February 27, 2003

Via Overnight Hand Delivery

Mr. Richard J. Grossi
Chairman
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303

c/o Mr. William J. Museler
President and Chief Executive Officer
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303

Re: Notice of Appeal of the Management Committee's February 13, 2003 Decision Concerning Implementation of a Capacity Market Demand Curve

Dear Chairman Grossi:

Pursuant to the Procedural Rules for Appeals to the NYISO Board, The City of New York hereby submits three copies of a Notice of Appeal of the Management Committee's decision at its February 13, 2003 meeting to implement a capacity auction Demand Curve.

A copy of this Notice of Appeal has been electronically transmitted to Ms. Kristen Kranz and Ms. Diane Egan to facilitate service on the members of the Management Committee and electronic website posting.

Very truly yours,

Michael J. Delaney, Esq.

Attachments

NOTICE OF APPEAL BY THE CITY OF NEW YORK AND CONSUMER POWER ADVOCATES OF THE MANAGEMENT COMMITTEE'S DECISION WITH RESPECT TO THE DEMAND CURVE PROPOSAL

I. SUMMARY OF ARGUMENT

In accordance with Article 5 of the NYISO Agreement and Section 1.02 of the Procedural Rules for Appeals to the ISO Board, the City of New York and Consumer Power Advocates hereby file this notice of appeal of the Management Committee's decision at its February 13, 2003 meeting to approve the implementation of a Capacity Demand Curve Auction.

The proposal adopted by the Management Committee creating an auction for generation capacity through a demand curve should be rejected by the Board because: (1) its adoption is antithetical to the development of a competitive capacity market; (2) it offers no assurance of new generation entry to the New York market; (3) it is overly inclusive, providing a windfall to many generators with no corresponding benefit to the market as a whole; (4) it will impose great costs on consumers without reasonable justification; and (5) it will artificially preserve inefficient, environmentally damaging facilities, thus undermining one of the promises of deregulation.

The Appellants respectfully request that the NYISO Board overturn the decision of the Management Committee, and reject the demand curve. To the extent that the Board believes that the current NYISO capacity market is so flawed as to require intervention, the Board should limit the implementation of the demand curve to a period of no more than one (1) year, thereby permitting an opportunity for assessment of its actual effects rather than the necessarily speculative claims currently made for it by its adherents. In addition, other capacity market improvements that are more consistent with a truly competitive market could be considered during the following year.

II. PRELIMINARY STATEMENT

The current situation in the New York State capacity market has revealed the existence of flaws, particularly with respect to the ability of a pivotal bidder to withhold capacity and thereby raise prices to the deficiency level. Arguably, even a small generator would have this ability whenever its available capacity exceeded the amount needed to create a deficiency. However, it has not been demonstrated that the demand curve is the appropriate solution to eliminate this potential for market power abuse.

In addition, the Board should not be unduly swayed by the specter of artificially high deficiency prices in the NYCA as the only alternative if the demand curve were not to be adopted. While the demand curve proposal as voted on in the Management Committee includes a reduction in the deficiency price to 1.5 times the cost of a gas turbine, there is no reason that such a change could not be effected separately. In fact, there exists no compelling rationale for the NYISO to have such an inflated deficiency price at all, particularly as it is wholly inconsistent with its counterparts in the neighboring regional markets.[1] Justification for the 3x multiplier in the NYISO tariff is entirely lacking. In any case, the existence of an inflated deficiency price should not be used as a straw man to artificially create a purported need for a demand curve.

III. ARGUMENT

1. The Implementation of a Demand Curve Is Contrary to the Development of a Competitive Market by the NYISO and Cannot Be Justified by the Mere Existence of Volatile Capacity Prices

It is inescapable that the very concept of a demand curve represents an administratively determined price structure, and as such should clearly be disfavored.

[1] *See, e.g.*, deficiency charge of $4.87/kW-month ($58.44 annually) under ISO-NE Installed Capability Market MRP §11.6 (effective December 2001); PJM Control Area Reliability Assurance Agreement Schedule 11 §A, deficiency rate based on annual carrying charges of new combustion turbine

While there are undoubtedly circumstances under which temporary administrative solutions are warranted, such interference should be reduced to the extent possible, and limited in duration when implemented.

The central precept behind the creation of the NYISO was that it would oversee an orderly transition to a deregulated wholesale electricity market in this State. The restructuring order of 1998 contemplated that grid management would be kept separate and distinct from the setting of prices, thus preserving the independence of the NYISO. The underlying goal was to encourage the influence of competitive forces in the wholesale electricity market, while providing consumers with a manageable transition to a new market form. Implementation of a demand curve would clearly represent a retreat from that vision.

Electricity market volatility has increased since the advent of the restructuring process in New York State. This is true not only in the capacity market, but in virtually every aspect of the State's electricity markets. Thus, for consumers of electricity, the peak summer price plateaus under the former regulated system have been replaced by slopes that are not only far steeper than their predecessors, but have reached higher peaks.

This pattern, while undoubtedly disconcerting to electricity consumers who were promised lower prices under deregulation, should not be surprising. A hallmark of market deregulation is increased price volatility. Significant price oscillations are virtually inevitable in moving from a regulated environment to one that relies heavily on market-based price decisions. While the latter is inherently more uncertain than is a highly regulated market, that fact should not be viewed as a problem. Volatility has value to the extent that it encourages development of new and more efficient power plants.

2. The Demand Curve Offers No Assurance of New Market Entry

New York State, like many other areas of the country that have undertaken the electricity restructuring process, has admittedly experienced electricity market conditions that have caused great distress among some market participants. Many merchant generators have encountered precipitous declines in both their share prices and their credit ratings that are entirely unrelated to the restructuring in New York. Revelations of gross misconduct in energy trading activities have cast a pall over portions of the industry. Entities that were viewed as highly credit-worthy a year or two ago now struggle with total or partial loss of investor confidence. Most of the problems experienced by energy firms are a product of the excesses that too many members of the industry engaged in, thereby giving rise to a loss of investor confidence.

Demand curve adherents contend that new energy supply resources are not being added to the New York market, thereby raising the threat of future deficiencies. This view is highly dubious at best. For example, in New York City, recognized as one of the state's most constrained markets, new generation facilities with a capacity of more than 900 MW (equal to nearly five years worth of projected in-City load growth) are now under construction in the City, and should be on line by mid-2005.[2] The NYISO itself has recently suggested that while the New York City market remains tight, energy supplies should be adequate during the 2003 peak demand season.[3]

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[2] These projects are Keyspan-Ravenswood (250 MW with an operational date expected in late 2003), the Con Edison East River re-powering (adding approximately 175 MW net in late 2004), and NYPA Poletti (500 MW expected by mid-2005). Other potential new sources include the PSEG Cross-Hudson generator lead (550 MW now in the late stages of a PSC Art.VII application process, with a possible operational date in 2005), and at least the possibility of a Con Edison contract growing out of the current RFP (500 MW by the first half of 2006). In the aggregate, these projects would add nearly 2000 MW of generating capacity in New York City alone.

[3] NYISO Peak Load Forecast, issued February 25, 2003

More generally, in a statewide capacity market that is currently some 5% above the 118% requirement (exclusive of imports), it is unsurprising that we have very low UCAP prices. The mere fact that certain generators may now be experiencing an unsatisfactory return is simply not a reason to radically redesign the New York market, and to impose an administratively determined price schedule. As a practical matter, generators will face periods of scant profits just as at other times they will have earnings far superior to historical regulated rates of return.

Simply stated, one of the key characteristics of a deregulated market is and must remain the higher degree of risk borne by all market participants – a risk accompanied by the possibility of greater gains that are the counterpart to that increased risk. Particularly where the existence of the current lean period is more likely attributable to extrinsic financial market factors than it is to New York-specific causes, the NYISO should be very reluctant to address a temporary problem with a costly permanent "solution" that may not truly solve anything.

The amount of capacity that an LSE has to purchase is a derived quantity that is calculated to justify a reserve level that corresponds to the probability of shedding load no more than once in 10 years. Thus, the main function of UCAP is to assure reliability. Since the amount of capacity purchased is typically set at a level sufficient to meet the reserve requirement, quantities in excess of this requirement have no value towards meeting the reserve requirement and, as such, should not be entitled to additional revenues, particularly through the indiscriminate mechanism of the demand curve.

Despite the hyperbolic claims that have been made for the purported effects of the demand curve, there can be no certainty that it will encourage new market entrants. No

one can guarantee that implementation of the demand curve will itself actually result in the construction of new generation. The prospect of capacity revenue alone can hardly be determinative in generators' decisions concerning the New York Control Area. Such revenue would at best be an incremental factor that prospective investors in new generation would consider in evaluating the merits of such an investment – and would probably be secondary to energy prices and perhaps to ancillary services revenue as well. Accordingly, the Board should not accept the simplistic proposition that the implementation of the demand curve will give rise to new entry.

3. The Demand Curve Proposal Is Over-Inclusive and Would Operate Primarily to Confer a Windfall on Existing Generators

As the demand curve makes no distinction between new and existing generation sources, the benefits that it confers on generators will in large part flow to existing generation sources rather than to new market entrants. Some have suggested that such an outcome would be beneficial in that it would encourage existing generators to remain in the New York market. However, generators' economic circumstances clearly vary widely, and a substantial number of them are undoubtedly well compensated under the current NYISO market model. To confer additional revenue on them in an indiscriminate fashion is wholly unwarranted.

The proposed demand curve is thus far too blunt an instrument – one that would confer a substantial windfall on those generators that already operate highly efficient facilities that are at no risk of retirement or closure. Equally important, far more targeted alternatives that offer the prospect of attracting new generation facilities are already beginning to emerge. Thus, for example, Consolidated Edison has recently issued an RFP for 500 MW of new capacity, and the Public Service Commission has declared that

this mechanism is a prudent means of encouraging the construction of new in-City facilities.[4]

Finally, there is of course no necessary correlation between New York State earnings and investment in this State. Many merchant generators and other developers have broad geographic reach, and capacity revenues earned here might well flow to projects located elsewhere. This fact further undercuts the claimed direct connection between enhanced capacity revenues and the establishment of new generation facilities in New York State.

4. A Demand Curve Will Impose Very Substantial Costs on Consumers Without a Corresponding Benefit to the Market or to Reliability

The general lack of certainty on the demonstrable benefits of the demand curve is particularly noteworthy because the anticipated rate impact of the Curve on consumers - a factor too often ignored by its proponents during the NYISO Committee process[5] - is far from trivial. The Department of Public Service staff, while supporting a variant of the demand curve, has been forthright in acknowledging that its own estimate of the rate impact attributable to the curve could range up to hundreds of millions of dollars annually in New York City alone, translating to a rate increase of perhaps 8-10% in consumers' entire electricity bills attributable to the increase in capacity costs. The estimate provided by David Patton was far lower[6], while that from Carl Pechman was considerably higher than Patton's and included a discussion of the underlying rationale in support of his

[4] PSC Case No. 02-E-1656, Declaratory Ruling of January 24, 2003, at p. 12
[5] *See, e.g.,* the minutes of the December 13, 2002 BIC meeting
[6] David Patton, "Demand Curve Estimates" at MC meeting of January 9, 2003, and BIC meeting of February 11, 2003

estimate.[7] While such projected rate impacts and the assumptions underlying them are invariably subject to spirited debate, it is undeniable that the rate impact of the demand curve would be very significant, particularly in the successive years after its initial implementation in the form passed by the Management Committee.

The many unexpected developments in energy markets in recent years should induce a measure of humility in anyone attempting to predict the true benefits and costs of electricity market redesign efforts. At a minimum, however, as a policy matter there must be a demonstrable correlation between the burdens and benefits associated with any redesign proposal. This is particularly true with a change that clearly will entail far-reaching effects on consumers. The demand curve proposal fails to meet this test, and on that basis alone should not be adopted.

5. A Demand Curve Would Artificially Preserve Inefficient Facilities and Thereby Jeopardize Progress in Controlling Environmental Emissions

The deregulation process should lead to the reduced use or closure of less efficient power plants. Without the assured rate of return characteristic of a traditional regulated market, plants with particularly high heat rates would likely yield relatively quickly to more efficient competitors - a process that will also provide considerable environmental benefits.

Thus, for example, the phasing out of a 30-year old upstate plant should not itself be a cause for alarm. To the extent that the prospect of an immediate plant closure might lead to a capacity deficiency and thereby threaten system reliability, a more sensible and narrowly tailored answer would be the use of a PPA. This would both prevent a precipitous plant closure, and simultaneously provide an interval that would permit

[7] Carl Pechman, "Review of Economic Analysis of Demand Curve Proposal" at special Management Committee meeting, February 13, 2003

potential new market entrants (whether new in-state facilities or imports) to realistically assess the energy prices they would need to provide in order to supplant the older facilities when the PPA period ended. Such a process would be far more likely to provide an orderly succession of energy suppliers, and would markedly improve environmental conditions without imposing needless costs on the rate-paying community. Even if a PPA were not to materialize in such a situation, the loss of in-state capacity would tend to raise prices, attracting imports that could respond almost immediately to New York State market anomalies.

6. The Demand Curve, If Implemented, Should Be In Effect For No No Longer Than One Year While Alternatives Are Considered

While the appellants believe that the ICAP market is in general a well-functioning market (a point that has been acknowledged by ISO Staff), we recognize that it could be improved. For example, a longer procurement period makes sense, and the current capacity market could be subject to abuse by a pivotal bidder.[8] It has not been made clear, however, that the demand curve is the best solution for this problem. Appellants believe that the ISO should adopt more rigorous market monitoring procedures for the capacity markets that would ensure that the kind of abuses that occurred in PJM could not occur here.

In the interim, the demand curve should be adopted for no more than a year so that alternatives can be considered. The FERC's SMD initiative, which we and the ISO support, requires that the ISO not adopt any permanent design for the State's capacity markets while the FERC is still considering a standard market design. Indeed, the ISO

[8] This problem previously existed in the PJM market and was resolved there with a number of market design changes. *See* PJM Interconnection, 95 FERC ¶ 61,175 (2001); the Pennsylvania Public Utility Commission also made findings in its Docket No. I-00010090 that the PJM installed capacity market had been subject to manipulation through economic withholding (PUC findings issued June 13, 2002)

itself has recently argued to the FERC that the best forum in which to comprehensively address all regional capacity issues is the collaborative joint Resource Adequacy Model (RAM) Group.[9]

Accordingly, if the Board decides to implement a demand curve, then the Board should file with the FERC for a one-year term only and permit market participants and ISO staff to continue to discuss alternatives to the demand curve while taking into account the discussions that are simultaneously occurring in the RAM group.

IV. Conclusion

For all the above reasons, the appellants urge the Board to overturn the decision of the Management Committee in its entirety. In the alternative, the appellants ask that the administered market represented by the Demand Curve be limited in its application to a period of no more than one year.

Dated: February 27, 2003

Respectfully submitted,

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[9] Additional Comments of the NYISO, Standard Electricity Market Design Docket RM01-12-000, January 10, 2003, at p. 10