STATE OF NEW YORK DEPARTMENT OF PUBLIC SERVICE
THREE EMPIRE STATE PLAZA, ALBANY, NY 12223-1350
Internet Address: http://www.dps.state.ny.us

October 23, 2006

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

Re: New York State Department of Public Service Staff Motion In Opposition To Appeals From The Management Committee's September 29, 2006 Decision Approving In-City Installed Capacity Market Monitoring And Mitigation Measures (Motion #4)

Dear Ms. Antion:

Enclosed, please find three copies of the Department of Public Service Staff's Motion In Opposition to appeals from the Management Committee's September 29, 2006 decision approving market monitoring and mitigation measures.

Very truly yours,

David G. Drexler
Assistant Counsel
(518) 473-8178
Fax: (518) 473-7081

cc: Management Committee Members (via E-mail)

BEFORE THE BOARD OF DIRECTORS
OF THE NEW YORK
INDEPENDENT SYSTEM OPERATOR

Motion In Opposition Of The Staff of the New York State Department of Public Service To Appeals From The Management Committee's Decision Implementing Installed Capacity Market Mitigation Measures

INTRODUCTION AND SUMMARY

New York City (NYC) is a large load pocket, requiring about 9300 MW of local installed capacity (ICAP). About 5900 MW of ICAP is owned by three large suppliers (i.e., KeySpan, USPower Gen, and NRG). Each of these suppliers is pivotal in the sense that supply from each is needed in order to avoid a capacity deficiency. As such, each supplier has the ability to set market prices.

Due to market power concerns at the time Consolidated Edison Company of New York, Inc. (Con Edison) divested its generation units, various restrictions were placed on the purchasers of such units. Among other things, the divested generation owners (DGOs) were subject to bid/price caps limiting revenues to a maximum of $105 per kW-year. Further, the DGOs were restricted from selling their capacity under bilateral contracts with load serving entities, in order to prevent the price caps from being circumvented. Moreover, the DGOs were required to bid all ICAP resources into the auctions conducted by the NYISO, in order to prevent physical withholding.[1]

The NYISO's original capacity market design led to excessive price volatility and was unduly susceptible to market power abuse. In response, in 2003 the NYISO implemented demand curves for the capacity markets. Under this construct, changes in supply lead to gradual and predictable changes in market clearing prices. As supply increases, loads commit to purchase more than the minimum requirement, albeit at a reduced price. An important rationale for the Demand Curve is to prevent a small excess of supply from crashing the market price, thus protecting sellers from excessive downside risks.

In early 2006, approximately 1000 MW of new capacity entered service and was bid into the NYC market, leading to a reasonable expectation that capacity spot prices would decline, both in NYC and in the statewide market. However, the NYC ICAP spot market continues to clear at the level of the bid/price caps on divested generation, equivalent to $105 per kW-year, despite this recent addition of capacity. There is no other explanation, but that the 1000 MW of new capacity in NYC has led

[1] 84 FERC ¶61,287, Order Accepting Market Power Mitigation Measures As Modified, For Filing (issued Sept. 22, 1998).

to a significant increase in economic withholding in the NYC market,[2] impacting both the NYC and statewide capacity markets.

The mitigation proposal approved by the Management Committee addresses the exercise of market power by the three pivotal suppliers in the NYC market. The proposal would establish a conduct and impact test for DGOs, analogous to the mitigation measures already in place in the NYC energy market. The proposal also establishes a reference bid level of $82 per kW-year, which is well above the likely marginal (avoidable) costs of DGO capacity and is reasonable. The use of a generic reference bid level instead of lower unit-specific marginal costs represents a compromise, to limit downside price risks for suppliers and reduce the administrative burden on the NYISO. While there are various other issues regarding ICAP markets that need to be addressed, such as Forward Capacity Markets and the slope of the Demand Curve, those issues should not hold this proposal captive. Staff of the New York State Department of Public Service (DPS Staff) supports this proposal, which is equitable and reasonable, and recommends that it be implemented expeditiously in order to address the on-going exercise of market power. DPS Staff hereby responds to the appeals from the Management Committee's decision approving its implementation.

[2] It appears that almost 800 MW of NYC capacity is being withheld from the NYC market.

DISCUSSION

I. **The Proposed Mitigation Measures Are Necessary To Address The Exercise Of Market Power And The Associated Price Impacts**

The appeals do not dispute that market power is being exercised in the NYC ICAP market through economic withholding. However, this is the reason why the Management Committee approved the implementation of the mitigation measures. This exercise of market power in the NYC capacity market, and the substantial effect it has had on prices, was identified by the NYISO's independent market advisor. As Dr. Patton's 2005 State of the Market Report (August 2006, p.106-107) indicated:

> Prior to January 2006, virtually all of the capacity in New York City was sold. However, after the addition of new capacity in January 2006, there was virtually no increase in the amount of scheduled capacity and, thus, no reduction in clearing prices from the In-City suppliers' price cap. After examining the data on capacity and energy outcomes, we found that the unsold capacity participated in the energy market. The results shown in Figure 59 raise concerns regarding economic withholding from the capacity market. The lack of additional sales after the installation of new capacity in January 2006 had a *substantial effect on clearing prices* in the New York City UCAP market. The unsold capacity in New York City also raised Rest-of-State capacity prices. The capacity market in New York City is highly concentrated and these results are consistent with one or more suppliers having market power (emphasis added) (Figure 59 omitted).

This exercise of market power must be addressed in the short-term so that consumers are not forced to pay artificially high prices that are the result of uncompetitive markets. While it has been maintained that the economic withholding by DGOs does not violate any current provisions in the NYISO's tariff, that is not a reason to reject the MC approval. The tariff anticipates the potential for the NYISO to act prospectively. For instance, where conduct falls below the thresholds for imposition of mitigation measures, but the NYISO nonetheless determines such conduct constitutes "an abuse of market power," the NYISO is directed to request authorization from FERC "to apply appropriate mitigation measures."[3] The NYISO may also impose mitigation measures to "mitigate the market effects of a rule, standard, procedure or design feature of an ISO Administered Market that allows a Market Party to manipulate market prices or otherwise impair the efficient operation of that market, pending the revision of such rule, standard, procedure or design feature to preclude such manipulation of prices or impairment of efficiency."[4] Given the behavior Dr. Patton has observed, economic withholding in the NYC UCAP market is an abuse of market power, manipulation of market prices, and/or an impairment of the efficient operation of the market,

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[3] Attachment H, §1(b); see also, Attachment H, §3.2.3, which authorizes the NYISO to seek authorization from FERC "to apply an appropriate mitigation measure to conduct that departs significantly from the conduct that would be expected under competitive market conditions but does not rise to the thresholds specified…if that conduct has a significant effect on market prices…, unless the ISO determines…that the conduct [is]…attributable to legitimate competitive market forces or incentives."

[4] Attachment H, §2.4(b).

as described in Attachment H (ISO Market Power Mitigation Measures). Therefore, corrective action is warranted.

II. The Proposed Mitigation Measures Are Equitable

NRG asserts that alteration of the existing bid/price cap is inequitable, given that the price it paid for its units was based on an expectation that the existing mitigation measures would continue (p.2-3). However, it is unreasonable for generators to expect that the mitigation measures FERC approved in 1998 will never get modified, and will simply remain as they are forever.

Taking the argument (i.e., that the existing mitigation measures must be maintained in unaltered form, given prior expectations at the time of Con Edison's divestiture) to its logical conclusion would mean that any market rule cannot be changed once it is approved. For example, it would have precluded the introduction of the demand curve in 2003, which benefited suppliers by increasing sales and limiting price reductions during periods of excess supply. Obviously, such an approach would lock in the market to inefficient and outdated rules. The NYISO Board should reject this argument.

At the time of divestiture, there was an expectation that new entry into the market would discipline prices so that the price cap of $105/kW-year, which was considered to be higher than the cost of new entry, could be removed.[5] Under these circumstances, investors in the DGO assets would have expected to realize a capacity price below the price cap in the future, and would have reflected that expectation in the valuation of the generation assets accordingly. Thus, there is no basis to support an argument that Con Edison's ratepayers realized proceeds from the sale of assets valued commensurate with an expectation of a permanent $105/kW-year capacity price. Moreover, ratepayers in the Rest-of-State market did not receive any proceeds associated with the divestiture of Con Edison's assets, yet they have been impacted by the economic withholding by some DGOs.

Rather than shying away from the proposed mitigation measures under the guise that it will add to regulatory uncertainty, it is more important to recognize the on-going exercise of market power and implement measures that work toward getting the market right. This will help ensure consumer confidence in competitive markets by sending a signal that the exercise of market power will not be ignored in the NYISO markets. Regardless, the DGOs have had the benefit of prices at the $105 cap for over *seven years*.

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[5] 84 FERC ¶61,287, supra; KeySpan Hieronymus White Paper, posted as part of MC meeting materials at: http://www.nyiso.com/public/webdocs/committees/mc/meeting_materi

KeySpan’s claim that the new DGO reference price will become the new price ceiling is incorrect and should also be rejected. Contrary to this assertion, the mitigation measure approved by the MC does not modify existing bid and price caps. Rather, it simply introduces a new layer of conduct and impact tests to detect economic withholding by DGOs. When a DGO fails such tests, their bid will be replaced with a pre-determined reference bid price. While the proposed mitigation measures would establish a $82 kW-year reference price for the DGOs, the DGOs will still be able to receive up to the $105 kW-year price cap, and new capacity can get a price even higher.

III. **The Proposed Mitigation Measures Are Reasonable**

KeySpan's claims that the proposed mitigation measures are not justified and cannot be supported lack merit. The proposed conduct and impact tests are analogous to the approach used to detect withholding behavior in the New York City energy market and are reasonable. In fact, the NYISO Market Monitor has indicated that the conduct and impact test approach is a valid measure to use in detecting market power in capacity markets.[6]

als/2006-09-29/agenda_08_CRA_International_Summary_of_Findings.pdf.

[6] Market Monitoring, Analysis and Performance of Proposal for IN-City Capacity Mitigation, presented at the September 5, 2006 ICAP working group meeting.

The energy market mitigation is based on a reference bid that is intended to reflect unit-specific marginal energy costs. A comparable reference bid level for the capacity market would be based on the unit-specific ‘To-Go’ cost (i.e., avoidable cost net of other market revenues).[7] However, Market Monitoring determined that a lot of effort would be needed to compute individual reference prices based on to-go costs, which would delay implementation of the mitigation proposal. Moreover, the NYISO Market Monitor indicated that to-go costs are expected to be relatively low, leading to concerns over excessive price volatility and even reliability, if prices were forced that low. According to the Market Monitor, "[a]fter net revenue estimates are subtracted from the avoided cost estimate,…reference prices for most generators [were expected] to be less than anticipated demand-curve price outcomes."[8]

In light of these concerns, the MC proposal attempted to address the problem by fixing the reference bid level at $82/kW-year, an amount well above what the Market Monitor estimated as ‘to-go’ costs. With the 3% threshold, the conduct test does not

[7] August 31, 2005 filing of PJM Interconnection, LLC in FERC Docket Nos. ER05-1410 and EL05-148, Tab G – Affidavit of Joseph E. Bowring.

[8] Market Monitoring, Analysis and Performance of Proposal for IN-City Capacity Mitigation, presented at the September 5, 2006 ICAP working group meeting.

kick-in for bids until they exceed $84/kW-year. This protects New York City suppliers from excessive price volatility.

Appellants argue that if a reference bid level were adopted, it should be even higher than $82. The $82 value was originally based on a safe harbor for capacity bids in the FERC-approved ISO-NE Forward Capacity Market.[9] Appellants suggest increasing this level based on inflation and other factors to $90 or more. However, such high reference bid levels would fail to address the very problem of economic withholding that the MC proposal is attempting to address. For example, allowing a price of $90 per kW-year would permit continued economic withholding of over 500 MW of capacity.

IV. Various Safeguards Are Already In Place To Protect Against The Exercise Of Monopsony Power On The Part Of Buyers, While There Is Relatively Little Protection From Suppliers

Generators have raised concerns with the slope of the NYC Demand Curve and the potential exercise of monopsony market power on the part of loads. The Demand Curve, introduced in 2003, helps mitigate market power with respect to loads as well as suppliers. Prior to the Demand Curve, an increase in supply had the potential to crash the capacity market price because there was no increase in demand as price declined (i.e. loads

[9] ISO-NE used 75% of the cost of new entry (CONE) as a safe harbor for capacity bids by new resources. Using assumptions about the NYC CONE and offsets for expected energy and ancillary services revenues yielded $82/kW-year.

just purchased the minimum requirements). Under the Demand Curve, an increase in supply leads to only a moderate decrease in price, as loads are obligated to purchase more as price declines. Thus, the introduction of the Demand Curves in 2003 protects suppliers from potential monopsony market power, by increasing demand and limiting price reductions in periods of excess supply. The MC proposal provides comparable protection for loads, by ensuring that prices will slide down the Demand Curve as intended during periods of excess supply.

V. Additional Issues Regarding The ICAP Market Should Be Addressed As Part Of The Upcoming Demand Curve Reset

Several generators have raised other issues with respect to the ICAP market, such as the slope of the Demand Curve and monopsony power. The generators ask that these issues be addressed before the proposed mitigation measures are put into place. While these are significant issues that need to be considered and DPS Staff is committed to working on these issues in earnest, they should be addressed through the Demand Curve Reset process already underway. Each of these issues will likely be highly contentious, including Forward Capacity Markets, and will require significant discussion among interested stakeholders. It is unreasonable to hold the Management Committee’s proposal for mitigating the on-going exercise of market power hostage to such a process.

CONCLUSION

It is clear that the DGOs maintain market power in the NYC ICAP/UCAP market. Given these market power concerns, significant mitigation measures were implemented so that the DGOs could not wield their market power inappropriately. However, that is exactly what has been happening within the NYC market. Therefore, additional mitigation is warranted to curb the abuse of market power. The Joint Proposal represents a reasonable and equitable means to do so, while stakeholders work to address additional issues within the ICAP market.

Respectfully submitted,

David G. Drexler
Assistant Counsel
NYS Department of
Public Service
Three Empire State Plaza
Albany, New York 12223-1350
(518) 473-8178
Fax: (518) 473-7081

Dated: October 23, 2006