NOTICE OF APPEAL OF KEYSPAN-RAVENSWOOD, LLC AND NRG POWER MARKETING, INC TO THE MANAGEMENT COMMITTEE FROM THE BUSINESS ISSUES COMMITTEE'S APPROVAL OF MOTION #3 AT THE DECEMBER 13, 2002 BIC MEETING

I. INTRODUCTION

KeySpan-Ravenswood, LLC ("Ravenswood") and NRG Power Marketing, Inc. on behalf of itself and its affiliates that own electric generation capacity in New York (collectively the "In-City Capacity Suppliers") appeal the Business Issues Committee's ("BIC's") approval of Motion #3 to amend the New York System Operator ("NYISO") Demand Curve proposal at the December 13, 2002 BIC meeting. Motion #3 amended the NYISO proposal by requiring the retention of existing rules applicable to In-City divested generation owners ("DGOs") rather than allowing DGOs to sell capacity pursuant to bilateral transactions under the oversight of the NYISO market monitor and Federal Energy Regulatory Commission ("Commission"). In-City Capacity Suppliers request that the Management Committee ("MC") overturn the amendment in Motion #3 and that the MC approve the NYISO Demand Curve proposal as originally presented to the BIC, including the NYISO's proposed changes for the DGOs, and implement it prior to the Summer 2003 Capability Period auctions.

II. SUMMARY

As presented by the NYISO and discussed at various Installed Capacity Working Group ("ICAP WG") meetings, the NYISO Demand Curve proposes, among other things, to implement a spot market for capacity, eliminate the restriction against bilateral DGO capacity sales, and apply the Divested Generation Unit Capacity revenue cap on an annual basis rather than a monthly basis. The NYISO Demand Curve proposal will benefit the wholesale energy market and customers because it will:

(1) ensure short and long term system reliability;

(2) improve market price signals and liquidity; and

(3) limit extreme capacity price volatility and market power.

The BIC's decision to amend and reject the NYISO's Demand Curve Proposal ignores the urgent need to make further modifications to the NYISO's capacity market design before the Summer 2003 Capability Period to ensure continued investment in the reliable operation and maintenance of existing facilities, as well as attract the new supplies required to maintain system reliability. There is general agreement that the existing NYISO market design for installed capacity is not working well and is in need of improvement. New and efficient supply resources are not entering the market. In fact, many projects are being put on hold or even cancelled outright. Moreover, some existing resources are on the verge of being driven out of business prematurely.

These problems arise because the current NYISO market design does not produce market-based prices for energy, capacity and ancillary services that support new capacity investments. Even existing investments in marginal units are likely uneconomic as well. In addition, the current capacity market is illiquid and void of any forward price visibility preventing any meaningful or efficient forward contracting. Based on the current below cost price signals in the NYISO market buyers and sellers are hard pressed to come to terms on price. Buyers can't justify paying the cost sellers require to provide the service as long as the market is providing the service at below cost. Furthermore, current restrictions against bilateral transactions for a significant percentage of in-city capacity are unnecessarily preventing both short and long-term transactions from taking place between in-City suppliers and purchasers. This is further delaying the development of a forward capacity market. Continuing the monthly application of the revenue cap also skews the market prices for the DGO capacity preventing price signals that will encourage development and enhancement of existing resources. These restrictions also put DGO capacity at an unfair competitive disadvantage to other market participants because DGO capacity must be sold in short term auctions subject to monthly price caps while other market participants can transact longer term and outside of the auctions.

The current market design is causing volatility in both prices and reliability, which benefits neither suppliers nor customers. The NYISO's Demand Curve proposal will establish a competitive and liquid price for an important reliability product without the instability and volatility that has plagued the existing market. Allowing bilateral transactions and an annual revenue cap instead of a monthly cap will help forward markets develop and reduce market power. Accordingly, the Demand Curve should be implemented as originally proposed by the NYISO, without the amendment noted in Motion #3, before the Summer 2003 Capability period auctions.

III. BACKGROUND

Originally, mitigation measures applicable to specific generation divested by the Consolidated Edison Company of New York, Inc. were implemented to protect against the potential exercise of market power.[1] Pursuant to these mitigation measures, DGO capacity could not be sold under bilateral contracts and it had to be bid into the NYISO auctions.[2] In addition, DGO capacity was subject to a bid cap and a price cap of equal value.[3] Ultimately, the NYISO adopted these mitigation measures into its own tariff.[4]

In the past, Ravenswood has raised concerns with respect to the bilateral restriction in complaints to the Commission[5] as well as during numerous NYISO stakeholder proceedings. For example, under the current bilateral restriction, some DGO capacity is guaranteed to go unsold and be paid nothing during periods of in-City capacity surplus. This is because the restriction against entering into bilateral transactions forces such capacity to be offered into the NYISO auctions after other non-mitigated suppliers have had the opportunity to hedge bilaterally. In addition, even if DGO capacity is sold in the auction, the longest it can be sold forward is six months because that is the

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[1] *Consolidated Edison Company of New York Inc.*, 84 FERC 61,287 (1998).

[2] Id.

[3] Id.

[4] *New York Independent System Operator Inc.*, 97 FERC 61,241 (2001); *New York Independent System Operator Inc* 99 FERC 61,246 (2002).

[5] *KeySpan-Ravenswood, Inc. v. New York Independent System Operator Inc.*, 99 FERC 61,252 (2002) (“Ravenswood Complaint”).

longest auction conducted by the NYISO. Ravenswood has argued that continually being limited to short-term capacity sale opportunities is an unfair business restriction.

Furthermore, DGOs cannot effectively hedge their capacity position using contracts for differences due to the price cap. The price cap forces either the DGO or its counter party to take the risk that the capacity market may clear above the price cap. Considering price certainty is the very reason market participants enter into contracts for differences, the unhedgeable risk of the price cap being exceeded severely limits and even prevents the use of contracts for differences. Only when counter parties are somewhat "certain" that the market-clearing price will be below the price cap due to sufficient capacity surpluses, will they enter into contracts for differences for DGO capacity. This does not occur very often and even if it does it is only for very short terms, such as one to six months. As noted above, Ravenswood has argued that the restriction against bilateral transactions, which prevents DGO capacity suppliers from hedging their positions for longer than one to six months, is not reasonable.

Notwithstanding the Commission's past retention of the restriction against bilateral DGO capacity transactions, in response to the Ravenswood Complaint, the Commission encouraged the NYISO "to examine, in consultation with its stakeholders, the feasibility and market impact of allowing in-City ICAP bilateral transactions."[6] At that time the NYISO had not taken a position on the merits of the bilateral restriction.[7]

For over six months now the NYISO and market participants have discussed the various issues associated with demand curves and DGO capacity bilateral transactions as part of a stakeholder process conducted by the ICAP WG. During that process it was pointed out that the NYISO currently monitors all capacity committed to the New York Control Area, including bilateral

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[6] Id. at 9.

[7] Id.

commitments, to ensure there is no double counting. In addition, the NYISO market monitor stated at the ICAP WG meetings that it is confident it can monitor DGO capacity bilateral transaction terms and prevent the exercise of market power and any attempts to circumvent other market rules. Moreover, it was noted that the Commission now has electronic quarterly reporting ("EQR") requirements that provide unrestricted access and visibility to all energy, capacity and ancillary service sale transactions of suppliers, including the In-City Capacity Suppliers. All pertinent aspects of the energy, capacity and ancillary service transactions, including price, term, quantity and counter party are disclosed in these EQRs on a quarterly basis and filed with the Commission. This was all presented to the ICAP WG and BIC in support of the NYISO's proposal to implement a demand curve and remove the restriction against DGO capacity bilateral transactions.

IV. ARGUMENT

The NYISO staff worked extensively with market participants and the NYPSC staff over the past six months to improve the existing capacity market by replacing the current deficiency auction with a spot market demand curve auction. The NYPSC staff was the entity that initially proposed the concept of a demand curve. The NYISO determined three demand curves, one each for Long Island, New York City and New York State should be implemented. The curves were based on the annual levelized cost of an inexpensive peaking facility without credits for energy or ancillary service revenues. Each curve transitioned to zero at various percentages above the minimum reliability amount.

In addition, the NYISO determined it could monitor DGO capacity bilateral transactions and prevent the exercise of market power or circumvention of mitigation rules. This determination was based on DGOs agreeing to disclose the terms and conditions of the bilateral transactions to the NYISO and the Commission rules requiring suppliers file EQRs. Implementing the spot market demand curve and eliminating the bilateral prohibition will resolve many of the problems with the current market and go a long way toward the transition to a viable long term resource adequacy market. Finally, the NYISO poposes to retain the revenue cap on DGO capacity but apply it on an annual basis rather than a monthly basis. To delay the implementation of the NYISO's Demand Curve proposal, as it was originally proposed, will further delay the development of competitive markets that will support the investments needed to reliably supply customers.

The spot market Demand Curve as proposed by the NYISO; i) ensures short and long-term reliability by valuing capacity in excess of required minimums; ii) improves price signals by providing a liquid market for bilateral agreements to be benchmarked and balanced against; and, iii) reduces price volatility and market power by eliminating the almost vertical demand curve in the existing market. Forward capacity markets alone, as proposed by some market participants, will continue to be subject to the same reliability, liquidity and volatility issues that exist in the market today and will not be able to develop efficiently unless a workable and reliable spot market, as provided by the demand curve, also exists. Elimination of the bilateral restriction on DGO capacity will also help the forward capacity market develop and eliminate an unfair and unnecessary market restriction. Neither the NYISO or market participants should allow these important market improvements to be delayed.

As noted above, at the time the bilateral restriction on DGO capacity sales was originally implemented and finally incorporated into the NYISO tariff, neither the NYISO nor its market monitoring unit had taken a position on the merits of such a restriction. During the recently concluded six-month ICAP WG stakeholder proceeding, the NYISO and market participants considered the feasibility and market impact of allowing in-City ICAP bilateral transactions. Some market participants were concerned that if bilateral transactions were permitted, DGOs would sell capacity at prices in excess of the current price cap. In addition, some market participants claimed that if this mitigated capacity were sold bilaterally only those market participants that purchased it would receive the benefit of the price cap.

A. <u>As the NYISO recognizes permitting DGOs to sell engage in bilateral capacity transactions will provide benefits without the risk of the exercise market power.</u>

With respect to the first concern, the NYISO and its internal market monitor stated at the December 13, 2002 BIC meeting, as well as during various ICAP WG meetings, that it has the capability to monitor such transactions and prevent the exercise of market power and any attempts to circumvent other market rules. The NYISO currently monitors *all* capacity committed to the New York Control Area, including bilateral transactions, to ensure it is not double counted. Therefore, the NYISO is already performing some monitoring of bilateral capacity transactions and would simply have to obtain copies of the detailed agreements associated with the in-City transactions to verify compliance with the rules. The NYISO agreed to perform this additional function and review the agreements. The DGOs did not object to such disclosure or review. Expanding the ability of market participants to transact in-City capacity in bilateral transactions will help facilitate and increased forward capacity commitments further improving the market and reducing market power. Accordingly, the efforts required by the NYISO to review the agreements are well worth the time.

Furthermore, the Commission's EQR filing requirements provide market participants, the NYISO and the Commission with any additional information required to determine if improper transactions are entered into. The EQR filing requirement itself is a mitigation measure in that improper transactions will not be entered into because all terms, including but not limited to counter party, must be disclosed. Specifically, all pertinent aspects of the energy, capacity and ancillary service transactions, including price, term, quantity and counter party are disclosed in these EQRs on a quarterly basis and filed with the Commission. Such unrestricted access and visibility of the terms and conditions of all energy, capacity and ancillary service sale transactions coupled with the NYISO's commitment to specifically monitor DGO bilateral capacity sale transactions should render any concerns about potential improper market behavior moot.

Based on the fact that there are less intrusive ways to protect the market and ensure market rules are being complied with, there is no justification to retain the unfair and unduly discriminatory prohibition against DGO bilateral capacity sales. DGOs' forward contracting capabilities are currently severely restricted to the competitive disadvantage of DGOs and the proposed revision provides adequate protection yet allows the market to develop. Therefore, the prohibition should be lifted.

With respect to the second concern, that is -- if mitigated capacity is sold bilaterally only those market participants that purchased it will receive the benefit of the price cap -- it is simply an indication that for some reason certain market participants are unwilling to hedge their risk and prefer the spot market. Notwithstanding the fact that some market participants do not want to purchase DGO capacity bilaterally, they are unwilling to allow others to do so. These market participants do not have a perpetual contract right[8] to purchase DGO capacity in the NYISO auction at the lesser of the market clearing price or the price cap. What they fail to point out is that bilateral transactions may at times be above or below spot market prices. Accordingly, "the benefit of the price cap" to the market participants that purchase DGO capacity bilaterally could turn out to be no "benefit" at all. At times the bilateral market prices will be above spot market prices and at others they will be below the spot market. What the purchaser (and seller) in a bilateral is really doing is gaining the real benefit of price certainty regardless of where the market may clear in the future. The bottom line is if market participants want to achieve price certainty they should be allowed to do so. Regardless, a market participant will only purchase capacity (DGO or otherwise) forward in a bilateral agreement if they can purchase it at the right price. If the purchaser thinks capacity prices will average less than the

[8] Currently, there are no contractual agreements between the DGOs and any market participant for the *sale* of capacity. All that exists are temporary market power mitigation rules that were expected to change as the market evolved and the NYISO gained experience. The NYISO has now determined there is a better and less intrusive way to mitigate the potential exercise of market power and accordingly it is reasonable to revise the rules.

price cap then they should attempt to negotiate that price or rely on the spot market and take their chances. However, they should not be allowed to prevent others from achieving price certainty with a bilateral transaction. Just because some market participants don't want to hedge doesn't mean others should be forced to make the same decision.

As is the case with forcing DGOs to sell all their capacity in short term auctions, it is also unreasonable to prevent market participants from entering into transactions when there are means to monitor and prevent the potential abuse of market power. Under the existing capacity mitigation rules DGOs have all the downside and no viable means to hedge their risk. The NYISO is able to monitor DGO capacity transactions and there is no longer a reason to maintain the prohibition. The less intrusive monitoring by the NYISO, as opposed to a total prohibition, will help the capacity market mature into a long-term resource adequacy market and provide DGOs the opportunity to better balance the risks in the market. With these revised protections in place, there is no justification to continue the unfair and unduly discriminatory prohibition against DGO bilateral capacity sales. Therefore, the bilateral prohibition should be lifted.

B. <u>As the NYISO proposed the revenue cap on DGO capacity should be applied on an annual basis.</u>

The NYISO Demand Curve proposal retains the revenue cap on DGO capacity but would apply the cap on an annual basis rather than a monthly basis. As the NYISO and ICAP WG recognized, 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. The NYISO's Demand Curve proposal and its annual application of the revenue cap improvement should also be adopted as recommended by the NYISO.

IV. CONCLUSION

In-City Capacity Suppliers respectfully request the Management Committee overturn the amendment in Motion #3, and approve the NYISO Demand Curve proposal as originally presented to the BIC by the NYISO on December 13, 2002, and implement it prior to the Summer 2003 Capability Period auctions. The actual operation of the market indicates price signals are below the cost of entry as well as the cost of many existing resources. Reliability cannot be sustained in such a market. Accordingly, the capacity market needs to change to reflect the reality of the needs of customers, the electric system and installed supply resources. Otherwise, additional installed supply resources will not be developed and existing installed supply resources will retire prematurely thereby jeopardizing reliability.

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Respectfully submitted,

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