NOTICE OF APPEAL OF AQUILA ENERGY MARKETING CORP. AND MORGAN STANELY CAPITAL GROUP, INC. TO NEW YORK INDEPENDENT SYSTEM OPERATORS BOARD OF DIRECTORS OF THE PENALTY AND DISCLOSURE PROPOSALS

I. PRELIMINARY STATEMENT

Pursuant to ' 5.07 of the ISO Agreement, Aquila Energy Marketing Corp. (AAquila@) and (Morgan Stanely Capital Group, Inc.) (AAppellants@) appeals to the NYISO Board of Directors (ABoard@), the Management Committee=s (AMC@) approval of a motion (Motion #8) that requests the NYISO make a Federal Power Act ' 205 filing with the Federal Energy Regulatory Commission (ACommission@) to amend the Market Mitigation Plan (AMMP@) to permit the NYISO discretionary authority to penalize and disclose the names of penalized suppliers when market mitigation is imposed.

II. SUMMARY OF ARGUMENT

At the MC meeting of April 18, 2001 in Albany, New York, the MC voted to approve two proposals presented by the New York State Consumer Protection Board, known as the Penalties and Disclosure Proposals (AProposals@).

The Board should deny the MC=s request because the proposed amendments to the MMP are unwarranted, ill-conceived, unworkable, discriminatory and will drive suppliers of energy out of New York bulk electric markets. If the Board approves the MC=s request to impose draconian penalties, as well as the proposal that would significantly injure the reputation of supplier by disclosure of their names and it will send the wrong message to suppliers of energy, at the very time when additional energy is needed by New York.

The first proposal would impose additional and draconian penalties on suppliers in the Real Time Energy Market in New York for bidding behavior resulting in mitigation. The latter proposal would, under certain conditions, authorize the NYISO to disclose publicly the names of the entities that have incurred these penalties.

The Proposals, moreover, contains a confusing and perhaps fatally ambiguous provision that appears to enable the NYISO to reach back and punish behavior that was not punished at the time the

alleged behavior occurred -- retroactively 14 days for physical withholding and retroactively 5 days for economic withholding.

Most significantly, the Proposals confers broad discretion on the NYISO staff to withhold punishment or to impose it based on whether the punishment is Aonerous@ or will have Alittle or no deterrent value.@ How will the NYISO staff decide whether a penalty under the Proposals, that perforce, will be applied in addition to the sanctions under the current MMP, is Aonerous@ or not or whether it will have Adeterrent value@? If NYISO determines to impose the additional penalty on some, but not on others there will undoubtedly be claims of discriminatory treatment and the resulting extensive flow of litigation. If the NYISO staff, in order to avoid accusations of discriminatory treatment, imposes the additional penalties and public disclosure requirements in all cases, then the Proposals= grant of discretion is a dead letter and the effect of the Proposals are truly draconian. If the NYISO staff refrains from imposing the additional penalties and public disclosure requirements in all cases, the Proposals are unnecessary and redundant. The grant of discretion in the Proposals must also be viewed in light of the Commission=s decision in its November, 1999 order on the NYISO=s MMP. In that decision, the Commission rejected portions of the earlier version of the MMP for conferring too much discretion on the NYISO=s Market Mitigation Unit (AMMU@).

It also bears repeating that the Proposals overlay the approved MMP of the NYISO. As this Board well knows, the current MMP sanctions behavior of suppliers to the market in the form of requiring suppliers to bid their Areference prices@ as their default bid, and imposing Afinancial obligations@ for physical withholding. These Proposals come at a time when the Board=s Market Advisor has found no evidence of market power abuse statewide. Moreover, the Proposals would be implemented in addition to mitigation rules already applicable to generators located within New York City. In short, the Proposals are redundant and there is no evidence that they are needed.

Finally, the Proposals are Athe thumb on the scale@ of the balance struck between the operation of competitive market forces and the NYISO=s duties under the currently approved MMP. Under the Proposals, the penalties, and their scope and size, could seriously, if not fatally, damage the financial viability of suppliers in the market and will severely damage the reputation of the market participant. For example, if

mitigation action occurs for a Athird@ time in a period of seventy-two months, the damages are four times the MWs mitigated, times the LBMP at the bus, plus a reduction of a supplier=s entire fleet of generation to bidding its marginal operating cost, for a period of six months.

Under the current MMP, the NYISO=s liability for errors in the implementation of the approved MMP is only in the case of Awillful misconduct.@ A Amistake@ or Aerror@ in imposing mitigation sanctions under the Proposals has far more consequences than the approved MMP contemplated. Under the current regime, sanctions of the size and scope contemplated under the Proposals could only be imposed following a filing by the NYISO with and review by the Commission. If the Proposals are to go into effect, it is essential that the standard of liability for errors in implementation change from the current Awillful misconduct@ standard to a standard considerably closer to an ordinary negligence standard. In addition, the NYISO will be exposed to the prospect of litigation for damages due to injury to reputation, for erroneous decisions to disclose market participants who have been mitigated. As noted, the consequences of erroneous implementation of the Proposals are simply too great to permit imposition of the draconian penalties with the practical impunity that the current liability standard affords.

III. A DESCRIPTION OF THE PENALTY AND DISCLOSURE PROPOSALS

The Penalty and Disclosure proposals, as approved by the Management Committee[1], would authorize the NYISO to financially penalize and disclose names of suppliers of energy if a market participant engaged in conduct that warranted mitigation action. The NYISO would have the discretion to waive any financial penalties or public disclosure that could potentially be imposed on a supplier, if the NYISO determined that the sanctions Aare onerous or provide no deterrent value.@[2]

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[1] The Penalty and Disclosure proposals were approved by 60.66% of the vote on the Management Committee. Each of the Appellants voted in opposition to the proposals.

[2] *See* Motions #7 and #8 approved by Management Committee at April 18, 2001 meeting.

The financial penalties are as follows:

1st Mitigation Action = (#of MW mitigated during mitigated hours) x (LBMP at the mitigated generator=s bus) x 2;

2nd Mitigation Action within 24 months of the first = (#of MW mitigated during mitigated hours) x (LBMP at the mitigated generator=s bus) x 3;

3rd Mitigation Action within 24 months of the second = (#of MW mitigated during mitigated hours) x (LBMP at the mitigated generator=s bus) x 4.[3]

The Proposals would also impose an additional penalty for a third infraction: mitigation of the bids on all of the mitigated party=s New York generation units to their respective reference bid curve for a six-month period.[4]

These sanctions would not apply to mitigation actions which occur through the use of the NYISO=s Automatic Mitigation Process (AAMP@), or to Load Serving Entities (ALSEs@) or Loads, or in-city mitigation or ancillary services.[5] In short, the penalties effectively apply only to the Areal time@ energy market. However, the Proposals also provide that Aonce the penalty is triggered, it is applicable to all previous market activities by the offending market party that: (1) are deemed to be of the same type as the activity that was mitigated, and (2) occurred prior to the implementation of the mitigation by the NYISO, but not more than 14 days prior to the implementation of the mitigation by the NYISO for physical withholding and not more than 5 days prior to the implementation of mitigation by the NYISO for all other mitigation actions.@[6]

If the penalty is triggered, a supplier of energy that is sanctioned under the Proposals can dispute the

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3 *See* Penalties for Conduct that Results in the Application of Market Mitigation, presented by NYS Consumer Protection Board, at 2-3.

4 *Id.* at 4.

5 *Id.*

6 *Id.* at 5.

NYISO=s determination via the Alternative Dispute Resolution (AADR@) procedures established in the ISO Agreement and Service Tariff.[7]

IV. ARGUMENT

A. THE MMP DOES NOT NEED TO BE AMENDED.

[7] *Id.* at 4.

The MMP, in it is current form, is not in need of amendment. As this Board will recall, the current MMP was fashioned to balance the need to prevent intrusion into rational economic decisions of market participants and the need to protect the market from substantial price distortions caused by the exercise of market power.[8]

The NYISO has been successful in that endeavor as demonstrated by the Market Advisor=s recent report.[9] AThe reference price methodology has been an effective means to monitor for withholding and indicates that suppliers are responding to the economic incentives to bid resources at marginal costs.@[10] The Market Advisor has also stated that with the exception of several isolated instances, his Aanalysis revealed that suppliers bid in a manner consistent with workable competition.@[11] Furthermore, the isolated instances where suppliers bid in a manner inconsistent with a workably competitive market have been effectively remedied by the current MMP.[12] In fact, the Market Advisor in an earlier report to the Board declared that electricity prices in eastern New York would have dropped by 48 percent, had it not been for a doubling fuel prices and the outage of Indian Point 2.[13] Thus, the overwhelming evidence indicates that the New

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8 NYISO Market Mitigation Plan, Addendum A, '1 at 1.

9 *See* Annual Assessment of the New York Electric Markets 2000 at Slide 83.

10 *Id.* at Slide 37.

11 *Id.* at Slide 83.

12 *Id* at Slide 83.

York Markets are workably competitive and electricity prices have increased due to fuel cost and outages, not market power.

[13] New York Market Advisor Preliminary Market Assessment of the New York Electric Markets (October 17, 2000).

The NYISO has recognized that its present MMP is effective and has argued before the Commission that no further mitigation mechanisms are needed. In the protest to the ' 206 filing of Consolidated Edison Company of New York, Inc. requesting further mitigation to deal with alleged market power abuse in the Real-Time Market in New York City, the NYISO stated that it Abelieves that it has in place or is implementing appropriate monitoring and mitigation processes to deal with market power or other competitive problems throughout the state, including New York City, pursuant to its existing Market Mitigation Measures.@[14]

Given the fact that market power abuse has not been a problem historically in the New York energy markets and that the NYISO and its Market Advisor believe that the currently approved MMP has effectively dealt with the isolated incidences of market power abuse, why would the Board wish to amend the MMP? The saying - A if it ain=t broke, don=t fix it@ - clearly applies in this situation.

Any benefit that may be derived from altering the MMP to include penalties and disclosures evaporates when this Board considers the risks associated with undertaking the responsibility of imposing such severe penalties on suppliers of energy. These risks include increases in the financial exposure of the market participants for potential erroneous decisions, increases in the NYISO=s financial exposure for penalizing and disclosing suppliers in an inconsistent manner, increases in litigation expenses if disputes arise when penalties are imposed and the risk that suppliers will leave the market or do so during periods when supply is most needed.

B. THE TERMS OF THE PROPOSALS ARE AMBIGUOUS AND ILL-CONCEIVED.

The terms used in the Proposals are ill-conceived, unclear and subject to a number of interpretations. If the Proposals are upheld by the Board, there will certainly be litigation over what the terms mean and how they are to be applied.

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[14] Motion of New York Independent System Operator, Inc. to Intervene and Protest Request of Consolidated Edison Company of New York, Inc. to Revise Localized Market Power Mitigation Measures, at 1, Docket No. ER01-1385

For instance, the Proposals permit the NYISO to waive all penalties if they would be Aonerous or provide no deterrent value@[15] Because the standard is so overbroad and vague, it is likely to lead to inconsistent results. In addition, the standard Aonerous standard value@ is so obtuse that it gives no guidance to the NYISO of when sanctions should or should not be imposed. For example, by what standard is a penalty to be considered onerous? Is not the taking of money from any supplier of energy considered onerous? Or is it onerous to penalize a company to such an extent that the NYISO bankrupts the entity?

The other standard, Aprovide no deterrent value,@ is equally amorphous and will be difficult to apply consistently. Furthermore, for a deterrent to be effective it has to be onerous. Therefore, if a sanction has a deterrent value, will the NYISO waive it because it is onerous?

Another provision subject to a number of interpretations is the section entitled ADuration of Market Activities Encompassed by the Penalty.@ This provision would require the NYISO to look back 14 days from the day that mitigation took place if there was physical withholding, and 5 days if there was economic withholding, to determine if there were Aprevious market activities@ that Aare deemed to be of the same type as the activity that was mitigated.@ The penalty Ais applicable to all previous market activities by the offending market party,@ subject to aforementioned time limitations.[16]

There is no description of what is meant by the term Asame type of activity as was mitigated.@ Does it mean that if the mitigation that triggered the penalty was economic withholding in the Real-Time Market that economic withholding in the Day-Ahead Market in the look-back period is the Asame type of activity@? Is sanctioned activity by one generator in a fleet of generators the Asame type of activity@ for similar conduct of another generator in the fleet during the look-back period? Is the MMU required to investigate for such

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[15] *See* Motions #7 and #8 approved by Management Committee at April 18, 2001 meeting.

[16] *See* Penalties for Conduct that Results in the Application of Market Mitigation, presented by NYS Consumer Protection Board, at 5.

conduct during the look-back period in all cases?

C. THE LOOK-BACK PERIOD IS UNWARRANTED.

The look-back period in the Proposals is not necessary since the MMP monitors market behavior on an ongoing basis. Under the Proposals, the NYISO is required to look-back from the date of the mitigation action to determine whether there has been the Asame type of activity@. Putting aside the problem of interpretation, why does the NYISO need to use its limited resources to look back for activity that is prohibited under the MMP when the MMU monitors for market power abuse all the time? Are the proponents of the Proposals saying that the MMU is not doing its job, or that the MMU misses activities that may be instances of market power? As noted above, there is no evidence that the MMU has not fulfilled its obligation under MMP. Accordingly, there is no reason to have a look-back provision in the Proposals.

D. THE NYISO MAY NOT HAVE THE AUTHORITY TO RETROACTIVELY PENALIZE MARKET PARTICIPANTS.

The NYISO does not have the authority to retroactively penalize market participants. Under the Proposals, the NYISO can penalize a supplier for the Asame type of activity@ occurring in a period prior to the time when the conduct was investigated and mitigated. This sort of retroactive refunding to the Schedule One charges raises serious question of legality, since even the Commission cannot make refunds of charges after a rate is declared illegal.[17]

As stated by the D.C. Circuit Court of Appeals case *City of Piqua:*

> In essence, the rule against retroactivity is a Acardinal principle of ratemaking: a utility may not set rates to recoup past losses, nor may the Commission prescribe rates on that principle.@ [citation omitted]... The retroactive ratemaking rule thus bars utility refunds for past

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[17] *See FPC v. Sierra Pacific Power Co.,* 350 U.S. 353 (1956); *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.,* 341 U.S. 246 (1951); *Public Service Co. of New Hampshire v. FERC,* 600 F.2d 944, 957 n.51 (D.C. Cir.1979)

excessive rates, or the Commission=s retroactive substitution of an unreasonably high or low rate with a just and reasonable rate.[18]

[18] *City of Piqua v. FERC*, 610 F.2d 950 at 954 (D.C. Cir. 1979).

If the Commission cannot refund charges after the fact, it follows that the NYISO, whose authority flows from the Commission=s authority, cannot retroactively penalize certain market participants and refund other market participants through credits to the Schedule One charges. Clearly, the rate charged is the market-based rate approved by the Commission. The imposition of a retroactive penalty would be retroactive rate making and therefore contrary to the Federal Power Act. In addition, the Commission specifically stated, when approving the current MMP, that: AWe require that the ISO file a further revised mitigation plan to clarify that mitigation for market power is prospective only@[19]

E. THE PROPOSALS GIVE TOO MUCH DISCRETION TO NYISO.

The Proposals grants the NYISO too much discretion in determining whether or not to impose penalties. Leaving aside problems with the ambiguous Aonerous and little or no deterrent value@ standard, the NYISO staff will be saddled with the responsibility to impose potentially severe penalties on suppliers of energy.

If the NYISO applies a narrow view in imposing penalties, it will be accused of not enforcing the MMP. If the NYISO applies the penalties using a middle-of-the-road approach, it will be faced with accusations of discriminatory treatment, resulting in litigation. If the NYISO takes an expansive approach to imposing the penalties, it will be accused of being heavy-handed and driving suppliers out of the market.

Furthermore, the standard for liability of the NYISO in carrying out its duties under the MMP would have to change from Awillful misconduct@ to one based on error because of the size and scope of the penalties. Immunizing the NYISO under such a high standard of culpability clearly shifts the leverage to the MMU, especially during the consultation period that must accompany and precede any mitigation under the current MMP. A supplier, erroneously accused of conduct warranting mitigation, may more readily concede and accept a less onerous penalty imposed by the MMU under its broad discretion than of incurring potentially significant penalties as a result of the ADR process.

The Board should also be mindful of the Commission=s strong preference for limiting the discretion that the NYISO has in implementing mitigation measures. The Commission rejected an earlier version of

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[19] *See New York Independent System Operator, Inc, et. al.,* 90 FERC & 61,317 at 62,055.

proposed mitigation measures and stated that Aportions of the proposed mitigation plan have unacceptable features (e.g., too much discretion, lack of specificity).@[20] Clearly, the Proposals have the same flaw as the rejected provisions of the proposed MMP, and therefore, will not pass muster before the Commission.

F. THE PROPOSALS ARE DISCRIMINATORY.

[20] *New York Independent System Operator, Inc., et. al.,* 89 FERC & 61,196 at 61,605.

The Proposals are discriminatory because only suppliers of energy are at risk of receiving the draconian penalties. Load and (ALSEs@) will not be sanctioned under the Proposals. No rational explanation is given for this distinction between market participants and, as the Board knows, the Federal Power Act prohibits preferential and discriminatory treatment in rate-making.[21]

One possible explanation is that the proponents of the Proposals do not believe that the exercise of market power by Load or LSEs is a problem in New York, and therefore, there is not a need to address it in the Proposals. Using that same rationale, this Board should deny the MC=s request to amend the MMP, since the Market Advisor and the NYISO have stated that the suppliers Abid resources at their marginal cost.@[22]

Ultimately, fairness dictates that when the NYISO makes a determination regarding market participants, it does so in an unbiased fashion and treats entities comparably in similar circumstances. If the Board approves these Proposals, the NYISO will lose a measure of its impartiality because it will be treating some market participants in a substantially different manner. There is no reason why Loads or LSEs should be meted out lenient penalties for the same behavior that results in draconian penalties being imposed on suppliers. The Board must therefore reject the Proposals on the grounds of fairness.

V. CONCLUSION

The implementation of the proposed amendment to the current MMP approved by the Management Committee are (1) unnecessary, (2) unworkable, and (3) discriminatory, and (4) replete with risks. For these reasons, the Board should deny the Management Committee=s request to make a '205 filing regarding the Penalty and Disclosure proposals. Therefore, the Appellants respectfully request the NYISO deny the Management Committee=s request to file with the Commission the amendments containing the provisions of the Proposals.

Respectfully submitted,

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[21] Federal Power Act '' 205 and 206.

[22] *See* Annual Assessment of the New York Electric Markets 2000 at Slide 37.

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