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<u>Via Hand Delivery</u>

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 of Management Committee's September 29, 2006 approval of Motion #4 recommending adoption of proposed in-City installed capacity market monitoring and mitigation measures

Dear Ms. Antion:

Pursuant to the Procedural Rules for Appeals to the ISO Board, please find enclosed three originals of Independent Power Producers of New York, Inc.'s ("IPPNY") Notice of Appeal of the Management Committee's September 29, 2006 approval of Motion #4 recommending adoption of proposed in-City installed capacity market monitoring and mitigation measures. A copy of the enclosed Notice of Appeal has been delivered today to Ray Stalter, of the NYISO staff, for circulation to all members of the Management Committee via electronic mail.

IPPNY respectfully requests that it be given the opportunity to present oral argument before the Governance Committee with respect to this appeal.

Very truly yours,

/s/David B. Johnson
David B. Johnson

Enclosures

cc: Ray Stalter, via e-mail

NOTICE OF APPEAL OF MANAGEMENT COMMITTEE'S
SEPTEMBER 29, 2006 DECISION APPROVING CAPACITY
MARKET MONITORING AND MITIGATION MEASURES

SUMMARY

Independent Power Producers of New York, Inc. ("IPPNY"), acting on behalf of its members identified in the footnote below, who are members of the NYISO's Management Committee ("MC"), hereby appeals the MC's September 29, 2006 decision to approve Motion #4.[1] Motion #4 recommends that the NYISO Board adopt proposed in-City installed capacity ("ICAP") market monitoring and mitigation measures (the "Proposal") applicable to the divested generation owners ("DGOs") and file them with the Federal Energy Regulatory Commission ("FERC").

The NYISO Board should reject the Proposal and establish a schedule for the ICAP working group to perform a comprehensive evaluation of the ICAP markets , because the Proposal (1) was hurriedly prepared and is devoid of any meaningful analysis or evidentiary support demonstrating the necessity or appropriateness of such a tariff change; (2) is one sided, in that it fails to address the exercise of market power by buyers; (3) has not received the support of the NYISO's Independent Market Advisor, as required by tariff before a new mitigation mechanism may be approved; (4) if adopted, would send diametrically opposite signals to the marketplace concerning the need for and timing of new capacity resources in the NYISO compared to the findings in the NYISO's inaugural Comprehensive Reliability Planning Process ("CRPP"); and (5) is an inequitable, blatant price suppression tactic, sending a strong message of "Buyer Beware" to any entity contemplating investment in New York.

[1] AES Eastern Energy, LP, Brookfield Power Corp., Dynegy Power Marketing, Inc., Entergy Nuclear Power Marketing, LLC, Fortistar/Lockport Energy Associates, L.P., Indeck Energy Services, Inc., KeySpan-Ravenswood, LLC, Mirant New York, Inc., New Athens Generating Company, LLC, NRG Energy, Inc., PPL EnergyPlus, LLC and PSEG Energy Resources & Trade, LLC.

ARGUMENT

I. THE PROPOSAL LACKS EVIDENTIARY SUPPORT AND HAS NOT BEEN SUFFICIENTLY DEVELOPED OR ANALYZED.

The Proposal, issued less than two days before the MC meeting, establishes, for the first time, a generic reference price and conduct and impact tests that, if failed, would cause DGOs to have their bids replaced by arbitrary, non-generator-specific reference prices. In establishing the reference price, the proponents used figures established by Levitan for 2005 for the in-City cost of new entry arbitrarily reduced by 25%. This amount was then further arbitrarily reduced by $50/kW-year, supposedly representing 100% of the net energy and ancillary services revenues of a facility with a heat rate less than 10,000 btu/hr, as filed by the NYISO in its demand curve reset filing.[2] Equally arbitrary, the conduct and impact thresholds were set at 3%. Neither the 25% offset, the $50 reduction, nor the 3% thresholds were supported by any analysis or record evidence whatsoever.

In contrast to the development process for the ICAP demand curve, and the reset process, the Proposal was hastily prepared, has changed continually and is wholly without any evidentiary support.[3] Market participants have not had adequate time nor been given adequate information to perform a comprehensive analysis of the many complicated issues that need to be addressed before such significant changes to the ICAP markets can be seriously considered. Neither NYISO Staff nor the NYISO's Independent Market Advisor, the two entities upon which market participants must rely for such information, has had adequate time to provide a comprehensive analysis. The NYISO's Market Monitoring and Performance Unit ("MMP") has only had time to

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[2] It should be noted that FERC rejected the $50 proposed by the NYISO and required it to be revised to $48.

[3] The ICAP demand curve was not approved by the MC until after more than six months of extensive debate and deliberation in the NYISO committee process. The reset process took many months and involved an outside independent expert as well as the NYISO experts and Independent Market Advisor. This demonstrates the complexity of the ICAP market and the need to carefully craft any significant changes to it. All of this has been lacking as part of the current process to add new mitigation.

prepare and present a preliminary analysis of an earlier, different proposal.[4] The result is an ill-conceived proposal that the MMP correctly concluded is "not ready for implementation."[5]

At the June 30, 2006 ICAP working group meeting, Consolidated Edison Company of New York, Inc. ("Con Edison") and Department of Public Service Staff ("DPS Staff") presented to market participants, for the first time, eight vague and unsupported proposals to mitigate in-City ICAP bids. It was not until the August 1, 2006 ICAP working group that Con Edison and DPS Staff narrowed their proposals to two alternative conduct and impact tests. Even at this stage, both of these approaches still lacked clarity and detail. Both remained bereft of any analysis or evidentiary support. After only one ICAP working group meeting, during which a large number of significant issues concerning the two proposals were raised but left unanswered, Con Edison and DPS Staff unilaterally deemed the proposal ready for a vote.[6] Only eight days later, at the August 9, 2006 Business Issues Committee ("BIC") meeting, Con Edison and DPS Staff had narrowed their proposal to one of the alternatives, a generator-specific reference price proposal.

At the BIC meeting, market participants reiterated the significant issues concerning the various proposed alternatives that had been raised eight days before, such as the slope of the in-City demand curve, the need for bilateral contracting for DGOs, the potential for large, regulated load serving entities to exercise market power through out-of-market capacity contracts, the interaction between capacity and energy market mitigation measures and thresholds, the

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[4] The MMP's preliminary analysis is one of the meeting materials for the September 5, 2006 ICAP working group meeting and can be found at: https://www.nyiso.com/public/webdocs/committees/bic_icapwg/meeting_materials/2006-09-05/ICAPWG_Preliminary_Analysis_Incity_ICAP_090506.pdf ("MMP Analysis"). Indeed, the one factor that remained the same from the BIC proposal -- the 3% threshold -- was one of the many factors questioned by the MMP in its preliminary analysis.

[5] MMP Analysis at slide 12.

[6] This departs from the long-standing practice of first receiving a recommendation from the appropriate working group before considering such a dramatic change to the market.

interaction between capacity markets and all other markets and impacts on long-term capacity markets. Up to the time of the BIC meeting, none of these concerns had been addressed, much less resolved. No analysis had been performed to assess the impacts of the proposal and no evidence was offered in support of the proposal. Nothing changed at the BIC meeting. Nonetheless, load interests pushed through the generator-specific reference price proposal by a 60.13% affirmative vote at the BIC.

The NYISO's MMP presented its preliminary analysis of the BIC proposal at the September 5, 2006 ICAP working group meeting. This was the MMP's first and only analysis of any of the various alternative mitigation approaches. As a threshold matter, the MMP established that "[a] change of this type requires a full market impact assessment to ensure that implementation will not interact with other market arrangements in a way that produces unintended outcomes." Specifically, the MMP stated a full evaluation is needed to:

> 1. Ensure that it does not distort long-run investment signals
> 2. Understand energy, ancillary services and capacity price impacts across the investment cycle
> 3. Understand short and long-run impacts on
>   - Virtual trading
>   - Seams issues and inter-jurisdictional transactions
>   - Reliability
>   - Constraint and scarcity pricing
> 4. Understand interactions between the proposed approach and the current setting of the demand curve[7]

Turning to the specific aspects of the BIC proposal in its preliminary analysis, the MMP stated its concerns that the proposal would produce reference prices for most generators that would be "substantially less than anticipated demand-curve price outcomes."[8] The MMP was also concerned that the 3% conduct test proposed as part of the proposal is potentially too low. Finally, from a software and implementation standpoint, the MMP also stated its concerns that

[7] MMP Analysis at slide 12.

[8] *Id*. at slide 6.

there has been no determination of the required technical/software modifications and that it needed to conduct an analysis to ensure conduct and impact thresholds are appropriately set. As a result, the MMP concluded the proposal approved by the BIC is "not ready for implementation."[9]

Ultimately, a substantially revised approach, not previously shared with the vast majority of market participants (all of which are affected by the Proposal) until less than two days before the MC meeting, was approved by the MC.[10] As with the proposal approved by the BIC, there was no time to perform a comprehensive analysis to assess the impacts of the Proposal approved by the MC, no attempts were made to address the concerns market participants had previously raised and no evidence was provided in support of the Proposal.

The Proposal also relies on stale data and is internally inconsistent. When asked how the three percent threshold for the conduct and impact test was derived, Con Edison acknowledged that the threshold was its estimate and was only meant to take into account inflation. Yet the Proposal's reference price of $82/kW/year is based on cost of new entry estimates in 2005 dollars, not 2007 dollars when the Proposal is proposed to be implemented. One market participant moved to amend the Proposal at the MC to remedy this internal inconsistency by using 2007 reference numbers rather than the incorrect 2005 numbers, but the proponents of the Proposal refused to accept this reasonable amendment.[11]

Since the concept of mitigating ICAP bids was first proposed in late June, no record has been developed to demonstrate that the existing mitigation measures are unreasonable or that the Proposal will provide the right pricing signals to needed existing and new units. Nor has there

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[9] *Id*. at slide 12.

[10] An evaluation of the Proposal approved by the MC clearly demonstrates numerous, significant changes in comparison to the BIC proposal. No evidentiary support or analysis was provided for any of these changes either.

[11] Motion # 4a failed with 40.61% affirmative votes.

been any analysis demonstrating that the proposed thresholds and structure for reference prices are appropriate. There has been a similar lack of any evidentiary support for the other major aspects of the Proposal. The reason is simple. None has been developed. The failure to conduct a comprehensive analysis of the impacts of the Proposal contrasts starkly against the support provided for the ICAP demand curve proposal, which, among other things, included a dollar impact on the energy markets.[12] As the MMP concluded with respect to the earlier mitigation approach approved by the BIC, the Proposal is not ready for implementation. The Board should reject the Proposal and direct the ICAP working group to conduct a comprehensive evaluation of the ICAP markets.

II. THE PROPOSAL IS ONE-SIDED AND WHOLLY FAILS TO ADDRESS IDENTIFIED BUYER MARKET POWER ISSUES

As further evidence of the rushed efforts of the Proposal's proponents to advance their price cutting agenda, the Proposal is completely one-sided. It imposes harsh mitigation measures on the supply side of the market but does nothing to protect the market from monopsony power potentially exercised by large, regulated load serving entities through out-of-market capacity contracts. As amply demonstrated by Dr. Hieronymus in his Analysis of the Joint Proposal for In-City Capacity Mitigation ("Hieronymus Analysis"),[13] the current ICAP market mitigation design, lacking any protections against the abuse of buy-side market power, is vulnerable to the exercise of monopsony market power by large, regulated providers-of-last-resort ("POLR"), such as Con Edison, which can suppress ICAP market clearing prices by entering above-market contracts with new capacity resources and bidding them into the ICAP auctions at below-cost

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[12] The demand curve was also initially phased in to mitigate "rate shock" to purchasers, notwithstanding the fact that there were financial benefits to procuring additional capacity and the financial benefit of avoiding imminent deficiency prices.

[13] The Hieronymus Analysis is one of the meeting materials for the September 29, 2006 NYISO MC meeting and is available at:
https://www.nyiso.com/public/webdocs/committees/mc/meeting_materials/2006-09-29/agenda_08_KeySpan_Hieronymus_White_Paper.pdf

rates. This strategy is particularly attractive where the POLR is able to recover all costs incurred pursuant to the above-market contract through rate recovery mechanisms approved by the New York Public Service Commission ("PSC").

As Dr. Hieronymus also explained, permitting such a condition to persist will lead to a bifurcated market where new capacity can receive the cost of entry but existing resources are held to depressed clearing prices. Ultimately, this would likely lead to re-regulation of the market through individual reliability-must-run contracts. Recognition of the seriousness of this threat to competitive capacity markets has led our neighbors to the east and south to include specific provisions in their new capacity market designs to protect against the abuse of monopsony power.[14] If left unaddressed, potential investors will not be able to have any confidence in forward market analyses to support their investments. Instead, they will know that they will constantly bear the risk that out-of-market purchases by large load entities could devastate their future revenues.

III. THE PROPOSAL IS UNNECESSARY AND WILL HARM THE MARKET.

The Proposal seeks to develop reference prices for divested generation in a manner that appears to be designed to ensure that market prices will be less than or equal to the new reference price. At its heart, the Proposal is nothing more than a hasty, ill-advised response to a mistaken belief that prices set in the recent in-City ICAP auctions are too high. In the short time since DPS Staff first expressed its concern with the recent in-City ICAP auction results, a number of market participants have exhibited a rush to judgment that the fact that in-City ICAP clearing prices did not drop given recent capacity additions constitutes proof that a market flaw exists requiring immediate and one-sided market rule changes.

[14] *See*, Hieronymus Analysis, footnote 29.

None of these market participants have addressed the compelling explanation set forth in the NYISO's June 7, 2006 letter to FERC demonstrating that the market results and bidding behavior, of which these market participants now complain, were explicitly recognized and expected by FERC, PSC and Con Edison. Moreover, they were relied upon by prospective purchasers when formulating their bids when Con Edison auctioned its generation assets in three relatively large bundles. They were also relied upon by investors who developed and constructed new and efficient capacity in New York City. The PSC and FERC also recognized that Con Edison chose to sell its assets in three bundles to maximize the proceeds from the sale. To address market power concerns resulting from Con Edison's decision to sell its assets in this manner, the PSC required, and FERC approved, a pre-defined set of mitigation provisions, including the $105/kW/year bid and price cap applicable to DGOs. This was slightly less than Con Edison's 1996 cost-based rate. After Con Edison and its customers benefited from maximizing the revenues received from the sale, it is inequitable to deprive the DGOs and other investors in the market of the expected market signal. This is even more inequitable in light of the fact that the cost of new entry is substantially more than the existing price and bid cap and new entry is required. As noted by Dr. Hieronymus, one incorrect assumption when establishing the price and bid cap was that the cost of new entry would be less than $105/kW/year.

Based on the cost-of-entry studies performed in support of the development of the ICAP demand curve, it is clear that the bid cap approved more than eight years ago is less than the cost of new entry and with the recent capacity additions in New York City, results in prices that are well below the cost of new entry. Yet, as demonstrated in the Hieronymus Analysis, the Proposal, if implemented, will likely cause market prices for in-City ICAP to fall much lower than the already insufficient ICAP prices that exist in the current market, destroying the intended purpose of ICAP markets to create market revenues adequate to maintain system reliability.

At a time when the NYISO's CRPP has signaled an imminent need for new capacity, market prices must support new entry. The NYISO and its Board must show confidence in the market and not allow short sighted market participant votes to scare off investment. Neither the markets nor market participant votes should signal that needed existing and new resources have limited value and should be retired or not developed. If allowed to go into effect, the hastily designed and poorly considered Proposal would significantly impair the efficacy of the NYISO's ICAP markets. It would also send the message to potential investors that they cannot have confidence that they will be able to receive the benefit of any bargain they enter into in New York. Rather, in the absence of a strong response from this Board, what investors will have learned is that loads will decide when the prices they pay are too high and will "adjust" them accordingly. Both of these outcomes would be devastating to the ability of New York to attract new investment and retain existing needed facilities and would jeopardize reliability and the markets themselves. In their zeal and haste to reduce prices, market participants representing load interests ignore these basic facts notwithstanding the findings in the NYISO's CRPP, which was just overwhelmingly approved by both the NYISO Board and the MC. The Board should reject this blatant attack on the integrity of the New York market.

IV. THE BOARD CANNOT APPROVE THE PROPOSAL BECAUSE THE INDEPENDENT MARKET ADVISOR HAS NOT RECOMMENDED IT.

The Proposal has not been developed in compliance with the Market Monitoring Plan and therefore cannot be approved by the Board. The Market Monitoring Plan requires that the Independent Market Advisor recommend proposed mitigation measures before they are filed with FERC for approval and implementation.[15] As discussed above, the NYISO's Independent Market Advisor has not recommended the Proposal be adopted and has not even offered any analysis of the Proposal.

Indeed, contrary to the intent of the Market Monitoring Plan, the Independent Market Advisor has had no role in sponsoring the Proposal. In fact, when the MMP presented its views

[15] Market Monitoring Plan § 8.1.

on the problems associated with the Proposal at the September 5 ICAP working group meeting, it indicated that its concerns were shared by the Independent Market Advisor. The Proposal has been driven purely by load-interested market participants at the NYISO. Therefore, the Board should reject the Proposal and direct its Independent Market Advisor and MMP to work with market participants to develop a comprehensive evaluation of the ICAP markets.

IV. CONCLUSION

In light of the foregoing, IPPNY respectfully requests that the Board reject the Proposal, refer the matter of a comprehensive evaluation of the ICAP markets to the ICAP working group and establish a schedule for evaluation and development of any appropriate revisions to the NYISO-administered ICAP market.

Respectfully submitted,

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By: */s/David B. Johnson*
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Dated:October 16, 2006
Albany, New York