

# STATE OF NEW YORK DEPARTMENT OF PUBLIC SERVICE

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## PUBLIC SERVICE COMMISSION

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June 26, 2000

Honorable Richard J. Grossi  
Chairman, New York Independent System  
Operator Board of Directors  
c/o William J. Museler  
Chief Executive Officer  
New York Independent System Operator  
3890 Carman Road  
Schenectady, New York 12303

Re: New York State Public Service Commission's Motion  
in Opposition to Appeals of Management  
Committee's June 5, 2000 Decision to Establish  
Bid Caps in Energy and Ancillary Services  
Markets.

Dear Chairman Grossi:

Pursuant to the "Procedural Rules for Appeals to the  
ISO Board" and the notice issued June 21, 2000, the Public  
Service Commission of the State of New York respectfully submits  
the attached Motion in Opposition to the appeals of the  
Management Committee's decision to establish bid caps of \$1000  
per megawatt hour for the energy and ancillary services markets.

Due to the importance of addressing all aspects of  
this issue, this response exceeds the page limitation set forth  
in the Rules. We therefore seek a waiver of that requirement.

Sincerely,

Saul A. Rigberg  
Assistant Counsel

**MOTION OF THE PUBLIC SERVICE COMMISSION IN  
OPPOSITION TO APPEALS OF THE MANAGEMENT COMMITTEE'S  
DECISION TO ESTABLISH BID CAPS**

Pursuant to the ISO's Procedural Rules for Appeal and a notice issued June 21, 2000, the New York Public Service Commission (PSC) respectfully submits this response in opposition to the appeals of the Management Committee's (MC) June 5 vote to establish a temporary \$1000 per megawatt hour (MWh) bid cap for this summer through October 31, 2000. The PSC's response addresses appeals filed by Coastal Power Sales, et al. (Coastal), Orion Power of New York (Orion), and Hydro Quebec Energy Services (U.S.), Inc. (H.Q) (collectively, Appellants).

Upon consideration of the appeals, the PSC continues to strongly support a bid cap for the July to October period as a necessary protection against non-competitive market prices. With the exception of an issue raised by Orion, which we address below, Appellants have offered flawed arguments that were discussed -- and dismissed -- by the Market Participants in extensive discussions at the May 24 and June 5 MC meetings, at open forums and sector caucuses and in other conversations as well as in telephone conferences in the days between those two MC meetings. The \$1000 MWh cap is an appropriate

compromise between imposing cost-based bids and no new protections.

We make this recommendation despite our philosophical reluctance to embrace bid caps. We would much prefer that such a step were not needed. However, it is reasonable to expect that this summer, without a cap added to the ISO's shield to protect consumers against imperfect market conditions, suppliers would be able to exert market power and profit unreasonably at the expense of consumers.

#### **PRELIMINARY STATEMENT**

Given the expected difficult situation facing New York this summer -- a number of significant start-up problems, the resolutions to which have not yet been fully tested and implemented, and a tight energy market -- the PSC has reluctantly concluded that imposition of a temporary bid cap of \$1000/MWh for energy (some 30-40 times normal off-peak prices)<sup>1</sup> and ancillary services (more than 100 times normal off-peak prices) is necessary for the summer.

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<sup>1</sup> We note that the cap in the California Control Area is \$750/MWh.

The bid cap is one part of the three-pronged approach comprised also of vigilant and thorough monitoring of prices and bid behavior on the one hand and expeditious use of Temporary Emergency Procedures (TEPs) and market power mitigation measures on the other.

A bid cap is simple compared to other mitigation measures. It does not involve after-the-fact adjustment of prices and billing and is relatively easy to interpret. It is also less intrusive, not coming into play except in extreme situations when consumers are most vulnerable to abuse of market power.

This bid cap should not be necessary when the New York markets can effectively incorporate and utilize such mechanisms as interruptible load, price capped load bids, and other price sensitive responses by which customers can protect themselves against high prices. In a properly functioning market, buyers have accurate, visible prices and can choose to buy less when prices go up. Many experts have cited the near total lack of demand responsiveness, that is, the almost total inelasticity of demand, as a key weakness that leaves peak markets vulnerable to market power and necessitates the use of a bid cap as a needed

mitigation measure until an adequate amount of demand can respond to real-time prices.

This temporary measure provides a critical "safety net" while only minimally intruding upon the market. It allows the NYISO staff and the Market Participants to concentrate on fixing the currently known problems and ensuring system reliability without the diversions and controversy that would result from very high price spikes.

It also offers some partial protection to retail marketers that may be severely prejudiced by a time-consuming refund process. However, the temporary bid cap would not in any way diminish the NYISO's obligation to monitor bids and prices and take appropriate actions.

**I. ESTABLISHMENT OF A BID CAP IS JUSTIFIED  
AND NECESSARY UNDER THE CIRCUMSTANCES**

Appellants argue that no facts were presented to justify a bid cap lower than the \$10,000 amount that is the current limit of the "bid box." This is incorrect. During discussions at the MC meetings on May 24 and June 5 as well as at the special working group meeting convened by parties specifically to address the design of the bid cap, numerous reasons were offered and explained to justify the

imposition of a bid cap. Notable among the reasons provided are the following:

- a. There have been numerous events since the start-up of the ISO that indicate that problems exist with market design and implementation. The run-up of reserve prices in February drew sharp attention to some of these problems. While many of the problems have been or will be fixed, not all will be adequately resolved for this summer.
- b. This is the first summer during which the wholesale electric generation market and the bulk power transmission system will be operated by the ISO. Summer conditions can be expected to stress the system significantly, certainly more than it has been stressed to date. Under such circumstances, it is reasonable to assume that the wholesale electric system during the summer may experience additional market design or implementation problems. This is no time to subject the market to additional risks that could jeopardize the long-term development of competitive markets by thwarting retail competition and inviting re-regulation.
- c. Summer conditions will be the most susceptible to abusive or anti-competitive behavior by suppliers. During discussions of the need for a bid cap, many parties repeatedly noted that one of the major problems with the current market is the lack of any structures or mechanisms that allow significant price-sensitive load response. No meaningful way exists for consumers to participate in the wholesale electric market in a fashion that could effectively curtail market power abuses. There are also major barriers to entry into the market so that no additional significant supplies can be expected to materialize for the summer period. It is also well understood that the ISO has very limited flexibility in operating the system with respect to meeting reliability constraints at all times. Given

these constraints that must be closely adhered to in order to assure reliability, the lack of

new supplies, and the absence of meaningful demand-side involvement, suppliers, on the summer's hottest days, may well be able to virtually name their price. This is not what one would expect to occur in a well-functioning, competitive market.

## **II. THE BID CAP ESTABLISHED BY THE MANAGEMENT COMMITTEE IS FAIR AND REASONABLE**

Appellants claim that the bid cap adopted by the MC is exceptionally intrusive and denies them the opportunity to receive market-based rates. This is a misunderstanding of the actual bid cap proposal adopted by the MC. First, the proposed cap, at \$1,000/MWh, is very high, far above any generator's actual running cost. No evidence has been offered by any supplier that its costs even approach the neighborhood of \$1,000/MWh. Second, the cap is limited in duration, expiring on October 31, 2000. Third, the cap supplements existing controls by removing from controversy the most non-competitive behavior of suppliers in a tight market. Fourth, it does not attempt to set cost-based caps on each supplier or type of generator, although such an intrusive approach might be justified under the circumstances present in New York.

As a consequence, the Market Participants that voted in favor of the bid cap proposal are relying very

heavily on the ISO's TEP authority and market power monitoring effort and mitigation authority to ensure that the market functions properly during the vast majority of the hours in which prices will be below \$1,000/MWh. The issue, then, is not whether suppliers will receive market-based rates, for they will at all times when bids do not exceed \$1,000/MWh. The issue is whether \$1,000/MWh is too high a cap to prevent abuse of market power.

In this regard, it is important to note that no supplier has a grandfathered right to market power and the abuse of that power. No supplier should be making investment decisions or entering into contracts on the assumption that it will be able to exercise such unwarranted power. Claims by some suppliers that restraints on such behavior injure them and harm the market are without merit. As one party noted at the MC meeting on May 24, if the suppliers are arguing that they would charge well in excess of \$1,000/MWh for a significant amount of time this summer, then they are offering compelling evidence that the market is not workably competitive.

The fact that some suppliers apparently expect to be able to force the New York Control Area and neighboring control areas to enter into a bidding war, which will not bring forth any more supply but would only



drive up prices, is not an expectation that the ISO Board should fulfill by failing to support the bid cap motion.

**III. LOAD CANNOT ADEQUATELY HEDGE ITSELF AGAINST  
MARKET POWER ABUSES**

Appellants assert that some load is already heavily hedged and that the bid cap will result in a subsidy from this group to those that have failed to hedge themselves adequately for the upcoming summer. Mr. Roy Shanker, in his statement supporting HQ's filing, constructs an extreme example in which 90% of the load is fully hedged and 10% is not hedged at all.

It is unreasonable to expect all load to be fully hedged at a reasonable cost since Load Serving Entities (LSEs) and their customers cannot perfectly forecast their load. A more reasonable assumption is that less than 90% of all load is significantly hedged. If all loads were hedged for 80% of their consumption, then they would face additional costs of over \$400 million due to a single price spike of \$10,000/MWh for 8 hours.<sup>1</sup>

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<sup>1</sup> This calculation assumes an average statewide consumption of 28,000 MW for these 8 hours, with only 20% of consumption directly affected (i.e., the other 80% is assumed to be hedged). (28,000 MW x 20% x 8 hours x \$9000/MWh = \$403 million.)

Appellants also claim that the MC's proposal would increase Schedule 1 uplifts for which load is not hedged. This is incorrect; the MC's proposal will actually significantly decrease Schedule 1 uplifts.

First, in the day-ahead market, very high bids by externals lend to high payments to the externals in the form of a Bid Production Cost Guarantee (BPCG). These payments are collected from LSEs through the Schedule 1 uplift. Capping the bids at \$1000/MWh would reduce these payments and, hence, the uplift substantially.

Second and more striking, however, is the effect on uplift due to market power abuse that would occur when suppliers are able to specify long minimum run times, thereby forcing the ISO to take supply at a very high price for an extended period of time even though it is only needed for a few minutes. For all but the few minutes for which the high cost supply is actually needed, the ISO would recover the excess costs associated with having agreed to purchase supply at those high prices by charging load an increased uplift.

Indeed, a moderate-sized generator, in one day alone, would add as much to uplift as was added by the overcharges the ISO paid to generators for reserves in the entire month of February. For example, suppose that due to

a summer heat wave, suppliers are confident that all available generation will be needed to meet forecast demand. Under those circumstances, a supplier could place an "all or nothing" bid into the day-ahead market, requiring the NYISO to take its entire capacity for all 24 hours at \$10,000/MWh even if the potential shortage exists only for a few MWs for one hour. Not only would the supplier receive an energy payment of \$10,000/MWh for the peak hour, but it would also receive a BPCG guaranteeing it \$10,000/MWh for its entire output for all 24 hours. During the remaining 23 hours, Locational Based Marginal Prices (LBMPs) could be much lower, perhaps only \$200/MWh (reflecting the highest running costs of gas turbines).

In this case, the ISO would pay the supplier the entire difference between the bid cost and actual LBMP over the 23 hours that the bid cost exceeded LBMP. The ISO would recover these costs through a Schedule 1 uplift. The resulting uplift could be enormous: A 300-MW unit (just 1% of the supply) could receive over \$67 million in uplift, in addition to \$4.38 million in energy payments in one day alone. This is as much as the entire uplift for reserves during this past February and March. The MC proposal

constrains the Schedule 1 exposure by limiting combined payments to a generous \$24,000/MW per day (\$7.2 million per day for a 300-MW unit) and suspending the BPCG when energy prices average above \$200-MWh for the day (as in the above example).

It is telling that if the cross-subsidy problem were as severe as Appellants allege, LSEs that are heavily hedged for the summer period would have opposed the bid cap proposal. They did not. They understood that the bid cap proposal offered them some protections from abuse of market power on the part of suppliers, against which they could not hedge themselves.

#### **IV. A BID CAP WOULD NOT HARM RELIABILITY IN THE SHORT- OR LONG-TERM**

Reliability of New York's Bulk Power System is of the highest importance to the PSC and is not something that this Agency is willing to compromise. Reliability in the short-term will not be adversely affected by imposition of a \$1000/MWh bid cap. The bid cap may result in some non-Installed Capacity (ICAP) generators seeking out higher prices in adjacent control areas on very high load days. However, the New York Control Area has sufficient ICAP supplies to meet projected peak demand with adequate

reserves. To address extenuating circumstances, the ISO retains full authority to institute emergency procedures including making uncapped emergency purchases from adjacent ISOs.

Indeed, the absence of a bid cap may result in less supply than had a bid cap been in place. Without a bid cap, the temptation to restrict output to drive prices to \$10,000/MWh (the current cap as per the bid box) is huge. A \$1,000/MWh bid cap substantially reduces the temptation to withhold supplies, yet is high enough to ensure that all available generation will offer to run.

Regarding the long-term outlook, there is a lengthy list of companies that desire permission to build new generation in New England, New York, and PJM. This attests to the fact that it is exceedingly profitable to build and operate power plants in the Northeast. It is an observable fact that the PJM cap of \$1,000 has not driven developers from that area. It would be imprudent for investors to make multi-million dollar investments premised on the belief that they would be able to exploit market imperfections during start-up of ISO operations and extract payments in excess of \$1,000/MWh.

**V. SOLE RELIANCE ON THE ISO MARKET MONITORING AND MARKET MITIGATION POWERS IS NOT ADEQUATE FOR THIS MARKET AT PEAK TIMES**

Appellants argue that instead of imposing a bid cap, we should be content to rely upon the ISO's ability to monitor and mitigate market power abuse. As Appellants recognize, the ability of the ISO to correct market power abuses is limited to after the abuse has occurred, been documented, and acted upon by the ISO. FERC, moreover, has so far refused to allow imposition of retroactive adjustments following an abuse of market power.

As explained earlier, the ISO will be quite busy monitoring the market and being vigilant to prevent market power abuses over the wide range of bids up to \$1,000/MWh. The bid cap is desirable in that it prevents behavior that is most inconsistent with what would be expected in a competitive market from occurring in the first place. It is also worth noting that suppliers including some of the Appellants have claimed that there are numerous problems with the market as it is currently structured and implemented. Yet, the Appellants now argue that we should have full confidence in the ISO's ability to ensure that the markets operate as originally intended this summer.<sup>1</sup>

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<sup>1</sup> Coastal states that the bid cap proposal contradicts the

It is widely agreed by experts that the electric system is most vulnerable to market power at peak times. This is when the elasticity of supply becomes negligible (because there is no more supply), making the exercise of market power easier than at any other time, and extremely profitable to owners of generation. For example, consider the following statements from a recent paper by two economists, Severin Borenstein and James Bushnell<sup>1</sup>:

The combination of very inelastic short-run demand and supply (at peak time) with the real-time nature of the market (costly storage and grid reliability requirements) make electricity markets especially vulnerable to the exercise of market power.

While it is easy to argue that volatile prices would be seen in even a perfectly competitive market with these attributes, it is equally easy to demonstrate that if firms of noticeable size are not exercising market power, they are doing so out of the goodness of their heart, and against the interest of their shareholders.

In implicit or explicit recognition of the vulnerability of electricity markets to market power, almost every organized electricity market

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ISO's statements in its FERC response to the complaints of NYSEG and Strategic Power Management that bid caps are premature. The ISO's statements were made in a different context and for a different purpose and without the benefit of the subsequent thorough discussion of the arguments for and against bid caps.

<sup>1</sup> Severin Borenstein and James Bushnell, Electricity Restructuring: Deregulation or Reregulation, February 2000, University of California Energy Institute, Berkeley, California, [www.ucei.berkeley.edu/ucei](http://www.ucei.berkeley.edu/ucei) at pages 8, 9, and 11.

currently operating around the world has in place some form of price or revenue cap. In some markets this is described as a "software" limit; the bidding software cannot accept too many

digits in the bid. In others, such as Australia, prices are capped at a "value of lost-load," a proxy for consumption value. In many regions, price caps have been considered a necessary expedient to bridge the gap between current conditions and a world in which electricity markets feature price-responsive demand.

As noted in the example given above, it is precisely at peak times that the dollar value of the harm to consumers from market power could exceed \$400 million in one day.

We stated earlier that the PSC concurs with the views of many commenters in that we prefer not to use a bid cap. Generally, the PSC prefers to let prices be set by a properly functioning market and to minimize intervention into the market. But, it is the severity of the economic impact of market power during peak times in particular that makes it imperative to put in place a measure that is effective at limiting abuse when the market is tight and leaves the market unimpeded at other times.

#### **VI. ORION'S CONCERN ABOUT RECOVERING LEGITIMATE COSTS CAN BE RESOLVED**

For the bid cap to be effective, suppliers must not be able to circumvent its intent. This required including in the Motion adopted by the MC certain



conditions including provision IV.D. This provision specifies that BPCGs would be suspended for a supplier that bid minimum generation levels, start-up costs, or minimum run times when the LBMP at the supplier's bus averaged \$200/MWh (an extremely high average daily price) or more per day. Thus, under these conditions, the supplier would receive no payments beyond those provided by the LBMP. The provision would prevent a supplier from being able to bid a long minimum run time, thereby forcing the ISO to take the supply at \$1000/MWh for up to 24 hours when it is needed for just a few minutes.

Orion has expressed a concern about this provision. It argues that its gas turbines often do not set the clearing price even when they are the most expensive generation operating. As a result, Orion argues, LBMP payments might not cover their bid cost. Thus, Orion is concerned that the suspension of BPCGs will reduce its ability to recover legitimate costs. It suggests the ISO should instead allow a maximum hourly price of \$1,000/MWh for gas turbine operators. This price would include minimum generation and energy bids and start-up costs.

Orion's solution is unworkable because it does not adequately protect against the ability of gas turbine owners to tie acceptance of a \$1000/MWh bid at a critical

period with a long minimum run time at that price. Orion's concern, however, can be addressed under the bid cap proposal which has been approved by the MC. Under that proposal, Orion's BPCG would not be suspended, and it would be ensured recovery of its energy bids, as long as it did not submit bids for its minimum generation level, start-up cost or minimum run time.<sup>1</sup> The PSC believes it would be reasonable for the ISO to assure owners of gas turbines that it would honor a minimum one-hour run time for their units, thus obviating the need for the owners of such units to bid minimum run time.<sup>2</sup>

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<sup>1</sup> Our understanding is that Orion does not need to explicitly bid start-up costs and minimum generation levels for its gas turbines.

<sup>2</sup> We encourage the ISO and Market Participants to consider a longer term solution under which generators' start-up costs, minimum run times, and minimum generation levels would be fixed once at the beginning of each capability period.

**CONCLUSION**

For the reasons expressed above the PSC urges the Board to reject the appeals, and file with FERC as soon as possible, the bid cap proposal approved by the Management Committee.

Respectfully submitted,

Saul A. Rigberg  
Assistant Counsel

Dated: June 26, 2000  
Albany, New York

cc: Market Participants