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Via Hand Delivery

March 7, 2003

Hon. Richard J. Grossi
Chairman, New York Independent System
Operator Board of Directors
C/O William J. Museler
President and CEO
New York Independent System Operator, Inc.
3890 Carman Road
Schenectady, NY 12303

Re: Motion in Opposition to Appeals Regarding Management Committee's Approval of an
Installed Capacity Demand Curve

Dear Chairman Grossi:

Pursuant to Section 4.01 of the Procedural Rules for Appeals to the ISO Board, please find enclosed the "Motion of the Independent Power Producers of New York, Inc., in Opposition to Appeals Regarding the Management Committee's Approval of an Installed Capacity Demand Curve." Please note that the Independent Power Producers of New York, Inc. requests oral argument before the Governance Committee on this matter. A copy of the Motion has been e-mailed to Kristen Kranz, of the ISO's staff, who has agreed to serve it on the members of the Management Committee today.

Very truly yours,

David B. Johnson

Enclosures

cc: Kristen Kranz, via e-mail
Robert Fernandez, Esq., via e-mail
Elaine Robinson, Esq., via e-mail

MOTION OF THE INDEPENDENT POWER PRODUCERS OF NEW YORK, INC., IN
OPPOSITION TO APPEALS REGARDING THE MANAGEMENT COMMITTEE'S
APPROVAL OF AN INSTALLED CAPACITY DEMAND CURVE

The Independent Power Producers of New York, Inc. (“IPPNY”),¹ on behalf of those of its members listed below² that are also members of the New York Independent System Operator’s (“NYISO”) Management Committee (“MC”) hereby moves in opposition to the appeals³ of the MC’s February 13, 2003 approval of an Installed Capacity (“ICAP”) Demand Curve proposal (“DC Proposal”).

IPPNY respectfully requests that the NYISO Board deny the Appellants’ appeals. The DC Proposal is critically necessary to address fundamental flaws inherent in New York’s existing ICAP market design. As recognized by the staff of the Department of Public Service (“DPS”) and its Chief of Regulatory Economics, Mr. Mark Reeder,⁴ the NYISO and many others, the existing ICAP market design is significantly flawed. As explained below and in the attached affidavit of Mr. Mark D. Younger (“Younger Affidavit”), the DC Proposal will provide more accurate price signals that will induce construction of new, and retention of needed existing, capacity in New York. After lengthy discussions during numerous working group meetings to develop a method to fix the flaws in the current ICAP market design, the DC Proposal was the sole proposal that parties identified that remedies the flaws in the existing ICAP market design. The MC’s vote on the DC Proposal, which received majority support in three of the five NYISO sectors and garnered votes in all sectors, fully complied with NYISO procedures.

I. THE DC PROPOSAL IS CRITICALLY NEEDED.

A. THE EXISTING ICAP MARKET DESIGN IS SIGNIFICANTLY FLAWED.

The current New York ICAP market reliability rules promulgated by the New York State Reliability Council (“NYSRC”) require Load Serving Entities (“LSEs”) to purchase sufficient generation capacity to cover their forecasted peak load plus a minimum required reserve amount, currently set at an

¹ IPPNY is a not-for-profit trade association representing more than 100 companies involved in the development, operation, marketing, and sale of electric power in New York.

² Constellation Power Source, Dynegy, Energy Mission Marketing & Trading, Entergy Nuclear Northeast, NRG Power Marketing, Inc., and PSEG Energy Resources & Trade.

³ Appeals were filed by Multiple Intervenors (“MI”); the City of New York and Consumer Advocates (“the City of New York”); Agway Energy Services, Inc., ECONergy Energy Company, Inc. and Mirabito Gas & Electric, Inc. (“Agway”); Strategic Energy, L.L.C. (“Strategic”); Select Energy, Inc. (“Select”); New York State Electric and Gas Corp. and Rochester Gas and Electric Corp. (“NYSEG”); and Strategic Power Management, Inc. (collectively the “Appellants”).

⁴ See Proposed Resource Demand Curves for NYS, NYC, and LI, NYDPS, presented at the November 12, 2002 ICAP Working Group meeting; Mark Reeder, Government Intervention Into Wholesale Electric Markets To Assure Generation Adequacy (November 6, 2002) (“*Government Intervention*”).

additional 18 percent margin, to meet reliability requirements.⁵ LI LSEs must purchase a minimum of 95 percent of their peak load requirements from LI suppliers and NYC LSEs must purchase a minimum of 80 percent of their peak load requirements from in-City suppliers.⁶ LSEs can secure these requirements via bilateral contracts or by participating in a six-month capability period auction (or “strip auction”) and/or in monthly auctions. If an LSE fails to reach the applicable locational and/or statewide minimum ICAP requirement (“MIR”), the NYISO is required to enter the LSE’s shortfall into a deficiency auction. The NYISO bids on the LSE’s behalf at a price equal to an administratively determined “deficiency charge.” If the market is deficient of capacity, the auction will clear at the deficiency charge. Pursuant to the NYISO’s tariff, for the Summer 2003 Capability Period, the NYISO must set the deficiency charge at three times the levelized carrying cost of a gas turbine (“GT”).

Because the current ICAP rules result in both supply and demand converging at an artificially-designated point, during times of even slight excess capacity supply, prices in the ICAP market have spiraled towards zero.⁷ Conversely, when sufficient capacity to meet the MIR is not available, ICAP prices increase to the deficiency charge, as LSEs compete with each other to secure sufficient ICAP.

The signals to the market that additional generation is needed in New York do not occur until a deficiency occurs in either a locality or statewide. A deficiency triggers a spur of activity to address the need for electric capacity. Because of the lumpiness of generation, the added capacity is likely to bring the State or locality into an excess capacity condition, which results in a collapse of ICAP prices. When ICAP prices collapse, investors are unable to recover their capital investments. Thus, the current ICAP market design sets incentives only to add enough capacity to remain in a deficiency condition or just barely meet the MIR.

As discussed in the Younger Affidavit, the market clearing price for ICAP for the February 2002 through March 2003 period was approximately \$13.07/kW/yr for the statewide market (“Statewide”), translating to a clearing price of approximately \$2.50/MWh for an upstate customer with a 70% load factor.⁸ In contrast, if sufficient ICAP were not available to meet the MIR, this summer’s Statewide

⁵ In addition, the NYISO requires LSEs in Long Island (“LI”) and New York City (“NYC”) to comply with local ICAP reliability rules.

⁶ The discussion herein is equally relevant in the context of local reliability requirements and the Statewide requirement. For simplicity, we will address our discussion primarily to the Statewide requirement.

⁷ Mr. Reeder notes that “[m]arket participants often talk about the 118% reserve level as a cliff, and use the term ‘falling off the cliff’ to represent what happens to price when reserves grow to exceed the target.” *Government Intervention* at 9.

⁸ Younger Affidavit at ¶ 7.

deficiency charge will reach \$255/kW/yr, translating to approximately \$49.10/MWh for an upstate customer with a 70% load factor.⁹ Over the long run, the ICAP market will need to clear at the deficiency rate once every three or four years due to the low ICAP prices during periods of essentially any excess supply and the deficiency rate being set at three times the cost of a GT.¹⁰

The result is that the current ICAP market is either boom or bust; it induces extremely low prices at times of any surplus capacity that must be balanced by extremely high ICAP prices during deficiency. Recent ICAP strip auctions have yielded \$0.65/kW-month Statewide and \$7.50/kW-month in NYC. These amounts stand in stark contrast with Mr. Reeder's assertion – which was confirmed by Dr. Patton – that over the long run a sustainable capacity market must allow suppliers to receive, on average, a capacity price that is sufficiently high to induce entry of new generation.

This market structure harms resource reliability, because it discourages generators – particularly those peak suppliers whose revenues come almost exclusively from ICAP payments – from remaining in the New York energy market. In upstate New York, many units that run only a small percentage of the year are needed to maintain desired levels of reliability during peak conditions. However, at \$0.65/kW-month, many of these units cannot cover their property taxes and fixed operation and maintenance costs. Those that are fueled by natural gas and run only a small number of hours per year cannot make up the revenue shortfall via energy profits and are in jeopardy of permanent shut-down, if the ICAP market is not corrected. This is particularly critical at a time when the NYISO has openly recognized that “significant amounts of new electric generating capacity”¹¹ will be needed in New York to meet its requirements by 2005.

Moreover, Mr. Reeder acknowledges the boom-bust cycle in ICAP prices benefits no one because the revenue streams are not likely to be predictable enough to allow investors and lenders to rely on them for planning and financing new capacity and to perform effective planning for existing facilities. In addition, the boom-bust cycle undermines incentives for parties to execute long-term ICAP contracts. LSEs and generators would have great difficulty in reaching agreement on a long-term ICAP price, because the existing ICAP market design would ensure that LSEs could purchase ICAP at extremely low prices at some point in the future and that generators could receive extremely high ICAP revenues at

⁹ *Id.* at ¶ 10-11.

¹⁰ *Id.* at ¶ 13.

¹¹ *Power Alert II – New York's Persisting Energy Crisis*, Report by the New York Independent System Operator, May 27, 2002, p. 5.

some point in the future, as well. Thus, the large potential bid/offer spread makes it risky for regulated LSEs to enter long-term agreements due to the potential for subsequent prudence disallowances.

B. THE DC PROPOSAL IS ESSENTIAL TO REMEDY EXISTING ICAP MARKET DESIGN FLAWS.

The DC Proposal, a concept initially proposed by the DPS, is an adjustment to the existing, administratively set 118 percent MIR vertical demand curve, to incorporate a more gradual slope that appropriately and rationally values additional capacity in the market beyond the MIR. The DC Proposal provides for a phase-in of full GT costs over three years to moderate potential price impacts. In the third year, the DC Proposal provides that the demand curves for the three regions (Statewide, NYC and LI) will be based on the full levelized cost of a GT in each respective region, set at the MIR.

The DC Proposal would replace the existing deficiency auction with a “spot auction.”¹² LSEs would certify all of the capacity they had contracted for as bilaterals and obtained through the strip and monthly auctions. Suppliers with uncommitted capacity may offer their ICAP into the spot auction and would be able to specify the price of their offer. The NYISO would submit the demand curve as the range of price/quantity combinations that the LSEs would be willing to pay for capacity. The price and quantity of ICAP that the LSEs would be obligated to secure would be set at the point that the aggregate offers of supply and the bids of the LSEs cross on the demand curve.

The DC Proposal is necessary to reduce the price volatility that results from the existing ICAP market design. Because the demand curve effectively eliminates the “cliff” phenomenon inherent in the current design, it would eliminate the boom-and-bust of ICAP prices that results from the current ICAP market design. In addition, the demand curve sends more accurate price signals to the markets regarding the true value of additional capacity. The current design effectively considers all capacity exceeding the MIR as virtually worthless. Because, currently, a portion of the available ICAP is not needed to meet the State’s reliability requirements, suppliers will inevitably drive ICAP prices down in an effort to ensure that they are selected in the auction.¹³ The demand curve properly values capacity in excess of the MIR.

¹² Although the demand curve applies only in the Spot Auction, it will likely directly affect the prices in the bilateral market and the strip and monthly auctions because parties will have a better sense of their payment requirement if they wait for the spot auction.

¹³ NYSEG’s argument that the current ICAP market design should not force needed generation to retire because they can bid their going forward costs is incorrect. *See* NYSEG at 6. In order to be qualified to offer ICAP into any auction covering a period as short as one year, a generator must already have committed to most of the “fixed” expenditures it will incur in that upcoming period. Its avoidable, or “going forward” costs, therefore, are relatively low, approaching zero, over such a short time period. *See* Affidavit of Mark D. Younger attached to Motion of AES NY, L.L.C. *et al.* in Opposition to Appeals at ¶ 6.

Conversely, when a deficiency occurs, LSEs will not be subject to the high deficiency charge payments that are required under the current ICAP market design.

In addition, reducing volatility and establishing predictable ICAP prices would allow investors and developers to incorporate future ICAP payments as a reliable source of revenue in two ways: (1) it will better stimulate long term bilateral contracts, and (2) developers will be able to demonstrate to their investors a more stable revenue stream via the demand curve spot auction. This, in turn, would facilitate the construction of new generating facilities in the New York energy markets. Because the prices from the ICAP auctions are visible to the public, market participants would be able to rely on these values in developing long-term capacity or capacity/energy contracts. Thus, in direct contrast to the existing structure, as well as any other alternative structure that has been presented, the DC Proposal meets the Federal Energy Regulatory Commission's ("FERC") goals in its Standard Market Design Notice of Proposed Rulemaking ("SMD NOPR") to require that "resource adequacy" be addressed based on a long-term horizon.¹⁴

Contrary to the Appellants' assertions, the DC Proposal is designed to ensure that new investments – either in the form of improvements to existing facilities or in the construction of new facilities – occurs in the State. As noted earlier, the DC Proposal would signal the need for additional capacity to the market in the form of higher ICAP prices. As available capacity decreases, the ICAP prices would gradually increase. The increase in capacity payments would inform the market of the desirability of new facilities in the State. Because the DC Proposal would result in reliable and predictable prices, investors could determine whether it would be desirable to enter the market. Conversely, as ICAP prices drop, making new investments would not be as profitable and the market will react accordingly. By providing better signals to the market, the DC Proposal would promote market-based, supply-and-demand behavior in the ICAP market. The market signals resulting from the adoption of the DC Proposal will spur new investment in generation when that investment is appropriate.¹⁵

¹⁴ *Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electric Market Design*, 100 FERC 61,138, ¶ 520 (2002). Appellants' claims that the DC Proposal is inconsistent with the SMD NOPR lack merit. FERC clearly recognized that mechanisms that encourage the development of installed capacity were needed where energy markets were mitigated, such as in New York. The NYISO Board should take this opportunity in approving the DC Proposal to lead the country in designing efficient and rationale installed capacity markets.

¹⁵ It is also noteworthy that, before the NYISO commenced operations, vertically integrated utilities frequently carried and charged their ratepayers for 100 percent of the costs of capacity independent of whether they exceeded the MIR. The proposed Demand Curve would not allow generators to recover 100 percent of their costs for excess capacity. Unlike the prior regulated market method for recovering investment costs, the Curve's slope would represent the decreasing marginal utility of excess capacity.

II. THE DC PROPOSAL WAS THE PRODUCT OF A LONG, DELIBERATIVE, CONSULTATION PROCESS AND RECEIVED WIDE SUPPORT FROM ALL MARKET SECTORS.

The DC proposal, which received support from a majority of three of the five sectors and received votes in all sectors at the MC, resulted from extensive consultations, discussions, and deliberations. The concept of a demand curve has been under discussion for almost a full year during which time interested members had numerous opportunities to participate. DPS Staff introduced the initial concept of the demand curve in the Spring of 2002. Starting in the summer of 2002, the ICAP Working Group held numerous meetings to address the flaws in the current ICAP market design and in these meetings the concept of a demand curve was discussed as a possible solution. Contrary to NYSEG's assertions, the DC Proposal did not preclude full discussion of other alternatives.¹⁶ A limited number of alternative proposals were proposed by other parties. However, these parties either failed to address issues raised by other members or voluntarily withdrew the proposed alternatives from discussion. In addition, NYSEG and other Appellants do not state any substantive reason for failing to advance their last-minute alternative at any point during the previous year when they could have been as thoroughly and rigorously discussed as the DC Proposal.

III. THE MANAGEMENT COMMITTEE VOTE FULLY COMPLIED WITH NYISO PROCEDURES.

Appellants¹⁷ argue that the MC's vote on the DC Proposal was improper because MC members were prohibited from voting on the measure by a ruling of the MC's chairperson ("Chair"). The Appellants' argument lacks merit. Contrary to the assertions made by Agway,¹⁸ the Chair did not unilaterally rule to declare the new Members ineligible to vote. As the draft minutes of the meeting reflect, the Chair ruled after consulting outside counsel representing the NYISO at the meeting. The draft minutes of the meeting reflect that the NYISO counsel opined that to allow the new Members to vote "would be inconsistent with the spirit of the committee process."¹⁹

In addition, Section 4.03 of the MC Bylaws states that "[a]ll procedural rulings of the Chairperson may be challenged by motion, which, if seconded, shall be subject to an immediate vote without further debate." Appellants chose not to exercise their right, clearly set forth in the Bylaws, to

¹⁶ NYSEG at 8.

¹⁷ NYSEG at 9; Select at 6; Agway at 5; and MI at 2.

¹⁸ Agway at 4.

¹⁹ Draft Minutes of the NYISO Management Committee Meeting – Special Meeting, held on February 13, 2003, at p. 1.

request a vote on the Chair's ruling. Having failed to move to overturn the Chair's ruling at the MC meeting, the Appellants cannot now challenge the Chair's decision. Allowing them to do so would undermine the orderly conduct of NYISO meetings and would, in effect, render the right to challenge procedural decisions of the Chair mere surplusage.

Select's objections²⁰ to holding a special MC meeting two days after the Business Issues Committee ("BIC") meeting was held are also without merit. A review of the NYISO's calendar since its inception reveals that most of the regularly scheduled MC meetings have been held within the 15-day period of appeals and replies set forth in Article XIII of the BIC Bylaws.²¹ Moreover, there is no provision in the MC or the BIC Bylaws that requires tariff modifications to be addressed at the former committee before they may be considered at an MC meeting. Additionally, actions on matters requiring tariff modifications are not final until and unless the MC and the NYISO Board approve the modifications. Thus, no members were adversely affected or disadvantaged by not being able to appeal the BIC's vote approving the DC Proposal because they had a full opportunity to be heard at the MC.

IV. CONCLUSION

In light of the foregoing, IPPNY respectfully requests that the NYISO Board deny the Appellants' appeals, approve the DC Proposal and make the necessary tariff filings with FERC to implement the DC Proposal on an expedited basis.

Respectfully submitted,

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Albany, New York 12207
(518) 465-9313

Attorneys for
Independent Power Producers
of New York, Inc.

By:

David B. Johnson

Dated: March 7, 2003
Albany, New York

²⁰ Select at 7.

²¹ The special MC meeting to vote on the DC Proposal is also not inconsistent with past practices for scheduling special MC meetings. In 2002, at least two special MC meetings were held to vote on measures that had been addressed at BIC meetings held four days earlier or less.

AFFIDAVIT OF MARK D. YOUNGER

Mark D. Younger, having been duly sworn, deposes and states as follows:

1. My name is Mark D. Younger. I am employed as Vice President of Slater Consulting. My business address is 69 Werking Road, East Greenbush, New York 12061.
2. My entire professional career has been devoted to matters relating to electric generation and the development of competitive electricity markets. Before NYISO operation commenced, I was a key participant on the NYISO Technical Team tasked with developing detailed rules and procedures for the NYISO's administered market. Since the NYISO commenced operating, I have been an active participant in the NYISO workgroups addressing market design flaws and methods to improve the market design. My resume is available upon request.
3. I have been asked by the Independent Power Producers of New York to explain the benefits of the Installed Capacity ("ICAP") Demand Curve ("DC") proposal approved by the Management Committee ("MC") on February 13, 2003.
4. I believe that the DC is critically necessary to correct a significant flaw in the current market structure and ensure that, going forward, the ICAP market provides a sufficiently stable price signal to support the financing of new generation and the continued operation of existing generation.
5. The current ICAP market design is based upon a vertical ICAP demand curve set at the minimum NYISO Statewide and Locality ICAP requirements ("MIR").
6. Over time, this market structure has revealed the flaw inherent in its design; specifically, due to its vertical "cliff" design, it has shown a tendency to clear at near zero price levels when the amount of ICAP exceeds the MIR by relatively small amounts and fails to account for the significant benefits that additional ICAP provides to competitive energy markets.
7. The market clearing price for ICAP for the February 2002 through March 2003 period was approximately \$13.07/kW-year for the statewide market and \$88.74/kW-year for New York City. The upstate clearing prices translate to approximately \$2.50/MWh for an upstate customer with a 70% load factor $((13.07/\text{kW-year} * 118\% \text{ requirement} * 1000 \text{ MW/kW}) / (.7 * 8760 \text{ hours/year}) =$

\$2.52/MWh). The New York City clearing price translates to approximately \$11.60/MWh for a customer with a 70% load factor ($(88.74/\text{kW-Month} * 80\% \text{ requirement} * 1000 \text{ MW/kW}) / (.7 * 8760 \text{ hours/year}) = \$11.57/\text{MWh}$).

8. The clearing prices in both markets have been trending downward even though there has been load growth and no significant additions to capacity over this period. Last winter the Statewide UCAP market cleared at more than \$1.50/kW-month, while this winter the clearing prices have dropped to less than \$0.60/kW-Month. Indeed, the clearing price in the Statewide UCAP market strip auction was \$0.65/kW-month and with the monthly auctions for each month clearing well below that level. Likewise, last winter's NYC UCAP clearing prices averaged more than \$9/kW-month but have now dropped to approximately \$6.60/kW-month. In each case, the price dropped while load grew over this period with no significant increase in supply.
9. For the existing market design to provide a signal for new generation, the low clearing prices in periods where capacity exceeds the MIR by effectively any margin must be offset by periods where the ICAP market clears at the deficiency rate.
10. Under the existing NYISO tariff, the deficiency rate starting for the 2003 Summer Capability Period will be three times the levelized cost of a Gas Turbine ("GT"). The NYISO has estimated the levelized cost of a GT at \$85/kW-year, \$139/kW-year and \$159/kW-year in the Statewide, Long Island and NYC markets, respectively. This results in deficiency rates of \$255/kW-year, \$417/kW-year, and \$477/kW-year for these markets.
11. The deficiency rate will translate to approximately \$49.10/MWh for a consumer with a 70% load factor in the statewide market. The deficiency rate in NYC for the same consumer translates to approximately \$62.20/MWh.
12. Under the existing ICAP market structure, the frequency of the periods where the market clears at the deficiency rate will be determined by the frequency required to provide sufficient average ICAP revenues to induce new generation entry.
13. With the ICAP market tending to clear close to zero during periods of essentially any excess and with the deficiency rate being set at three times the cost of a GT, over the long run, the ICAP market

will need to clear at the deficiency rate once every three or four years. Even accounting for reaching the deficiency rate at these times, this design, by its very structure, fails to provide a sufficiently stable environment for siting new generation and maintaining existing generation. Indeed, given that the design causes prices to crash to very low prices as soon as sufficient generation is added during a deficient period to meet the MIR, the signal to meet the MIR will be blunted.

14. The DC proposal approved by the MC will address the flaws in the existing ICAP market. The DC provides a more stable price signal than does the current design. It replaces the fluctuation between near zero prices and the deficiency rate that is the hallmark of the current market design with a more gradual and predictable relationship between the amount of capacity in the market and the clearing prices. New generation will be able to be built in New York without causing capacity prices to collapse.
15. Moreover, in contrast to the current market mechanism, which essentially assumes that the next tenth of a MW beyond the MIR is valueless, the DC also recognizes that there is both a reliability and energy market benefit to having more capacity than the MIR.
16. Finally, the DC provides the basis to allow for longer-term forward contracting. By reducing the likely range of clearing prices, the DC enhances the ability of both generators and Load Serving Entities (“LSE”) to enter into longer-term bilaterals, because the cost/lost opportunity of being wrong in the forecast value will be significantly reduced.

Mark D. Younger

Sworn to before me this
day of March, 2003.

Notary Public