

City of New York

July 3, 2003

Via Hand Delivery

Mr. John W. Boston
Board Chairman
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303

c/o Mr. William J. Museler
President and Chief Executive Officer
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303

Re: Notice of Motion in Opposition to Appeal of the Management Committee's June 18, 2003 Decision Concerning Revisions to the Capacity Market Demand Curve

Dear Chairman Boston:

Pursuant to the Procedural Rules for Appeals to the NYISO Board, The City of New York hereby submits three copies of its Motion in Opposition to the Keyspan-Ravenswood, LLC appeal of the Management Committee's decision at its June 18, 2003 meeting to implement Demand Curve revisions.

A copy of this Notice of Appeal has been electronically transmitted to Ms. Kristen Kranz and Ms. Diane Egan to facilitate service on the members of the Management Committee and electronic website posting.

Very truly yours,
/s/ Michael Delaney
Michael J. Delaney, Esq.

Attachments

**Motion in Opposition By The City of New York
To Appeal of The Management Committee's June 18, 2003
Decision Concerning Revisions to the Capacity Market Demand Curve**

I. Preliminary Statement

In accordance with Article 5 of the NYISO Agreement, and Section 4.01 of the Procedural Rules for Appeals to the ISO Board, the City of New York (City) hereby files its Motion in Opposition to the appeal by Keyspan-Ravenswood, LLC (Keyspan) of the Management Committee's action at its June 18, 2003 meeting to approve revisions to the capacity market Demand Curve. The Committee's action was taken in direct response to a May 20, 2003 Order from the Federal Energy Regulatory Commission (Commission), which directed the elimination of the Supplemental Supply Fee (SSF) in order to reduce the likelihood of withholding by capacity suppliers in the capacity auction.¹

One of the principal changes made in the revisions was to permit NYISO purchases of additional capacity in the event of an auction deficiency, but to limit the price paid in such secondary transactions to a level not exceeding that reflected in the applicable Demand Curve. Keyspan asks the Board to overturn the decision of the Management Committee, and to permit the purchase of capacity by the NYISO at levels above the Curve, so long as those prices remain "reasonable."

For the reasons outlined below, the City views the Keyspan position as being both unreasonable and inconsistent with the expressed concerns of the Commission in its May 20 Order, and urges the Board to reject the Keyspan appeal.

¹ Commission Order in *New York Independent System Operator*, Docket No. ER03-647-000, p.25, n.37 (May 20, 2003)

II. Argument in Opposition

As the Board is well aware, the implementation of the Demand Curve by the NYISO has been a highly contentious issue both here and in the subsequent proceedings before the Commission. However, barring reconsideration by the Commission of its May 20, 2003 Order, or possible judicial intervention, the existence of the Demand Curve is now a fact of life in New York. Many consumer interests vigorously opposed the concept out of a concern over the likely rate impacts associated with the Curve, but the Board reached a conclusion that, in its view, the potential benefits outweighed such contrary considerations. It is universally recognized that there will be a considerable rate impact flowing from implementation of the Curve. While there have been conflicting views expressed over the likely dimensions of that impact, it is fair to say that all interested parties recognized that capacity prices would rise under the Curve.

Yet, seemingly not content with the prospect of such higher (and rising due to the Curve phase-in mechanism) prices, Appellant seeks to have the NYISO make capacity purchases at levels exceeding even those generated by the Demand Curve. Such a practice would impose still higher prices on New York ratepayers. Moreover, it would potentially encourage the forms of capacity auction gaming that the Commission expressed specific concerns over in its Order.

In advancing its proposition, Keyspan raises the specter of lack of reliability, suggesting that the response of the NYISO staff and the Management Committee to the Commission's May 20 Order is inadequate to meet Reliability Council requirements. This purported concern is misplaced, and is principally employed to justify a proposal that suffers from virtually the same infirmities that the late SSF manifested - the creation

of a prospect that staying out of the auction would yield higher capacity prices later. Such a market scheme would thus create a perverse incentive, and is particularly inappropriate in a system in which generators or other capacity suppliers are the only active bidders.

It is hardly sufficient to suggest, as Keyspan does, that only “reasonable” prices above the Demand Curve clearing level would be paid,² and that in any case market monitoring would suffice to prevent abuses. At least in the present Demand Curve context, the fluid concept of reasonableness would be arguably undefined – and perhaps indefinable, except by the application of additional administrative interference with the interplay of capacity market forces. While the NYISO has a vigorous market monitoring and mitigation system in place, that fact alone may well not be sufficient to adequately limit capacity market gaming, as the recent experience in a neighboring capacity market reveals all too clearly.

In 2001, the PJM Interconnection (PJM) market experienced a market distortion that makes this point tellingly, and suggests that structural limitations in capacity markets must be in place in addition to market monitoring and mitigation tools. It is just this sort of appropriate structural market limit that the Management Committee vote of June 18 implemented. While the precise form of the capacity market in PJM is not entirely comparable to that in the New York Control Area, and of course does not have a Demand Curve in place, the events of early 2001 provide a serious cautionary note – and one that the Commission itself alluded to in eliminating the SSF here.³

² Keyspan Appeal, p. 8

³ Order of May 20, 2003, p.25

In early 2001, PJM capacity market prices soared virtually overnight from less than \$1.00/megawatt-day to over \$177/megawatt-day – the applicable capacity deficiency rate. Following an investigation by the PJM market monitoring unit, this dramatic increase was attributed principally to the actions of one pivotal capacity owner that was in a position to withhold, and to thereby distort the entire regional capacity market. Due to a structural flaw in the then-existing PJM capacity market design, it was an economically rational decision for a pivotal bidder to engage in such withholding in order to obtain supranormal revenues for its capacity.

The Pennsylvania PUC found, based on its own investigation and that of the PJM MMU, that one firm both exercised market power for capacity, and also used its role as a member of the PJM Reliability Assurance Agreement (RAA) Reliability Committee to prevent or delay market rule changes needed to end the putative exercise of market power.⁴

Ultimately, a capacity market redesign was submitted by PJM to the Commission, and the appropriate RAA amendments were accepted by the FERC in May of 2001.⁵ While the corrective measure taken was primarily to broaden the pool of recipients of the deficiency charge (thus reducing the individual incentive to profit by forcing a deficiency), the same entity suspected of distorting the market argued that the RAA changes would threaten PJM system reliability.⁶ The Commission was unpersuaded by this claim, and approved the RAA changes.

⁴ Pennsylvania PUC Docket No. I-000100090 (Statement issued June 13, 2002). *See also* Statement of PUC Commissioner Aaron Wilson, Jr. of the same date.

⁵ *PJM Interconnection, LLC*, FERC Docket No. ER01-1440-000, Order Accepting Amendments to RAA, (May 4, 2001), 95 FERC 61,175; *aff'd in PPL Electric Utilities Corp. v. FERC*, (D.C. Circuit No. 01-1369, November 26, 2002)

⁶ *Id.* at p. 5

The PJM experience cited here is germane to the NYISO in that it illustrates in a rather stark fashion the general principle that capacity markets are clearly subject to manipulation, even if a vigilant MMU is in place. This is obviously not a mere fanciful or theoretical concern on the part of the City, or of other consumer interests in the NYCA - or vitally interested parties elsewhere.⁷ More importantly, as we observed above in n.3, the Commission itself took specific note of the prior PJM case in issuing its May 20 Order. It is therefore reasonable to infer that the PJM events have informed the Commission's judgment here concerning the potential threat posed by flawed market structures, or those with the potential for unintended adverse market consequences.

In essence, the proposal advanced by Keyspan in its appeal suffers from essentially the same deficiencies as the former SSF, and should be rejected by the Board. As fn. 37 of the May 20 Order makes clear, the Keyspan formulation would be contrary to the clearly expressed intent of the Commission. Inherent in that footnote is the notion that capacity prices higher than those generated by the Demand Curve create a risk of market distortions and gaming incentives.

Moreover, the Commission made explicit the point that suppliers accepted in the auction must be paid the same price as that paid by LSEs. The Commission also implicitly recognized in its Order the somewhat experimental nature of the Curve – and in doing so it suggested that the NYISO acquire some experience with its operation, and that if it proves inadequate to its purpose, the Commission would entertain proposals for an adjusted Curve structure. Such experience has not yet been acquired by the NYISO,

⁷ Indeed, it is noteworthy that one of the parties who raised specific concerns over the market distorting effects of the former SSF proposal was PJM's own Market Monitor. *See Motion to Intervene of PJM Interconnection, LLC* in FERC Docket No. ER03-647-000, Declaration of Joseph E. Bowring, Manager, PJM MMU, p.4, ¶ 11 (April 16, 2003)

and the Board should recognize that this is not the time to create still another potential incentive for attempts to game an emergent capacity market. To do as Keyspan suggests in its appeal would risk the NYISO opening itself to a variant of the behavior that gave rise to the Commission's concerns.

New York consumers are now subject to the higher prices associated with the Demand Curve. While the Board and others ultimately concluded that the potential value of the Curve outweighed its concededly higher capacity prices, no defensible basis exists for now exceeding even those higher Curve prices, as Keyspan proposes. This is particularly true in that, as some have already noted,⁸ the present severe market glut of generation facilities means that the NYISO's current estimate of the embedded levelized price of a GT is itself likely inflated. If this contention is accurate, the purported cost of entry embodied in the Curve is artificially high. In any case, there is no reason to introduce yet another rate impact on a Demand Curve structure that has yet to be tested in our market.

Finally, it should be noted that Keyspan, in its assertion concerning the NYISO market mechanism approved in the Management Committee vote, suggests that payment above the Demand Curve clearing price is thereby prevented. This contention ignores the dynamic effect of withholding from the auction - the fact that capacity is not bid in will itself move the Curve. Thus, capacity payments will likely be made above the clearing price that would have prevailed if the additional capacity had not been withheld.

⁸ See e.g., Board Appeal by NYSEG/RGE of February 13, 2003 MC vote implementing a Demand Curve, at p. 3

III. Conclusion

For all the above reasons, the City urges the Board to reject the appeal lodged in this matter, and uphold the June 18, 2003 decision of the Management Committee to revise the Demand Curve provisions.

Dated: July 3, 2003

Respectfully submitted,

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