

October 23, 2006

Via Hand Delivery

Ms. Karen Antion
Board Chairman
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303

C/o Mr. Mark Lynch
President and Chief Executive Officer
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303

**Re: Notice of Motion in Opposition to Appeal of the Management
Committee's September 29, 2006 Decision Concerning Mitigation Revisions
to the Capacity Market**

Dear Chairman Boston:

Pursuant to the Procedural Rules for Appeals to the NYISO Board, The City of New York and Consumer Power Advocates hereby submit five copies of their Motion in Opposition to the Appeals of the Management Committee's decision at its September 29, 2006 meeting to implement capacity market mitigation measures.

A copy of this Notice of Appeal has been electronically transmitted to Ms. Leigh Bullock and Ms. Debbie Eckels to facilitate service on the members of the Management Committee and electronic website posting.

Very truly yours,

Michael J. Delaney, Esq.

Attachments

**Motion in Opposition by the City of New York
And Consumer Power Advocates To Appeals of the Management Committee
Decision of September 29, 2006 Concerning Mitigation Measures
For Capacity Market Operations**

In accordance with the Procedural Rules for Appeals to the ISO Board, the City of New York (City), and Consumer Power Advocates (CPA) hereby file their Motion in Opposition to the appeals filed herein by KeySpan-Ravenswood LLC, various IPPNY members, NRG, and ECS. Consumer Power Advocates is an association of large, non-profit institutions whose primary goal is to decrease the cost of energy by focusing on regulatory decisions and programs which impact energy consumers in New York City.

Appellants challenge a vote taken by the Management Committee on September 29, 2006 to approve certain specified market mitigation measures applicable to the in-City capacity market in order to diminish the likelihood of market distortions by pivotal bidders in that market.

Summary

Under challenge here are the terms of a broadly supported vote in the Management Committee (MC) to address the practice of economic withholding. This action will permit the capacity market to operate as it was intended – setting the clearing price as a function of the interplay of supply and demand, and reducing, if not eliminating, the likelihood of gaming of the capacity market system currently in effect. The appeals filed in this matter should be rejected by the Board, and the action of the Management Committee should be upheld and implemented with a Federal Power Act Section 205 filing.

The mitigation measures proposed here are entirely reasonable ones, and moreover, are the products of a stakeholder process that notably included the Staff of the Department of Public Service (DPS). DPS was the entity that initially expressed concerns in June of this year over the operation of the capacity market, and DPS was also instrumental in helping to craft the mitigation measures that

ultimately became the MC motion under attack here. The advent of 1000 megawatts of new City capacity failed to lower prices – thus in large measure refuting the explicit promise of the expensive 2003 demand curve addition to the NYCA market. Indeed, in some instances the capacity clearing prices actually increased compared to the 2005 strip auction, a result that was clearly anomalous, and one that occasioned an entirely justified market participant response. That response ultimately took the form of the MC action under challenge here.

The MC-approved mitigation measure is thus no parochial end user measure intended only to lower costs, as some Appellants have suggested. Rather, it is a reasoned and widely supported reaction to existing bidding practices that distort the capacity market, and thereby impose supranormal prices on the consuming public while enriching capacity providers in a manner that exceeds even the generous current compensation formula. The actual parochial concerns at issue here are those of the beneficiaries of the supranormal capacity pricing that has heretofore been permitted to occur, not the end users and many others who supported the measure at the Management Committee.

The Board should reject the appeals filed herein, and proceed to implement the mitigation measures set out in the MC action item approved on September 29, 2006.

Argument

1. Generators Should Not Be Entitled To Artificially High Capacity Prices

The existence of a capacity market price cap does not imply that under all circumstances such a cap becomes a floor as well as a ceiling for Divested Generation Owners (DGOs). As noted in the Con Edison Motion in Opposition, the cap was created because the DGOs were pivotal suppliers that could exert market power in the In-City capacity market, and it was necessary to temper the exercise of that power. As such, the cap is but one of the mitigation measures for

capacity and energy that was created to reflect the economic realities that prevailed, and still prevail, in New York City.

NRG argues that additional mitigation would alter the currently established rules.¹ This is true – just as it is true of every other NYISO-administered market change that has taken place in the several years that the NYISO has been in existence. Regulatory risk is inherent even in a partially deregulated market. Like generators, energy consumers have borne the financial consequences of various changes. The free interplay of market forces in New York is thus limited in various ways. One of the key characteristics of our deregulated market is the greater risk – and the potentially greater reward – for market suppliers. Thus, NYISO regulations, policies and tariffs are subject to change, and appellants can hardly claim surprise or inequity from the fact of periodic market design adjustments.

Thus, there can be no reasonable expectation that a particular cap subject to no further adjustment would continue indefinitely. And in the face of market distortions, it is sometimes necessary to recognize structural weaknesses and to address them, as has been done here by the Management Committee. Untrammelled market forces cannot be permitted to hold sway over the welfare of the public, especially when undue power is apparently being exercised.

Finally, as been mentioned elsewhere, there is clear judicial authority for the proposition that the purpose of a capacity market and capacity payments is not to reward existing generators for their investments, but to ensure system reliability. In that sense, the capacity market is a construct, not a mere account against which generators may draw at their will.

2. The Vote by the Management Committee Was Well Supported

It is also noteworthy that the Management Committee approval vote here was substantial. Despite the strained efforts of KeySpan to parse the vote for signs that it was not overwhelmingly

¹ NRG appeal at p.3

affirmative,² nearly 70% of market participants voted in favor of adoption of the measure. While such vote totals cannot be determinative in considering an appeal, and the Board must consider any issue arising before it on its own merits, widespread market participant support remains a legitimate factor for the Board's consideration. This is particularly true in the face of spurious suggestions by some appellants that a narrow coalition of end users has in some Machiavellian fashion pushed through a measure at the Management Committee without truly broad support.

3. Recent City Capacity Prices Have Clearly Been Excessive

The price of a commodity should decrease as the supply of that commodity increases. This theory underlies the demand curve market design that was implemented by the NYISO and approved by FERC in May of 2003.³ It was also expected by FERC, which stated in its Demand Curve Order that the demand price would gradually fall for amounts of capacity beyond 118 percent of peak load.⁴

During the past year approximately 1,000 MW of new capacity was added in the City, yet the price of capacity has mysteriously remained at the maximum permissible price cap level. Unaccountably, appellants argue that prices should not have decreased with this additional capacity,⁵ a view that is antithetical not only to traditional economic theory, but to the positions taken by many the supporters of the demand curve implementation, who explicitly made the connection between new market entrants and the resulting decrease in prices to be expected from their arrival.

This is a key distinction, particularly given the enormous capacity of KeySpan-Ravenswood, and KeySpan's resultant status as a pivotal bidder in the highly constrained City market. For New York City and CPA, there are clearly critical potential market power issues

² KeySpan appeal at p. 1, n. 2

³ *New York Independent System Operator, Inc.*, Order Conditionally Accepting for Filing Tariff Revisions, 103 FERC ¶61,201 (May 2003) (Demand Curve Order)

⁴ Demand Curve Order at Para. 5

⁵ NRG, p.3; KeySpan, pp.-2-3; IPPNY, p. 6

implicated by the 2006 capacity bidding patterns. These issues alone fully justify the implementation of the MC-approved capacity mitigation measures.

The City has experienced the development of approximately 1000 MW of new generating capacity since the beginning of 2006, increasing the amount that could be bid into the installed capacity auctions. NYISO President Mark Lynch, in a letter sent to the FERC Office of Enforcement earlier this year addressed related concerns that had been brought to his attention:

He stated that “despite the additional capacity, spot auction prices have not decreased,” a result he attributed to the fact that “several suppliers [are] in the position of being ‘pivotal’ and thus able to maximize profits by bidding enough capacity at the price cap to maintain ICAP prices at that level.”⁶ Mr. Lynch further characterized this as an “apparent anomaly of an increase of supply over demand without a resulting drop in prices,” and while saying he saw no tariff violation, brought the matter to the attention of the FERC Office of Enforcement for such consideration and action as it may deem appropriate.⁷

In the case of KeySpan, the issue of its status and role as a pivotal capacity bidder is only heightened by its use of contractual arrangements to financially purchase 1,800 MW of capacity in the New York City market for a period of three years at a fixed price of \$7.57 per kW-month.⁸ The company has publicly expressed confidence that average City capacity prices will in fact exceed that level, and observed that as of the first monthly summer auction period in

⁶ Letter of NYISO President Mark S. Lynch to Susan Court, Esq., Director, FERC Office of Enforcement (June 7, 2006), at p. 1, available at: nyiso.com/public/webdocs/documents/regulatory/filings/2006/06/ltr_fer_installed_cap_market_06072006.pdf

⁷ *Id.*, p. 3

⁸ Securities & Exchange Commission Form 8-K filed by KeySpan Corporation, May 4, 2006, Accession Number 0001062379-06-000054; First Quarter 2006 Earnings Conference Call, p. 9 (May 4, 2006)

2006, the Zone J capacity price settled at \$12.71 per kW-month.⁹ Clearly, confidence concerning maintenance of inflated capacity clearing prices is not likely to be misplaced when a dominant entity it is in a position, even when acting unilaterally, to make capacity prices clear well above that level.

The corrective action approved by the MC here was not hasty or precipitate, as certain appellants have claimed. In fact, it is responsive to a concern first raised by DPS more than five months ago. An initial DPS analysis in early June, 2006 of the price level for the recent capacity auctions revealed the price to be in large part the product of a failure to bid some 800 MW into the May and June capacity auctions. Having conducted a preliminary review of the auction numbers, DPS representatives indicated that economic withholding appeared to have effectively kept capacity prices considerably higher than they would have been had the remaining 800 MW been bid into the auction:

Based on NYISO posted data, it appears that about 800 MW of NYC capacity went unsold in the spot auctions for May and June 2006. This implies higher prices in both the NYC and statewide capacity markets, compared to an auction where all available NYC supplies had cleared.

If all available NYC capacity had been sold, the NYC UCAP price would have dropped by about \$7.26/kW-month (from \$12.71 to \$5.45). In addition, the NYS UCAP price could have dropped by as much as \$1.28kW-month....¹⁰

This history of the concern that culminated in the Joint Proposal at the MC makes it particularly disingenuous of appellant NRG to characterize the motion that prevailed at the MC as solely an isolated Con Edison concern on the grounds that “the New York Department of Public

⁹ *Id.*

¹⁰ Discussion presentation by NYSDPS, “In-City Capacity Market Performance” at NYISO stakeholder meeting of the ICAP Working Group, June 12, 2006, available at: nyiso.com/public/webdocs/committees/bic_icapwg/meeting_materials/2006-06-12/in_city_capacity_market_performance_nydps.pdf

Service is not a voting member of the Management Committee”¹¹ This observation by NRG is apropos of nothing except an apparent attempt to deny the key role of DPS in first raising a concern over apparent capacity market distortions, and its continuing role in attempting to address those distortions with corrective measures at the ICAP Working Group, the BIC and the MC, as the respective meeting minutes and presentations of those bodies from June through September of 2006 will reflect.¹²

The period leading up to summer 2006 was the first period with large-scale capacity excess in the City. The inflated capacity strip and monthly auction price levels that prevailed despite the advent of new capacity understandably led to incredulity in many quarters, including claims that there was market manipulation, or at a minimum, that pivotal providers of capacity were exercising undue market power and that flawed market structures were being permitted to continue in New York.¹³

4. Economic Withholding Has Kept Capacity Prices Artificially High

It appears that this lack of a price response to an increase in supply was caused by economic withholding. The NYISO Services Tariff, Attachment H, Section 2.4 defines economic withholding in the energy market as “submitting bids for an Electric Facility that are unjustifiably high so that (i) the Electric Facility is not or will not be dispatched or scheduled, or (ii) the bids will set a market clearing price.”

In the capacity market, the yearly price cap has been translated into individual monthly caps for each of the three DGOs. Based on the slope of the demand curve, it appears that the

¹¹ NRG appeal at p. 1, fn. 1

¹² See *e.g.*, comments of Raj Addepalli at MC meeting of September 29, 2006, at p. 5 of 13

¹³ See *e.g.*, June 27, 2006 letter of Assembly Energy Committee Chair Hon. Paul Tonko to Messrs. Kelliher, Flynn and Lynch; July 14, 2006 letter of Teresa Santiago, Executive Director, Consumer Protection Board to NYISO president Mark Lynch; July 19, 2006 letter of Multiple Intervenors to NYISO President Mark Lynch.

supplier with the highest monthly cap can receive an increase in revenue by bidding its full amount of capacity at a price it knows in advance will set the demand curve clearing price at its cap because it knows that at least a part of its bid must be taken. With a calculus of the relative revenue to be derived from getting an artificially high price for a portion of its possible capacity, it can make a decision to maximize its capacity revenue. However, the amount that does clear can result in greater revenues to that generator when compared to revenues it would have received at a lower demand curve clearing price where all of its capacity would clear the auction. Thus, such a party has the ability to, in the words of Dr. Hieronymous at the September 29 MC meeting, not only to know the demand curve clearing price in advance, but to set it.

The foregoing bidding choice may well represent sound economic decision making by the pivotal bidder(s). And it may well comport with applicable regulations and with the existing tariffs of the NYISO, as President Lynch said in his aforementioned June 2006 letter to the FERC Enforcement Office. But neither of those considerations provides any reason not to take prompt corrective steps to address market “anomalies,” as the MC has done here.

The Mitigation Measures will apply to all DGOs. The proponents of the Motion passed here state that this is because it appears that each of the DGOs can independently act as a pivotal supplier. Since each DGO has a slightly different price cap, only the supplier with the highest monthly cap can bid into the demand curve market in a way that forces the market to clear at its price cap. If the supplier with the highest monthly price cap were to be mitigated, the supplier with the next highest cap would be in a position to exert market power by bidding all its capacity at its cap. A review of recent auction results shows that capacity clears at the KeySpan price cap, as was noted by Con Edison.

5. The Mitigation Measures Solve the Problem without Causing Adverse Effects on the Market

A. Capacity Market Mitigation Action Is Warranted

The NYISO has an obligation to mitigate the opportunity for parties to artificially raise capacity prices by economically withholding. The NYISO Market Services Tariff, Attachment H, Section 4.5.a states:

If and to the extent that sufficient installed capability is not under a contractual obligation to be available to serve load in New York and if physical or economic withholding of installed capability would be likely to result in a material change in the price for installed capability in all or some portion of New York, the ISO, in consideration of the comments of the Market Parties and other interested parties, shall amend this Addendum, in accordance with the procedures and requirements for amending the Plan, to implement appropriate mitigation measures for installed capability markets.

The MC recognized that obligation, and fulfilled it by passing the Mitigation Measures by a 69.54% affirmative vote. The NYISO Board must similarly act to amend the tariff and implement the approved mitigation measures.

The City and CPA support the position set out by Con Edison on the issue of the role of the Market Monitor (MM). In sum, the MM route is but one of the avenues by which market changes such may be effected – not the exclusive route

B. The Mitigation Measures Approved by the Management Committee Address a Demonstrated Problem

The Mitigation Measures establish a conduct and impact test that compares the capacity bid of an In-City generator, in the demand curve spot auction, with that of its reference bid to determine if the bid of such generator is inconsistent with the workings of competitive markets. If a DGO bid is the produce of the exercise of market power then its bid will be mitigated to the reference price. This will keep that DGO from unilaterally setting the clearing price for capacity. Importantly, it will not itself necessarily reduce the revenues paid to DGOs.

To the extent that DGOs can bid in such a way as to impede the intended operation of the Demand Curve and, thereby, artificially set the market clearing price and raise capacity prices statewide, the reform adopted by the MC is needed.

C. The Demand Curve Is a Spot Market, Not a Forward Market

The City and CPA join with Con Edison in its discussion of the distinction between the individual six-month and monthly capacity auctions, and the long run cost of entry question. The current demand curve spot markets are intended to reflect available supply in the current month – not expected available supply in some future period. A review of the data shows that currently there is currently significant excess in-City capacity, which will be used up in coming years. The identified need for new capacity that was identified in the NYISO's CRP is for the year 2011 and beyond, not for 2007 or 2008 as some appellants have attempted to characterize it. Con Edison's comprehensive analysis of the market in its service territory, the System Reliability Assurance Study (SRAS) of December 2005 posits an even later capacity need date – 2012. And despite the confusion sought to be fostered in some filings herein, the operative date for the key retirement of the 875 MW NYPA Poletti plant has now been extended past 2008 into 2009, and may well go to the date of early 2010, as IPPNY recognizes in its filing herein.

In another obvious *non sequitur*, KeySpan's appeal quotes the undersigned at the recent MC meeting as stating that the City has identified 1000 MW of new capacity needed to moderate prices. In fact, the sequence of events was as follows: Mr. D'Andrea introduced as an exhibit at the September 29 MC a Power Point presentation that accompanied a speech by Gil Quiniones, Chair of the City's Energy Policy Task Force. The speech, in a manner familiar to all of us, explained the elements of the Power Point at some length. Aside from the fact it was inherently misleading for KeySpan to present to the MC a visual outline of such remarks without the actual remarks, Mr.

D'Andrea and others at the MC then presumed to interpret the Power Point, and did so in an inaccurate fashion.

The remark attributed to the undersigned by the appellant KeySpan was simply to correct such misimpressions – including the key one that the 1000 MW sought in 2004 by the Task Force had nothing to do with reliability. Most importantly, the focus of the Quiniones discussion was to look backward at what the City's Task Force had declared in January 2004 (*e.g.*, the 1000 MW being sought for price moderation), and to examine what elements of the 2004 projections had or had not come to pass in the succeeding years, such as the fact that the many expected older plant retirements had not occurred, thus reducing reliability concerns for some years to come.¹⁴

D. The Proposal Would Allow the Demand Curve to Follow the Normal Workings of Supply And Demand

The Mitigation Measures would allow the price of capacity to move with the quantity of available supply. Depending upon the circumstances, the Mitigation Measures would allow the market price to rise and fall in response to supply and demand. As such, the proposal does not adversely impact the future price signal.

Appellants take issue with the \$82 reference price. In doing so, Appellants fail to recognize that price is not what they would be paid for capacity but, rather, it is a mitigated bid. Generators would still get paid the clearing price as determined by the intersection of the supply bids and the demand curve.¹⁵ At an \$82/kW-year reference price, non-DGOs that lack market power will be able to set the clearing price. And, as recognized by the supporters of the demand curve and by FERC itself, all points on the demand curve represent a just and reasonable price for the associated volume.

¹⁴ See minutes of September 29, 2006 MC meeting at p. 6 for further details

¹⁵ DGOs will receive the demand curve price except to the extent that it exceeds their price caps, in which case they will be paid at the price cap level.

E. Appellants' Self-Serving and Dilatory Tactics Should Not Be Countenanced by the Board

Appellants argue that the proposal was not adequately studied by the NYISO, and that the NYISO itself claims it needs more time to assess total market impacts.¹⁶ The Mitigation Measures are only intended to let the demand curve work as designed. Presumably, the NYISO conducted all such key analyses already in connection with adoption of the demand curve in 2003, and in subsequent reviews. Nothing of any moment has changed since then in terms of the application of the market design. At that time, parties recognized that price would vary with supply. The same is true now.

As a result, the appellants' argument is essentially a dilatory tactic to allow generators to maintain existing inflated revenue streams. It is perhaps best exemplified by KeySpan's September 13, 2006 introduction of a list of scores of purportedly unaddressed questions or issues at the ICAP Working Group meeting. All generators benefit from delay since the result of delay is continued higher capacity prices both In-City, and because of the market design, in the Rest of State capacity market as well, as DPS has pointed out from the first instance.

Generators have no vested entitlement or right to capacity revenues priced at the price cap. As Con Edison has observed, in a properly working market they would not have an entitlement to any particular price for capacity. The market price was intended to fluctuate and their revenues were intended to fluctuate. Thus, there is no equitable reason to keep capacity prices artificially high. Market participants should not have to wait until the demand curve is reset in May 2008, or until a new capacity market may be developed in order to realize spot market capacity prices that are the result of the normal workings of supply and demand and not the result of the exercise of market power in the current month-to-month market.

¹⁶ NRG, pp. 6-8; ECS, p. 1; IPPNY, pp. 2-5; KeySpan, p. 14.

Conclusion

For all the above reasons, the City and CPA urge the Board to uphold the September 29, 2006 decision of the Management Committee in this matter, and to implement reasonable mitigation measures that will ensure the capacity market is not distorted by market participant practices that are at variance with the sound operation of such markets.

Dated: October 23, 2006

Respectfully submitted,

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