UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Market-Based Rates for Wholesale Sales of Electricity, Capacity and Ancillary Services	**)** **)**	**Docket No. RM04-7-000**

COMMENTS OF THE NEW YORK INDEPENDENT SYSTEM OPERATOR

In accordance with the Notice of Proposed Rulemaking ("NOPR") in the above docket issued by the Commission on May 19, 2006,[1] the New York Independent System Operator, Inc. ("NYISO") offers these comments on the Commission's proposal to revise its regulations governing the approval of market-based rates for public utilities. The NYISO urges the Commission to adopt final regulations that are consistent with the well functioning and highly competitive markets administered by the NYISO, including the market power mitigation measures administered by the NYISO, which are carefully tailored to preserve competition in those markets. To this end, the NYISO submits the following comments on the NOPR.

I. COMMENTS

A. Relevant Geographic Market -- ISO Region

The NOPR states, at P25:

> Sellers located in and a member of regional transmission organizations (RTO)/independent system operators (ISO) that perform functions such as single central commitment and dispatch with a single energy market and Commission-approved market monitoring and mitigation may consider the geographic region under the control of the RTO/ISO as the default relevant geographic market for purposes of completing their analyses.

Similarly, at P51 of the NOPR the Commission states that it

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1 115 FERC ¶61,210

> proposes to continue to designate the RTO/ISO in which a seller is located and is a member as the default relevant geographic market for RTO/ISOs with sufficient market structure and a single energy market, and not require sellers to consider, as part of the relevant market, markets first-tier to the RTO/ISO in which the seller is located and is a member.

The NYISO strongly endorses this approach to the definition of the relevant geographic market in areas with markets such as those administered by the NYISO. New York has had over six years of successful operation of competitive markets throughout New York State, the geographic area administered by the NYISO. A predicate for that success has been the ability of all Market Participants to sell at market-based rates. At the same time, New York has proven to be a sufficiently large area to sustain robust markets, without having to consider the additional competition from surrounding first-tier control areas. Of course, as is also the case in New York, trading across control area boundaries may ultimately indicate the relevant geographic market is larger than a given control area. *See* NOPR P56 ("Evidence of active trading throughout the proposed geographic market would also be considered."). The Commission's final rules should not restrict the widest possible participation by qualified entities at market-based rates in the New York markets.

1. <u>Role of the NERC Reliability Functional Model in Defining Markets</u>

The NOPR requests comments on "whether or not the adoption of the NERC [Reliability] [F]unctional [M]odel should change the criteria for specifying the default relevant geographic market . . . ." NOPR P52. The process of developing and enforcing reliability standards should be fundamentally neutral in its effects on competition and competitive markets. Under the most recent version of the Reliability Functional Model (version 3, April 21, 2006) posted on the NERC website, the "Balancing" and "Market

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Operations" functions appear to correlate to the traditional notion of a Control Area operator for purposes of assessing competitive markets. Thus, under the NOPR, the adoption of the NERC Reliability Functional Model would appear to create issues more of terminology than substance. Whatever the terminology, the process of defining geographic markets should focus on the area in which grid operations generally facilitate the ability of generators to compete in the scheduling and dispatch of resources, and the ability of loads to purchase from such resources. That is certainly the case in the New York Control Area, and indicates that the traditional concept of a "control area" is a valid starting point for the analysis of market-based rates.

2. Submarkets

The NOPR, at P61, notes that the Commission's "experience with corporate mergers and acquisitions indicates that these same RTOs have, at times, been divided into smaller submarkets for study purposes because frequently binding transmission constraints prevent some potential suppliers from selling into the destination market." The Commission then asks whether it should "continue its approach of considering the entire geographic region as the default relevant market." The Commission also asks whether, "if the Commission determines that an RTO/ISO submarket is the appropriate default geographic region in a particular case and an applicant is found to have market power within that submarket, should the Commission consider mitigation in addition to existing RTO market monitoring and mitigation?" *Id.* at P61.

The NYISO submits that experience over the last six years with competitive markets in New York provides a case study of the appropriateness of (a) designating the ISO region as the default geographic market notwithstanding the existence of subareas

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that may separate in price from the larger region because of transmission constraints, and (b) relying on ISO mitigation measures to deal with possible market power problems in such subregions. Any large centrally dispatched area, such as New York, is likely to have transmission constraints that from time to time cause prices to separate. Given the central dispatch of the larger area, including the subregions, however, and the functioning of the larger area as a single market in the absence of constraints, the larger area remains an appropriate default analytical starting point.

If subareas within the larger centrally dispatched region are isolated by significant and relatively frequent transmission constraints, it may be necessary for the Commission to determine whether the nature and extent of the constraints warrant market power mitigation measures to ensure that rates in those subareas remain just and reasonable. The NYISO has considerable experience with locational market power because of the constraints into New York City, and has implemented Commission-approved mitigation measures tailored to the unique circumstances in New York City. Based on this experience, the NYISO is not aware of any facts that would warrant a generic departure from the use of the entire RTO/ISO region as the default geographic market.

In parallel with determination of the geographic market, the assessment of mitigation measures should have a presumption in favor of reliance on ISO mitigation measures, including measures for subregions. The ISO would remain responsible for the scheduling and dispatch of generation in the subregions as well as its larger area, and any mitigation measures would have been approved by the Commission on the basis of an analysis of market power conditions in the larger ISO region and its subregions. Experience in New York indicates that measures in addition to existing ISO measures are

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not likely to be warranted, either in the larger area or its subregions. In New York City, the NYISO's conduct and impact market mitigation measures are applied at lower thresholds than in the "rest of state," in recognition of the frequency of transmission constraints into the City. With those thresholds, the mitigation measures are consistent with the region-wide approach to mitigation, and have proven effective in moderating efforts to exercise market power, while preserving the structure of bid-based, clearing price auctions for energy and ancillary services. They also serve to limit mitigation of a seller's portfolio to only those units that are in fact capable of exercising market power because they are located in a constrained subregion, when the remaining units in the portfolio may not have that ability in other parts of the control area. Nothing in the New York experience demonstrates a need for additional mitigation measures for market-based rates over and above those implemented by the NYISO. To the contrary, that experience demonstrates the efficacy of conduct and impact mitigation at appropriate thresholds in controlling efforts to exercise market power both in the ISO region generally and in distinct ISO subregions with relatively frequent transmission constraints.

B. Control and Commitment of Generation

In P49 of the NOPR, the Commission identifies various functions, and asks whether they "should merit a finding or presumption of control," but then asks whether, "rather than focusing on these discrete items, should the Commission establish a presumption of control for any entity that has some discretion over the output of the plant(s) that it manages?" The NYISO endorses this latter approach. Based on the NYISO's experience in the administration of bid-based markets, what matters in the control of a plant is the ability to determine or significantly influence (a) the levels of the

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bids from the plant, and (b) the level of output from the plant. The final rule should focus directly on these critical facts, rather than creating presumptions based on indirect indicia of an ability to control these key competitive parameters. For example, plant engineering or technical operations may be outsourced without conferring an ability to control price or output, so that the outsourcing is not of particular competitive significance. Likewise, credit or liquidity decisions may be critical to the long-term financial success of a plant, but involve no control over bid or output levels.

If, however, an entity can determine or significantly influence bids or output, a presumption that places a burden on that entity to demonstrate that that it is not in a position to benefit from a possible exercise of market power would be well grounded in competition policy. Similarly, if more than one party is in a position to exercise control over bids or output, then both such parties should have that burden. Those issues turn on questions of fact that should be addressed directly on their merits, rather than through presumptions based on factors that may not be applicable in particular circumstances. Such presumptions could thus have unintended consequences or divert attention from the competitively critical considerations. Because of the fact-specific nature of these issues, the NYISO endorses the Commission's proposal to "allow individual sellers to rebut the presumption on the basis of their particular facts and circumstances." NOPR P49.

C. <u>ISO Mitigation Measures</u>

1. <u>Use in Approval of Market-Based Rates</u>

The NOPR at P60 notes that "if a market power study showed that an applicant had local market power, the applicant could point to RTO mitigation rules as evidence that this market power has been adequately mitigated." The NYISO strongly endorses

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this approach. As noted above, the NYISO has in place a regime of Commission-approved market power mitigation measures that have protected ratepayers from market power abuse in energy and ancillary services markets, including in transmission-constrained subregions, while fostering robust clearing price auctions using market-based bids. Based on its six years of experience in administering the New York markets, the NYISO is not aware of a need for any additional mitigation measures as a condition of market-based rates.

2. <u>Interaction of RTO/ISO Mitigation and Mitigation to Cost-Based Rates</u>

As pointed out in the NYISO's January 6, 2004 comments in response to the Commission's Conference on Supply Margin Assessment, Docket No. PL02-8-000 ("SMA Comments"), the use of additional mitigation measures over and above the Commission-approved NYISO mitigation measures could be highly disruptive of the NYISO's markets, and require extensive software and other changes. For example, the NYISO's conduct and impact mitigation is based on limiting a seller's bids, while that seller remains eligible to receive the market-clearing price if its mitigated bid is infra-marginal. Imposing a price cap to limit an individual seller's revenues to a cost basis would be fundamentally inconsistent with the well-established pricing and settlement processes in New York, would distort efficient responses to market price signals and would require the NYISO to make significant, time consuming and expensive revisions to its software to keep track of transactions entered into by entities that would be subject to Commission-imposed revenue caps.

In addition, consistent with the approach to market definition discussed above, mitigation measures should be applied on a market-by-market basis; measures from one

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market should not be applied in another market, where the market conditions and market rules and procedures may be different. As the NOPR recognizes, a key factor in market definition is determining the relevant geographic market. NOPR P25 *et seq.* This necessarily implies that one geographic market area may be determined to be competitive, while a neighboring area may not be. It makes no economic sense to use, in effect, mitigation measures appropriate to one geographic market in another where the conditions and the approach to mitigation may be quite different.

The NYISO recognizes the Commission's desire to avoid sending inappropriate price signals to mitigated generators that might cause them to export power at times when it would not be economically rational to do so, but for differing mitigation regimens in two (or more) neighboring markets. With regard to the NYISO and its neighbors, the Commission can avoid this concern by applying any cost-based mitigation it imposes to limit the maximum bids that the seller may submit, without limiting the revenues that the mitigated seller may receive.

If a seller is limited to submitting cost-based bids as a mitigation measure in a market adjacent to New York, that seller should remain eligible to receive the market-clearing price if it sells into New York, for all the reasons discussed above and in the SMA Comments. From New York's perspective, there is no reason in principle to distinguish such a seller from the other competing sellers, both internal and external, in the payment of the market-clearing price to all sellers whose bids are accepted. This is confirmed by the fact that the NYISO's Commission-approved market rules make no such distinctions; all accepted sellers receive the clearing price.

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In markets such as those administered by the NYISO, the market clearing price represents the marginal cost of supplying energy at a given time and location, and the efficiency principles underlying the design of clearing-price auctions dictate that all potential suppliers, whether internal or external, with marginal costs at or below the clearing price should be able to respond to the market's price signals. Moreover, if an external seller is able to sell into an ISO region, that would indicate that the relevant geographic market is larger than the ISO region, and that mitigation measures more stringent than those within the region are unlikely to be warranted, whatever the conditions in a neighboring region that would have been analyzed as a distinct geographic market. *See* NYISO Market Administration and Control Area Services Tariff ("Services Tariff"), Attachment H §4.2.2(e)(1) (exempting External Generators from automated mitigation measures).

In short, the Commission's final rule should not mix apples and oranges by applying mitigation measures from one geographic market to another, and its mitigation should be implemented in a manner that will not distort the ability of sellers to respond to regional market price signals. In the NOPR, at P146, the Commission asks whether sellers subject to mitigation in their home control area should be considered to be engaged in economic withholding in the home area if they to sell power at market-based rates outside that control area. They should not. As stated in the NYISO tariff: "Taking advantage of opportunities to sell at a higher price or buy at a lower price in a market other than an ISO Administered Market shall not be deemed a form of withholding or otherwise inconsistent with competitive conduct." Services Tariff, Attachment H §2.4(c). Similarly, mitigation should not be limited to sales that "sink in" the mitigated market, at

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least in clearing price auctions such as those administered by the NYISO. NOPR P148. The clearing prices are established by the interaction of all eligible buyers and sellers, and there would be no practical basis, nor economic justification, for carving out marketers or brokers who may export their purchases.

Ideally, to maximize the efficient use of resources sellers should be free to respond to market price signals in all markets in which they are eligible to sell. While this may not always be the case because of differing market or other rules in different areas, any such seams issues between markets should not be exacerbated by the final rule on market-based rates. In particular, with regard to the NYISO and its FERC-regulated neighbors, PJM Interconnection, LLC and ISO-New England, the Commission can ensure that sellers respond to market price signals by designing its mitigation in a manner that will permit even mitigated entities to receive the applicable market clearing price.

3. Ancillary Services

In general, the NYISO endorses the conclusion that if an ISO is authorized to conduct markets for ancillary services, any seller seeking to enter such ancillary services markets should be covered by the ISO's market-based rate authorization. In the NOPR, at P191, the Commission states that "its experience to date indicates that the data problems associated with market analysis involving sales [of ancillary services] to an ISO, for example, should not be insurmountable and an appropriate showing of a lack of market power can be made," noting in a footnote that the NYISO purchases Regulation, Frequency Response Service and Operating Reserves at market-based rates. The NYISO endorses the NOPR's approach, to the extent it is predicated on all eligible sellers being able to benefit from the Commission's authorization of the NYISO to purchase ancillary

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services for loads at market-based rates. Correspondingly, it would be antithetical to the NYISO market design if the final regulations resulted in some sellers having different opportunities or incentives to sell ancillary services than others because of mitigation measures; all eligible sellers should receive the market-clearing prices for ancillary services that are supplied on a market basis. The final regulations should not impose burdensome and duplicative market data requirements on a potential seller of ancillary services, either directly or through data demands to an ISO, if the ISO has already received Commission authorization for market-based ancillary services.

II. CONCLUSION

The NYISO requests careful consideration of the foregoing comments, so that the final regulations on market-based rates are consistent with the well functioning and highly competitive markets administered by the NYISO, including the market power mitigation measures administered by the NYISO.

Respectfully submitted,

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