



Robert E.
Fernandez
General Counsel
and Secretary
(518) 356-7504
(518) 356-4702 (fax)
email: rfernandez@nyiso.com

Magalie Roman Salas
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, D.C. 20426

Re: Order Seeking Comments On Proposed Revisions To Market-Based Rate
Authorizations; Docket Nos.EL01-118-000 and EL01-118-001

Dear Secretary Salas:

Enclosed for electronic filing are the New York Independent System Operator's ("NYISO") Comments in the above-captioned dockets. In its Comments the NYISO (1) requests that the Commission clarify the operation of certain of its proposed Market Behavior Rules as they will apply to Locational Marginal Price markets in the northeast; (2) recommends that the Commission rely on regional market monitors as a first "line of defense" in enforcing the new Market Behavior Rules; and (3) recommends that the Commission extend the scope of the Market Behavior Rules to cover all market participants.

Due to service disruptions that occurred in the NYISO's control area on August 14, 2003, through August 17, 2003, and the extensive involvement of NYISO senior management personnel in the effort to restore service to load, it was not possible to obtain management review and sign-off for these Comments by the Commission's August 18, 2003, due date. The NYISO respectfully requests that the Commission accept these Comments one day out-of-time.

Sincerely,

/s/ Robert E. Fernandez

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Investigation of Terms and Conditions of)	Docket Nos.	EL01-118-000
Public Utility Market-Based Rate)		EL01-118-001
Authorizations)		
)		

**COMMENTS OF THE
NEW YORK INDEPENDENT SYSTEM OPERATOR**

The New York Independent System Operator (“NYISO”) offers these Comments¹ in support of the Federal Energy Regulatory Commission’s (the “Commission”) proposal in its June 26, 2003, Order Seeking Comments On Proposed Revisions to Market-Based Rate Tariffs and Authorizations (“Order”) to identify and take affirmative action to prohibit anticompetitive behavior and the exercise of market power in the nation’s energy markets. However, as footnote 18 of the Order recognizes, certain of the Commission’s proposed revisions to market-based rate tariffs and authorizations may be too broadly stated and could be read to prohibit or inhibit legitimate market activities that are necessary to ensure that the northeast locational marginal price (“LMP”) markets remain functional, liquid and robust. In order to ensure that the market behavior rules “compliment any RTO or ISO tariff conditions and market rules that may apply to sellers in these markets” as intended (*see* Order at P 8), the Commission should revise or clarify certain of its proposed Market Behavior Rules to account for the unique characteristics of, and preserve the viability of, the northeast LMP power markets.

¹ Due to service disruptions that occurred in the NYISO’s control area on August 14, 2003, through August 17, 2003, and the extensive involvement of NYISO senior management personnel in the effort to restore service to load, it was not possible to obtain management review and sign-off for these Comments by the Commission’s August 18, 2003, due date. The NYISO respectfully requests that the Commission accept these Comments one day out-of-time.

I. INTRODUCTION

The NYISO supports the Commission's goal of addressing and limiting the potential for market power abuse, collusion, gaming and manipulation that result in price anomalies and improper wealth transfers. In achieving this goal, it is vitally important to craft rules that do not disrupt legitimate competitive behavior, and the operation of supply and demand.

The Commission's effort is driven principally by the market failures that occurred in California and nearby western markets. The California market suffered from well-documented design flaws that enabled manipulative and abusive behavior by market participants. In contrast, the New York and the northeast electricity markets do not suffer from the same design flaws and have not been subjected to pervasive market manipulation or the exercises of market power. Further, the NYISO market rules permit certain market activities (*e.g.*, virtual trading) that may be confused with activities prohibited by proposed Market Behavior Rule #2.

Thus, the Commission needs to be very careful about how it defines impermissible behavior for each of the following reasons:

- The Commission's Market Behavior Rules must not inadvertently proscribe legitimate market activities that it has already approved in the New York and other LMP markets. These market activities foster market liquidity, robustness, and price convergence between forward and real-time markets.
- To the extent that the Commission deems it necessary to specifically identify prohibited behaviors it must do so clearly, narrowly and precisely

and must be certain that its proposed rules will not have unintended adverse consequences.

- Vague or overbroad proscriptions that chill legitimate market behavior will distort or mute market signals that are necessary to foster new investment in generation and transmission.
- The Commission must take care not to exacerbate the post-Enron problems that currently plague the capital markets that finance electricity projects.

As an alternative, the NYISO recommends an approach that relies on the ISOs and RTOs (in cooperation with the Commission’s Office of Market Oversight and Investigation (“OMOI”)) to identify, diagnose and rectify manipulative behavior in the context of the specific markets they administer. A variant of this approach worked well early in the NYISO’s existence when its tariff authority permitted NYISO to take emergency corrective actions in response to certain market anomalies. This authority allowed the NYISO to address, among other issues, “phantom” transactions between ISOs by which certain parties gamed the system to create profits that resulted from neither competition nor the interplay of supply and demand. Similarly, the NYISO used its prior tariff authority to address market flaws that limited the ability of capacity limited and energy limited resources to structure their offers to sell into the energy market. Ultimately the emergency corrective actions were codified as permanent rules in NYISO’s tariffs.

Finally, the Commission’s proposed Market Behavior Rules should include similarly worded corollary rules that apply to transmission owners and load serving

entities. These entities may engage in manipulative or abusive behavior that arises from system outages within their control, monopsony power, bidding behavior in energy and capacity markets, and improper relationships or communications between merchant and regulated affiliates.

II. COMMENTS ADDRESSING SPECIFIC MARKET BEHAVIOR RULES

A. Market Behavior Rule #1: Unit Operation

Seller will operate and schedule generating facilities, undertake maintenance, declare outages, and commit or otherwise bid supply in a manner that complies with the rules and regulations of the applicable power market.

The NYISO supports the Commission's proposed Market Behavior Rule #1 and proposes that the following language be added thereto:

In addition, Seller will use its best efforts to comply with the operating instructions of the applicable power system operator, and will promptly inform the power system operator if it is unable to follow the dispatch instructions it receives.

As modified, Market Behavior Rule #1 will bolster the effectiveness of the NYISO's existing rules and provide the NYISO and other market administrators the means to compel compliance with instructions that may address reliability or market issues that occur when a market participant refuses to follow operational instructions. The ramifications of failing to follow operating instructions may be manifested in reliability problems or anomalous market results (e.g., the dispatch of a more expensive marginal resource to replace the energy and capacity that the Seller is failing or refusing to provide). Avenues for seeking to penalize non-compliance with market rules include seeking Commission review of such potentially abusive behavior.

B. Market Behavior Rule #2: Market Manipulation

Actions or transactions without a legitimate business purpose which manipulate or attempt to manipulate market prices, market conditions, or market rules for electric energy and/or electric energy products which do not reflect the legitimate forces of supply and demand are prohibited. Prohibited actions and transactions include, but are not limited to: (A) pre-arranged offsetting trades of the same product among the same parties, which trade involves no economic risk, and no net change in beneficial ownership (sometimes called “wash trades”); (B) transactions predicated on submitting false information to transmission providers or other entities responsible for operation of the transmission grid (such as inaccurate load or generation data; scheduling non-firm service or products sold as firm; or conducting “paper trades” where an entity falsely designates resources and fails to have those resources available and feasibly functioning); (C) transactions in which an entity first creates artificial congestion and then “relieves” such artificial congestion; (D) collusion with another party for the purpose of creating market prices at levels differing from those set by market forces; and (E) bidding the output of or misrepresenting the operational capabilities of generation facilities in a manner which raises market prices by withholding available supply from the market.

The Commission’s efforts to identify specific transactions that are not permitted in sub-parts (A) through (E) of Market Behavior Rule #2 should be clarified, revised or eliminated for the reasons and in the manner set forth below.

1. Potential Conflict With Existing Market Provisions

In footnote 18 of its Order, the Commission recognizes that significant portions of Market Behavior Rule #2 could be applied in ways that are inconsistent with the workings of the NYISO and other northeastern LMP markets. Footnote 18 states that the Commission “does not intend to prohibit transactions taken consistent with market rules ISO or RTO markets such as virtual bidding or day ahead markets where ‘simulated’ congestion may be reflected in pricing as part of market design.” The NYISO requests that the Commission clarify how the proposed Market Behavior Rules will be applied to transactions in LMP markets such as New York, and that the proposed Market Behavior

Rules will not apply where their implementation would be inconsistent with the operation of a Commission-approved market. A “one size fits all” set of Market Behavior Rules could chill appropriate market behavior in the New York and other LMP markets. In addition, the proposed Market Behavior Rules may conflict with Commission-approved market-specific mitigation measures that are already in effect.

The NYISO requests that the Commission further clarify that Market Behavior Rule #1 and Market Behavior Rule #2 (a) are intended to supplement or bolster the authority or ability of tariff administrators to enforce the rules and regulations applicable to the market they administer and are not intended to detract in any way from the tariff administrator’s authority; and (b) are intended to supplement, not supplant, market-specific mitigation measures the Commission has previously approved (*i.e.*, preexisting market mitigation measures are not superceded by the Commission’s Market Behavior Rules).

Behavioral proscriptions, such as those contained in portions of the Commission’s proposed Market Behavior Rule #2, that could be applied to legitimate or benign transactions in complex LMP markets will be perceived as presenting additional risks for generation owners, developers, and other market participants and may affect market participant behavior. Increased regulatory risk due to uncertainty about the “rules of the road” and the ability to recover costs may cause investors to expect increased returns from their investment in generation projects. Thus, higher market prices may be necessary to induce the construction of new generation in New York and other regions. In the worst case, perceived uncertainty may further chill the willingness of the capital markets to invest in new generation projects. For these reasons, the Commission’s

conduct-based Market Behavior Rules should be narrowly tailored to specifically identify prohibited conduct and distinguish it from acceptable market behavior. At the same time, reliance on a narrowly defined set of prohibitions creates the risk that market participants may escape sanction for behavior that does not fall within a specific proscription. The NYISO's proposed solution addresses both of these concerns.

2. NYISO's Proposed Solution

As an alternative to implementing the broad conduct-based proscriptions against certain types of gaming specified in examples (A) through (C) of Market Behavior Rule 2 that may have the unintended consequence of chilling legitimate behavior, the NYISO recommends that the Commission rely upon ISO and RTO market monitoring units to craft and implement rules specifically tailored to address improper conduct if and as it arises in the specific regional markets.

Examples (A) through (C) of Market Behavior Rule #2 address certain types of conduct that can constitute gaming of market rules in ways that result in inefficient market outcomes. By definition, any such conduct must be analyzed and understood in the specific context of the rule assertedly being gamed, and must ultimately be thwarted by the adoption of new rules that are not subject to such misuse. It follows that the range of potential problems is as diverse as the range of market rules, and that appropriate remedies must be tailored to the market design and other rules in which the abused rule functions. These concerns are particularly acute in the complex, interacting markets in the northeast. At the same time, northeast LMP markets have well-established procedures for monitoring market conduct and performance, and developing and revising market rules.

Penalizing a bad actor, requiring that unjustly derived profits be disgorged, or revoking market-based rate authority may ultimately be required in certain circumstances, but the NYISO believes that it is most important to first cure the vulnerability in the market structure and close the “loophole” the bad actor(s) choose to exploit. The ISO and RTO market monitoring units should be the Commission’s first line of defense against market abuses and gaming since they have first hand knowledge of the market and operational rules of the markets they administer. The ISO/RTO market monitoring units are thus in the best position to monitor for market manipulation, craft specific remedies that address improper behaviors if they arise, and quickly implement those remedies.

Because it is difficult to predict when new efforts to manipulate the power markets will occur and the form the manipulative conduct will take,² the market monitoring units must have the ability to respond to abusive conduct as soon as it is identified. The Commission should establish procedures for ISOs and RTOs to put in place temporary, interim rules (subject to appropriate procedural safeguards) to immediately deal with both new methods of market manipulation and the exercise of market power as soon as these problems are identified. Such an approach would permit ISOs and RTOs to address unanticipated problems with narrowly tailored rules that deter or defeat specific manipulative conduct without deterring conduct that is important to the

² One example of a change in market operation that may present an opportunity for market manipulation is the NYISO’s upcoming application for authorization to implement, and subsequent implementation of, version 2.0 of its SMD software. Despite significant quality assurance testing, it is possible that the newly developed software will include flaws that can be exploited by market participants. In its filing seeking authority to implement SMD 2.0, the NYISO also intends to seek temporary authority to modify its market rules on an emergency basis to permit the NYISO to protect the market it administers from the exploitation of unanticipated flaws in the SMD 2.0 software.

efficient operation of the markets. Commission approval would ultimately be required to make any such emergency corrective measures permanent.

While the NYISO believes that the regional market monitoring units should play a central role in addressing market abuses, we anticipate that the market monitoring units would work closely with the OMOI and build upon the cooperative relationships that have begun to emerge. The NYISO expects that OMOI would intervene as necessary to address problems that are beyond the ability of the regional market monitors to handle. Continuing to build on the relationships already established between MMUs and the OMOI will enhance OMOI's familiarity with regional and local market issues, and will result in the most efficient use of the Commission's limited resources.

3. Comments on Proposed Proscriptions

In its discussion below the NYISO identifies portions of the proposed Market Behavior Rule #2(A) – (C) that, contrary to the Commission's intentions, can be read to have an overly broad scope, or to be inconsistent with the existing market rules and present operation of the New York market. It also expresses concerns about the wording of the references to collusive conduct and market power abuse in examples (D) and (E) of Market Behavior Rule #2.

a. Prohibition of Wash Trades

Market Behavior Rule #2(A) prohibits "wash trades" and similar transactions. This prohibition does not address market manipulation; financial transactions with no net impact should not affect market outcomes. The relevant aspects of this rule should be included in the Commission's proposed Market Behavior Rule #4 and applied to price reporting.

Under the NYISO's rules, market participants are permitted (even encouraged) to arbitrage prices and loads between the day-ahead, real time, and longer term markets using mechanisms such as virtual bidding (of load or generation) and submitting bids that effectively cancel each other out in the day-ahead and real-time markets. If the prohibition set forth in Market Behavior Rule #2(A) were applied to those kinds of market transactions, rather than to price reporting, this prohibition would have a number of substantial adverse impacts. The Commission should clarify that the prohibitions set forth in Market Behavior Rule #2(A) will not apply to market transactions in the northeast LMP markets for the following reasons:

First, the proposed rule does not recognize differences in transaction term, and would therefore apparently prohibit "book-out" transactions, whereby market participants cash out deliveries under long-term transactions with offsetting short-term transactions to avoid the transaction costs associated with taking the long-term transaction to delivery. Such a prohibition would increase the cost of settling long-term transactions and therefore discourage forward contracts.

Second, a fundamental characteristic of both ISO market systems and bilateral or multilateral electronic trading systems is that there are no "retakes." When a market participant mistakenly buys instead of sells, or accidentally buys more energy or capacity than it needs, the market participant cannot avoid the financial consequences simply by saying it made a mistake. Instead, it must attempt to close out the erroneous position as quickly as possible, which may entail entering into an offsetting transaction, possibly with the same party or on the same trading platform. These transactions are legitimate and prohibiting them would prevent desirable market outcomes.

As explained above, wash trades that have no legitimate purpose should also have no effect on an LMP market. If the Commission’s purpose is to prevent the reporting of wash transactions from impacting price reporting, that purpose can be more appropriately addressed by modifying Market Behavior Rule #4.

b. Submission of False Information to Grid Operators

Market Behavior Rule #2(B) addresses market participants that supply inaccurate information to transmission providers or other entities responsible for operation of the transmission grid. In the NYISO markets, this could include information regarding generation availability in forward reliability evaluation processes, supplying inaccurate information regarding real-time generation availability, or scheduling transactions that are designed to fail check out. Each of these actions can be used to withhold capacity from the market, or to manipulate resources scheduled to be available in real-time, and should be deterred. At the same time, it must be recognized that the essence of a market-based LMP pricing system is that individual market participants are free to take financial positions in forward markets that may differ from their real-time consumption or generation patterns. Similarly, the prohibition on “paper trades” would arguably prohibit virtual supply and demand bids (for demand bidders that are authorized to transact at market-based rates), an important element of northeast markets.³ The Commission should clarify in the final Market Behavior Rule that the prohibition on supplying “inaccurate load or generation data” and engaging in “paper trades” is not intended to preclude virtual demand or supply bids in day-ahead or other forward markets, as these bids and offers would not necessarily match any physical obligation of the bidding entity.

³ See, *New York Independent System Operator, Inc.*, 97 FERC ¶ 61,091 (2001); *Morgan Stanley Capital Group, Inc. v. New York Independent System Operator, Inc.*, 93 FERC ¶ 61,017 (2000).

c. Transactions That Create and Then Relieve Congestion

Market Behavioral Rule #2(C) prohibits “transactions in which an entity first creates artificial congestion and then ‘relieves’ such artificial congestion.” There are circumstances in which transactions may be scheduled in forward markets to profitably distort forward prices by creating congestion in forward markets which will not exist in real-time. Where this conduct has occurred, the affected ISOs and RTOs have adopted measures to address it.⁴

The Commission should clarify that the proposed Market Behavioral Rule is not intended to prohibit desirable conduct seen routinely both in LMP markets in the northeast and in TLR based congestion management systems outside the northeast. Like the prohibition on “False Information” discussed above, this part of the proposed Market Behavioral Rule could be read to preclude the use of virtual load and supply bids for arbitrage of day-ahead and real-time prices. This result clearly does not comport with the Commission’s intent in proposing the Market Behavior Rules. While the Order does not define “artificial congestion,” any virtual demand offer submitted in a day-ahead market by a physical generator could be characterized as creating congestion that might be relieved by that generator’s supply offers—or the supply offers of any other participant in the virtual transactions markets. Similarly, virtual supply offers submitted by a Load Serving Entity (“LSE”) in a day-ahead market would be likely to relieve congestion created by the physical loads of that LSE. These sorts of virtual load and supply bids

⁴ See, for example, NYISO April 1, 2003 filing in Docket ER03-690-000, re non-competitive proxy buses and the discussion of the use of virtual load bids to create congestion in PJM, PJM Market Monitoring Unit, PJM Interconnection State of the Market Report 2000 at 97-98.

have been successfully implemented in northeast markets,⁵ provide an important mechanism for the arbitrage of day-ahead and real-time markets while avoiding withholding of generation from the day-ahead commitment process, and have not resulted in the manipulation or distortion of prices. A prohibition of such virtual load and supply bids would be more likely to reduce, rather than increase, the efficiency and competitiveness of day-ahead markets.

The potential adverse impact of the proposed order on arbitrage utilizing virtual load and supply bids could be limited to a degree by restricting the meaning of “artificial congestion” to congestion that exists in forward markets but not in real-time. This would be analogous to the standard PJM uses in evaluating the impact of virtual load bids on FTR values. Such a definition would clarify that virtual load and supply bids that cause day-ahead congestion to better approximate real-time congestion are legitimate arbitrage. Even with such a definition of “artificial congestion,” however, the Commission’s order would in effect prohibit arbitrage transactions by loads and suppliers that turn out in real-time to be unprofitable. Since market participants cannot perfectly forecast congestion, the rule would artificially increase the risk of arbitrage transactions by whatever costs are imposed under the prohibition.

A second concern with the wording of proposed Market Behavior Rule #2(C) is that it would apparently prohibit changes in day-ahead schedules in response to changes in market conditions between day-ahead and real-time, a result that the Commission could not have intended. In practice, congestion that existed in forward markets may not exist in real-time because market participants have responded competitively to changed

⁵ They were also called for in the Commission’s *Notice of Proposed Rulemaking on Standard Market Design*, 67 Fed. Reg. 55452 (August 29, 2002).

real-time conditions. Prohibiting such responses to real-time market conditions would serve to restrict competition, not to promote it. For example, any import or export transaction scheduled at an external proxy bus that is reversed in real-time would appear to fit the definition of creating artificial congestion (when the transaction is scheduled day-ahead) and then relieving it (when the transaction is backed down in real-time). This behavior, however, is efficient and important to maintaining reliability. A central concept of the day-ahead and real-time markets in the Northeast is that day-ahead schedules are financial, and the market designs contemplate that if market prices are different in real-time than expected day-ahead, then market participants will adjust their schedules from day-ahead so that real-time schedules are consistent with real-time prices.

The New York ISO in particular utilizes financial scheduling processes at the external proxy buses premised on the operation of competitive markets at those proxy buses, and an important part of this competition is the ability of market participants with day-ahead transactions to reduce or eliminate those schedules in real-time in response to changes in the price differentials across those interfaces. The proposed rule would apparently prohibit much of the competitive response on which the NYISO markets at the external proxy buses are premised.

The Commission should clarify the scope of its proposed Market Behavior Rule and, more specifically, that Market Behavior Rule #2(C) is not intended to prohibit legitimate arbitrage between forward and real time markets.

d. Prohibition Against Collusion by Market Participants

Examples (A) through (C) of Market Behavior Rule #2 deal with potential instances of gaming of market rules. The remaining examples deal with the significantly

different concepts of anti-competitive behavior (Example D) and the abuse of market power (Example E). In contrast to Examples (A) – (C), which address abuse of the particular rules of a specific market, the Commission’s Examples (D) and (E) address conduct that attacks the fundamental economic underpinnings of any competitive market, and that are of concern in all competitive markets, not just electric markets. These examples should be consistent with the larger body of competition law.

In Example (D), the Commission should align its definition of illegal collusion as closely as possible with the definition of illegal collusion under the antitrust laws. The antitrust laws include volumes of judicial precedents, and vast amounts of economic learning, dealing with the appropriate scope of prohibitions on collusion in a wide range of circumstances. Moreover, the antitrust laws apply to the electric power industry just as they do to virtually all other businesses in the U.S. The Commission’s rules should both take advantage of, and be consistent with, this broader body of law and learning.

Accordingly, the NYISO recommends that Example (D) be reworded to state: “(D) collusion or any other form of agreement or understanding with another party that unreasonably restricts competition.” This formulation is consistent with the standard antitrust prohibition on multiparty conduct. As presently worded, the example appears to include an intent test, by referring to the “purpose” of a collusive act. This would be a significant departure from the standard antitrust approach to collusion. In addition, by referring specifically to pricing levels, the existing definition appears to exclude the variety of non-price restraints that can result from anti-competitive collusion. Finally, the existing definition could be understood to depart from antitrust standards by referring to “market forces” rather than “competition,” and by not including the concept of an

“unreasonable” restraint. The concept of an “unreasonable restraint on competition” is widely understood and applied across the economy generally, and should accordingly be the standard applied by the Commission.

e. Withholding Available Supply

In order to achieve consistency with existing antitrust precedent and learning, example (E) should be reworded to state: “(E) engaging in physical or economic withholding, or other form of abuse of market power, that significantly affects prices or excludes competitors.”

Proposed Market Behavior Rule 2(E) prohibits the “bidding the output of or misrepresenting the operational capabilities of generation facilities in a manner which raises market prices by withholding available supply from the market.” If implemented, this rule should at a minimum be modified to make clear that it: (i) addresses outright physical withholding of capacity (*i.e.*, not offering the unit’s capacity to the market at all), whether by misrepresentation or other means, as well as economic withholding; and (ii) does not prohibit submitting bids that equal a unit’s legitimate marginal costs, including opportunity costs, at different output levels.

More generally, the example should make clear that its prohibitions can be implemented by existing market mitigation measures approved by the Commission. The New York ISO’s conduct and impact tests, including their implementation in the NYISO’s Automated Mitigation Procedures (“AMP”), are widely recognized as the most advanced and practical means of addressing physical and economic withholding. The conduct and impact tests apply bright-line standards that provide market certainty while preventing market power abuse, but allowing prices to rise to legitimate scarcity levels.

In addition, implementation of the conduct and impact tests by the AMP avoids the need for after-the-fact price corrections.

It is essential that any rules intended to deter the exercise of market power permit legitimate competitive behavior and allow prices to rise as forces of supply and demand dictate. For this very reason, the NYISO's conduct and impact mitigation measures, including their implementation in the AMP, require factual pre-determinations that (1) the market participant's bid has been raised significantly when compared to historical bids by the market participant (or other indicia that the bid does not reflect the bidder's marginal cost), and (2) any resulting withholding by the market participant substantially impacts prices in the relevant market. The Commission's proposed Market Behavior Rule makes no attempt to distinguish competitive from anti-competitive behavior or to set a threshold that will permit market participants to have reasonable flexibility to adjust their bidding behavior to legitimate market forces. The Commission should revise its proposed Market Behavior Rule to account for these necessary prerequisites to an exercise of market power.

In addition, any prohibition on withholding supply from the market should not be triggered by the inclusion of legitimate opportunity costs in a unit's bid. In particular, the Market Behavior Rule should permit opportunity cost bidding, or compliance with special bidding rules, by energy limited units. The offer prices of such units can be and are appropriately used to allocate the limited output of these units to those hours in which the output would have the highest value. Offer prices also serve the purpose of ensuring that energy limited units retain sufficient ability to generate energy that they are able to

provide reserves in formal reserve markets or for self-supply by vertically integrated utilities.

It is unclear whether the proposed prohibition against withholding would apply only to real-time markets or also to forward markets. It is not anticompetitive or inefficient for market participants to decline to enter into forward contracts at less than the expected real-time price. Any assessment of the cost of providing supply in forward markets should also account for start-up and no-load costs, not simply incremental generation costs.

C. Market Behavior Rule #3: Communications

Seller will provide complete, accurate, and factual information, and not submit false or misleading information, or omit material information, in any communication with the Commission, market monitors, regional transmission organizations, independent system operators, or similar entities.

The NYISO applauds the Commission's proposal to explicitly require complete and accurate disclosure and suggests that the Commission's proposal to require accurate disclosures to market monitors, market administrators and the Commission be supplemented with an explicit requirement that market participants provide information to these entities promptly, upon request. The obligation to produce data pursuant to market Behavior Rule #3 should be broad enough to permit market monitors, market administrators, and the Commission to review transactions that clear in the ISO administered markets, bilateral transactions and contracts or other agreements that can affect market performance. Market monitors, in certain circumstances, have a legitimate need to examine bilateral transactions or arrangements to determine their effect on market outcomes.

D. Market Behavior Rule #4: Reporting

To the extent Seller engages in reporting of transactions to publishers of electricity or natural gas price indices, Seller shall provide complete, accurate and factual information to any such publisher. Seller shall notify the Commission of whether it engages in such reporting for all sales. In addition, the Seller shall adhere to such other standards and requirements for price reporting as the Commission may order.

Accurate price reporting by published indices is important to the operation of wholesale electric and gas markets. The NYISO believes that the Commission’s proposed prohibition on “wash trades” set forth in proposed Market Behavior Rule #2(A) should be altered from a behavioral prohibition to a rule that requires the specific identification and separate treatment of wash transactions when they are publicly reported.

E. Market Behavior Rule #5: Record Retention

Seller will retain all data and information necessary for the reconstruction of energy or energy product prices it charges, or the prices it reports for use in published price indices, for a period of three years.

The NYISO supports the Commission’s proposed language.

F. Market Behavior Rule #6: Related Tariffs

Seller shall not violate or collude with another party in actions that violate Seller’s code of conduct or Order No. 889 standards of conduct.

The NYISO believes that the language proposed by the Commission will assist the Commission, market administrators and their market monitoring units in policing market participant conduct by Sellers in the wholesale markets. However, the NYISO believes the Commission’s proposed Market Behavior Rules (or variations thereon) should apply to all market participants, not just Sellers.

The NYISO agrees with the sentiments expressed in Commissioner Brownell’s concurrence regarding the application of certain of the Commission’s proposed prescriptions to only one segment of the wholesale power market – Sellers. Like Sellers (to which the proposed Market Behavior Rules will apply), wholesale purchasers, transmission owners and load serving entities (to which the proposed Market Behavior Rules will *not* apply) are capable of manipulating the market or exercising market power for their own benefit, or for the benefit of their affiliates.

Hypothetically, it may be possible for a transmission owner (“TO”) that holds congestion revenue rights to benefit from a delay in returning a transmission line that is out for maintenance to service if such a delay would result in higher congestion revenues. A second example where a market participant other than a Seller might benefit from the exercise of market power is when a TO that is affiliated with a LSE removes a tie from service, resulting in congestion in the TO’s service territory and reducing LMPs on the low-side of the constraint.

Most transmission owners, wholesale purchasers and load-serving entities (or their affiliates) participate in the NYISO markets as buyers, sellers or both and have market-based rates on file with the Commission. In addition, transmission owners are subject to the Commission’s Order No. 889 Standards of Conduct. The Commission has jurisdiction to require these market participants to satisfy rules appropriate to their market roles that parallel the final Market Behavior Rules applicable to Sellers. The NYISO recommends that the Commission adopt Market Behavior Rules that apply to *all* entities participating in jurisdictional markets, regardless of the nature of their market participation (seller, wholesale purchaser, transmission owner, virtual market participant,

load serving entity, etc.), and make parallel modifications to the Commission’s Standards of Conduct to address market manipulation, anticompetitive behavior or the exercise of market power by any such entity (for their own benefit, or to benefit their affiliates).

By adopting Market Behavior Rules applicable to all market segments, the Commission will ensure comparable treatment of all market participants.

III. ASSESSING APPROPRIATE PENALTIES FOR VIOLATIONS

In the Order the Commission proposes to limit market participant exposure under the proposed Market Behavior Rules to the disgorgement of unjust profits. As Commissioner Massey suggests in his Concurrence, the simple disgorgement of unjust profits, by itself, will not provide a sufficient deterrent to anticompetitive or unjust manipulative behavior. The worst thing that can happen under the Commission’s penalty proposal is that the bad actor will be placed in the same position it would have been in if the anticompetitive or manipulative behavior had not occurred.

The NYISO believes the disgorgement of unjust profits sets an appropriate penalty floor and that Commissioner Massey’s proposal to require “bad actors” to make the market whole would set an appropriate penalty ceiling (as might the revocation of a market participant’s market-based rate authority). Between these extremes, the NYISO suggests that the Commission retain the discretion to impose an escalating schedule of penalties based on the nature and extent of the violation of the proposed Market Behavior Rules.⁶ This additional authority is appropriate as a supplement to the Commission’s

⁶ Section 5.12.12 of the NYISO’s Services Tariff grants the NYISO discretion to impose a series of escalating sanctions on Installed Capacity (“ICAP”) suppliers that fail to satisfy their ICAP obligations to the New York market. Copies of the relevant portions of the NYISO’s Market Administration Control Area Services Tariff are appended as Attachment A hereto.

proposed requirement that unjustly derived profits be disgorged, in order for the penalties to deter inappropriate conduct.

In paragraph 40 of the Order the Commission explains that while it will impose time limits on the filing of complaints addressing prohibited conduct by market participants, it will not apply a similar time limit to Commission-initiated complaint proceedings. The NYISO and its market monitoring unit effectively act as an extension of the Commission's OMOI in many ways and should be exempted from the Commission's proposed time limit for bringing a complaint alleging breach of the Market Behavior Rules for the same reasons the Commission and its Staff are exempted from this requirement. *See* Order at P 40.

IV. DISCUSSION OF SCARCITY RENTS AND MARKET POWER

A basic issue underlying the application of rules designed to police non-competitive pricing is the need to distinguish between legitimate scarcity prices and monopolistic prices. Electric market rules must distinguish between prices that, although high, reflect a competitive balancing of supply and demand, and prices that reflect an exercise of market power. *See* June 26 Order, Concurrence of Commission Brownell. When supply and demand conditions are such that meeting load requires the scheduling or dispatch of high-cost units, or high-cost increments on the upper portions of the output curves of otherwise more moderate cost units, market prices should reflect the legitimately high costs associated with that scheduling or dispatch. In addition, if supply and demand conditions require that units be used for energy that would otherwise supply operating reserves with a consequent reduction in operating reserves levels, prices should reflect the value of the foregone reserves. Either circumstance can result in relatively

high prices that are just and reasonable. At the same time, however, the potential for high prices during legitimate shortage conditions should not provide a license for sellers to set prices at arbitrarily high levels through the use of market power.

The key factor in distinguishing between scarcity and the exercise of market power is determining whether any suppliers are engaging in economic or physical withholding—i.e., whether shortage conditions are the result of withholding, or high demand and not enough supply. In New York, that determination is made, and should continue to be made, through the application of the NYISO's Commission-approved Market Mitigation Measures ("MMM").⁷ If application of the MMM conduct and impact tests⁸ indicates that prices are not being significantly affected by economic withholding, and there is no evidence of significant physical withholding, then absent other unusual circumstance, the NYISO would ordinarily conclude that prices are being set by legitimate market forces. The NYISO expects, and has experienced, prices at quite high levels under certain supply and demand conditions.

There is no economic justification, however, for permitting suppliers to push prices to artificially higher levels by economically or physically withholding resources during periods of high demand. While it is critical for markets to send price signals that reflect legitimate scarcity, artificially high prices can be just as inefficient as artificially

⁷ Attachment H to the NYISO Market Administration and Control Areas Services Tariff (the "Services Tariff").

⁸ The "conduct" test applies a specified dollar or percentage threshold to determine if there has been a significant increase in bid price. The thresholds are applied against the unit's "reference levels," which are set at the competitive bidding level for the unit or output block involved, or at a level that reflects the legitimate marginal costs, including opportunity costs, for that unit or output level. *See* Attachment H to the Services Tariff. Units with high costs, or with high costs for certain output blocks, will have correspondingly high reference levels. The "impact" test applies specific dollar or percentage thresholds to determine if bids that cross the applicable conduct thresholds have had a significant effect on prices.

low prices. Over stimulation of new entry can be just as undesirable as under stimulation. In New York, the MMM appropriately accommodates these competing considerations, by mitigating significant withholding but otherwise letting prices rise to scarcity levels as market forces dictate.

The NYISO urges that the final Market Behavior Rules: (a) distinguish between scarcity and competitive prices on the basis of whether prices have been significantly affected by withholding; and (b) permit the NYISO to continue to administer its previously approved Market Mitigation Measures to preserve an appropriate balance between permitting scarcity prices to send appropriate signals to the market and mitigating the exercise of market power.

V. NOTICES AND COMMUNICATIONS

Please address all notices and communications to:

Robert E. Fernandez
Belinda F. Thornton
Elizabeth A. Grisaru
Alex M. Schnell
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303
Phone: 518-356-8707
Fax: 518-356-4702
rfernandez@nyiso.com
bthornton@nyiso.com
egrisaru@nyiso.com
aschnell@nyiso.com

VI. CONCLUSION

For the reasons set forth in detail above, the NYISO respectfully requests that:

1. the Commission revise its proposed Market Behavior Rules (in particular its Market Behavior Rule #2) to address the NYISO's concerns; and
2. the Commission consider these Comments, filed one day out-of-time, in its deliberations in the above-captioned dockets for the reasons set forth in footnote one hereto.

Respectfully Submitted

/s/ Robert E. Fernandez

Robert E. Fernandez
Elizabeth A. Grisaru
Alex M. Schnell
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303
518-356-8707

Date: August 19, 2003

Attachment A

Section 5.12 of the ISO Market Administration and
Control Area Services Tariff
Of the New York System Operator

**5.12.12 Sanctions Applicable to Installed Capacity Suppliers and
Transmission Owners**

Pursuant to this Section, the ISO may impose financial sanctions on Installed Capacity Suppliers and Transmission Owners that fail to comply with certain provisions of this Tariff. The ISO shall notify Installed Capacity Suppliers and Transmission Owners prior to imposing any sanction and shall afford them a reasonable opportunity to demonstrate that they should not be sanctioned and/or to offer mitigating reasons why they should be subject to a lesser sanction. The ISO may impose a sanction lower than the maximum amounts allowed by this Section at its sole discretion. Installed Capacity Suppliers and Transmission Owners may challenge any sanction imposed by the ISO pursuant to the ISO Dispute Resolution Procedures.

Any sanctions collected by the ISO pursuant to this Section will be applied to reduce the Rate Schedule 1 charge under this Tariff.

5.12.12 (a) Sanctions for Failing to Provide Required Information

If (i) an Installed Capacity Supplier fails to provide the information required by Subsections 5.12.1(i), (ii), (iii), (iv), or (viii) of this Tariff in a timely fashion, or (ii) a Supplier of Unforced Capacity from External System Resources located in an External Control Area or from a Control Area System Resource that has agreed not to Curtail the Energy associated with such Installed Capacity, or to afford it the same Curtailment priority that it affords its own Control Area Load, fails to provide the information required for certification as an Installed Capacity Supplier established in the ISO Procedures, the ISO may take the following actions: On the first day that required information is late, the ISO shall notify the Installed Capacity Supplier that required information is past due and that it reserves the right to impose financial sanctions if the information is not provided by the end of the following day. Starting on the third day that the required information is late, the ISO may impose a daily financial sanction of up to the higher of \$500 or \$5 per MW of Installed Capacity that the Generator, Interruptible Load Resource, System Resource, or Control Area System Resource in question is capable of providing. Starting on the tenth day that the required information is late, the ISO may impose a daily financial sanction of up to the higher of \$1000 or \$10 per

MW of Installed Capacity that the Generator, Interruptible Load Resource, System Resource, or Control Area System Resource in question is capable of providing.

If an Installed Capacity Supplier fails to provide the information required by Subsection 5.12.1(v) of this Tariff in a timely fashion, the ISO may take the following actions: On the first calendar day that required information is late, the ISO shall notify the Installed Capacity Supplier that required information is past due and that it reserves the right to impose financial sanctions if the information is not provided by the end of that first calendar day. Starting on the second calendar day that the required information is late, the ISO may impose a daily financial sanction up to the higher of \$500 or \$5 per MW of Installed Capacity that the Generator, Interruptible Load Resource, System Resource, or Control Area System Resource in question is capable of providing.

If a TO fails to provide the information required by Subsection 5.11.3 of this Tariff in a timely fashion, the ISO may take the following actions: On the first day that required information is late, the ISO shall notify the TO that required information is past due and that it reserves the right to impose financial sanctions if the information is not provided by the end of the following day. Starting on the third day that the required information is late, the ISO may impose

a daily financial sanction up to \$5,000 a day. Starting on the tenth day that required information is late, the ISO may impose a daily financial sanction up to \$10,000.

5.12.12(b) Sanctions for Failing to Comply with Scheduling, Bidding, and Notification Requirements

On any day in which an Installed Capacity Supplier fails to comply with the scheduling, bidding, or notification requirements of Subsections 5.12.1(vi), (vii), or (x), or with Section 5.12.7 of this Tariff, or in which a Supplier of Installed Capacity from External System Resources or Control Area System Resources located in an External Control Area that has agreed not to Curtail the Energy associated with such Installed Capacity, or to afford it the same Curtailment priority that it affords its own Control Area Load, fails to comply with scheduling, bidding, or notification requirements for certification as an Installed Capacity Supplier established in the ISO Procedures, the ISO may impose a financial sanction up to the product of a deficiency charge, calculated pursuant to the Table in Section 5.14.1 of this Tariff (pro-rated on a daily basis), and the maximum number of MWs that the Installed Capacity Supplier failed to schedule or Bid in any hour in that day provided, however, that no financial sanction shall apply to any Installed Capacity Supplier who demonstrates that the Energy it schedules,

bids, or declares to be unavailable on any day is not less than the Installed Capacity that it supplies for that day rounded down to the nearest whole MW.

In addition, if an Installed Capacity Supplier fails to comply with the scheduling, bidding, or notification requirements of Sections 5.12.1(vi), (vii), or (x), or with Section 5.12.7 of this Tariff, or if an Installed Capacity Supplier of Unforced Capacity from External System Resources or from a Control Area System Resource located in an External Control Area that has agreed not to curtail the Energy associated with such Unforced Capacity, or to afford it the same curtailment priority that it affords its own Control Area Load, fails to comply with the scheduling, bidding, or notification requirements for certification as an Installed Capacity Supplier established in the ISO Procedures during an hour in which the ISO curtails Transactions associated with NYCA Installed Capacity Suppliers, the ISO may impose an additional financial sanction equal to the product of the number of MWs the Installed Capacity Supplier failed to schedule during that hour and the corresponding Real-Time LBMP at the applicable Proxy Generator Bus.

CERTIFICATE OF SERVICE

I hereby certify that copies of the Comments of the New York Independent System Operator, electronically filed with the Commission in Docket No. EL01-118, et al. were mailed to the parties appearing on the Secretary's official service list in this proceeding by first-class mail, postage prepaid.

Dated at Schenectady, NY, this 19th day of August, 2003.

/s/ Alex M. Schnell
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303
518-356-8707