Via Electronic Mail and First Class Mail

January 7, 2002

Mr. Charles King
Secretary of the Management Committee
New York Independent System Operator, Inc.
3890 Carman Road
Schenectady, NY 12303

Re: Notice of Appeal of Keyspan-Ravenswood, LLC and NRG Power Marketing, Inc

Dear Mr. King:

On December 30, 2002, Keyspan-Ravenswood, LLC and NRG Power Marketing, Inc ("Keyspan-NRG") filed a Notice of Appeal of the Business Issues Committee's ("BIC") approval of Motion # 3 on December 13, 2002 to amend the NYISO's proposed demand curve. Consolidated Edison Solutions, Inc. ("CES") opposes the Keyspan-NRG appeal of the BIC's approval of Motion #3 and urges the Management Committee to reject the Keyspan-NRG appeal.

Background – Motion #3 amended the NYISO's proposal for a demand curve so as to retain two existing rules applicable to in-City divested generation owners ("DGOs") that are essential to maintaining a competitive retail market in New York City. The two specific rules that the NYISO was proposing to change are:

1. DGOs are not permitted to sell their mitigated capacity bilaterally and have to offer it into the NYISO administered auctions – the NYISO proposed to allow bilateral transactions.
2. The DGO revenue cap of $105/kw/yr is applied on a monthly basis, consistent with the obligation period in the NYISO's capacity market –the NYISO proposed to apply the cap on an annual basis.

Bilateral Prohibition – In its appeal, Keyspan-NRG argues that the bilateral restriction precludes the DGOs from making forward sales of capacity. Although Keyspan-NRG correctly acknowledges that DGOs can enter into capacity hedges through financial Contract for Differences ("CFDs"), Keyspan-NRG claims that CFD hedging "does not occur very often and even if it does it is only for very short terms, such as one to six months". CES believes that this is factually incorrect since CES, through its wholesale supplier, has entered into multiple CFDs with one of the appellants for terms extending up to 17 months forward.

Keyspan-NRG also argues that bilateral restrictions are no longer needed as "the NYISO [has] determined it could monitor DGO capacity bilateral transactions and prevent the exercise of market power or circumvention of mitigation rules". As presented at the 12-13-02 BIC meeting, CES believes lifting the bilateral prohibition would fundamentally disrupt the in-City retail markets. Because the in-City clearing price under the demand curve is likely to be materially higher than the DGO revenue cap, the lower cost DGO mitigated capacity would become a financially attractive and scarce resource. Although the NYISO can monitor wholesale capacity transactions, it is unclear how the NYISO would be able to detect and prevent either a sale of mitigated capacity that was tied to an above market sale of energy or a streaming of mitigated capacity to an affiliated retail LSE[1]. Removing the prohibition on bilaterals will result in increased opportunities for market manipulation, particularly when an LSE affiliate of the DGO exists, and would not introduce any additional legitimate opportunities that could not be achieved through financial transactions such as CFDs.

Application of the DGO Revenue Cap – Keyspan-NRG argues that "the application of the revenue cap on an annual basis allows for the market to react in months when capacity is in short or surplus supply, sending more appropriate price signals to induce development of new capacity and retention and enhancement of existing resources." Keyspan-NRG's argument is flawed because the revenue cap is only applied to the existing DGO units and does not impact the economics of new generation. Furthermore, Keyspan-NRG has made no case that the existing rules - which have resulted in a weighted average clearing price of over $90/kw/yr over the past two years - have produced insufficient revenues to retain the existing DGO resources.

[1] Because the NYISO has no jurisdiction over retail electricity sales, the NYISO would have no way of precluding a DGO from offering all its mitigated capacity to its affiliate retail LSE. Such a streaming of the mitigated capacity would give the retail affiliate a competitive advantage over other in-City LSEs, allowing the retail affiliate to either increase market share over their competitors who were purchasing capacity at the higher non-mitigated rate or circumvent the revenue cap and increase profits by selling retail products with the installed capacity component priced at the unmitigated rate, or a combination of the two.

As CES pointed out in the ICAP working group meetings and at the BIC, an application of an annual revenue cap in a monthly market would create significant market distortions because it

- Discourages in-City capacity hedges. In order to apply the revenue cap after the fact, LSEs would be liable for a form of "Capacity Uplift" to fund the DGO settlement. This would undermine the effectiveness of any hedges (e.g. bilateral contracts with non-mitigated units or CFDs with mitigated units) that the LSE had entered into;
- Creates financial uncertainty for LSEs since they would not know actual capacity costs until the end of the settlement period;
- Is complex to administer and somewhat arbitrary. The ISO conducts up to 8 different auctions for the same calendar month of supply and the DGO settlement would depend on each individual DGO's auction bidding strategy; and
- Creates new and potentially inefficient incentives for DGOs. If the initial auction clears under the revenue cap, it creates a financial incentive for DGOs to withhold capacity; if it clears over the cap, it reduces the incentive to maximize subsequent auction revenues.

CES notes that when the ISO had a seasonal procurement obligation, they effectively applied the revenue cap on a seasonal basis. This approach worked because the procurement obligation and the revenue cap were applied on the same time step. However, applying the cap on a different time-step would distort the in-City capacity market, harming retail LSEs and non-mitigated capacity suppliers.

Very truly yours,

Stephen B. Wemple
Director, Retail and Regulatory Affairs

cc: Robert Fernandez, Esq., via e-mail
Dominic Cordisco, Esq., via-email
Kristen Kranz, via e-mail

Attachments: CES Presentation at 12-13-02 BIC Meeting
12-3-02 "Issues with Keyspan Proposal to Apply the $105 Revenue Cap"