Independent Power Producers
of New York, Inc.

Gavin J. Donohue
President and CEO

Via Email July 20, 2006

Mr. Mark S. Lynch
President & CEO
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303

Re: In-City ICAP Market Performance

Dear Mr. Lynch:

I am writing, not as Chairman of the NYISO's Installed Capacity Working Group (ICAPWG), but in my role as a representative of the Independent Power Producers of New York, Inc. (IPPNY), to address alleged issues that have arisen over the past month concerning the in-City ICAP market performance and allegations of improper exercise of market power in the in-City ICAP demand curve spot market auctions for June and July. At the outset, let me applaud the NYISO for setting the record straight in your letter of June 7, 2006 to Susan Court, FERC's Director, Office of Enforcement (June 7 Letter). I encourage the NYISO to continue to take a comprehensive, reasoned and deliberative approach to any consideration of market rule changes that may be appropriate to enhance the effectiveness of the NYISO's ICAP markets.

I have observed, during the four meetings that have taken place since staff of the New York State Department of Public Service (DPS) first raised the alleged in-City issue at the June 12, 2006 ICAPWG meeting[1] that a number of market participants have exhibited a rush to judgment and a knee jerk conclusion that the failure of in-City ICAP clearing prices to drop given recent capacity additions constitutes proof that a market flaw exists requiring immediate market rule changes. Unfortunately, none of these market participants have addressed the compelling explanation set forth in your June 7 Letter demonstrating that the market results and bidding behavior of which these market

[1] As ICAPWG Chair, I have scheduled two special meetings of the ICAPWG over the past month (June 30 and July 12), in addition to adding this issue to the agendas of the regularly scheduled ICAPWG meetings (June 12 and July 6), to address expeditiously the concerns raised by DPS staff and other market participants. Another meeting is scheduled for August 1, 2006.

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participants now complain was explicitly recognized by FERC, the New York Public Service Commission (PSC) and Consolidated Edison Company of New York, Inc. (Con Ed) when Con Ed was authorized to divest its generation assets in three relatively large bundles. Part and parcel of that asset sale was a pre-defined and approved set of mitigation provisions, including the $105/kW/year bid and price cap applicable to divested generation owners (DGOs).

Indeed, Con Ed and the PSC designed the mitigation provisions to address the concentration issues attendant to these asset bundles, and chose large bundles specifically to increase revenues from the asset sales, as recognized in the following: "The company states that it can best maximize overall value by divesting its assets as large bundles, and the three packages represent the fewest number consistent with the goal of promoting competition and maximizing the proceeds."[2] Having realized the benefit of increased revenues from the DGOs for the sale of the assets, certain parties now seek to deprive the DGOs of their part of the bargain, in a classic bait and switch.

Although the DGOs have been capped at the $105/kW/year rate through periods of relative ICAP scarcity and higher pricing, both pre- and post-demand curve implementation, it now is suggested the DGOs' opportunity to seek the revenues they bargained for during divestiture should be limited further during periods of (in our view, artificial) surplus, even though offers and clearing prices at the approved price caps were expected when the structure of the asset sales was approved, as stated in your June 7 Letter. This same expectation was carried through in the demand curve implementation; the caps and associated market mitigation measures were not revised. The cost-of-entry studies, which were the basis for FERC's approval of the demand curve, indicate the cost-of-entry is significantly greater than the existing price and bid caps. Accordingly, it should be no surprise that prices in the market clear at or around this cost-of-entry. In fact, if prices were significantly less, as some market participants suggest, that would be a concern to future reliability and market changes would be warranted.

Allowing market rule changes that would affect this type of "heads I win, tails you lose" outcome would send the message that potential investors cannot have confidence that they will receive the benefit of any bargain they enter in New York. This, at a time when the NYISO's Reliability Needs Assessment (RNA) indicates a need date of 2010 and the NYISO has found that NYC would be capacity short in 2008 but for the extension of service of the old Poletti unit (which must cease operation no later than February 2010).

Is the current ICAP market design perfect? Certainly not; many believe that the one month obligation procurement period applicable in the NYISO is inadequate to send appropriate signals for needed resource additions and that a longer-term forward market

[2] Case 96-E-0897, Order Authorizing the Process for Auctioning of Generation Plant, Issued July 21, 1998, p.4.

obligation , in addition to the shorter-term auctions, is required to send the proper long- and short-term price signals. Others suggest that the slope of the in-City demand curve is too steep and should be modified. One thing is clear, though, and that is that any changes to the market design should be well considered and not designed to address one issue without looking at the bigger, long-term picture.

To date, market participants have not even reached consensus on whether any changes are appropriate for the ICAP markets. Assuming for the sake of argument that changes to address the alleged in-City issues would be appropriate, there is no clear direction as to the nature of the issue that the changes should address. Is the issue a behavioral one, for which mitigation procedures may be appropriate, or is it a structural one, for which market design changes would be warranted?

Acceding to suggestions by certain market participants that hastily designed and poorly considered market changes should be made would be the death knell of the efficacy of the NYISO's ICAP markets. It would be devastating to the ability of New York to attract new investment and maintain existing investments. It is noteworthy that Dr. Paynter of the DPS staff identified the fatal flaw of the legacy ICAP market structure in a paper recommending the benefits of demand curve that he drafted in July of 2002. It was not until February 2003, after more than six months of extensive debate and deliberation in the NYISO committee process, that the demand curve was approved by the Management Committee. This demonstrates the complexity of the ICAP market and the need to carefully craft any significant changes to it.

Thank you for your consideration of our views. Please do not hesitate to contact me, if you have any questions.

Very truly yours,

Glenn D. Haake

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