

## **NOTICE OF APPEAL**

Strategic Energy L.L.C. (“Strategic”), a load serving entity (“LSE”) in New York and several other states, submits to the Board of Directors (“Board”) of the New York Independent System Operator, Inc. (“NYISO”) this appeal of the Management Committee (“MC”) decision to approve Motion No. 2, the “Demand Curve” proposal, at its February 13, 2003, meeting.

## **SUMMARY OF ARGUMENT**

The Board should reject the Demand Curve proposal as it fails to address New York’s resource adequacy needs by merely transferring more consumer dollars to generators without any assurance they will direct the additional revenue towards new generation units. The Demand Curve does not solve any of the problems that suppliers claim exist under the current ICAP market design. Contrary to the position of the Independent Power Producers of New York (“IPPNY”), LSEs will be reluctant to enter long term installed capacity (“ICAP”) agreements due to anticipated regulatory changes the Federal Energy Regulatory Commission (“FERC”) might impose through its Standard Market Design (“SMD”) and the risk of additional changes to the Demand Curve during periodic reviews at NYISO over the next few years and beyond. Suppliers contend that inelasticity in the current ICAP market design drives prices below a level sufficient to provide a financial incentive to build new generation.<sup>1</sup> In fact, the low rest of state (“ROS”) ICAP prices reflect current surplus capacity in the ROS region and existing proposals for adding capacity. The lack of a requirement that generators spend ICAP

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<sup>1</sup> Notice of Appeal of Independent Power Producers of New York to the NYISO Management Committee, December 27, 2002.

payments on new generation, not ICAP market inelasticity, results in no new generation being built with ICAP revenue.

## ARGUMENT

### **I. The Demand Curve will not create more revenue certainty for suppliers than the existing ICAP system.**

Suppliers claim that revenue streams of the current capacity market are too small to persuade investors and lenders, and that they cannot rely on these revenue streams, for planning and financing new capacity. Moreover, they believe the Demand Curve will promote long-term bilateral contracts better than the current market. This premise is false for two reasons. First, LSEs have no interest in entering long term bilateral ICAP contracts while the strong possibility exists that FERC may require through SMD a form of resource adequacy radically different from the Demand Curve. Second, the proposed tariff language will subject the Demand Curve to an independent review and possible amendment by the end of next year and every three years thereafter. LSEs will be reluctant to enter long-term capacity agreements if changes to the resource adequacy system over the next few years will allow LSEs to procure cheaper ICAP or none at all.

### **II. The Demand Curve, like the existing ICAP system, does not guarantee generators will build new resources in New York; it only promises to impose more costs on New York electricity consumers.**

The Demand Curve forces LSEs to pay for capacity now worthless under the current system by administratively placing value on surplus capacity unnecessary to meet the State's reliability requirements. Consumers, of course, will pay for this increase in supply eligible for ICAP money under the Demand Curve. Suppliers contend that under the current system, they must bid too low for ICAP so as to ensure they are selected in

the auction.<sup>2</sup> This is exactly how a functioning market works. The goal of the New York ICAP market is not to provide suppliers with a steady amount of set revenue, but to ensure an adequate supply of electricity. If current supply is adequate, this will be reflected in capacity credit prices. The Demand Curve forces consumers to pay for capacity they neither want nor need. The true failure of New York's resource adequacy system arises from the current tariff allowing existing generators to pocket ICAP revenues rather than providing a mechanism to attract new supply sources.

Other regulatory issues also pose a barrier to new resources. Upon releasing the peak load forecast and capacity outlook for New York in the summer of 2003, the NYISO issued a press release alarming New Yorkers that New York needs more resources to be built soon or else face the risk of the lights going out.<sup>3</sup> In the NYISO release, President William J. Museler only cited the plant siting law as a barrier to new generation. The failure to mention insufficient capacity payments invites speculation that NYISO believes capacity payments to existing generators are irrelevant to new resources.<sup>4</sup>

New York City consumers pay over \$1 billion a year to the owners of generators as an incentive payment for generators to build new resources in the city; they get nothing for their money. Most of the incentive payment goes to *existing* generators, not *new* generators. \$1 billion should be buying more than a 1,000 megawatts of new, cleaner traditional generation- each year.<sup>5</sup>

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<sup>2</sup> Id.

<sup>3</sup> NYISO press release, "New York Independent System Operator Announces Summer Electricity Forecast," February 25, 2003.

<sup>4</sup> Id.

<sup>5</sup> For example, the NYPA 500MW Poletti project underway in Queens, will produce 500 MW with a cost of almost half a billion dollars. See <[www.nypa.gov/ar01/pages/index.htm](http://www.nypa.gov/ar01/pages/index.htm)>

The failure of ICAP has forced parties to find a solution independent of the so-called “resource adequacy market”. For example, faced with a local reliability problem in southwest Connecticut, ISO New England (“ISO-NE”) solicited and received offers in response to a Request for Proposals to supply 80 megawatts of new resources. ISO-NE understood that giving existing units more ICAP payments would not create new resources needed for reliability. Ultimately, direct reliability payments for the installation of new resources will ensure reliability. Similarly, NYISO has a local reliability problem in New York City. By contrast, NYISO last year opted to increase the ICAP payments to existing resources in the hope an increase will create an incentive for generators to build in-City resources. Consolidated Edison, understanding the seriousness of the situation and the remote chance of ICAP revenue leading to new generation, issued its own RFP for 500 megawatts of new resources in-City. Under the Demand Curve, the new generator will only get a small fraction of the more than \$1 billion a year that New York City customers will pay for ICAP; it seems likely Consolidated Edison will directly pass through the cost of its new capacity directly to its customers.

### **III. The Demand Curve encourages market manipulation.**

Under the Demand Curve, suppliers have an incentive to withhold supply to move themselves up the demand curve to secure higher prices. All participants know how many credits exist, the aggregate demand, and the number of credits supply must withhold to drive the price of credits to the deficiency rate. As a result, the structure of the Demand Curve begs for abuse. No provision has been included in the Demand Curve proposal to prohibit suppliers from withholding ICAP from the market. The NYISO

Market Monitoring Unit (“MMU”) did not weigh in during the debate as to whether it could detect withholding. The Board should not adopt the Demand Curve proposal without being assured it could not be manipulated without detection.

**IV. Alternatives to the Demand Curve are cheaper for consumers and will ensure the construction of new resources.**

Less costly and more effective resources adequacy proposals are available for the New York market. This reason alone warrants the Board rejecting the Demand Curve proposal. Strategic agrees with Multiple Intervenors that their alternative is less costly for the market than the Demand Curve. Their alternative proposal, however, like the current resource adequacy system, does not guarantee new generation. Long term contracts in the energy market, not an artificial capacity market, and demand response programs will ensure adequate future resources. NYISO should continue to implement market design changes, so the cost of generation reflects the true cost of electricity, such as adopting scarcity pricing rules that will set energy prices at \$1,000/MWh, or higher, during shortages of ten-minute reserves. The NYISO should also implement modifications to the Special Case Resources and Emergency Demand Response programs so that demand resources will set the market clearing price.

The NYISO should improve its bilateral energy markets to provide better price signals to generators and more supply options to loads. Currently, far too much of the load is settled in the NYISO day-ahead and hourly markets making for illiquid bilateral energy markets<sup>6</sup>. Long-term bilateral energy markets provide a better signal to resource developers than administrative price-fixing.

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<sup>6</sup> In PJM and ISO-NE only 10 – 20% of energy settles in the spot markets, compared to 50% in NYISO.

Strategic acknowledges that the generation community needs adequate revenue to stay in business. Peaking generators seek additional compensation for units they claim cannot receive adequate revenues and profits in the few hours they operate because of price mitigation and low reserves payments; they seek capacity payments to make up for the shortfall. Illogically, they seek capacity payments for all units, not just the reserve or peaking units that are not recovering all of their costs. The NYISO has yet to perform a cost of service study, including a review of energy revenues, that justifies the price levels that are to be used in the demand curve.

If the problem of peaking units being uneconomic actually exists, only two solutions exist to resolve the problem: lift the price caps or subsidize the peaking units either with direct subsidies or higher reserves payments. Eliminating price caps will also foster a stronger market for the demand response component of resource adequacy; Technology, such as advanced metering and energy information systems, has a significant role to play in this effort. The existence of market signals that reflect the true value of energy and the ability of end users to capture this value, either directly or through their LSE, is a fundamental prerequisite of effective demand response.

## **CONCLUSION**

The Board should reverse the decision of the Management Committee and return the Demand Curve proposal to the lower committees for them to construct an alternative resource adequacy system that costs consumers less and guarantees the construction of new resources with its revenue.

Respectfully submitted,

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Dated: February 27, 2002  
Brooklyn, New York