October 23, 2006

VIA HAND DELIVERY

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

Re: Motion in Support of the Appeal of The Independent Power Producers of New York

Dear Ms. Antion:

On behalf of US Power Generating Company, LLC, I have attached three original copies of its Motion in Support of the Appeal of The Independent Power Producers of New York, Inc. ("IPPNY").

IPPNY appealed the Management Committee's ("MC") September 29, 2006 decision to approve Motion #4. Motion #4 was based on a presentation that contained a number of important considerations including a discussion of the need to consider load bidding rule changes. Motion #4 recommended, among other things, that the Board of Directors adopt certain Installed Capacity ("ICAP") market power mitigation measures and file those same measures with the Federal Energy Regulatory Commission ("FERC") pursuant to Section 205 of the Federal Power Act.

A copy of this Motion in Support has been delivered to Mr. Ray Stalter for circulation to all members of the MC, via electronic mail. Lastly, we request oral argument.

Very Truly Yours,

Liam T. Baker
US Power Generating Company, LLC

LTB/DUS/aaw
Enclosures
ALB 1093072v1 10/23/2006

US POWER GENERATING COMPANY, LLC
MOTION IN SUPPORT OF APPEAL OF
INDEPENDENT POWER PRODUCERS OF NEW YORK, INC.

I. EXECUTIVE SUMMARY

US Power Generating Company, LLC ("US Power Gen") files this Motion in Support of certain aspects of the Appeal of the Independent Power Producers of New York, Inc. ("IPPNY") which was submitted to this Board on October 16, 2006 (the "Appeal"). IPPNY appealed the MC's September 29th decision to recommend that the Board of Directors adopt a proposal (the "Proposal") related to the ICAP markets[1]. The MC asked the Board to file certain new, supply related market power mitigation measures with the FERC pursuant to Section 205 of the Federal Power Act. However, these measures were only a part of the overall Proposal. The Proposal also included an acknowledgement that some parties believe there is a need to address load bidding issues as well. In fact, US Power Gen was able to support the Proposal because it included this acknowledgement as well as a call for a comprehensive and timely review of all elements of the ICAP market. For the same reason, US Power Gen now files this Motion in Support to support IPPNY's request in its Appeal for a comprehensive evaluation of the ICAP markets and the establishment of a schedule therefore.

II. BACKGROUND

US Power Gen believes that certain fundamental structural flaws in the current ICAP market construct recently became apparent and that rule enhancements are

[1] See Motion #4, Joint Con Edison and DPS Proposal, presented at the Management Committee September 29, 2006

necessary to correct them. These flaws were brought to light by the recent addition of 1,000 MW of new contracted capacity in New York City which was built pursuant to out-of-market discriminatory mechanisms. Certain parties have focused on supply side bidding behavior in an effort to address these flaws. However, structural flaws also exist, and are perhaps more significant, on the load side of the market.

US Power Gen supported Motion #4, because, among other things, the Proposal contained many important commitments that are necessary to ensure the Proposal results in an effective solution to these structural flaws, including the following:

- *Consider other capacity market changes in the context of minimizing seams issues with respect to capacity markets*
- *Parties agree to work collaboratively to further address the concerns of some parties with respect to the potential exercise of market power by sellers and buyers*
- *Parties agree to consider, in the course of the 2008 demand curve reset process, removal of or modification to the existing DGO bid and price caps*[2]

US Power Gen strongly believes that the load bidding issue and other structural issues must be addressed if the capacity markets are to meet one of their core intended purposes -- ensuring the long term reliability of the system. USPG further believes that these issues can be addressed in two stages.

First, the potential for the load side of the market to exercise market power through their bids can, and should, be addressed now. Load side issues must be addressed in the short term through tariff changes that are filed along with the supply side changes that

[2] *Id.* at slide 6.

have been proposed. Issues such as the proper structure for a longer term forward procurement market and the potential removal of, or modifications to, the existing Divested Generation Owner ("DGO") caps will require far more analysis, followed by in depth discussion concerning the specific design for these changes. Thus, these issues should be considered as part of longer term process that has a defined schedule with detailed milestones. IPPNY's request for a comprehensive ICAP market review and the establishment of a schedule therefore is consistent with such an approach, and therefore, US Power Gen supports IPPNY's Appeal and urges the Board to adopt this two stage approach.

III. ARGUMENT

A. CONCERNS REGARDING THE POTENTIAL EXERCISE OF MARKET POWER BY BUYERS MUST BE ADDRESSED IN THE SHORT TERM.

The concept of 'buyer side' market power as a theory, and its exercise in practice, is hardly a novel one. Over the past year, approximately 1,000 MW of new generation was added within New York City. The terms under which this capacity was built and by whom (e.g., the Con Edison contract for the output of the SCS Astoria facility), the manner in which this contracted capacity was then bid into the market and the resultant effect on In City clearing prices all make one thing abundantly clear. The *unconstrained exercise* of buyer-side market power in the New York ICAP markets has now become an issue that likely will require specifically targeted load bidding mitigation measures to be added to the NYISO's tariffs in order to deliver a balanced structure.

This additional supply produced an estimated total supply of 10,375 MW of ICAP (9,813 MW UCAP) within New York City.[3] Forecasted peak load for New York City for Summer of 2006 was 11,627.8 MW, resulting in a Locational ICAP Requirement ("LCR") of 9,302 MW (8798.1 MW of UCAP). Consequently, the result of the out-of-market discriminatory additions was to take the NYC ICAP market well beyond its minimum capacity requirements. Referring to the 2006 Summer Demand Curve for NYC (the "Demand Curve"), if the total available supply had cleared the market(s) in the auction process, it would have been 11.5% beyond the minimum LCR and the Demand Curve would have established a market clearing price of approximately $5.50/kW-month[4]. This did not happen. Instead, the prices for almost all the ICAP sold In City in the Summer of 2006 cleared at, or near, the shaped price cap of Keyspan-Ravenswood, LLC ($12.71/kW-month).

Certain parties alleged that those clearing prices demonstrate economic withholding on the part of Divested Generator Owners ("DGOs"). The Proposal was intended to address those allegations. The very same circumstances which spawned the Proposal, however, illustrate the buyer side market power issue. The approximate 1,000 MW of new generation is owned by, or contracted to, large Load Serving Entities

[3] In May 2006 there were 350.4 MW of SCR resources in New York City. See http://www.nyiso.com/public/webdocs/committees/bic_prlwg/meeting_materials/2006-06-__05/2006_May_registration.pdf. The New York Independent System Operator 2006 Load and Capacity Data Book page 48 shows 9,524.8 MW of Installed Capacity for generating units in New York City on April 1, 2006. Page 54 shows 500 MW for the addition of SCS Astoria, LLC.

[4] As a result of the new additions, there is enough NYC winter capacity to exceed the zero point on the NYC demand curve.

("LSEs") in NYC[5]. Based upon the Summer of 2006 clearing prices, these LSEs must have either directly bid or directed that such capacity be bid by others into the ICAP auction at a price below their actual costs -- in fact, a price likely to be well below their actual all-in costs.

That is, it appears that this capacity was bid at, or close to, zero dollars in order to ensure that every one of these new MWs cleared the market. Because the capacity is financially supported by the aforementioned LSEs through out-of-market contracts, capacity revenues for these new generators are not directly tied to the ISO capacity auction results. Most importantly, were ICAP clearing prices to decrease to the levels expected by some parties, the aforementioned capacity investments would appear to be even further uneconomic, in that their entry cost and/or purchased power agreement payments would far exceed the market clearing prices – at least in the near term. Why would an LSE pay substantially more for a product than it is in fact worth? The logical explanation is that the LSEs would benefit from the resulting collapse in the market clearing price. If allowed to continue, this load bidding practice would kill the capacity market because no entity would provide a market based response to a need for additional capacity so long as out-of-market behavior by LSEs could render their investment worthless. This newly exposed flaw to the buyer side of the current market structure must be corrected as soon as possible.[6]

[5] The 500 MW New Poletti facility is owned and operated by the New York Power Authority for the benefit of its own customers. The 500 MW Astoria Energy LLC facility is under contract to Con Edison for a term of 10 years.

[6] USPG notes to the Board that both the ISO-NE and PJM ICAP proposal included specific bidding provisions that are applied to all new capacity that is bid into their respective markets. These provisions were included to prevent the very buyer side market power issues that have come to fruition in New York.

In last year's Reliability Needs Assessment (the results of which were approved by most of the very parties that supported Motion #4), the NYISO revealed a pressing need for new generation to be built in Southeastern New York. By cobbling together a mix of presumed future demand side response, a transmission line that currently remains in the siting process and a whole host of capacitor bank installations, the Comprehensive Reliability Plan ("CRP") reported that the need had been addressed -- for now. However, this year's RNA base case reveals a pronounced load increase over last year and fewer MWs of proposed future generation. While the results of the 2006 RNA study are not yet known, US Power Gen believes that it is highly likely that additional capacity needs in Southeastern New York will be identified once again.

The 2005 CRP reported that entities proposing market based generation solutions have identified the need for long term contracts to support such investment. To be clear, US Power Gen does not oppose long term contracts to ensure the construction of needed new facilities. However, there must be rules governing how this new capacity enters the market from a bidding perspective.

Absent a corresponding review of, and likely changes to, the capacity bidding practices of loads, any such contracts are likely to be bid into the market in a way that artificially will depress the clearing prices thereby incorrectly signaling to other potential new generation resources, needed existing demand response and generating facilities that they are, in fact, no longer needed. This same process of adding new capacity under contract can be expected to continue each time a need for new capacity is identified, thus repeatedly depressing capacity prices at just the time when circumstances would otherwise exist that would increase capacity prices and send new-build signals. If

permitted to occur, this cycle could have long term effects on the reliability of the system. Thus, capacity bidding practices of loads must be addressed in the short term.

B. REMOVAL OF, OR MODIFICATIONS TO, THE EXISTING DGO BID AND PRICE CAPS SHOULD BE CONSIDERED IN THE COURSE OF THE 2008 RESET PROCESS.

Currently, ICAP market power mitigation is achieved utilizing FERC approved bid and price caps on DGO capacity. The actual price levels for the bid and price caps have not been adjusted since 1999.[7] This hard cap is then shaped to reflect summer and winter differentials in DGO capacity, such that each DGO has the opportunity to achieve the equivalent of the cap, on an annual basis.

The Proposal, if implemented in its current form, would render the existing bid and price cap unnecessary. Retaining the existing cap simply prevents the DGOs from receiving a clearing price above the $105/kW-year cap, should a non-DGO resource become marginal. This is not mitigation, it is punishment. That is, retaining the existing $105/kW-year cap would simply prevent DGOs from receiving higher prices during times of near-equilibrium or shortage conditions. We respectfully encourage the Board to include consideration of removal of, or modifications to, the bid and price caps in any direction given to the Market Participants.

[7] The translation from the original $105/kW-year level to $112.95 kW/year only reflected a change from an ICAP to UCAP methodology. The actual price level remained flat.

C. MINIMIZATION OF ICAP MARKET SEAMS WITH ISO-NEW ENGLAND ("ISO-NE") AND THE PJM INTERCONNECTION ("PJM")

As the Board is aware, ISO-NE's Forward Capacity Market design was approved by the FERC earlier this summer. Proposed tariff modifications to implement aspects of the approved design currently are pending before the FERC. Likewise, PJM has filed, and currently is awaiting FERC approval of, certain enhancements to its ICAP market structure. These enhancements include elements which are sorely lacking in New York's market:

- Forward procurement component
- Market power mitigation or price discipline applicable to *buyers*
- A recognition that, by nature, new entry is lumpy

Both the PJM and ISO-NE settlement agreements are unique and include a multitude of changes to their respective existing ICAP market structures, some of which US Power Gen would most likely object to, were they applied to New York. Thus is the nature of a settlement agreement.

The instant matter before the Board is not a settlement. While the Proposal recognizes ICAP market seams may be created as a result of the Proposal's implementation, it does not state whether or how these seam issues should be addressed. We believe that the New York ICAP market is, or soon will be, isolated from its two adjoining neighbors. It is not too late to prevent this divergence.

We are confident that, with proper support from the NYISO Staff who will play a critical role in providing needed analyses, the market participants could craft balanced and appropriate changes to New York's ICAP design. In the short term, load bidding market power mitigation provisions could be addressed, resulting in a balanced and effective market structure. Thereafter, the analyses needed to develop comprehensive and forward-looking enhancements to the existing ICAP structure could be commenced as a second step. Were such balanced enhancements unable to garner 58% of the MC vote, then perhaps the NYISO stakeholder process is, as Keyspan-Ravenswood, LLC claims, "broken"[8].

[8] See Appeal of Keyspan-Ravenswood, LLC footnote 2.

IV. CONCLUSION

For the foregoing reasons, US Power Gen supports certain aspects of the IPPNY Appeal and requests that the Board send this matter back to the MC to: (i) expeditiously develop short term load bidding mitigation measures; and (ii) define a detailed process, with milestones, to address the longer term capacity market issues.

Dated: October 23, 2006

Respectfully submitted,

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ALB 1093071v1 10/23/2006