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October 16, 2006

Ms. Karen Antion
Chair, NYISO Board of Directors
c/o Mr. Mark S. Lynch
President and CEO
New York Independent System Operator, Inc.
10 Krey Boulevard
Rensselaer, NY 12144

Re: Notice of Appeal from September 29, 2006 Management Committee Meeting

Dear Ms. Antion:

Pursuant to the Procedural Rules of Appeals to the NYISO Board, NRG Energy, Inc. ("NRG") hereby submits three originals and one copy of its Notice of Appeal of the September 29 Management Committee Votes on Motions 4, 6, and 7 and Request for Oral Argument. A copy of this appeal has been electronically transmitted to the NYISO staff for purposes of services to all members of the Management Committee.

Please date stamp the copy of the Notice of Appeal and return it to our courier.

Please do not hesitate to contact me at 609-524-4601 if you have any questions about this notice.

Respectfully submitted,

Christopher C. O'Hara (DB)

Christopher C. O'Hara
Assistant General Counsel - Regulatory

cc: NYISO Management Committee

Notice of Appeal of NRG Energy, Inc. of the September 29 Management Committee Votes On Motions 4, 6, and 7 and Request for Oral Argument

I. Executive Summary

NRG Energy, Inc. (NRG) hereby appeals to the Board of Directors the September 29, 2006 Management Committee (MC) votes on Motions 4, 6, and 7 for consideration at the November 21, 2006 meeting. NRG requests that the Board hold oral argument on the issues raised herein. The three motions pertain to revisions to the In-City ICAP mitigation rules. The net result of the votes on these motions is that the MC adopted a proposal sponsored by Consolidated Edison Company (ConEd) to impose a new, lower bid cap on the In-City units of the divested generation owners (DGOs), without addressing the severe capacity market price suppression caused by the NYISO's treatment of ConEd's own bilateral contract with the brand new Astoria (SCS) unit and other self-certified new generating capacity.[1] As a result of this omission, ConEd's proposal will send the wrong price signal regarding the need for investment in New York City, provide a license for ConEd and other large load-serving entities ("LSEs") to continually suppress capacity prices, and inequitably reduce the market value of the DGOs' existing units, while sending a message of regulatory instability to all market participants. The Board should reject or modify the Management Committee decision and take the other actions set forth herein for the following reasons:

1. the ConEd proposal will reduce or eliminate critically-needed market-based investment in both new and existing generation units in New York City, while increasing both the need for and the cost of out-of-market long term contracts to support investment in new and existing generation;
2. the ConEd proposal is unsupported, lacks adequate analysis, fails to consider the short-term or long-term impact on investment, reliability and market dynamics and has not been supported by the NYISO's market monitoring unit;
3. the ConEd proposal materially disrupts the balance of interests, expectations, and financial positions undertaken under the existing market construct, which was approved by Federal Energy Regulatory Commission (FERC);
4. the existing mitigation measures are functioning as designed, anticipated and intended by ConEd itself, and as approved by FERC, and provide market revenues at a level consistent with the regulatory compact that resulted in the price paid for the DGO assets and the amount of stranded costs to be recovered from ConEd's captive customers; and
5. the ConEd proposal is discriminatory in its design and effect and any additional mitigation measures should only be considered as part of a comprehensive review of the capacity market and resource adequacy issues.

[1] Although referred to as the Joint Proposal, the New York Department of Public Service is not a voting member of the Management Committee, and the proposal was sponsored by ConEd.

II. Request For Relief

The Board should reject or modify the Management Committee's approval of the ConEd proposal (Motion No. 4) and address the important market reforms contained in the NRG proposal (Motion No. 7). Specifically, the NRG proposal includes measures that (i) incorporate bilateral contracts for new power plant development in the creation of efficient capacity market price signals, (ii) limit both the ability and the incentive of large capacity buyers such as ConEd to exercise market power and suppress prices below competitive levels through such contracts, and (iii) require the development of a forward procurement mechanism that will secure competitive resources and projects in an orderly, timely and efficient manner.

If the Board does conclude that some immediate tariff change to address how resources bid into the capacity market is required, at the very least, that tariff change must incorporate bidding and reference price rules for capacity with out-of-market contracts as set forth in the NRG proposal. Only by sending accurate price signals that represent the true long-run marginal cost of needed resources can NYISO avoid the price discrimination and stymied incentive for investment that will result from the ConEd proposal.

III. The Existing Mitigation Measures Are Functioning As Intended And Approved In An Explicit *Quid Pro Quo* Among DGOs, ConEd And New York Consumers

A. Alteration Of This *Quid Pro Quo* Is Inequitable And Will Staunch Market Investment In New York City.

NRG is one of the three DGOs in New York City subject to the price and bid cap mitigation measures specified in Section 4.5(b) of Attachment H of NYISO's Services Tariff. These caps were designed by ConEd and approved by the PSC, and subsequently by FERC, with the explicit intention of allowing higher capacity prices that would lead purchasers of divested generation to pay more for the assets, thus reducing stranded cost recovery charges to New York consumers who had previously been ConEd's captive customers. As FERC stated in its original order approving these provisions:

> [T]he New York Commission concluded that ConEd's proposal strikes an appropriate balance by minimally inhibiting market development while ensuring that consumers are protected from high prices.[2]

FERC's order further explained this balance as follows:

> [W]hile a reduction in the price cap should result in lower capacity prices to ratepayers in the short-run, it may also depress the proceeds from the auction which, in turn, can result in higher prices in the long-run (in the form of higher stranded costs).[3]

Indeed, FERC explicitly noted that the mechanism by which these higher prices, higher auction proceeds, and reduced stranded cost payments from customers were to be obtained:

> [S]uppliers are likely to bid the price cap and set the market clearing price at that level even as new generation is added and supply increases. This is because, until the supply increases sufficiently to supplant substantial amounts of existing

[2] *Consolidated Edison Company of New York, Inc.*, 84 FERC ¶61,287, at note 1 (1998).

[3] *Id.* at slip op. p. 8.

capacity, the existing suppliers will be assured that at least some of their capacity will be selected at any price and so they have an incentive to bid the price cap to maximize revenues on those sales.[4]

Thus, when NRG acquired its In-City units, the price it paid for the units was based upon, among other things, an expectation that the existing mitigation measures would continue and that it would be able to bid the units in accordance with the FERC-approved mitigation. NRG's reliance on the New York PSC's and FERC's established capacity market mitigation measures supported NRG's valuation and the price it paid for the ConEd assets, and these higher prices reduced the cost of recovery ConEd's stranded costs from its captive customers, as intended. Now that ConEd and its customers have benefited from the prices NRG and other DGOs paid for the divested assets, ConEd seeks to alter the approved and established rules in a manner that will unquestionably reduce capacity prices, and thus the market value of the divested assets. The bald inequity of such an approach – proposing market rules that will increase asset prices when selling the assets, and then proposing to change the rules so they suppress both prices and asset values when buying capacity from the assets – can only be seen as self-serving for an LSE (not to mention its unregulated affiliates), and is profoundly harmful to those market participants who relied on these rules when they bought the assets. Such a "bait and switch" treatment – if approved by the NYISO Board and by FERC – would undermine the credibility of the NYISO and any other regulatory agencies in the eyes of all investors and lenders.[5] The unavoidable result would be to decrease the attractiveness of New York City as a place to invest in generation, while also increasing both the difficulty and the cost of financing any investment in New York.

B. There Has Been No Violation of the Market Rules Approved to Implement the Explicit *Quid Pro Quo* Among DGOs, ConEd and Its Customers

The ConEd proposal is based upon the simple observation that there has been an increase in supply, but no resulting drop in prices (although this was foreseen in 1998 by FERC and apparently anticipated and relied on by ConEd itself in selling its divested assets for high prices and thus reducing stranded cost charges to its customers). ConEd has argued that the failure of prices to fall represents an exercise of market power by DGOs and a failure of the market mitigation provisions, even though the bidding behavior is fully consistent with the approved market rules and the existing mitigation provision is, in fact, functioning as intended. Simply put, the existing mitigation measure was carefully designed to balance the interest in reducing stranded costs with the interest of ensuring an appropriate capacity market price. NRG agrees with NYISO President Mark Lynch's conclusion in his June 7, 2006 letter to FERC that there have been no violations of the Section 4.5(b) mitigation measures, and those measures are being enforced consistent with the FERC and PSC orders that underpinned original DGO acquisitions.[6]

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[4] *Id.* at note 17.

[5] Note that the DGOs have not only been abiding by the approved capacity market mitigation rules, but are subject to numerous other restrictive mitigation measures for the products it sells, including: the energy bid components of day ahead market including energy bids, start-up costs, and minimum acceptable running costs; reserve offers; In-City capacity price and offer caps; must offer requirements; and a prohibition on bilateral contracts. All of these mitigation measures are set forth in Attachment H. There has been no showing that the existing mitigation scheme is insufficient.

[6] *See* Letter from NYSIO President Mark Lynch to FERC Director of Enforcement Susan Court (June 7, 2006).

IV. The ConEd Proposal Is A Diversion From The Most Serious Flaw In The New York City Capacity Market's Design

ConEd's attempt to reduce prices by reducing DGO bid caps is not only inequitable, as discussed above, but it obscures a much more serious policy challenge: new entrants, despite costing much more than DGOs, are able to distort the market outcome by being bid in at less than their true cost (indeed, self-certified resources are effectively bid in at zero), because they recover their costs through an out-of-market mechanism (i.e., bilateral contract) and are not dependant on the market to recover their costs. Thus such new entrants can be used to artificially suppress capacity market prices below the competitive level.

A. The Lack Of Reference Prices To Ensure Efficient Bids For New Resources, Not The Offer Caps Of DGOs, Is The Main Threat To Efficient Prices And Investment In New York City

ConEd's focus on reducing the bid caps of DGOs in order to reduce prices obscures a deeper and more serious flaw in the New York City capacity construct. While the capacity market is designed to send a price signal showing the net revenue needs of new investment when the locational capacity requirement is just being met, today nearly 1000 MW of such new investment is currently suppressing market prices far below the cost of new, needed entrants in the capacity market. If these new resources were bidding at their net revenue needs, as they should in an efficient capacity market, the New York City capacity market would be clearing at a price above the current price caps and offer caps of DGOs, and DGO bid levels would therefore be irrelevant. Instead, under NYISO capacity market procedures, such bilaterally-contracted resources can be bid into the market at significantly below cost – even zero – thereby artificially suppressing prices. ConEd's proposal is a smokescreen that obscures this glaring flaw in the New York City capacity market design. This flaw must be addressed, because New York City critically needs new investment, and such new investment is almost certain to require some level of bilateral contracts to help ensure project financing.

B. New Resources Are Critically Needed For Reliability

In 2006, approximately 1000 MW of new combined cycle generating capacity in New York City entered commercial operation, all of it undoubtedly constructed at prices above the existing DGO price cap. Of this capacity, approximately 500 MW was built by the New York Power Authority. The other 500 MW is owned by Astoria Energy, LLC (an affiliate of SCS Energy, LLC) and was constructed in pursuant to a long-term contract with ConEd. This 1000 MW of capacity, together with the planned retirement of the Poletti unit, barely provides sufficient capacity for the In-City supply to meet the 80% *minimum* locational capacity requirement through 2008. The NYISO's recent decision that the Poletti unit should not retire until 2008, at the earliest, reinforces the fact that all of this new capacity is needed for reliability.[7]

The NYISO is well aware that additional investment in generation capacity is critically needed in New York City. The NYISO 2005 Comprehensive Reliability Plan ("CRP") projected load growth of one to two percent through 2010 for New York City and forecasts the Zone J requirement to reach 12,105 MW in 2010. The CRP further projected that the New York City

[7] *See* NYISO 2005 Comprehensive Reliability Plan ("CRP"), page 32, Table 7.2. Furthermore, the 2008 requirement would not be met but for the delayed retirement of 850 MW of "old Poletti."

Zone J capacity will remain constant at 10,274 MW through 2008 and then decrease as a result of the publicly announced retirement of the 850 MW old Poletti steam station.[8] The CRP included an Invitation for Market-Based Solutions, in response to which the NYISO received only two proposals located in New York City.

The CRP indicated that these two projects are needed to maintain reliability requirements as of 2011, and further noted that:

> Although these developers have significant financial resources available to them, the proponents of market-based generation solutions also stated that their viability may depend upon entry into long-term contracts for the sale of their output.[9]

The NYISO Board must recognize that, while bilateral contracts are needed, the NYISO's capacity market must provide the correct price signal to encourage parties to enter into those contracts. Simply put, if the market provides an inaccurate, suppressed price signal, load-serving entities will have no incentive to enter into competitive bilateral arrangements at the true price.

FERC Chairman Kelliher himself recently expressed similar concerns regarding the infrastructure In-City:

> The Commission is equally concerned that our nation has adequate generation and transmission facilities to ensure a reliable supply of electric energy at reasonable prices. ... The Commission has also approved rules, such as those governing the New York Independent System Operator (NYISO) installed capacity auction and related mitigation measures, which are intended to encourage sufficient electricity supply. The experience of New York City this summer shows the need for adequate investment in the electricity system.[10]

NRG urges the NYISO Board not to adopt the ConEd proposal, which will discourage, rather than encourage, the adequate electric supplies so important to the City, the State, and FERC. Instead, the NYISO Board should endorse the NRG proposal, which directly corrects the primary flaw limiting such investment.

C. Today, These Needed New Resources Are Effectively Bid At Zero Into The Capacity Market, Allowing LSEs With Contracted Capacity To Effectively Suppress Prices Below The Competitive Level

Under existing NYISO practice, new self-certified capacity resources are effectively being entered into the capacity market at a price of zero, instead of their net revenue requirement which would be more reflective of a competitive market bid. If their bids were entered into the

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[8] *See* 2005 CRP, Table 7.2. The CRP aggressively assumes all existing In-City generation except old Poletti will remain in-service. Over 20% of the In-City capacity – almost 2000 MW – is old, inefficient peaking units installed around 1970, that are nearing the end of their useful life. Capital expenditures are difficult to justify based upon energy market revenues and existing capacity prices. Suppressing the capacity prices further reduces the incentive to make those investments, reducing the units' reliability, and ultimately triggering the retirement of the units. If these units are needed to satisfy local reliability requirements, then out-of-market contracts, such as reliability must run contracts, will be required.

[9] *See* 2005 CRP, page 17. Indeed, the validity of the supply and demand projections in the CRA must be questioned given the new record peak set in the NYISO region this summer (33,939 MW), significantly exceeding the forecast.

[10] *See* Letter from Joseph T. Kelliher, Chairman - Federal Energy Regulatory Commission, to The Honorable Paul D. Tonko, Chairman - Committee on Energy, New York State Assembly (August 24, 2006).

capacity supply curve at the net revenue requirement level as such is identified by the Levitan study (or indeed, at any level above the DGO offer caps), these units would be the marginal units in the capacity auction and would set price, as they should. The capacity market would then provide a strong price signal representing the real net revenue needs of efficient new investment, and would stimulate robust investment – including investment through bilateral contracts. By contrast, under the current approach, a buyer such as ConEd can effectively put its thumb on the capacity market scale, and push the price down as far as the DGO bid cap simply by contracting for more capacity.[11] Seen in this light, the ConEd proposal to reduce the DGO bid cap will have the effect of suppressing the capacity market price even further, in a short-sighted manner that may reduce prices today, but increase them in the future due to resulting shortage of investment, stemming from the increased regulatory risk and flawed market design.

The Board must look beyond the short-sighted, self-interested price suppression set forth in the ConEd proposal and consider the long-term viability of NYISO markets and the need to attract new generation development. It is especially important to ensure that bilateral contracts do not have the effect of suppressing market prices and increasing market risk, since some level of bilateral contracting is almost certain to be needed to help finance substantial competitive investments in new generation resources. NRG's motion, building on extensive experience in other capacity market redesign efforts, provides the NYISO with an expedient and effective means to ensure that new bilaterally-contracted resources and self-built resources contribute to, rather than detract from, efficient market prices.

V. ConEd Has Failed To Substantiate The Need For Its Proposal While Improperly Circumventing NYISO's Process For Changes To Market Mitigation Provisions

ConEd has argued that the failure of In-City ICAP clearing prices to drop given recent capacity additions requires immediate market rule changes. ConEd has presented, however, absolutely no legal or policy analysis or other evidence to support its proposed tariff revisions (and indeed did not provide any proposed tariff language). ConEd did not and cannot support the imposition of any additional mitigation on the DGOs. Nor has ConEd made an attempt to support the proposed mitigation measures as just and reasonable, or indeed as anything but mitigation for the sake of lower prices. Both FERC and the Court of Appeals have repeatedly rejected such one-sided, poorly supported market design changes. More critically, ConEd also failed to present any analysis of the impact of the proposed revisions on the short-term capacity market, on the financial positions of market participants that have relied on the short-term capacity markets, or on the critical issues of the long-term impact of these changes on the capacity market's ability to support investment, manage risk, and ensure reliability.

Finally, ConEd did not engage the NYISO market monitoring unit in the development of its proposal, and the NYISO market monitoring unit is not convinced any such change is needed or appropriate. At the Business Issues Committee and Management Committee meetings, the NYISO staff clearly expressed the need for further analysis of the impacts of the ConEd proposal on the market.

Indeed, the procedures for modifying mitigation measures specified in the FERC-approved Market Monitoring Plan (MMP) were completely circumvented here. The MMP exists

[11] *See, e.g.*, "Analysis of the Joint Proposal for In-City Capacity Mitigation," William Hieronymus (September 2006) (this report is part of the record from the September 29 MC meeting).

for the very purpose of ensuring that (i) changes to mitigation rules are carefully considered, and (ii) that the resulting market outcome is in-line with the objectives of a competitive market. This entails, among other things, a balancing of interests between sellers and buyers and ensuring that reliable price signals are provided. Specifically, Section 8.2 of the MMP states:

> A description of all effective and proposed mitigation measures and of the standards for the application of each such measure shall be made available through the NYISO website or comparable means. Prior to the submission of any market power mitigation measure to the FERC for approval as specified above, *the Market Monitoring Unit* shall notify the Market Parties and other interested parties and provide an opportunity for comment on the proposed measure, and *shall submit such measure for review and vote by the Management Committee in accordance with the procedures applicable to tariff filings.*[12]

This safeguard was completely circumvented here and the result is a one-sided, punitive measure that will fail to achieve the competitive price signals that are the goal of the MMP.

The Board must ensure that Section 8.2 of the MMP is adhered to and that the market implications of the ConEd proposal are properly analyzed. In addition, the Board should direct the market monitoring unit to complete its analysis and present its findings to the NYISO stakeholders and the Board before deciding on whether to act on any proposal. The mere fact that the stakeholder process that considered the ConEd proposal was able to produce more votes for rather than against price suppression is no reason for the NYISO to allow its own tariff requirements for modifications to market mitigation measures to be circumvented.

VI. The NYISO Board Should Direct NYISO Staff And The ICAP Working Group To Develop Means to Ensure Bilaterally-Contracted and Self-Supplied Capacity Do Not Suppress Capacity Market Prices As Part of The Consideration Of Any New Mitigation Measures

Recent settlement agreements pertaining to the design of the capacity markets in neighboring regions contain important policy developments, and the Board should direct further study of theses issues contemporaneously with any consideration of additional mitigation to be imposed on DGOs. Specifically, both the recent ISO-NE and PJM settlements recognize that bilateral contracts may suppress market clearing prices, whether through ordinary bidding dynamics or through the exercise of monopsony power by LSEs. In each region, provisions have been devised to limit such price suppression. The NRG proposal contains provisions addressing this issue, and the Board should require consideration of this element of the NRG proposal.

Buyer's market power is a legitimate concern. An entity that has an out-of-market mechanism for cost recovery (i.e., a bilateral contract or a guarantee of cost recovery through retail rates) can bid that generation into the capacity market below its cost, thus distorting the market outcome for the entire supply side of the market. The incentive for such action by an LSE can be very strong, since there might be significant savings resulting from the LSE paying the suppressed price for the LSE's entire capacity obligation.

In what may be the most well-considered approach to this issue, the Forward Capacity Market ("FCM") settlement approved by FERC this spring includes an "Alternative Price Rule"

[12] *See* New York Independent System Operator Market Monitoring Plan, Section 8.2 (July 26, 1999) (emphasis added).

for capacity bids, such as those from "out-of-market" bilaterally contracted resources, that are bid at zero or other levels that manifestly do not represent their true costs.[13] As the Connecticut Department of Public Utility Control explained in comments filed in support of the ISO-NE settlement:

> [T]he Alternative Price Rule helps to ensure … that the competitive cost of new entry sets the Capacity Clearing Price and, therefore, provides incentive for investment in new capacity.
>
> ....
>
> [I]t is important that unrepresentative bids do not distort the competitive market outcome. Too much volatility above or below the cost of new entry will create undue risks for investors and increase load's costs. The Alternative Price Rule should help prevent that volatility by identifying and excluding bids that do not represent true costs. In no way does the Alternative Price Rule preclude self-supply or bilateral contracting or delegitimize those transactions …. Load may arrange any form of self supply and may thereby protect itself from uncertain capacity prices. Indeed, so long as a self-supply resource bids its true costs reflecting the cost of new entry, it can – like any other New Capacity – set the Clearing Price …. Only when the self-supply resource's bid does not reflect its costs will it be deemed Out-Of-Market and potentially trigger the Alternative Price Rule. The Rule is a reasonable mechanism to protect the Capacity Clearing Price from distortions that will create undesirable volatility and risks that increase load's costs.[14]

Such a rule is necessary in New York to reduce the incentives and potential for bilaterally-contracted capacity to suppress prices without restricting the ability of market participants to engage in, and realize the full value of, commercially reasonable bilateral contracts.

In addition, a forward procurement mechanism for capacity that establishes lead times and commitment periods will provide an improved forward price signal and should result in the construction of new capacity when required. The NYISO auctions produce price signals based only on the outcomes of six month, monthly, and spot markets. There are no opportunities through the NYISO markets beyond the six month term. As a result, the NYSIO market is failing to send any forward price signal and the NYISO is not taking the necessary steps to ensure that capacity will be constructed by the time it is needed. The market structures in ISO-NE and PJM, in contrast, have established lead times of three years and commitment periods of one year or more. Therefore, existing and new generation compete head-to-head and the new entry disciplines the potential market power held by existing generation in concentrated markets. While the NRG proposal contained both of these critical components, the ConEd proposal focuses simply on lowering the bid cap of the DGOs so that the clearing prices will be at or below these revised bid caps, and the Board should also require consideration of this element of the NRG proposal.

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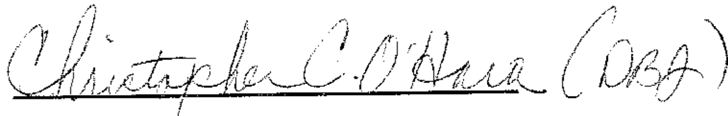
[13] *Devon Power LLC*, 115 FERC ¶ 61,340 (June 16, 2006); *see, e.g., id.* at PP 109-115 (discussing the Alternative Price Rule).

[14] *See* "Load Supporters' Reply Comments," submitted by the Connecticut Department of Utility Control *et al.*, Docket Nos. ER03-563-000 *et al.*, at pp. 29 - 30 (April 5, 2006).

VII. Conclusion

The Board should reject the Management Committee's approval of the ConEd proposal to impose additional mitigation on DGOs as unsubstantiated and unanalyzed, and as likely to hamper needed investment in New York City by increasing regulatory and market risks, and thus costs, facing investors. If the Board determines that immediate reforms are necessary, they should be balanced, consider the impact on new entry and retirements, and should not trigger over-reliance on out-of-market bilateral contracts to replace wholesale market competition. Specifically, the Board should require the Management Committee to modify its recommendation to reflect the important market reforms contained in the NRG proposal. In particular, the NRG proposal contained provisions that appropriately incorporate bilaterally-contracted and self-supplied new capacity into the price clearing mechanism, reduce incentives for the exercise of buyer market power, and establish a longer term forward procurement. Furthermore, the Board should direct the market monitoring unit to work with market participants, as required by the MMP, to analyze the impact of any changes to the In-City capacity mitigation measures, before they can be considered by the Management Committee.

Respectfully submitted,



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