

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

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| New York State Electric & Gas Corporation, |) | |
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| Complainant |) | |
| |) | Docket No. EL00-70-000 |
| v. |) | |
| |) | |
| New York Independent System Operator, Inc., |) | |
| |) | |
| Respondent. |) | |

**SECOND ANSWER OF
NEW YORK STATE ELECTRIC & GAS CORPORATION
TO MOTIONS TO INTERVENE AND DISMISS
COMPLAINT AND PROTESTS**

New York State Electric & Gas Corporation (“NYSEG”) submits this Second Answer¹ pursuant to Rule 213 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (the “Commission”), 18 C.F.R. § 385.213 (1999), to motions of certain parties to intervene and/or dismiss NYSEG’s April 24 Complaint in this docket.

¹ NYSEG filed on May 30, 2000, an answer to specified motions filed in this docket on or before May 22, 2000. This answer responds to motions filed after May 22nd by the parties listed in Attachment A.

I. EXECUTIVE SUMMARY

Subsequent to the filing of NYSEG's April 24 Complaint in this Docket ("Complaint"), the markets administered by the New York Independent System Operator, Inc. ("NYISO") have continued their erratic performance, providing additional objective data which further corroborates the software and market design flaws and implementation problems (the "Market Flaws") that NYSEG identified in the Complaint. The Market Flaws have not yet been tested by sustained high demand periods, but, have produced troubling warning signs that the NYISO asks this Commission to ignore. Predictably, some of the generators/marketers (collectively described in this answer as the "Suppliers") take a similar position. As discussed below, Commission inaction in the wake of both clear, unrefuted evidence and disputed issues of fact would be a gamble that could cause substantial harm to retail electricity competition and consumers throughout New York and impede further regional transmission organization efforts throughout the country. Such inaction would also fail the Commission's statutory duties under the Federal Power Act ("FPA") and deny electricity consumers the protections to which they are entitled.

NYSEG filed the Complaint only after repeated and documented attempts to resolve the Market Flaws through the NYISO's committees, staff, senior management, and Board of Directors. NYSEG had no choice because the Market Flaws were and remain too severe to go unchecked through the summer season. Fearing continued irrational market results would be exacerbated under the strains of peak load, NYSEG asked the Commission to adopt an interim safety net, but only while the NYISO went through its transitional debugging period. The safety net would help to insure that rates are just and reasonable while the NYISO has an opportunity to correct the Market Flaws.

Notwithstanding the NYISO's plea to the Commission and to market participants to have confidence in the NYISO's ability to correct these flaws before the summer hits, and notwithstanding a common theme repeated by many Suppliers that there are no problems or that the problems are insignificant or will be solved before the summer, the market results since NYSEG filed the Complaint only corroborate the need for immediate action. For example, since April 24, the Balancing Market Evaluation software ("BME") used for the Hour-Ahead Market experienced price swings between

negative \$60,000 and positive \$60,000 per MWH inside of a single hour; the NYISO experienced Real-Time Market (“RTM”) prices of approximately \$3,500 per MWH and corrected them to below \$200; and prices have bounced like a ping pong ball between irrefutably high off-peak prices and negative prices. On May 7 and 8, 2000, when a prelude to modest summer weather hit, the NYISO had to reserve prices, which means they are subject to future correction, in the RTM for 26 hours and in the Day-Ahead Market (“DAM”) for 24 hours. On May 24, 2000, real-time prices in the Capital Zone went from negative \$1,141.38 to positive \$1,229.14 in a span of seven minutes. This week a new anomaly appeared. On June 5 and 6 NYSEG witnessed a simultaneous reduction in Total Transfer Capability (“TTC”) for at all external interfaces in the western part of the state². Despite a clear arbitrage opportunity, where PJM prices were well below New York Control Area (“NYCA”) prices, NYSEG was stymied when it tried to import cheaper energy. The NYISO has not provided a clear explanation as to why this happened. Even in June, after many changes have been implemented, unusual things are happening for which there is no explanation at this time.

In contrast to the NYISO position shared exclusively by some Suppliers, most other parties taking a position in this proceeding cite significant Market Flaws and the need for an interim safety net. Industrial customers, competitive energy services companies (“ESCOs”), consumer advocates, municipal utilities, transmission owners, public power supply authorities, cities and counties, and the New York Public Service Commission all support some form of interim safety net during the NYISO’s transitional period. On June 5, 2000, in a vote of no confidence in the market, the NYISO Management Committee passed by a nearly two-thirds majority (63%) a motion to introduce interim bid caps for energy and ancillary services. Rather than showing a balanced recognition of market problems, the NYISO has responded in its motion to intervene and dismiss the Complaint that the problems are not significant, yet has offered scant evidence to support this conclusion. ISOs are charged with a public function. They are a preliminary supplement to the regulatory process. The NYISO’s failure to recognize market problems, and the impact they cause, is very troubling. Instead, as if it could admit no wrong, the NYISO belittles or ignores the problems, yet at the same time states

² This includes the PJM, Ontario Hydro and Hydro Quebec.

that it anticipates or expects that corrective action will be implemented before the summer peak season. As witnessed by many interventions and the June 5 vote of the Management Committee to adopt bid caps, the NYISO has not instilled confidence in a substantial portion of the market. With its plethora of experts, the NYISO uses a series of averages and generalizations to sweep the Market Flaws under the rug. As discussed below, from the perspective of real traders, load serving entities and electricity consumers, this jargon does not overcome many troubling facts showing a market in distress.

Not even the Suppliers are united in denying the Market Flaws or the need for a safety net. The Suppliers that intervened in this docket may be divided into three groups. First, some object to any form of light-handed discipline or safety net while the NYISO gets through its transitional period. Without any factual support whatsoever, they argue that the problems do not exist or are not substantial. They also argue that any form of safety net would cause the end to generation in competitive markets in New York for years to come.³ Second, other Suppliers concede that there are many Market Flaws, but object to any interim safety net.⁴ Finally, some Suppliers agree that the Market Flaws warrant a safety net or some form of mitigation.⁵

It is truly ironic that some Suppliers argue that NYSEG has blown the NYISO's start-up problems out of proportion while arguing that any interim safety net will end generation development in New York. Unlike the Suppliers, NYSEG has provided factual information to substantiate its claims. NYSEG also demonstrates below that the Suppliers' claim that any interim safety net would be the end of a competitive market in New York is ridiculous. NYSEG does not seek revocation of market-based power sales tariffs of Suppliers for bilateral transactions. It is the NYISO's market-based charges paid to Suppliers and the market-based charges paid by customers which are producing erroneous results in the ISO-administered markets. NYSEG's Complaint seeks a safety net with

³ These Suppliers include: Constellation, Indeck, IPPNY, Orioin and NRG. See Attachment A for complete company names.

⁴ These Suppliers include: Acquila, Dyngergy, EPSA, PG&E, PP&L, PECO, Sithe, and Williams.

⁵ These Suppliers include: NEMA, NIMO and PSE&G.

respect to these markets only.

The NYISO does not deny the existence of many Market Flaws: (a) wrongly curtailed bilateral transactions caused by a software evaluation phase that is riddled with flaws; (b) misapplied rules to fixed-block generation causing unnecessarily high energy prices; (c) tariff violating supra-competitive payments to generators through misapplied lost opportunity payments; (d) delayed and inaccurate load data information which prevents final billing to load serving entities (LSEs”) going on several months now; and (e) explicit warnings from neighboring ISOs that inter-control area energy transactions may be out this summer. A list of other Market Flaws exist, which the NYISO contests, including: (a) the severity and imports of inefficiencies significantly reducing energy imports into the NYCA; (b) the right to extend Bid Production Cost Guarantees (“BPCG”) to external generators; (c) odd congestion patterns not seen prior to the NYISO’s taking control of the NYCA energy markets; and (d) and absurdly volatile energy prices. As demonstrated below, with respect to this latter category of issues there remain disputed issues of fact. Either set of issues alone would preclude the grant of a motion to dismiss. Notwithstanding the data it holds, the NYISO has not credibly demonstrated that the market problems are small in nature. After reviewing all of the arguments contained in the motions to dismiss the Complaint, NYSEG is confident that the Commission will find that Market Flaws remain, that the Market Flaws have not been shown to be *de minimus*, and that the NYISO has not demonstrated that it will have all of the corrective action implemented in time to avoid further exploitation of those flaws during peak load conditions. NYSEG has satisfied its burden to demonstrate that significant Market Flaws persist, that an interim safety net is the only reasonable course of action to guide the NYISO through its first summer; and that a refund effective date is legally required.

The safety net should be designed to carry the NYISO through the summer peak period during which time the Market Flaws are being corrected. Intervenors make much of the “chill” on future development that would be created by any market intervention at this time. But that argument does not withstand scrutiny. The current situation in New York is entirely distinguishable from a situation in which high prices due to scarcity or legitimate competitive forces send appropriate market signals for new investment. High prices due to Market Flaws will not send market signals to spur new generation.

Market participants will not invest on the basis of prices that are the result of Market Flaws that will be corrected within six months. Indeed, the price volatility and price corrections that the market is currently experiencing due to Market Flaws call into question whether any economic price signals at all are emanating from the NYISO administered markets today. (The bilateral markets are an entirely different matter.)

Another argument advanced along these lines is that, while intervention to correct obvious flaws could in theory be justified in the current circumstances, it is not advisable because of longer term consequences to the market. In other words, the mere fact that a temporary intervention has taken place – even a temporary intervention in a brand new market with obvious flaws -- will be enough to chill future investment, because potential investors will fear that it will happen again under different, inappropriate circumstances, such as whenever prices rise substantially. This position boils down to an argument that regulators cannot be trusted to discern the difference between high prices caused by the forces of supply and demand and high (and low) prices caused by new systems that are still being debugged. This argument should be flatly rejected.

Finally, one word about NYSEG's motive is appropriate to differentiate myth from fact. Some of the Suppliers parrot the following party line – “NYSEG is unprepared for the summer; it is not hedged; its shareholders bear market price risk; and NYSEG filed the complaint to manipulate the bilateral market in which NYSEG had an RFP.” Although all of these claims are irrelevant to this case, they may be distracting. NYSEG is as prepared for the summer as any utility can be. It is nearly fully hedged. NYSEG is requesting Commission action because the impact of unreasonably high prices could have a debilitating effect on the emerging competitive retail energy market in New York. Moreover, many retail customers in New York will pay market prices for electricity, including all of Con Edison's customers who are subject to Con Edison's fuel adjustment clause. The claims about manipulating the bilateral market are baseless. The Complaint was developed and filed only when it became clear that NYSEG's five-month quest to get the NYISO to correct the Market Flaws would not be achievable before the summer. Rather than attributing impure motives to NYSEG's Complaint, all market participants should be asking:

- Are there serious Market Flaws?

NYSEG along with a significant majority of the market say yes.

- Are the Market Flaws likely to create erroneously high prices and inefficiencies in the Market this summer?

NYSEG along with a significant majority of the market say yes.

- Are an interim safety net and legal remedy needed?

NYSEG along with a significant majority of the market say yes.

Motivations aside, if prices are not the result of a properly functioning competitive market and are not cost-based, they are not just and reasonable. This Commission authorized and modified the NYISO market structure.⁶ It may not wash its hands clean of the ongoing problems within its jurisdiction.

As NYSEG demonstrates in its Complaint and in this Answer, Market Flaws are resulting in erroneously high prices. The FPA's "just and reasonable" standard does not allow the Commission to acquiesce in the NYISO's inaction.

For all the reasons discussed below, NYSEG urges the Commission to take the following action: (i) deny the motions to dismiss the complaint; (ii) order the implementation of an interim safety net through a combination of appropriate bid caps and market price screens with the requirement that the NYISO diligently implement its Temporary Extraordinary Procedures ("TEP") to correct erroneous market prices to the level that would have been achieved had the Market Flaws not existed; (iii) establish a refund effective date of June 23, 2000; (iv) order refunds of all over-charges caused by Market Flaws; (v) establish a hearing to the extent that any of the issues established above present

⁶ See *Central Hudson Gas & Electric Corp., et al.*, Order Conditionally Authorizing Establishment Of Independent System Operator, 83 FERC ¶ 61, 352 (June 30, 1998). See also *Central Hudson Gas & Electric Corp., et al.*, Order Conditionally Accepting Tariff and Market Rules, Approving Market Based Rates, and Establishing Hearing and Settlement Judge Procedures, 86 FERC ¶ 61,062 (January 27, 1999).

disputed facts which must be resolved in order for the Commission to determine appropriate longer-term action; (vi) grant any necessary waivers to effect any of the foregoing; and (vii) grant such other relief as the Commission deems just and reasonable or in the public interest.

II. BACKGROUND

On April 24, 2000, NYSEG commenced this proceeding by filing its Complaint against the NYISO. After extensive negotiations with other market participants to reach a more broadly supported consensus, NYSEG agreed to amend the April 24 filing to withdraw the request that the Commission suspend market-based bidding and require that cost-based bids set the market clearing prices for energy in the NYISO's locational-based marginal price ("LBMP") markets. NYSEG's original request for cost-based bidding is now moot, as is the affidavit of Dr. Steve Henderson which was attached to the original Complaint and addressed the cost-based bidding proposal⁷. On May 10, 2000, NYSEG amended the Complaint to request instead that the Commission approve implementation of a price screen mechanism to be developed in the NYISO Management Committee. NYSEG did not withdraw its other requests for relief, including (1) a refund effective date and (2) an investigation and refund of overcharges resulting from the Market Flaws.

On May 15, 2000, NYSEG wrote the Chairperson of the NYISO Management Committee requesting an emergency meeting to debate the price screen proposal and vote, if necessary, on a form of safety net for the summer capability period. A special meeting was convened May 24, 2000. The transmission owners presented a proposal on four different price screens and described how the screens could be implemented. Representatives of the Generators and Other Suppliers sectors voiced opposition to the proposed screens and NYISO staff raised legitimate issues which needed to be addressed. In parallel, other representatives discussed alternative safety net mechanisms for the summer, including bid caps and cost-based bidding. Sensing the urgency and the need for a workable safety net, NYSEG supported the bid cap proposal and, in conjunction with the transmission owners

⁷ If this proceeding is set for hearing, NYSEG will not be relying upon Dr. Henderson because of a conflict of interest. NYSEG will submit superseding authority for any points Dr. Henderson covered to the extent they remain relevant.

and the public power sector, agreed to work on an improved price screen proposal in tandem with the bid cap proposal.

The Management Committee voted (or so we thought) to adopt a \$1,000 per MWH bid cap (similar to the cap in PJM) applicable to energy sold in the NYISO's LBMP markets - - the DAM and the RTM. The meeting ended, and all participants left secure in their belief that the bid cap proposal would become effective, pursuant to the Management Committee's motion, on June 5, 2000. Not until late the next day, did meeting participants learn that the NYISO staff had miscounted the vote. Only 56% of the votes favored the bid cap proposal, just short of the 58% vote required to pass the motion. (It should be recognized that the Generator and Other Supplier sectors control 43% of the vote, and, when voting together, can veto any motion.) In reliance upon the mistaken vote and believing that a critical part of the safety net would be in effect in June, the Management Committee ended the meeting without discussing remaining alternative proposals or further debating the necessity of bid caps and price screens. The Management Committee subsequently convened another emergency meeting on June 5, 2000 and voted 63% in favor of adopting a \$1,000 per MWH bid cap.

III. NYSEG IS ENTITLED TO ANSWER MOTIONS TO DISMISS ITS COMPLAINT

Parties filing interventions and/or protests in this docket (the "Intervenors") raise a number of issues and request a variety of forms of relief. Though fashioned as motions to intervene and protests, some Intervenors' pleadings constitute motions to dismiss NYSEG's complaint. NYSEG is entitled to answer these motions under Rule 213 of the Commission's Rules of Practice and Procedures, 18 C.F.R. § 385.213 (1999).

Other Intervenors offer conclusions and other information the validity of which NYSEG disputes. The issues in this proceeding are sufficiently complex and the financial and reliability risks sufficiently large that NYSEG respectfully requests that the Commission permit NYSEG to answer Intervenor's comments so that the Commission will have a complete record upon which to base its decision. The Commission has allowed answers to responsive pleadings such as protests when such answers help to clarify issues or provide additional information that will assist the Commission in

reaching a decision.⁸

IV. OVERVIEW OF FILINGS

A number of the Suppliers and other intervenors agree with NYSEG that significant Market Flaws exist and support all or some of the relief requested in the Complaint, including the establishment of a “safety net” during the Summer 2000 peak period.

Most of the Suppliers, agree that some or all of the Market Flaws identified by NYSEG exist.⁹ In fact, in its intervention, PECO added to the list.

- PECO concurs that “NYSEG has correctly identified a number of flaws that are impacting the efficient administration of the NYISO markets” (PECO at 2.) PECO asks the Commission to monitor the NYISO’s progress and require frequent status reports. (PECO at 3-4.)
- PSE&G points out that market participants have concluded that “the current NYISO market is broke” and “the energy market in New York is neither open, robust nor liquid.” (Footnote omitted, PSE&G at 6.)
- IPPNY not only acknowledges that Market Flaws exist, it states that prior to NYSEG’s filing, IPPNY (among others) “identified significant Market Flaws including many of the flaws identified in NYSEG’s Complaint.” (IPPNY at 5.)
- EPSA acknowledges the existence of Market Flaws and agrees that the Commission should “direct the NYISO staff to ‘develop a consensus plan on an expedited basis to resolve the current problems.’” (EPSA at 7.)
- Sithe and AES agree that the NYISO should take all reasonable steps to correct any and all Market Flaws. (Sithe at 4.) Sithe adds: “No one disputes that possible market flaw issues need to be addressed expeditiously.” (Sithe at 9.)

⁸ PP&L Resources, Inc. et al., 90 FERC ¶ 61,203 (2000); Pacific Gas and Electric Co., 90 FERC ¶ 61,190 (2000); El Paso Natural Gas Company, 90 FERC ¶ 61,126 at n.12 (2000).

⁹ PSE&G, PECO, NEM, Orion, PG&E, SITHE, IPPNY, Enron, EPSA and Aquila.

- Aquila, Orion and PG&E Generating concede that the New York market has flaws. (Aquila at 4; Orion at 3; PG&E Generating at 5.)
- Merrill “recognizes and accepts that problems likely exist within the New York marketplace.” (Merrill at 4.)

Several Suppliers support some type of safety net. Some support an extension of the NYISO’s existing TEP authority, as previously granted by the Commission, in order to allow the NYISO the time needed to correct existing market and design implementation flaws.¹⁰ PSE&G, in addition to supporting TEP, also is in favor of implementation of the \$1,000/MWH cap proposed by the NYPSC in tandem with the NYISO’s continuing efforts to identify and repair Market Flaws. NEM has also recognized the need to mitigate any adverse consequence of the Market Flaws which its own members have experienced as well as NYSEG.

In contrast to the Suppliers opposing a safety net, every other segment of the market (transmission owners, the NYPSC, ESCOs, LSEs, consumer groups and associations, and governmental agencies) support a temporary safety net.¹¹ In sum, the vast majority of the Suppliers that have intervened, among others, acknowledge the existence of serious flaws in the New York markets. Many of these Suppliers agree that some type of safety net is required. No Supplier that opposes a safety net has offered any factual support for its position. The NYISO, the entity with the information and the obligation to function on behalf of all market participants, has taken a defensive position in this case. It denies the existence of any significant problems and fails to support its claim with any corroborating data.

¹⁰ These Suppliers include: KeySpan, Sithe and AES, Aquila, PSE&G, and IPPNY.

¹¹ Those supporting some type of safety net include: MEUA, NMEM, NSI, SPM, NYPSC, CPB, County of Westchester, and the City of New York.

V. MARKET FLAWS

The NYISO would have the Commission believe that NYSEG “dramatically exaggerates the number and severity of the Market Flaws in the NYISO-administered markets.”¹² The NYISO would also have the Commission believe that “[t]he NYISO has done a good job dealing with the problems it inherited,¹³ and will continue to effectively address any problems that emerge in the future,” and additionally, that the “Commission should not underestimate the NYISO’s ability to effectively address

¹² NYISO Motion, at 26.

¹³ On several occasions, the NYISO has attempted to shift blame for market flaw implementation problems to NYSEG and other entities, primarily transmission owners, by stating that the NYISO inherited the embedded Market Flaws which these entities created and dumped on the NYISO’s lap on November 18, 1999, the effective date of NYISO operations. See NYISO Motion to Dismiss Complaint, Motion to Consolidate, and Conditional Request for Expedited Complaint Procedure at 2, n.1 (Docket No. EL00-63-000) (“Ironically, all or substantially all of the software defects complained of in the NYSEG Complaint were contained in the system created, and then turned over to the NYISO, by NYSEG and its fellow transmission owners at the time the NYISO commenced operations.”) See also, NYISO Motion, at 26-27, “It must be noted that most of the alleged Market Flaws were implemented during the period prior to the NYISO’s start-up, when market design and implementation was directed by NYSEG and the other entities that created the NYISO’s software and markets, not by the NYISO.”

For the sake of accuracy, NYSEG is compelled to point out that the NYISO controlled much of the nuts and bolts development of the present energy markets prior to start-up. For instance, it is simply untrue that the transmission owners alone created the NYISO’s software. NYSEG and others created the tariffs to which the software must conform. The NYISO, and previously the New York Power Pool (“NYPP”) Staff, which constitutes much of the NYISO Staff today, were intimately involved in developing the current software, and in many cases were primarily responsible for modeling and software developments. Furthermore, the NYISO Board was constituted in December 1998, and selected the NYISO President and CEO in March 1999. Several software and consulting firms have worked under the direction of the NYISO in the past years, the NYISO directed and reviewed several market trials, and the NYISO was solely responsible for making the determination of whether to continue operations after two flaw-plagued weeks of operation or to exercise its Commission-approved Cutover Plan. It is improper to suggest that the NYISO simply “inherited” the many Market Flaws plaguing the system today. This blame shifting is not only inaccurate, but symbolic of a troubling institutional response -- defensiveness before recognition of the concerns of market participants.

Market Flaws.”¹⁴ Furthermore, the NYISO would have the Commission believe that overall performance of the NYISO-administered markets has improved considerably. As demonstrated below, to this date, the Market Flaws have not been contained sufficiently to avoid the need for both interim relief and a refund effective date.

Progress has indeed been made to correct certain Market Flaws, for which NYSEG commends the NYISO. One example is the NYISO’s commitment to adjust the Dependable Maximum Net Capability (“DMNC”) of generation resources, discussed below. The NYISO has also begun to take far more seriously market participants’ calls for more frequent and more substantive communications. Additionally, the NYISO has shown a greater willingness to recognize, investigate and report on specific Market Flaws. All of this is a welcome step in the right direction.

To end the discussion there, however, would be wrong. The Commission has a duty to assess and address the many problems and unaddressed issues swept under the rug by the NYISO, the very Market Flaws that NYSEG has been pointing out since January.¹⁵ Some of these Market Flaws, including tariff violations, remain undisputed or even unmentioned by the NYISO. Others have been contested. The bottom line is unchanged: serious Market Flaws continue to exist which frequently create prices that are not the result of a rational market, thus it can not be said that the NYISO-managed energy markets’ prices are just and reasonable.

A. Market Flaws About Which There Are No Disputed Issues Of Fact

On a number of issues, the NYISO and other parties do not contest the underlying existence of a Market Flaw or the relevant facts as presented by NYSEG. No party has raised material issues of fact associated with the following Market Flaws: (1) bilateral transactions erroneously curtailed by “random selection” and not *pro rata* as required by the NYISO Open Access Transmission Tariff

¹⁴ NYISO Motion at 27.

¹⁵ See the NYSEG letters to the NYISO pointing out the many areas of Market Flaws dated January 24 and February 25, attached to NYSEG’s May 30, 2000 Answer to Motions to Intervene and Dismiss Complaint and Protests in this docket.

("OATT"); (2) the numerous problems surrounding the operation of the BME; (3) the treatment of fixed block generators; (4) Lost Opportunity Payments in violation of the tariffs; (5) untimely and inaccurate load data; and (6) the concerns over inter-control area energy transactions voiced by neighboring ISOs. Any number of these issues would be enough to deny motions to dismiss the Complaint. NYSEG notes that the Operating Reserves market was found by the Commission to be not functional because of many Market Flaws.¹⁶ We will not repeat the Market Flaws addressed in that docket here.

1. The NYISO Curtails Bilateral Transactions in Violation of its OATT

The Commission went through great pains to make sure that transaction curtailments under the *pro forma* tariff of Order No. 888 would be fair and rational.¹⁷ Under the New York NYISO OATT approved by the Commission, bilateral transactions are supposed to be curtailed in accordance with the economic preferences of the transacting parties based on the decremental bids they submit to the NYSIO. As discussed below, the BME renders this curtailment process akin to the wheel of fortune. Moreover, when the NYISO must curtail transactions with equal decremental bids, it is supposed to administer the curtailments on a *pro rata* basis. As detailed in the Complaint, the NYISO has instituted a policy of arbitrarily and without authorization changing decremental bids in certain circumstances because the NYISO software does not conform to the NYISO OATT requirements.¹⁸ According to Attachment J, Section 5.0, of the NYISO OATT, if multiple transmission service curtailments are necessary for security or other reasons, the NYISO is supposed to implement curtailments based on decremental bids. If there are equal decremental bids, the software is supposed to curtail on a *pro-rata* basis, so that each market participant with the same decremental bid absorbs some of the curtailment.

¹⁶ Order on Tariff Filing and Complaints, Docket No. ER00-1969-000, May 31, 2000

¹⁷ See *Central Hudson Gas & Electric Corp., et al.*, Order Conditionally Accepting Tariff and Market Rules, Approving Market Based Rates, and Establishing Hearing and Settlement Judge Procedures, 86 FERC ¶ 61,062 (1999).

¹⁸ See NYSEG Complaint at 22.

Instead, the NYISO's software is incapable of *pro-rata* cuts. Rather than modify the software, the NYISO has instituted a quick fix in clear violation of the NYISO OATT. The fix involves randomly adding a few pennies to one or more of the equal decremental bids so that the bids are no longer equal. In this fashion, the curtailment process continues and by the luck of the draw, one market participant is lucky while another absorbs the full brunt or a disproportionate share of the curtailment. The NYISO does not address these unrefuted facts and tariff violations in its Motion.

2. The UNDISPUTED Facts Demonstrate the BME Continues to Wreak Havoc on Bilateral Transactions and Cause Inefficient Outcomes in the RTM

In the Complaint, NYSEG demonstrated that the BME which is used for transactions in the Hour-Ahead Market ("HAM") regularly produced price forecasts that were far different than the prices in the RTM. The NYISO concedes this fact.¹⁹ When the BME predicts low prices in the HAM, two uneconomic consequences result. First, the NYISO rejects offers of suppliers in the HAM when their bids are in excess of the BME forecast price. Second, parties to bilateral transactions are at high risk of suffering curtailment of their transactions and becoming subject to the RTM. The NYISO curtails import bilateral transactions submitted in the HAM²⁰ when the BME forecast price is below the decremental bids associated with the bilateral transactions and replaces the bilateral transactions with energy from the RTM. Decremental bids are the curtailment vehicle of the NYISO OATT. The Commission would not tolerate a single system transmission provider administering an OATT by cutting transmission service whenever the transmission provider thought it could supplant the transacting

¹⁹ NYISO Initial Report on Price Differential between Balance Market Evaluation and Real-Time (the "BME/RTM Price Differential Report"), May 23, 2000. See Attachment B.

²⁰ NYSEG recognizes that the NYISO has instituted a "must run" status for import bilateral transactions that are accepted in the DAM, and that this process has the potential to eliminate the ability for BME to curtail day-ahead import bilateral transactions for economic reasons. This, however, has been a recent fix and sufficient time has not elapsed to assess the results of this fix. Moreover, this fix does not address many of the BME problems discussed below.

parties' energy with cheaper energy, only to bill the customer for much more expensive energy. Yet this is exactly what is happening under the NYISO OATT. This curtailment approach is not consistent with the deliberate, rational and fair approach the Commission insisted all transmission providers take to transaction curtailments. Whenever BME predicts an erroneously low price, a phenomenon which occurs regularly, the NYISO rejects bids into the HAM that it should have accepted and curtails import bilateral transactions in accordance with decremental bids, and further, replaces energy from internal generators not on economic dispatch, only to replace them with RTM transactions at higher market clearing prices.

These two consequences, in turn, result in greater RTM energy requirements than would have occurred if the BME had not so erroneously forecast prices. These flaws in the BME push the NYISO up in the RTM bid stack to levels that would not have been hit had the NYISO not rejected economic offers in the HAM and curtailed economic bilateral transactions. These constantly recurring Market Flaws cause economic harm to market participants and unjustifiably high LBMPs in the RTM. The higher prices are not the result of a proper interplay between supply and demand in a competitive market. They are the result of software producing erroneous price signals.

While the preceding discussion focuses on situations where the BME under-forecasts the locational price for the upcoming hour, it is just as likely to over-forecast the price. In such instances the BME would accept additional energy offers in the LBMP market. When the real time price ends up being lower than the BME forecast, units that were committed by BME may be eligible for a supplemental payment under the BPCG. These payments are recovered through uplift charges from all load. Thus, the load is once again hit with an uplift charge due to forecast errors in the BME. The NYISO filing asserts that defects in the BME have little impact on real time prices, giving the impression that they have little impact on load. To the contrary, defects in the BME have a profound effect on total charges paid by load. The BME has real consequences for the total cost of energy for load. It accepts or rejects bids in the HAM, and it can create the need for supplemental payments to generators. The NYISO cannot hide from the defects in the BME by asserting that the BME has little impact on prices, or that its impact can be avoided through complex risky bidding strategies.

After searching the NYISO's Motion, there is absolutely no acknowledgment that this is a serious problem and no information whatsoever quantifying the cumulative economic impact of these shortcomings of the BME. The NYISO, however, concedes that the BME problems will not be solved any time soon.²¹ The NYISO has an obligation to use the TEP to recalculate market clearing prices to the levels they would have been had the BME functioned in an efficient manner and to adjust prices to that level. The NYISO is not making these corrections. To the extent the NYISO called on generators with bids exceeding the revised clearing prices, the NYISO could propose a bid guarantee for those generators, but at least the LBMPs would not be erroneously high with corrected prices. The following example is illustrative of the Market Flaw.

Assume that in a particular hour:

- 1) 250 MW is bid in the HAM on bilateral import transactions with decremental bids of \$1
- 2) NYISO receives new supply bids in the HAM for 250 MW at \$15
- 3) The NYISO has the following dispatchable resources in the RTM: 100 MW at \$35; 5 bids of 100 MW each at \$36; and 3 bids of 200 MW each at \$125
- 4) Total load in RTM is 1000 MW

The least cost way to serve load would be to accept the 250 MW of import bilateral schedules from the HAM, accept the 250 MW of supply bids from the HAM at \$15, take 100 MW at \$35 and 400 MW at \$36 from the dispatchable resources. The clearing price in RTM would be \$36, and load would pay \$36 for 750 MW of balancing energy.

Now, however, suppose that in the middle of this process, the BME had erroneously forecast

²¹ See BME/RTM Price Differential Report, at 1, "Some of the reasons for differences [in prices between BME and real-time] are within the ability of the NYISO and the Market Participant to control. These can largely be remedied. Others are beyond the NYISO's or the Market Participants' ability to anticipate or control. Thus, there will always be some differences."

a price of -\$10 in the balancing market (not the lease bit far-fetched from a system that forecasts prices of negative \$10,000 to negative \$60,000).

In that case, the result would be the following:

- 1) 250 MW of HAM bilateral schedules would be curtailed based on their decremental bids of \$1
- 2) 250 MW of HAM supply bids of \$15 would not be accepted in real-time, the NYISO would have had to accept 400 MW of \$125 bids

The clearing price would be \$125, and load would end up paying that price for the entire 1000 MW of load. We don't know what the price was on the 250 MW of bilaterals that were cut, but we do know that for the remaining 750 MW of balancing load, the price was \$89/MWH too high because of BME's error.

Dr. Harvey's suggested fix for this is to tell LSEs to bid the import bilateral transactions with decremental bids at a very low price – presumably below -\$10 MWH, since that is what BME sometimes predicts. But obviously by doing this they forgo the opportunity to participate efficiently in the BME, one of the advertised benefits of the decremental bid feature of the New York model. Moreover, as described in NYSEG's pleadings in this docket and in this Answer, the BME may predict prices of negative \$65,000. The decremental bid process that is the *sine qua non* of transmission priority and curtailment of the NYISO OATT is nothing less than wacky. The NYISO's best advisors suggest that transmission customers should not complain; instead, they should game the system. The Commission saw first hand the results of similar advice from the NYISO in the operating reserves markets in other NYISO dockets.

The BME is broken, and the NYISO appears to believe it has the luxury of time to correct it. In the interim, the NYISO does not attempt to recalculate prices to avoid the erroneous windfall for suppliers and inefficient economic penalty for customers. In light of known flaws in the BME and its relationship to the RTM, the Commission should not simply turn the other way and allow these market inefficiencies to accumulate and compound. Prices must be corrected.

The undisputed facts show that the BME produces erroneous curtailments of import bilateral transactions and turns down economic resources only to replace them with more expensive resources. The undisputed facts show that the NYISO will not fix the BME soon. The undisputed facts show that the NYISO does not attempt to correct the LBMPs that are an outgrowth of the BME's shortcomings. Only the NYISO has the bid data necessary to calculate the cumulative economic impact of the associated Market Flaws. The NYISO's unsupported allegation that the Market Flaws are not significant is woefully inadequate and cannot form a rational basis for the Commission to abdicate corrective action in deference to the NYISO's sole discretion. The "just and reasonable" standard does not allow the Commission to acquiesce in the NYISO's inaction.

3. Fixed Block Generation

In its Complaint, NYSEG raised two flaws regarding the NYISO's administration of fixed block generation. Fixed block resources are bids that must be accepted on an all or nothing basis in fixed amounts. The first flaw was the NYISO's practice of using a fixed block generator to set LBMP in instances where accommodation of the fixed block resource in the dispatch also required the out-of-merit reduction of generation from a more economical resource. The basis for this concern comes from the fundamental definition of LBMP.

As defined in the NYISO Tariffs, LBMP is "a pricing methodology under which the price of Energy at each location in the NYS Transmission System is equivalent to the cost to supply the next increment of load at the location (i.e., the short-run marginal cost)." It is important to note that a fixed block resource, *i.e.*, a resource that can only be operated at its maximum output level, cannot serve the next increment of load because it has already reached its maximum output. Similarly, it is appropriate to allow the unit that has been dispatched down out-of-merit to set the LBMP whenever it is the unit that will be dispatched up to serve the next increment of load. This is not to say that there are not instances where a fixed block resource can and should set the LBMP. For example, in the dispatch interval just preceding the start-up of a fixed block resource, the fixed block resource will be the

resource to supply the next increment of Load and should indeed set the LBMP²². Using fixed block resources to set LBMP in such instances would send appropriate price signals that expensive resources are needed to meet the next increment of load. In contrast, the NYISO is allowing the fixed block bid to set LBMP after it is scheduled. It should not. Using the resource that was dispatched down out-of-merit to set the LBMP while paying a bid production cost guarantee to the fixed block resource yields prices and associated revenue streams that are consistent with the provisions of the NYISO Tariff. Unfortunately, the NYISO is not doing this.

The second flaw cited in the Complaint relates to the potential for the NYISO's pricing policy to allow fixed block resources to simultaneously eliminate congestion and set higher statewide clearing prices. This could occur in situations where the fixed block resource is committed to serve load on the congested side of an interface while relieving congestion due to the out-of-merit reduction of a generating resource on the unconstrained side of the interface. In such a situation the fixed block resource would set the price on both sides of the interface. Initial inquiries regarding this issue received a response from the NYISO that such results were simply supply and demand. Latter indications, however, revealed that the Security Constrained Dispatch ("SCD") algorithm improperly calculates clearing prices in such instances.

The following example indicates the flaw in the NYISO's current application of fixed block generation rules:

Generator A is located in West Zone. During hour 1, Generator A is the marginal generator in the state. No constraints are binding. In hour 2, load rises in East Zone and constraints bind such that Generator A cannot serve all the load in East Zone. Generator B, located in East Zone, is dispatched at a price higher than Generator A. Generator B can be dispatched flexibly, so there is no need to dispatch down Generator A. Under these circumstances, Generator A would continue to be the

²² The resource should not set the LBMP so long as it is not brought on due to a Local Reliability Rule.

marginal generator for West Zone and the LBMPs would diverge between the two zones.²³ This is LBMP pricing and the NYISO follows this practice. However, now assume Generator B bids a fixed block and cannot be dispatched flexibly. The size of its fixed block is larger than the amount of power that is needed to supply the extra load in East Zone, so that if Generator B's bid is accepted, Generator A must be dispatched down. The NYISO may determine that accepting Generator B's bid is nonetheless the least cost way to serve load in the state. NYSEG does not have any objection to that (unless the situation arises because generators that are needed for local reliability in a zone engage in block bidding strategies to extend their must-run status to larger blocks of capacity.) However, the NYISO's pricing protocol in these circumstances is to allow Generator B's bid to set the price in both East Zone and West Zone, apparently based on the premise that it is the marginal supplier in both zones. The result is that the LBMP at Generator A's bus is higher than Generator A's bid price, yet Generator A has been dispatched down and has excess energy that it is ready and willing to sell to the NYISO. This is a clear violation of the tariff and of LBMP pricing. Generator B is not the marginal generator for Zone A. Its block is fully dispatched. If load increased in Zone A it would be served from Generator A, not Generator B.

The result of this pricing practice is that even though Zone A is unconstrained, load in Zone A is paying for the cost of serving load in a constrained area. Even though the marginal cost of serving load differs between the two locations, the LBMP does not reflect that.

The NYISO infers that its practices regarding fixed block bidding allow for better price signals and less "socializing [of] what should be locational costs." See Footnote 91, in corrected NYISO Motion.

However, under the NYISO approach, the price signals are clearly erroneous and it is highly questionable whether the tariff allows the application of their rule. The NYISO does not have a mandate to minimize uplift at the expense of load.

In any event, the NYISO's approach demonstrates a willingness on its part to effect inefficiently

²³ Technically, it would diverge between the two generator busses. This would then cause a divergence in the zonal prices, which are an average of generator bus prices. In New York, generators are paid the nodal price at their bus; load is charged a zonal average price.

high LBMPs and consequently to have customers transfer supra-competitive payments to generators, not in the name of efficiency or economic rationality, but for administrative reasons. This avoidance of responsibility does not cost the NYISO in dollars – the customers have to absorb that technicality – but it does cost the NYISO in credibility and weakens the entire energy market structure in New York.

In its Motion, the NYISO acknowledges that there have been problems with the market design relative to fixed block resources, but contends that the NYISO has or will fix these problems in the near future. The NYISO points to the modeling of groups of fixed block resources as the source of the problem, *i.e.*, multiple gas turbine units bid in 160 megawatt blocks. The solution to this problem lies in the NYISO's efforts to negotiate with the owners of fixed block resources so that the units can be bid in individually as opposed to groups of fixed block units. Further, the NYISO contends that its treatment of fixed block resources is none the less compliant with the tariff.

NYSEG supports the NYISO's efforts to negotiate with the owners of fixed block resources such that the NYISO is able to commit single fixed block resources as opposed to multiple units. If successful, this will help reduce, but not eliminate the impacts of the NYISO's current pricing calculation. However, the NYISO fails to point to explicit tariff language that supports its contention that the current pricing methodologies are consistent with the NYISO tariffs. It simply states that it is compliant with the NYISO Tariffs. We disagree. More importantly, the primary focus should be on whether the market is working efficiently. Even if the NYISO were in compliance with the tariff, compliance with an erroneous tariff element is not

a defense to a market design flaw. The Commission recognized this when it authorized the NYISO's TEP.²⁴

²⁴ New York Independent System Operator, Inc., *et al.*, Order Approving Temporary Procedures, as Modified, 88 FERC ¶ 61, 228 (September 15, 1999) and New York Independent System Operator, Inc., Order Accepting for Filing, 90 FERC ¶ 61,320 (March 29, 2000). In addition, the NYISO filed for a further extension of TEP on May 26, 2000 in Docket No. ER00-2624.

4. Lost Opportunity Payments

In its Complaint, NYSEG stated that there are no tariff provisions allowing for application of Lost Opportunity Payments (“LOP”) to generators forced to back down to make room for the large fixed block generators. Arguably, some form of compensation should be made to generators dispatched down to make room for the fixed block generation, but not without a tariff provision permitting this outcome.²⁵ As NYSEG pointed out, the LOP applies only in the event that a supplier of Class A spinning reserves is dispatched down to allow additional reserves. The LOP applies to the reserves market only. Application of the LOP to the energy market absent a Commission filing is a violation of the existing tariffs. It is not possible for NYSEG to determine how much this has cost New York consumers. The NYISO is the only one who has the data to quantify this amount.

In its Motion, the NYISO concludes that the extension of the LOP to energy markets is consistent with the tariff. While the NYISO says it did not violate the tariff, the facts are not in dispute. The NYISO fails to cite a tariff provision that supports its position. NYSEG contends there is no such provision in the NYISO tariffs. The LOP has been in effect without a filed rate to underpin it, making its legal status under the FPA highly suspect.

5. Load Data Information

In the Complaint, NYSEG observed that the NYISO has been unable to establish sufficiently complete and accurate load data such that load serving entities (“LSE”) may assess the business they have conducted months ago. This makes it difficult for LSEs to evaluate their financial position, including assessing their exposure to the RTM, the attendant volatility and adjusting hedge strategies. Rather than focusing on the disruptive impacts this problem continues to have on LSEs throughout New York’s nascent competitive retail market, and rather than exercising leadership in solving the problem, the NYISO first focuses on shifting blame to third parties. In its Motion, the NYISO states, “The NYISO is equally surprised that the April 24th Complaint blames the NYISO for billing problems

²⁵ As described in Item 3 above, it is not clear that the NYISO is properly calculating clearing prices in instances when fixed block resources are dispatched and other resources are dispatched down out-of-merit. As such, the need for a lost opportunity cost payment is unclear.

associated with meter reads that are the responsibility of transmission owning utilities. For example, the April 24th Complaint suggests that the NYISO's load data has been inaccurate, despite the fact that the NYISO's ability to accurately calculate load is dependent on its receiving accurate data from the transmission owners. The sometimes poor quality of such data has undermined the NYISO's ability to generate accurate load data."²⁶

The critical question today is not who is to blame,²⁷ but whether on June 9, the problem has been corrected with any degree of market confidence, or whether an important element of the NYISO's functions impacting each LSE's business planning and market strategy is still deficient. As discussed more fully in the NYSEG Complaint,²⁸ the lack of load data severely hampers price signals and makes satisfaction of financial and accounting requirements a difficult proposition at best. Despite NYSEG's raising this issue in the April Complaint, NYSEG still does not have a final bill for November 1999. The NYISO's Motion provides the less than satisfactory response that "[t]he NYISO has worked closely with the transmission owners, and other market participants, to devise solutions to the outstanding problems. The NYISO is therefore confident that the billing process will work more smoothly in the future."²⁹ Emphasis added. The continuing unavailability of final load data and settlement for business concluded six months ago contributes to the instability of the market.

The lack of a final bill even for *November 1999* portends other complications as yet unknown. Until at least one billing cycle is complete, market participants cannot even begin to determine if the highly complex billing procedures are (1) correctly designed and (2) correctly implemented. There may be a host of billing problems that have not yet seen the light of day, but will demand exhaustive study and sorting out. If such problems come to light during a highly stressful and potentially chaotic stretch

²⁶ NYISO Motion at 47.

²⁷ NYSEG has complied with all data requests in a timely and appropriate fashion. NYSEG has not received any notification from the NYISO that NYSEG's information is either untimely or inadequate.

²⁸ See NYSEG Complaint at 20-21.

²⁹ NYISO Motion at 47.

this summer, the already serious problems afflicting today's energy markets will be compounded by the necessary reallocation of human resources.

6. Neighboring ISOs

The NYISO contends that NYSEG “greatly exaggerated the risk that PJM would stop pre-scheduling day-ahead transactions with the NYISO.”³⁰ As proof, the NYISO points to a PJM letter of May 22, 2000, which states that PJM is encouraged by a NYISO proposal to allow transactions scheduled in the day-ahead market of New York to be considered must-run for the BME evaluations.

A short review of the correspondence timeline fully justifies NYSEG's pointing out the very large risk that inter-control area energy transactions were in jeopardy. In a March 6, 2000 letter from PJM's Vice President of System Operations, Bruce Balmat, the PJM declared:

Over the last few weeks, PJM has noticed a disturbing trend of prescheduled contracts being routinely, and in many times significantly, curtailed. This has caused hardships to PJM operations that are unacceptable.

...

PJM requests that we return to the policy of only prescheduling contracts that have a high probability of operating as scheduled and that are not subject to reevaluation. PJM understands you may have the ability to change your procedures to allow day-ahead schedules to be considered “must run” intra day. PJM believes this change would allow us to continue prescheduling contracts if they are considered “must run” by both ISO's. If NY cannot change its policy; PJM will be forced to evaluate how we protect the operations of our system. This may include discontinuing the practice of prescheduling any transactions with the NY ISO.

Seven weeks later, there still was no reply from the NYISO to PJM's threat to discontinue prescheduled contracts, nor to PJM's helpful guidance as to a method to alleviate a problem. It was at the seven-week point that NYSEG brought the PJM letter to the attention of the Commission, as a

³⁰ NYISO Motion at 29.

symptom and forewarning of the severity of the import problem.³¹ The NYISO finally responded in writing to PJM three days after NYSEG filed its Complaint with the Commission.

Not surprisingly, the NYISO makes no mention of a May 17, 2000 letter by ISO New England President and CEO Philip Pellegrino stating that because of the NYISO's inability to provide real-time prices on a timely basis, he anticipates that inter-control area energy transactions will not occur during periods of pre-emergency and emergency conditions.³²

Despite the PJM's optimism that implementation of the de facto "must run" status for prescheduled transactions will "ultimately allow for fewer curtailments between the ISO's," the fact remains that ISOs on each flank of New York have fixed warning shots declaring that inter-control area transactions are in jeopardy. The NYISO cannot sweep this fundamental fact under the rug, nor should it escape the Commission's notice.

B. Market Flaws For Which Factual Issues Are In Dispute

The NYISO and certain Suppliers point to several Market Flaws that they contend are not as troublesome as NYSEG suggests, are consistent with the NYISO tariffs, or are naturally occurring events that do not suggest market inefficiencies. This list includes; (1) energy imports in the NYCA; (2) extension of the Bid Production Cost Guarantee to external generators; (3) odd transmission congestion patterns occurring only since the NYISO began managing the energy markets; and (4) extraordinary volatility in the BME and real-time markets. As demonstrated, these Market Flaws remain problematic and are the result of either tariff violations or market implementation failures causing impediments to efficient market operation.

³¹ See Attachment B of Kinney Affidavit to NYSEG Complaint, filed April 24.

³² A discussion of this issue and substantial excerpts from Mr. Pellegrino's letter to ISO New England market participants is included in NYSEG's May 30, 2000 Answer to Motions to Intervene and Dismiss Complaint and Protests in this docket.

1. Energy Imports Into The NYCA

In its Complaint, NYSEG amply demonstrated through analyses and affidavits that energy imports into the NYCA have become unworkable and that this fact could have very serious repercussions during the summer capability season. The NYISO Motion contends that it has instituted corrections to many of the import problems, and even in the absence of these corrections, there is no need for concern. “The NYISO expects that its corrective actions will succeed. Moreover, even if they were to fail, the April 24th Complaint fails to demonstrate that each NYISO market would not be workably competitive, especially given the NYISO’s ability to institute market power mitigation measures and the availability of other, less radical, tools to address any Market Flaws that may affect the NYISO-administered markets this summer.”³³

It is a plain fact that every market power analysis put forth by internal generators as a part of their applications to use market-based rates included imports of energy from outside the NYCA. For the NYISO to sweep aside this fact, and the analyses and affidavits submitted by NYSEG in its Complaint, is simply reckless. The NYISO offers no analysis to back up its position that imports will not play an essential role this summer in the New York energy markets. The NYISO’s out-of-hand dismissal of this extremely important issue does not bode well for New York this summer.

The NYISO’s experts, Dr. Harvey and Mr. Hartshorn, also contend that NYSEG’s analysis of PJM to NYISO price differentials apparently do not reflect the impact of real time price corrections, stating that on average New York prices have been less than PJM prices.³⁴ Further, they indicate that NYSEG’s analysis of arbitrage opportunities is flawed as market participants do not have the benefit of NYSEG’s 20-20 hindsight.³⁵ While seemingly plausible on the surface, closer analysis shows that both of these claims are incorrect.

³³ Corrected Version of the NYISO Motion, dated May 30, 2000, at 36.

³⁴ Id., Attachment 7, Joint Affidavit of Scott M. Harvey and Andrew Hartshorn at 6.

³⁵ Id. At 7. “[Kinney’s] analysis assumes, however, that an importer scheduling transactions in the Hour Ahead Market would have had access to all of the information that was available to Mr. Kinney after the fact.”

First, the NYISO's "average" numbers cover all hours. There are hours in which prices in PJM were higher than New York as well as hours in which prices were lower in PJM. To simply state that the averages are close completely misses the fact that in any given hour economic opportunities exist in one direction or the other. The NYISO's analysis would suggest that should one market be priced at \$20 dollars over the course of ten hours and an adjacent be priced at \$10 for the first five hours and \$30 for the last five hours that, there would be no opportunity for arbitragers to drive the prices together since on average the prices are equal³⁶.

NYSEG's analysis covered the hours in which prices in PJM were lower, and it was thus profitable to import from PJM. There were also hours when it would have been economical to export from New York into PJM. While NYSEG did not provide this analysis in its original filing, such an analysis would further show the inefficiencies and lack of liquidity between the two markets as evidenced by the lack of arbitrage.

That brings us to the issue of NYSEG's twenty-twenty hindsight. NYSEG has reviewed its previous analysis of those hours when the PJM price was less than the New York price by a sufficient amount to suggest that arbitrage was possible. To add a significant degree of conservatism to the analysis, and avoid the "twenty-twenty hindsight" issue, in its more recent analysis NYSEG looked at only these situations in which prices in PJM were lower than New York for three or more consecutive hours. Presumably after two hours of differentials, traders would have seen an opportunity to buy in PJM and sell in New York, were such a strategy feasible in the short term. We calculated the potential economic savings associated with starting transactions during the third hour of such occurrences. From January through May such transactions would have yielded over \$15 million dollars in savings. This may be viewed as a conservative measure of the foregone import savings in New York attributable to Market Flaws that hinder inter-pool transactions.

³⁶ Originally the BME was curtailing day-ahead transactions, as well. The NYISO has instituted a must bid fix, as noted above. See Footnote 18. NYSEG cannot determine the effectiveness of this fix at this time. Taken of its logical extremes, this would suggest that there should be no purchases of cheap energy from Canada in the summer and no sales of energy to Canada in the winter.

NYSEG would also like to address the NYISO's contention that energy traders require a lengthy period of price discrepancy before they will act on an arbitrage opportunity. Energy traders become reasonably adept at reading market trends, particularly in markets such as PJM where energy prices, weather patterns and load levels tend to correlate well. Given that PJM tends to be a somewhat warmer climate than New York, energy traders could well be expected to anticipate instances when the prices diverge with PJM lower, and move to arbitrage the differences rapidly.

Further, while NYSEG's analysis of arbitrage opportunities could be termed somewhat crude, it could very well understate the economic impacts of lost opportunities as it does not consider the movement down the bid stack that would result had BME not incorrectly rejected economic transactions. As demonstrated by the close analysis of BME flaws³⁷, forgone import transactions can result in an increase in the dispatch of flexible New York resources, causing a higher overall LBMPs in some or all zones. Had the economic transactions been allowed, the New York centralized market prices would also be expected to be lower. The converse also holds true when transactions in the opposite direction are foregone. In both instances market efficiencies and liquidity are lost.

In yet another example of the inefficient import market, a new anomaly has arisen just this past week on June 5-6. The circumstances on June 6th are as follows:

During on peak-hours, the PJM NYPP-West bus real-time LBMP averaged \$13.10 while the NYISO PJM Proxy bus real-time LBMP averaged \$31.31. An arbitrage opportunity existed and was recognized by NYSEG's energy traders early in the day. They were not paralyzed by a lack of perfect information as Dr. Harvey speculates. NYSEG attempted to schedule an import from the PJM energy market to the NYISO, but its transaction was rejected by the NYISO. The explanation provided by the NYISO was that no new imports would be allowed because of a constraint on the Central-East interface. Examination of the data provided by the NYISO raised more questions than it answered.

The Total Transfer Capacity ("TTC") and Available Transfer Capacity ("ATC") for the NYISO's external buses (New England, PJM, Ontario Hydro, and Hydro Quebec) moved sharply from normal levels to very low levels, even zero and below zero, at approximately Hour Beginning

³⁷ See section VA.2 above.

1100. Simultaneously, the ATC for the Central-East interfaces surged from zero to 707 MW and continued rising through Hour Beginning 1600, when it reached 1014 MW. At Hour Beginning 1700, the ATC for Central-East returned to zero. Although ATC returned on some external interfaces during this time frame, PJM remained at zero through the end of the day. This was the first time NYSEG noted a simultaneous reduction of TTC and ATC at all external interfaces, with the apparent goal of relieving an internal constraint. An inference that can be drawn from these facts that the NYISO is favoring internal transactions and resources over external transactions and resources, or lacks sufficient dispatchable resources to solve internal constraints. In either case this is very troubling.

Ostensibly, the NYISO posts this TTC and ATC information to assist market participants in understanding system conditions. Likewise, it posts the Hour-Ahead Market LBMPs, which are in essence the “next step” After the TTC/ATC determinant. In this instance, since the NYISO has decided to de-rate the external interfaces, it now must curtail any transactions on those interfaces that would violate the new, reduced interface limit. The BME software accomplishes this by calculating very low LBMPs (based on market participants’ transaction decremental bids) and curtailing any transactions with decremental bids that exceed these low LBMPs. Because the interface de-rating was so severe, the resulting LBMPs reached as low as -\$29,999.00. As a result of this action, NYSEG was not allowed to begin any new import transactions from PJM. Further, NYSEG learned at a meeting of the NYISO Scheduling and Pricing Working Group on June 7, 2000, that some market participants also had existing Day-Ahead Firm external transactions curtailed as well. Discussion of these events by market participants at the meeting was extensive.

In the aftermath of June 5th and 6th, NYSEG is disappointed that unexplained market manipulations have prevented the marketplace from responding to clear economic indicators. NYSEG has the knowledge, experience, and motivation to take action where appropriate to meet its obligations to the NYSEG load, yet it is prevented from doing so. Despite the NYISO’s insistence that the LBMP market is sound and is working correctly, according to rational economic theory, real-life experience has demonstrated that significant problems do exist, and even continue to crop up, and that these problems have not yet been corrected.

2. The NYISO's About-face on the Extension of BPCGs to External Transactions Violates the NYISO Tariffs

In an effort to alleviate the problem of inadequate energy imports, the NYISO extended the Supplemental Bid Production Cost Guarantee Payment (“BPCG”) to external suppliers. Many market participants view extension of the BPCGs to externals as both a fair and rational act. Unfortunately, the method by which the NYISO carried through this extension has apparently thwarted the objective and raised another tariff violation issue.

As stated in NYSEG’s Complaint, the extension of the BPCG should have solved part of the import problem, but results suggest it has not. One potential factor in the lack of response is the fact that the BPCG is in violation of the tariffs. For this reason, external market participants may not be engaging in import transactions at efficient levels because they fear that refunds of the BPCG supplemental payments will be required. To the extent the NYISO made payments and has incurred costs that are ultra vires of the tariffs, retroactive rebilling is appropriate.

It doesn’t help that the NYISO unilaterally changed its stance on the applicability of the BPCG to external generators. In the first months of operation, the NYISO staunchly rejected applying these BPCGs to external generators on the basis that the NYISO could not “commit”³⁸ external generation facilities, in part because external energy cannot be traced to any single generator. The idea of

³⁸ The BPCG was created to compensate generators whose bids are accepted and committed by the NYISO in the day-ahead market and then, for any of various reasons, the generator is unable to recover its minimum generation/start-up and energy bid price through the day-ahead LBMP and ancillary services revenues. See NYISO Services Tariff, Section 4.23, First Revised Sheet No. 63: “The NYISO shall determine, on a daily basis, if any Generator committed by the NYISO in the Day-Ahead Market will not recover its Minimum Generation and Start-Up And Energy Bid Price through Day-Ahead LBMP and Day-Ahead Ancillary Services revenues. If a Generator’s Minimum Generation and Start-Up Bid plus its net Energy Bid Price over the twenty-four (24) hour day exceeds its Day-Ahead LBMP revenue over the twenty-four (24) hour day, its Day-Ahead LBMP revenue may be augmented by a supplemental payment.” Emphasis added. In some instances, because of differences in the day-ahead and real-time LBMP, generators have on occasion faced the troubling circumstance of being committed to run and still owing the NYISO payments at settlement to cover required repurchase of energy at a loss in the real-time LBMP.

committing an external generator's energy to the NYCA was seen as impractical, and thus the BPCG was available to generators in the NYCA.³⁹

However, the NYISO has unilaterally changed its position on this issue, and made retroactive the BPCGs to the external generators going back to the NYISO startup date of November 18, 1999. The practical impact of this decision is that dollars are transferred from internal load serving entities to external generators, because funds for BPCGs are recovered through the NYISO OATT Schedule 1 charges. Thus, all transmission customers and load-serving entities serving retail access customers face a continuing large financial burden.

The NYISO tariffs make no allowance for such an extension. Absent a provision in the relevant tariff, the payments may not be made. While the NYISO claims that the tariff has not been violated, the facts are not in dispute. The NYISO should have made a required FERC filing to allow an extension of the BPCGs to external generators, if indeed that is the chosen path on which to proceed. It is important to note that such a fix has not been applied to LSEs, whose bilateral transactions are cut only to be replaced by RTM energy at prices above their decremental bids. Even if it were proposed, a system with so many patches, each of which may carry its own form of uplift, may soon produce inefficient and uneconomic results that customers are asked to bear. Unilateral action by the NYISO on this matter is wholly inappropriate and in violation of the tariffs.

3. Odd Congestion Patterns

As recently as June 1, 2000, the NYISO has calculated real-time LBMPs that include congestion components that conflict with other posted data, defy explanation, and send improper price

³⁹ This NYISO position was reiterated on numerous occasions, including responses in email sent by NYISO Vice President of Market Services, Charles King. In a December 11, 1999 email to participants on the Technical Information Exchange, Mr. King stated: "At the present time, there is no bid production cost guarantee of any kind for parties buying LBMP energy at, or selling energy into a proxy bus. ... The external supplier has no additional mechanism to recover costs other than the energy price itself. The rationale, is that the NYISO really has no indication where the energy is actually coming from and consequently cannot 'performance track' the supplier as can be done with the internal supplier, hence no bid production cost guarantee is provided (or perceived to be needed)."

signals. As discussed below, NYSEG believes that the market will continue to suffer a lack of confidence and lack of liquidity as a result of such illogical and unexplained results.

The congestion component of the LBMP is supposed to increase the LBMP in a congested zone and lower the LBMP in an uncongested zone. When there is no congestion, the congestion component is zero. Market participants are expected to examine day-ahead, forecasted and real-time LBMPs to gain insight on system conditions and how they relate to market participants' strategies of maximizing revenues or minimizing expenditures. This is an important aspect of a general concept usually referred to as "price signals" in a competitive market. Because congestion is indicative of transmission constraints and actual energy flows, market participants normally would react to these price signals by engaging in transactions that are economically efficient. The following is a recent example of the posted data providing an incorrect and virtually meaningless price signal to market participants.

On June 1, 2000, the ATC for the Central-East interface was forecasted to be zero or near zero for the on-peak hours. This indicates the presence of a Central-East constraint, a situation that produces higher LBMPs in zones east of the Central-East interface than in zones west of the Central-East interface. However, for many intervals beginning around 10:00 a.m., the real-time zonal LBMP for the Capital Zone became the lowest of all the zones in the state. Since the Capital Zone (Albany area) is east of the Central-East interface, this result is fundamentally wrong under LBMP theory. Further, it sends an inappropriate and erroneous price signal. Specifically, it incorrectly tells market participants that there is an excess of generation in the Capital Zone that cannot be utilized in any other neighboring zone because each and every transmission path -- to New England, the North Zone, the Mohawk Valley Zone, and the Hudson Valley Zone -- are loaded to capacity. This is virtually impossible and should have been investigated and corrected by the NYISO, yet the NYISO did not reserve this date and hour and did not correct these prices.

The continuing occurrence of indecipherable price signals will not serve this market well. Market participants expect a certain period of flux in a new market while all participants work to understand system conditions, market rules, and price signals and adjust their strategies to best suit their

needs. At the end of this period, participants expect a degree of consistency in the market, with reasonable volatility and prices that generally correspond to load levels. Participants hope to find useful correlation among the various data provided by the NYISO that will give insight into subtle market dynamics. Grossly irrational price signals with no explanation forthcoming from the NYISO, coupled with the host of other implementation problems, undermine and frustrate efforts by participants to understand the market.

Moreover, in its filing with the Commission to extend its Temporary Extraordinary Procedures, the NYISO states⁴⁰:

it must be recognized that corrections to software can be very time-consuming. Great care must be taken to ensure that one correction will not create new and different unintended consequences. Other anomalies are likely to surface which will require investigation and potential remediation. Despite the extensive training afforded to NYISO staff and the use of highly qualified expert consultants, the NYISO recognizes that fact patterns will continue to be presented by the marketplace that the various programs have not been specifically designed to address, especially as Market Participants become more imaginative in adopting their bidding strategies to the rules in place. Several software changes are currently underway. [Ma]ny other changes are likely to be necessary as unanticipated scenarios arise.

Market participants can conclude that the state of flux for the NYISO could last well into the summer load period. The NYISO has stated that it is implementing many changes to its system and is working on many more. As some problems are solved, it can reasonably be expected that new problems will arise, and the above anomalous LBMP problem may be one of these new problems. Unfortunately, new problems are unlikely to be addressed until market participants themselves gather evidence and take it before the NYISO. Already, NYSEG has many unanswered questions relating to occurrences of anomalous LBMPs. During this state of flux and uncertainty, market confidence and liquidity are not attainable.

⁴⁰ “Extension or Temporary Extraordinary Procedures of the New York Independent System Operator, Inc.,” Docket No. ER00-2624-000 3 (Filed May 26, 2000).

4. Unreasonably High Price Volatility

In its Motion, the NYISO argues that price volatility, particularly how the RTM is susceptible to greater volatility than the DAM and HAM, is not due to Market Flaws.⁴¹ The NYISO has gone on record suggesting that the RTM is extremely volatile by design.⁴² In a rational market, the RTM should indeed be more volatile than the DAM, because there is no time available to counteract unforeseen events when dealing in real-time. The question is therefore not which market is more volatile, but what degree of volatility over a period of time is legitimate in a correctly functioning competitive market, and what degree of volatility indicates the existence of inefficiency-producing Market Flaws. It remains largely a mystery as to why incidences of extreme volatility are so frequent in the New York markets. Some market participants have speculated that the NYISO's suggested work-arounds to known Market Flaws defeat an already fragile system. For example, the NYISO has recommended that market participants enter a negative decremental bid of the lowest amount possible, which is - \$9,999.99, if they wish to try to guarantee that a bilateral transaction not be cut in the BME. Soon, many market participants were employing this work-around procedure, which exacerbated the occurrence of decremental bids not being cut in a *pro rata* fashion, as the tariffs require, explained above. Another possible consequence of this recommended work-around is that extensive bidding by many parties at levels of -\$9,999.99 is corrupting the integrity of the energy market system, which appears in seemingly unexplainable symptoms.

A number of statements were made in the response to NYSEG's discussion of market volatility and NYSEG's comparisons of NYISO and PJM prices. The NYISO response notes "...Real-Time prices are, legitimately, much more volatile than Day-Ahead prices. It is therefore appropriate that Day-Ahead prices be somewhat higher than Real-Time prices, to reflect the lower price risk associated

⁴¹ NYISO Corrected Motion at 38.

⁴² Charles King, Vice President of Market Services for the NYISO, in a December 8, 1999 e-mail posted to the market participants stated: "Keep in mind that the real-time markets are, by design, wild and dangerous."

with a less volatile market.⁴³ Yet in May, with a hint of warmer weather, the price in the real time market nearly doubled that of the DAM LBMP was more than seventeen times that of the of Day-Ahead LBMP.

The NYISO response further notes that “Because the BME prices are not used for settlements, the NYISO does not expend resources identifying or correcting erroneously calculated BME prices.”⁴⁴ It was intended that market participants would use the BME to gauge changes from the DAM prices as an indication of market conditions and their impact on the real time prices. The BME has failed to give any clue as to what to expect in the RTM, thus limiting the ability of market participants to adjust positions of price exposure in the RTM. With the erratic behavior of the BME, it is not surprising that the majority of the market is tied to bilateral contracts or the DAM. The price signals in May tend to favor the continued approach of relying on bilateral contracts and the DAM.

The BME advisory prices for May were erratic. The average energy price for the month was - \$52.51 with a standard deviation⁴⁵ of \$2,997.40.⁴⁶ Average Peak and Off Peak advisory prices were \$73.91 and -\$353.91 respectively. BME certainly needs to be able to predict prices better if it is to have any value to the market participants or if it is going to continue to reject bids into the HAM and curtail bilateral transactions. As the hot temperatures of summer approach, pricing and volatility observed in prior months may become the norm.

⁴³ NYISO corrected motion at 40.

⁴⁴ Id., at 38.

⁴⁵ Standard Deviation is a statistical measure of volatility, risk or more uncertainty of set numbers in case prices. The greater the standard deviation, the more volatile the series of prices are around the average. The greater the volatility, the greater the uncertainty and risk associated with predicting outcome of the value or price.

⁴⁶ This calculation does not include values for May 8 Hours Beginning 1400 through 2300 and May 9 hours 1400 through 1600. During this period of abnormally hot weather, PJM was experiencing emergency conditions, and the NYISO was taking actions to assist PJM. On May 8, prices in the HAM went from -\$68,307.30 (that is negative \$68,307.30) to positive \$58,887.79 in the Capital zone in the span of one hour. That represents a change of \$127,195.09/MWH. Including these values for these hours would have increased the volatility above the numbers provided in this example.

PJM prices for May closely compare to NYISO DAM energy prices, as the NYISO points out in its Motion. For March and April the original, uncorrected pricing posted by the NYISO shows that the Time Weighted/Integrated Real-Time LBMPs compare more favorably to the PJM prices than do the DAM prices. Since the Time Weighted/Integrated Real-Time LBMPs and the PJM prices represent the real time market conditions, it is reasonable they would be similar. The difference for March and April respectively was \$1 and \$1.01, with the PJM price (PJM price being lower than the NYISO price). For May, the average DAM price closely compares to the PJM price with the difference being \$0.39/MWH between the two markets. The NYISO Weighted Average Real Time value (uncorrected) was \$48.91/MWH compared to \$28.68/MWH for PJM.⁴⁷ The NYISO prices do not provide any measure of certainty, thus adding risk beyond what might be expected in even an immature market.

5. The NYISO Still Fails to Recognize Available Resources, Though it Has Improved

Even where the NYISO has instituted relatively simple changes to known and acknowledged Market Flaws, the old ways seem to persist. The NYISO allowed more flexible operating capacity declarations of generators in recognition of operating factors that allow, at certain times, generation base points in excess of their DMNCs. The move was widely applauded, even though it took five months to accomplish.⁴⁸ In response, NYSEG requested that the NYISO change the DMNC of generating units for which NYSEG is responsible. Despite approval by the NYISO, eight of the nine generating units in the NYISO Market Information System generator database are wrongly represented for Maximum Summer Operating Limit and/or Summer Installed Capacity Contract values. Ongoing correspondence between NYSEG and the NYISO has failed to rectify the mistakes. These units remain incorrectly represented at the time of this filing.

⁴⁷ The uncorrected prices were used in the comparison because the market participants are reacting to this information.

⁴⁸ See NYSEG Answer of May 30 for an explanation of this corrective process.

C. The Commission Should Reject the NYISO's Claims That the Markets Are Working Well

In sum, the NYISO-managed energy markets remain plagued by Market Flaws, many of which NYSEG has been detailing in correspondence to the NYISO since January. Given the detailed Complaint and Affidavits that NYSEG filed with the Commission on April 24, 2000 and the NYISO's conclusory and evasive Answer, it can not be said (1) that NYSEG dramatically exaggerated the number and severity of Market Flaws, or (2) that the NYISO has done a good job with the problems it "inherited," or (3) that the performance of the NYISO-administered markets have improved considerably.

Any of several Market Flaws identified by NYSEG would be sufficient reason for establishing some type of safety net for the summer capability period. Taken together, the cumulative impact of the Market Flaws requires Commission action to compel the NYISO to protect market participants by way of a safety net.

NYSEG has attempted, where possible, to place a dollar figure on the impact of Market Flaws. In its calculation of one aspect of the energy import problem, NYSEG established that in the first three months of this year, the economic inefficiency of unworkable imports amounted to approximately \$29 million. See the Kinney Affidavit to NYSEG Complaint. That figure has grown in the intervening months. Other economic inefficiencies caused by Market Flaws, however, are not calculable because the necessary information is in the hands of the NYISO solely, and the NYISO has made no effort to provide information whatsoever. The NYISO asks the Commission to trust that it has the market under control and suggests that the documented problems do not and will not have a significant impact on the market. The Commission should be troubled by the lack of information provided by the NYISO and even more troubled if the analyses to back up its allegations that the markets are in fine shape do not exist.

VI. UNSUPPORTED AND UNPERSUASIVE SUPPLIER ARGUMENTS

A. Suppliers Fail to Demonstrate that an Interim Safety Measure and Refund Effective Date are Inappropriate

Some Suppliers categorically oppose any relief whatsoever. These Suppliers, however, have failed to offer any quantitative or qualitative evidence to refute the substantial evidence presented by NYSEG that the Market Flaws exist and are substantial. The Market Flaws have also been confirmed by the vast majority of the market.

Certain Suppliers that have purchased generation in the recent utility divestiture auctions argue that any form of safety net will ruin their revenue expectation. Their arguments imply that they believe they are entitled to rates that guarantee recovery of the premiums they paid for their new generation. Were this the case, no regulators would approve the divestiture transactions because the transactions would not be in the public interest. This is because rates would have to increase to cover the new higher book costs. Such a policy would be nonsensical.

For example, Orion argues that the high prices it paid were premised on selling energy, capacity and ancillary services at market-based rates. (Orion at 9.) IPPNY argues that NYSEG's proposal will penalize generators who reasonably expect to benefit from higher prices during summer 2000. (IPPNY at 17-18.) While these Suppliers complain that any safety net would disappoint their financial expectations, they should have expected prices produced by a properly functioning competitive market.

In the LBMP system, suppliers selling energy into the LBMP markets should expect to be paid a price that is set by the incremental cost of the marginal unit needed to serve the next MWH of load. The NYISO's expert witness and one of the principle architects of the NYISO LBMP system, Dr. William Hogan, concluded that "[i]n a competitive market in which generators are paid the market price, the economically efficient bidding strategy would be for generators to bid their costs." Affidavit of Dr. Hogan at 47, Comprehensive Proposal To Restructure The New York Wholesale Market, Volume V., dated January 31, 1997. Dr. Hogan suggests that regulators can use this principle by comparing a generator's bids to a generator's costs to determine whether that generator is attempting

to exercise market power. Id.

Suppliers that purchased generation in the divestiture auctions must have expected that the electricity market was going to be competitive. In the purchasers' filings submitted to the Department of Justice (the H-S-R filings), the Federal Energy Regulatory Commission (the request for market based rate authorization under Section 205 of the FPA) and the New York State Public Service Commission (the Public Service Law Section 70 filing), Suppliers had to show to the satisfaction of all three agencies that the divestiture was pro-competitive and/or that the market was competitive. Accordingly, the Suppliers represented that they were functioning in a competitive market and knew that prices in the LBMP markets should be set by the marginal units.

B. Supplier's Accusations of NYSEG's Motives for Filing the Complaint are Irrelevant

At least seven of the Suppliers have focused their arguments not on the existence or absence of Market Flaws but on NYSEG's motivation for filing the Complaint, a diversionary tactic. These Suppliers speculate that NYSEG filed this Complaint because it is inadequately hedged against fluctuating market prices this summer. PG&E, Aquila, KeySpan, Sithe and NRG argue that NYSEG is using the Complaint as vehicle to artificially reduce the price it will pay for energy this summer to serve its load. They conclude that NYSEG, by failing to enter long-term agreements with the purchasers of its recently divested generation to purchase energy, will be short this summer and, therefore, subject to the risk of market volatility.

Notwithstanding that NYSEG's motives are irrelevant with respect to the existence and severity of Market Flaws and the importance of an interim safety net, these Suppliers are wrong. These Suppliers conclude that NYSEG will be short simply because NYSEG decided not to enter long-term buy-back agreements with the purchasers of its generation facilities. Do these Suppliers suppose that a buy-back agreement (i.e., one type of a bilateral agreement) is the only means through which NYSEG could hedge its risk? In fact, NYSEG is nearly fully hedged this Summer. Although not relevant here, NYSEG's decision not to enter buy-back agreements was designed in part to further competition in the

energy markets.

NYSEG has two motives that prompted filing of the Complaint. First, NYSEG has a vested interest in seeing retail access take hold and succeed in New York. Retail access is jeopardized by the existence of Market Flaws. Second, NYSEG has an interest in the establishment of rationale, competitive markets in New York.

C. Bid Caps, Price Screens and Other Short-Term Safety Nets Do Not Discourage New Generation Development Or Market Participant Financing

Several Suppliers, like Merrill Lynch, argue that remedies such as caps and price screens will discourage generator development, impede financing of new market participants, and exacerbate existing problems by driving more generators to sell into other control areas. Their position loses credibility in light of PJM's \$1,000 per MWH price cap, in effect since its inception. PJM has processed applications for the construction of over 3,000 MW of new generation. The price cap in PJM does not appear to be discouraging generation development. Likewise, many developers requested system impact studies for over 15,000 MW of new generation in New England at a time when Market Rule 15 was in effect. ISO New England's version of New York's temporary extraordinary procedures do not appear to have discouraged development in New England.

Moreover, if developers invest based on Market Flaws that will be corrected within six months, they are not entitled to a vested right in continued Market Flaws. Such an investment approach defies logic and would be silly.

VII. The Commission has the Authority and the Duty to Grant the Relief Requested by NYSEG

A. The Commission Should Require an Interim Safety Net

Fashioning a remedy that will restore prices in the NYISO-administered markets to levels that are just and reasonable is not an easy task. The challenge in implementing a remedy is critical for the Commission to satisfy its statutory duty. For all the reasons discussed above, NYSEG urges the

Commission to take the following actions:

1. Order the implementation of an interim safety net through a combination of appropriate bid caps⁴⁹ and a requirement that the NYISO diligently implement its Temporary Extraordinary Procedures (“TEP”) to correct erroneous market prices in situations that the NYISO now ignores;
2. Establish a refund effective date of June 23, 2000, 60 days after the date of the Complaint, in order to make charges subject to refund so that if the NYISO fails to correct prices to the level that would have been achieved in a properly functioning competitive market, the Commission’s legal authority to establish refunds will be clear;
3. Order refunds of all over-charges caused by Market Flaws; and
4. Establish a hearing to the extent that any of the issues established above present disputed facts which must be resolved in order for the Commission to determine appropriate longer-term action.

First, the Commission should order an interim safety net. As proposed in the Complaint, NYSEG advocated cost-based bidding that would allow the marginal cost of the marginal unit to establish the LBMPs. In the alternative, NYSEG proposed price caps and a refund effective date. In the amendment, NYSEG withdrew the cost-based bidding proposal and advocated price screens pursuant to which prices above the screens would not be permitted unless the NYISO determined that they were the result of a properly functioning competitive market. Other market participants have supported cost-based bidding, price caps, price screens, and/or a refund effective date. As part of the price screen proposal, NYSEG and the other Member Systems agreed to use the Management Committee process to attempt to develop price screens. In that process, it became apparent that price

⁴⁹ As noted, the NYISO Management Committee on June 5, 2000 voted by a nearly two-thirds majority to implement interim bid caps. The NYPSC, Multiple Interventors and other parties in their motions to intervene in this docket proposed \$1,000 per MWH caps on energy and certain ancillary services. NYSEG supports these interim measures in tandem with the relief described above.

screens would be difficult for the NYISO to implement in time to facilitate rational prices in the Summer 2000 peak season, but the Management Committee voted by almost a two-thirds majority (63%) to implement simple bid caps as soon as possible so they would go into effect in June 2000. NYSEG expects that the NYISO will make a filing with the Commission to implement the price caps soon. The NYPSC's intervention in this docket and several other Intervenors asked the Commission to adopt interim bid caps as well.

In parallel, in the NYISO Management Committee process, the NYISO indicated it used some forms of price screens to implement the TEP and is willing to consider others. The process of developing appropriate price screens will continue in order to assist the NYISO in detecting Market Flaws and to instill greater confidence in the market that the NYISO is implementing the TEP in an appropriate manner. Still, however, the manner in which the NYISO implements the TEP is largely a mystery to the market. The Commission should direct the NYISO immediately to take the following steps with respect to the TEP:

1. The NYISO should provide information on how it screens both bids and output prices;
2. The NYISO should use the TEP or rebilling provisions of the NYISO tariffs to correct prices any time the NYISO determines that prices are influenced by or result from one or more of the following:
 - a. Software flaws, including software input or model flaws;
 - b. Metering errors;
 - c. Computational errors;
 - d. Deviations between models or inputs used in security constrained unit commitment ("SCUC"), BME and SCD that are known to produce inefficient results on a recurring basis;
 - e. Deviations from the NYISO Tariffs;
 - f. Market design problems resulting in inefficient commitment, curtailments, transaction schedules, or dispatch;
 - g. Operator errors; or

h. Implementation of a Local Reliability Rule.

In addition to these exercises of authority under the TEP, the NYISO should continue to monitor problems identified in the NYISO Temporary Extraordinary Procedures, Emergency Corrective Actions, or Market Power Monitoring and Mitigation Plans.

3. If the NYISO determines that prices were the result of or influenced by Market Flaws, then the NYISO shall, wherever reasonably estimated, establish the prices (“Corrected Prices”) that would have resulted in the absence of the Market Flaws. If it is not reasonably possible to develop the Corrected Prices based on particular circumstances, then the NYISO shall set the prices based on prices under similar conditions where the prices were validated by the NYISO.
4. Each time the NYISO discovers a new Market Flaw, not previously posted on the NYISO’s website, it shall post the Market Flaw, along with an explanation of the associated impacts on market prices and how and when the NYISO shall correct the flaw.

NYSEG urges the Commission to take these actions associated with the TEP for several reasons. First, when LBMPs are established at an erroneously high level due to Market Flaws, suppliers receive a windfall that is not the result of a properly functioning market, and customers pay erroneously high prices. Correction of such prices cannot be said to be unfair to suppliers, particularly if the problem is unrelated to market power or abusive bidding practices and the NYISO duly adopts a bid guarantee. Under these circumstances, no supplier is treated unfairly or inconsistent with reasonable financial expectations and load is not penalized as much as under the current approach. Moreover, the process of determining what prices would have been in the absence of the market flaw can be performed. Unless the work associated with accurately performing this task clearly outweighs the aggregate amount of the overcharges, the fact that work is required should not interfere with getting the job done. As discussed above, there are a variety of Market Flaws that go unchecked by the TEP. For example, see the discussion of the BME failures. The Commission should not allow this inaction to continue.

Second, the Commission should establish a refund effective date of June 23, 2000, 60 days after the Complaint was filed. In its order on the operating reserves markets, the Commission declined to adjust for operating reserve prices retroactively when the NYISO had failed to follow the TEP to adjust operating reserves prices. While NYSEG believes that retroactive adjustment is appropriate in that case, the Commission's reluctance to order this only reinforces the need to establish a refund effective date. For the February operating reserves market above, the NYISO's failure to invoke the TEP resulted in approximately \$70 million in over charges that cannot be said to be the result of a properly functioning competitive market. If the NYISO fails to invoke the TEP in situations this summer in which energy markets prices are erroneously high, the Commission must not allow the errors in the operating reserves market to be exponentially compounded. The damage to consumers could be extraordinary. Consequently, the Commission should establish a refund effective date, and if the NYISO fails to adequately implement the TEP, notwithstanding known or new Market Flaws, the Commission should require refunds of erroneously high prices. Placing suppliers in the position they would have been in had the Market Flaws not existed is just. Moreover, it sends the right price signal for stimulating new generation development because new generators will receive market clearing prices that are closer to the corrected prices than to the uncorrected prices after the flaws are corrected.

Notwithstanding those Suppliers that oppose a refund effective date (*e.g.*, Orion at 13-14), Section 206 of the FPA provides in relevant part:

Whenever the Commission institutes a proceeding under this section, the Commission shall establish a refund effective date. In the case of a proceeding instituted on complaint, the refund effective date shall not be earlier than 60 days after the filing of such complaint...

16 U.S.C. § 824e(b). Faced with significant undisputed and disputed evidence of the Market Flaws, and without any rational basis to conclude that the resultant prices are just and reasonable, the Commission must establish a refund effective date. *See, e.g., Central Montana Electric Power Co. v. Montana Power Co.*, 87 FERC ¶ 61,018 (1999).

The Commission should order the NYISO to use its authority under the TEP and the billing correction procedures to rebill any erroneous prices. The FPA's "just and reasonable" standard does not allow the Commission to acquiesce in the NYISO's inaction concerning the correction of erroneous

prices.

Finally, if the Commission finds that a triable issue of fact exists with respect to how it should proceed, the Commission should establish a hearing to resolve the issues.

B. The Commission Should Deny the Motions to Dismiss the Complaint

Those parties moving to dismiss the Complaint utterly fail to satisfy their burden. Rule 217 of the Commission's Rules of Practice and Procedure addresses the requirements that must be met in order for the Commission to summarily dispose of a proceeding. Rule 217 provides, in pertinent part, that:

If the decisional authority determines that there is no genuine issue of fact material to the decision of a proceeding or part of a proceeding, the decisional authority may summarily dispose of all or part of the proceeding.

Stated another way:

Summary disposition is appropriate if two conditions are met; first, the proponent must be afforded opportunity to present factual support for its arguments (and the evidence must be viewed of the light most favorable to proponent), and second, there must be no material fact in dispute (or facts presented by proponent must be accepted in making a decision) so as to make a hearing unnecessary.

Coastal States Marketing, Inc. v. Texas-New Mexico Pipeline Co., 25 FERC ¶ 61,164 (1983).

The party making a motion for summary disposition has the burden of demonstrating that there is no genuine issue of fact. *See e.g., Northern Border Pipeline Co.*, 60 FERC ¶ 61,176 (1992). "Because granting such a motion can terminate a case, the inferences to be drawn from the underlying facts must be viewed in the light most favorable to . . . the party opposing the motion." *ANR Pipeline Co.*, 71 FERC ¶ 63,004 (1995).

Applying these standards to the facts of this case, it is clear that the parties moving to dismiss the Complaint have not carried their burden. To the contrary, NYSEG has demonstrated that Market Flaws exist, that they are substantial, and that the Commission must act now.

Wherefore for the foregoing reasons, NYSEG respectfully requests that the Commission:

1. Deny the motions to dismiss the complaint.
2. Order the implementation of an interim safety net through a combination of bid caps and market price screens with the requirement that the NYISO diligently implement its Temporary Extraordinary Procedures to correct erroneous market prices to the level that would have been achieved had the Market Flaws not existed.
3. Establish a refund effective date of June 23, 2000.
4. Order refunds of all overcharges caused by Market Flaws.
5. Establish a hearing to the extent that any of the issues established above present disputed facts which must be resolved in order for the Commission to determine appropriate longer-term action.
6. Grant any necessary waivers to effect any of the foregoing.
7. Grant such other relief as the Commission deems just and reasonable or in the public interest.

Respectfully submitted,

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Dated: June 9, 2000

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

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|---|---|------------------------|
| New York State Electric & Gas Corporation, |) | |
| |) | |
| Complainant |) | |
| |) | Docket No. EL00-70-000 |
| v. |) | |
| New York Independent System Operator, Inc., |) | |
| |) | |
| Respondent. |) | |

SECOND ANSWER OF
NEW YORK STATE ELECTRIC & GAS CORPORATION
TO MOTIONS TO INTERVENE AND DISMISS
COMPLAINT AND PROTESTS

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UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

| | | |
|---|---|------------------------|
| New York State Electric & Gas Corporation, |) | |
| |) | |
| Complainant |) | |
| |) | Docket No. EL00-70-000 |
| v. |) | |
| |) | |
| New York Independent System Operator, Inc., |) | |
| |) | |
| Respondent. |) | |

SECOND ANSWER OF
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