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July 8, 2003

Hon. John W. Boston
Chairman, Board Of Directors
New York Independent System Operator, Inc.
c/o William J. Museler, President & CEO
New York Independent System Operator, Inc.
3890 Carman Road
Schenectady, NY 12303

Re: **Motion in Opposition by New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation To Notice Of Appeal filed by KeySpan-Ravenwood, LLC of the Management Committee's June 18, 2003 Decision Concerning Revisions to the Capacity Market Demand Curve**

Dear Chairman Boston:

Enclosed for filing are three copies of the Motion in Opposition of New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation to the Notice Of Appeal filed by KeySpan-Ravenwood, LLC of the Management Committee's June 18, 2003 Decision Concerning Revisions to the Capacity Market Demand Curve, pursuant to Section 5.07 of the ISO Agreement and Article IV of the Procedural Rules for Appeals to the ISO Board. A copy of this submission has been electronically transmitted to NYISO Staff for purposes of service on the members of the Management Committee.

Very truly yours,

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Enclosure

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MOTION IN OPPOSITION OF
NEW YORK STATE ELECTRIC & GAS CORPORATION AND
ROCHESTER GAS AND ELECTRIC CORPORATION
TO NOTICE OF APPEAL OF THE MANAGEMENT
COMMITTEE'S JUNE 18, 2003 DECISION CONCERNING
REVISIONS TO THE CAPACITY MARKET DEMAND CURVE

On June 27, 2003, KeySpan-Ravenswood, LLC ("Ravenswood") submitted its Notice of Appeal of the Management Committee's ("MC") June 18, 2003 approval of revisions to the capacity market (Motion #3 or "Demand Curve Revisions"). New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation (collectively the "Energy East Companies") respectfully submit this Opposition to Ravenswood's Appeal pursuant to section 4.01 of the Procedural Rules for Appeals to the ISO Board dated November 17, 1999. The Energy East Companies request that the Board of Directors ("Board") of the New York Independent System Operator ("NYISO") promptly reject Ravenswood's Appeal and allow the Demand Curve Revisions to be filed with the Federal Energy Regulatory Commission for the reasons discussed below.

I. EXECUTIVE SUMMARY

When the NYISO filed its proposal for a demand curve[1] to replace its existing installed capacity ("ICAP") market, it stated that the NYISO would purchase additional ICAP from the market at a supplemental fee ("Supplemental Supply Fee") of up to 1.5 times the estimated levelized cost of new entry for a single cycle gas turbine unit at those times when the NYISO capacity auction failed to produce enough capacity to meet the state's reserve requirement under the Demand Curve. The Commission rejected the Supplemental Supply Fee proposal on the grounds that it would encourage

[1] *New York Independent System Operator, Inc.*, FERC Docket No. ER03-647-000 (NYISO Demand Curve Compliance Filing, June 19, 2003) ("June 19 Compliance Filing"). The modifications to the ICAP market proposed in the June 19 Compliance Filing have become known as the "Demand Curve" and such term will continue to be used to refer generally to modifications to the ICAP market that employ an administratively determined curve to determine capacity prices.

withholding. *New York Independent System Operator*, Order Conditionally Accepting For Filing Tariff Revisions, 103 FERC ¶ 61,201 at ¶ 67 (May 20, 2003) ("May Order"). Pursuant to the May Order, if the NYISO purchases capacity outside of the auction, the NYISO should pay up to the auction clearing price, but not more, so as not to create an incentive to withhold capacity from the auction. In its Appeal, Ravenswood argues that when the NYISO purchases supplemental capacity, it should be required to pay suppliers their bid price, not the auction clearing price resulting from the application of the Demand Curve. Otherwise, Ravenswood claims, the NYISO will not be able to meet its reserve requirement.

The Board should reject Ravenswood's Appeal for several reasons. First, in the May Order, the Commission rejected the Supplemental Supply Fee aspect of the NYISO's proposal and further prohibited the NYISO from paying a supplier more than the Demand Curve clearing price.[2] The MC's approval of the Demand Curve Revisions recognized this, and the NYISO has an obligation to comply with the May 20 Order, which has not been stayed.

Second, it is premised on incorrect facts. The elimination of the Supplemental Supply Fee does not mean that the NYISO will not purchase sufficient quantities of capacity to meet the reserve requirement. Rather, it just means that the NYISO will pay a price less than what Ravenswood wants.

Third, if granted, Ravenswood's request will create significant market power abuse and gaming opportunities for suppliers. Forcing the NYISO to pay suppliers their bid prices above the auction clearing price for capacity will put the NYISO in the position of being blackmailed and will once again encourage suppliers to withhold capacity from the market. Moreover, the current market power monitoring and mitigation plan does not contain sufficient protections to address economic withholding of capacity.

Fourth, paying a price above the Demand Curve's auction clearing price will distort the effect of the Demand Curve. It will create a situation where some supply will be paid a Demand Curve price and some will be paid a much higher price. The Demand Curve is premised on paying all capacity suppliers a pre-determined administratively set price.

II. BACKGROUND

In the May Order, the Commission agreed with Consolidated Edison Company of New York, Inc. and Orange and Rockland Utilities that the Supplemental Supply Fee part of the Demand Curve filing had the potential to encourage capacity withholding when the system does not clear to meet the 118 percent minimum reserve requirement. Accordingly, the Commission ordered the NYISO to eliminate the Supplemental Supply Fee.[3] (May Order at 25, paragraph 67). On June 18, 2003 the MC passed revisions, as adopted by the Business Issues Committee on June 10, 2003, to clarify in part that "the supplemental supply fee shall be equal to the applicable Market-Clearing Price of Unforced Capacity determined in the ICAP Spot Market Auction."[4] June 19, 2003 was the statutorily mandated deadline to request rehearing of the May Order. Ravenswood did not request rehearing. Instead, on June 23, 2003, Ravenswood submitted a Motion for Clarification of the Commission's decision regarding the Supplemental Supply Fee aspect of the May Order.[5] On June 27, 2003, Ravenswood submitted the instant appeal that is nearly identical in substance to the Motion for Clarification it filed with the Commission.

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[2] May Order, ¶67 and footnote 37.

[3] May Order at 25 paragraph 67. The Supplemental Supply Fee is a charge to LSEs that was 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).

[4] NYISO Management Committee Meeting, Motion #3, June 18, 2003.

[5] *New York Independent System Operator, Inc,* Docket No. ER03-647-000, Motion for Clarification of Keyspan-Ravenswood, LLC, (June 23, 2003).

III. THERE IS ONLY ONE REASONABLE INTERPRETATION OF THE MAY ORDER AND THE NYISO MUST BE ALLOWED TO COMPLY WITH IT.

In recognizing the incentives for gaming associated with the Supplemental Supply Fee, the Commission specifically stated that, "[s]uppliers accepted in the auction … must be paid the same prices as that paid by LSEs in the auction" and prohibited the NYISO from paying a supplier in excess of the Demand Curve clearing price.[6] The language is clear and unequivocal. The MC's approval of the Demand Curve Revisions recognized this. The FERC filing approved by the MC is necessary to bring the NYISO's tariff in compliance with the May Order. Ravenswood's Appeal recognizes the NYISO's interpretation of the May Order in stating that, "[N]YISO 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."[7] If Ravenswood wanted to contest the holding of the May Order, it should have sought rehearing within the statutorily mandated deadline. Neither Ravenswood nor any other party sought rehearing or a stay of the FERC order on this issue. There is no legal basis for failing to comply with the May Order. The Energy East Companies urge the Board to allow the NYISO to proceed expeditiously with the FERC filing.

IV. THE NYISO SHOULD NOT PURCHASE ICAP FROM RAVENSWOOD OR ANY OTHER SUPPLIER AT A PRICE THAT IS HIGHER THAN THE AUCTION CLEARING PRICE UNDER THE DEMAND CURVE

The June 19 Compliance Filing did not change the NYISO's earlier Demand Curve filing concerning the NYISO's purchases of capacity when the auction clears below the 118% reserve level. Pursuant to the original filing, the NYISO would purchase additional ICAP from the market at a Supplemental Supply Fee of up to 1.5 times the estimated levelized cost of new entry for a single cycle

[6] May Order, ¶67 and footnote 37 (emphasis added).

[7] Ravenswood's Appeal, p. 9.

gas turbine unit and then charge that price to all load serving entities ("LSEs") for deficient amounts up to the Installed Reserve Margin. The revenue collected from the LSEs would be used to pay suppliers who offer capacity in this supplemental process. Dr. David Patton and several other parties expressed concern that the Supplemental Supply Fee would encourage withholding and advised against adoption of the Supplemental Supply Fee. In the May Order, the Commission agreed "that the Supplemental Supply Fee may create the potential for capacity withholding when the system does not clear to meet the 118 percent minimum" (May Order at ¶ 67) and, as noted above, rejected the Supplemental Supply Fee aspect of the NYISO's proposal and further prohibited the NYISO from paying a supplier more than the Demand Curve clearing price.[8].

Ravenswood now argues that if the Supplemental Supply Fee is eliminated the only price that the NYISO should be allowed to pay suppliers for providing such supplemental capacity is the suppliers' bid prices, not the auction clearing price under the Demand Curve. Ravenswood further argues that if the NYISO does not pay the suppliers' requested prices for supplemental capacity, the NYISO will not meet its reserve requirement and violate various reliability rules. According to Ravenswood, this shortfall will occur because no supplier will sell ICAP at less than its bid price and therefore, unless the NYISO pays that bid price, the reserve requirement will not be met. This is a formula for gaming and the exercise of market power.

The Board should reject Ravenswood's Appeal on the grounds that: (1) it is premised on incorrect facts and is disproved by history; (2) if granted, it would create significant market power abuse and gaming opportunities for suppliers; and (3) it will distort the effect of the Demand Curve.

A. Ravenswood Incorrectly Claims That The NYISO Will Not Purchase Sufficient Capacity

[8] May Order, ¶67 and footnote 37.

Ravenswood argues that the NYISO will not have sufficient capacity and will violate reliability requirements, if it is not forced to buy supplemental capacity at prices above the clearing price under the Demand Curve.[9] This is not true.

Eliminating the Supplemental Supply Fee will not cause the NYISO to fail to purchase quantities of capacity sufficient to meet the state's reliability needs. Rather, the elimination of the Supplemental Supply Fee merely avoids unjust and unreasonable prices that the NYISO would pay for such capacity. Rather than pay a Supplemental Supply Fee of 1.5 times the clearing price or Ravenswood's bid price, both of which could be significantly above the clearing price under the Demand Curve, the NYISO will buy additional capacity at a price determined by the Demand Curve. History has already disproved Ravenswood's theory that suppliers will not sell at the Demand Curve clearing price after the spot market auction. In the last Demand Curve auction, which cleared at 123% in-city, the NYISO went out and procured an additional 25 MW of capacity from suppliers <u>at the Demand Curve clearing price.</u>

Requiring the NYISO to pay a higher bid price for capacity that is completely demand inelastic, would create a formula for blackmail. The NYISO, forced to buy additional capacity, would be at the mercy of whatever price a supplier wants to set.

B. Ravenswood's Relief, If Granted, Would Create Gaming Opportunities For Suppliers and Market Power Problems

The Commission, recognizing concerns raised by Dr. Patton and others stated that "removing the Supplemental Supply Fee will reduce the incentive for suppliers to withhold capacity from the ICAP auction, and thus, will encourage a *greater amount of capacity to be bid into the spot market auction*". May Order, ¶ 67 (emphasis added). In fact, the May Order clearly indicates that one of the primary

[9] Ravenswood's Appeal, pp. 4-7.

reasons for accepting the Demand Curve was its potential to reduce incentives to withhold capacity by eliminating "the 'boom-bust' nature of the ICAP market." May Order, ¶ 67.

Paying suppliers the auction clearing price for capacity (i.e., the price produced by the application of the Demand Curve), will allow the NYISO to implement the Commission's order in a manner that is most likely to reduce incentives to withhold. As several intervenors established at FERC, the Supplemental Supply Fee would encourage withholding in the ICAP Spot Market Auction, drive the market deficient, and re-offer capacity at the much higher maximum Supplemental Supply Fee rate. It was the potential for this behavior that gave the Commission pause. May Order, slip op. at p. 25, ¶ 68. "… [S]uppliers accepted in the auction … must be paid the same price as that paid by LSEs in the auction. The 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, ¶ 67, fn. 37. Ravenswood's proposal to allow bidding and payment above the curve would only bring back the market power abuse and gaming opportunities that the elimination of the Supplemental Supply Fee has mitigated. Arguing that such above the curve bidding is acceptable because the market monitoring program will fix it is misleading. The existence of market monitoring did not prevent withholding from occurring in the past, and any such structure would require development of new monitoring standards, procedures, and penalties, all of which would be more complex and intrusive than are warranted when simply paying the price on the curve solves the potential problem.

In the May Order, the Commission noted that it was "willing to entertain any new proposal that address[ed their] concerns about withholding." May Order, ¶ 67. The NYISO can address the concern by paying all suppliers according to the curve. Prices on the curve are higher than they were prior to the curve.[10] In addition, more capacity is now purchased.[11] To require loads to pay even more than this to induce capacity to come into the market is unreasonable when there is no indication supply from generation and demand response is not or will not be available.

In addition, allowing suppliers to receive a price above the curve, and thus increase the potential for withholding, cannot be justified on a cost basis as Ravenswood attempts to do.[12] Ravenswood neglects to note the impact of net revenues from the energy and ancillary service markets, a critical concept in setting the curve. Suppliers receive higher energy and ancillary service prices and net revenues in times of relatively tighter supply. In the NYISO, prices are now more likely to reflect scarcity as a result of the NYISO's recent implementation of scarcity pricing rules and modification of the current market mitigation measures for 10 minute non-spinning reserves.[13] The potential for increased net revenues from the NYISO energy and ancillary service markets is great in NYISO.[14] The Demand Curve has already substantially increased the capacity revenues suppliers receive in the New York market. To add yet another source outside the Demand Curve when that source can lead to market manipulation is not necessary. Ravenswood's failure to acknowledge energy and ancillary service market net revenues appears consistent with its mischaracterization of the Commission's holding in the May Order.

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[10] Prices in NYC have increased approximately $2.00 (20%) and in Rest of State by close to $1.70 (approximately 300%).

[11] In New York State (as a whole) load serving entities purchased an additional 2000MW in excess of the 118% reserve requirement (or 124%).

[12] Ravenswood Appeal, p. 6.

[13] The Commission recently approved the NYISO's tariff amendments (a) to implement scarcity pricing to increase real-time energy prices to reflect economic demand response and special case resource prices and to set energy prices at $1,000 per MWH in times of 10-minute reserve deficiency (*NYISO*, 103 FERC ¶ 61,339 (June 20, 2003)); and (b) to lift the $2.52 cap on 10-minute non-synchronous reserves that has been in place since 2000 (NYISO, 104 FERC ¶ 61,002 (July 1, 2003).

[14] See the Company's April 28, 2003 Answer in this docket at Section III.C for a more complete discussion of the NYISO's and New York Public Service Commission's estimates of the substantial net revenues for energy and ancillary service sales available to suppliers.

Ravenswood claims that the Commission determined that the market required the Demand Curve in Year 3 to reflect the full cost of entry of a new unit without any offsets to reflect net revenues from energy and ancillary service sales. (*See* Ravenswood's Appeal at 2, 6, 7, 8, 10.) The Energy East Companies wish to clarify for the record that Ravenswood's revisionist interpretation of the May Order is erroneous. The Commission held as follows: "The Commission finds that if parties, such as the Multi-Sector Protestors, have issues to raise in reference to the parameters of the Demand Curve, Section 5.13.1(b) [of the NYISO Services Tariff] provides an avenue to address those issues." (May Order, ¶ 61.) The Commission then quotes the following passage from the tariff: "Section 5.14.1(b) states: 'Among other criteria, the review will determine the current localized levelized embedded cost of gas turbines in each NYCA Locality and the Rest of the State and associated Energy and Ancillary Services revenues.'" (*Id*. at fn 34.) Ravenswood's five separate references to this point do not change the Commission's holding. The Commission simply did not determine that the Demand Curve should be established without offsets for net revenues from energy and ancillary service sales. The amount of such offsets is a crucial part of establishing the Demand Curve.

C. Ravenswood's Request Would Upset the Symmetry Of The Demand Curve

The basic premise behind the Demand Curve is that the market will benefit from predictable capacity prices that follow a linear curve. The curve is designed so that as reserves bid in under the curve increase, prices decrease, but customers must buy capacity over and above the 18% reserve requirement (up to 32%); and as reserves bid in under the curve decrease, capacity prices will increase along the same curve. Consequently, the price for all capacity, both the capacity above and below the reserve requirement, will be purchased at a price determined by the Demand Curve. The Demand Curve established a trade off. In exchange for providing all generation capacity up to a 32% reserve requirement with the opportunity to be purchased, the price for such capacity will no longer be set by a market mechanism, rather the price will be administratively pre-determined and expressed functionally in the form of a demand curve.

Granting Ravenswood's Appeal would enable suppliers to have a market price that is greater than the Demand Curve price for much needed capacity while having an administratively determined price (i.e., the Demand Curve) for capacity that would otherwise not be needed. The Commission should not endorse this lopsided "have your cake and eat it too" philosophy of selling capacity.

V. CONCLUSION

The Energy East Companies respectfully request that the Board reject Ravenswood's Appeal and direct the NYISO to file the Demand Curve Revisions approved by the MC such that the NYISO will be in compliance with the May Order.

Dated: July 8, 2003

Respectfully submitted,

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