Fee, and thus, suppliers would have an incentive to stay out of the auction in order to receive a higher price after the auction." (May Order at 25 footnote 37).

[6] May Order at 25 paragraph 67.

[7] May Order at 25 paragraph 67.

The proposal approved by the Management Committee on June 18, 2003 would not only eliminate the Supplemental Supply Fee, it would prohibit the NYISO from procuring capacity required to meet minimum reliability requirements if it was priced even .01¢ above the Demand Curve clearing price. This presents a conflict. The NYISO would not meet minimum reliability requirements because purchasing the additional capacity required for reliability at above Demand Curve clearing prices would be prohibited. The Board should not allow this conflict to occur.

This unnecessary conflict between meeting NYSRC requirements and requiring all purchases of capacity to be at or below the Demand Curve clearing price can be avoided. The Board should direct that the NYISO may procure capacity to meet NYSRC requirements if such capacity: 1) is required to meet NYSRC requirements; 2) is offered at a reasonable price below the deficiency charge; and 3) the offer is reasonable and within the market monitoring and mitigation measures (*i.e.*, the offer does not represent the abuse of market power), regardless of whether the price is above the Demand Curve clearing price. This is the concept that was in the original filing and maintained in the June 19, 2003 compliance filing. During deficient periods, the June 19, 2003 compliance filing allows the NYISO to procure capacity to meet minimum reliability requirements by negotiating with suppliers at prices that satisfy the market monitoring and mitigation measures.

The Commission only eliminated the Supplemental Supply Fee, that is, the initial charge to LSEs at a predetermined rate. Notwithstanding the elimination of the Supplemental Supply Fee, the Commission left in place the NYISO's ability to seek out, negotiate for, and purchase capacity necessary to meet reliability needs at reasonable prices.[8] The June 19, 2003 compliance filing even

[8] The NYISO's original filing included tariff language, in Section 5.14.1(c), which described the market monitor's role in implementation of the installed capacity Demand Curve. This section indicated that offers from installed capacity suppliers would be subject to review pursuant to the NYISO Market Monitoring Plan-Market Mitigation Measures (Attachment H to the Services Tariff). Moreover, suppliers selected by the NYISO to provide capacity after the installed capacity Demand Curve spot market auction would be paid a negotiated price, subject to the standards, procedures, and (footnote continued on next page)

recognizes that by leaving these provisions in place, these provisions enable the NYISO to achieve the reliability it requires at a reasonable price, which is the defining purpose of the NYSRC, and the goal of the NYISO's capacity market as well as the Demand Curve.[9]

An example of the conflict is as follows. During periods when installed capacity deficiencies may exist, special case resources, new resources and even existing resources may be able to provide additional installed capacity and reliability to the market. However, the investments necessary to bring this capacity to the market may cost in excess of the Demand Curve clearing price for a number of legitimate reasons, but still be below the Supplemental Supply Fee. This situation is magnified in the first few years when even the Commission recognizes that the Demand Curve reflects prices that are less than the cost of entry. Accordingly, the NYISO could face a situation where a resource would be willing to provide reliability service to meet minimum requirements, but not at the clearing price of the Demand Curve because of legitimate cost factors and/or the Demand Curve being set below the cost of entry. If this occurs at a time of deficiency, and the NYISO refuses to procure the capacity, it would result in the NYISO not meeting the NYSRC minimum reliability requirement. This is not a desirable result.

The NYSRC rules do not allow the NYISO to choose not to meet reliability requirements because they are too expensive. In other words, the NYISO cannot choose to be deficient simply because the cost of reliability is in excess of the Demand Curve clearing price. That is not to say that the NYISO must procure capacity at any price. The Commission and the NYISO may and have

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remedies in the Market Monitoring Plan-Market Mitigation Measures. The May Order did not propose changes these procedures potentially required to meet reliability requirements and the NYISO's June 19, 2003 compliance filing did not change them either.

[9] "[W]e conclude that the proposal has been adequately supported and that there is a reasonable expectation that it will achieve the goal of improving reliability in New York . . . ." (May Order at 15 paragraph 35).

established several market monitoring and mitigation measures that protect against the potential of withholding of capacity to create excessive prices. Therefore, if the NYISO requires additional capacity to meet NYSRC requirements, and it is offered and available at a reasonable price and within the market monitoring and mitigation measures, *i.e.*, the offer does not represent the abuse of market power, then the NYISO should procure the capacity necessary to meet reliability requirements.

As noted earlier, the ability of the NYISO to procure this capacity at prices in excess of the Demand Curve clearing price is especially important during the first two years of the Demand Curve while it is artificially set at below the cost of entry to ameliorate potential rate impacts. Resources cannot be expected to provide reliability services for less than their costs, especially if they will address a short-term reliability issue and the potential to recover costs through capacity revenue is limited to one or two occurrences in a single six-month procurement period.[10] These short-term investments need to be recovered over very short periods, and therefore may be in excess of the Demand Curve clearing price. Specifically, special case resources that are not in the primary business of generating electricity, new resources accelerating construction schedules to meet the growing needs of demand, or even existing resources with the potential to make short-term investments in facilities to meet short-term reliability needs, will decide whether or not to participate in the market, or seek to participate earlier than planned, based on the short-term costs of doing so and the opportunity to recover those costs in the short term. Creating a situation where these potential resources would have no opportunity to recover the cost of providing necessary reliability services is not constructive.

[10] It should also be noted that due to the capacity market in New York consisting of two six-month procurement periods, resources that have costs above the Demand Curve have to receive revenues in excess of the cost of entry in the summer procurement period to offset their inability to receive their costs in the winter procurement period. Revising the NYISO market to an annual requirement would mitigate this issue and eliminate one of the translations required under the existing Demand Curve design, providing further visibility of the *annual* cost of providing reliability.

To prevent this potential reliability deficiency, the Board should direct the NYISO to implement the Demand Curve in a manner that meets the NYSRC reliability requirements and protects against withholding with its market monitoring and mitigation measures. The NYISO could then ensure that the NYSRC minimum reliability requirements are maintained at a reasonable cost. The Board should recognize that the Commission did not intend by its May Order to establish the Demand Curve clearing price, which will be at levels below the cost of entry in at least the first two years, as a price cap and sacrifice adherence to the installed capacity reserve requirements. Therefore, the Board should reject the Management Committee's June 18, 2003 modifications and allow the June 19, 2003 compliance filing to remain unchanged.

B. The NYISO's Original Filing Efficiently Protected Against Withholding, Yet Allowed The NYISO To Meet Minimum Reliability Requirements.

The NYISO's original filing contemplated the possibility of the Demand Curve clearing price being less than the cost of certain resources required for reliability. To ensure reliability, the NYISO's original filing proposed procuring additional capacity at prices above the Demand Curve clearing price under the supervision, monitoring and control of the NYISO market monitor.[11] In that way, reliability could be maintained at reasonable prices. The Commission did not instruct the NYISO to eliminate this language; it only instructed the NYISO to eliminate the Supplemental Supply Fee. That is exactly what the NYISO did in its June 19, 2003 compliance filing.

While the Demand Curve filing was pending approval at the Commission, a stakeholder proposal to further refine this procurement process at levels above the Demand Curve clearing price was developed and approved by the NYISO Business Issues and Management Committees. As was the case with the NYISO's original filing, the proposed refinement also allowed for the procurement of capacity at prices above the Demand Curve clearing price. However, the refinement required

[11] NYISO Tariff Third Revised Sheet No. 158, Section 5.14.1(c).

preapproval of such offers before they could be made in the spot market Demand Curve capacity auction. The NYISO informed the Commission of the potential for this revision in its comments in response to protests, and the Commission recognized the potential for such revisions and its willingness to entertain new proposals that address withholding.[12]

While these proposed refinements were being reviewed by the Board, the Commission issued the May Order. As a result, the NYISO and market participants revisited the refinement pending before the Board and, over Ravenswood's objection, NYISO staff and legal counsel decided that the May Order prohibited the NYISO from procuring any capacity from the spot market auction at levels above the Demand Curve clearing price. Accordingly, the NYISO and most market participants overturned the prior refinement and replaced it with a proposal, which was submitted to the Board, that allows reliability to be compromised in favor of price.

As noted above, Ravenswood disagrees that this is the intent of the Commission's May Order, and respectfully requests that the Board reverse the Management Committee's decision to clarify that the May Order did not alter the NYISO's original filing in this regard and does not diminish the NYISO's obligation to meet reliability requirements at reasonable costs. The NYISO's current interpretation misreads the May Order as establishing the Demand Curve clearing price, which is by definition less than the cost of entry in the first two years, as the new price cap. Establishing the price cap at levels below the cost of entry, even if it is only for a limited period of time, is a further disincentive to investment and, more importantly, could jeopardize reliability. The Board should not allow the NYISO to modify the Demand Curve pursuant to the Management Committee's decision.

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[12] May Order at 25 paragraph 67.

IV. CONCLUSION

Ravenswood respectfully urges the Board of Directors to reverse the erroneous decision made by the Management Committee to approve the proposed revisions to the Demand Curve, on the basis that the proposed revisions are in conflict with the NYISO's obligations to meet the NYSRC's reliability requirements. NYISO Staff should be directed to comply with the Commission's Order by removing the Supplemental Supply Fee and leaving in place language intended to allow the NYISO to achieve reliability at reasonable prices as was done in the June 19, 2003 compliance filing.

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Respectfully submitted,

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