

Hand Delivered

May 2, 2001

Hon. Richard J. Grossi
Chairman, New York Independent System
Operator Board of Directors
C/O William J. Museler
President and CEO
New York Independent System Operator, Inc.
3890 Carman Road
Schenectady, NY 12303

Re: Notice of Appeal of IPPNY

Dear Chairman Grossi:

Pursuant to the "Procedural Rules for Appeals to the ISO enclosed three original copies of the Notice of Appeal of the Independent Power Producers of New York, Inc. (IPPNY) on behalf of those of its members who also are members of the New York Independent System Operator's Management Committee, as identified on Attachment 1 hereto. I have e-mailed a copy of the Notice of Appeal to Kristin Kranz, of the ISO's staff, who has agreed to serve it on each member of the Management Committee today via e-mail.

Very truly yours,

Glenn D. Haake
General Counsel

Enclosures
cc: Kristin Kranz, via e-mail

Attachment 1

AES-NY
East Coast Power
Edison Mission Marketing & Trading
Entergy Nuclear Northeast
Indeck Energy Services, Inc.
Keyspan- Ravenswood, Inc.
Mirant New York, Inc.
NRG Power Marketing, Inc.
Orion Power New York
PG&E National Energy Group
Sithe Energies, Inc.
TransCanada Power Marketing, Ltd.
Automated Power Exchange (APX)
Dynegy
El Paso Merchant Energy
Enron Power Marketing, Inc.
HQ Energy Services US
Merchant Energy Group of The Americas, Inc.
PSEG Power New York

NOTICE OF APPEAL

The Independent Power Producers of New York, Inc. (“IPPNY”),¹ on behalf of its members that are also members of the New York Independent System Operator’s (“NYISO”) Management Committee,² hereby appeals to the NYISO Board of Directors (“Board”) the Management Committee’s April 18, 2001 decision to seek the joint filing of a proposal that would increase and expand the penalties imposed by the NYISO pursuant to its Market Mitigation Plan (“MMP”) (the “Penalty Program”)³.

IPPNY, on behalf of the Appellants, respectfully requests that the Board deny the Management Committee’s request to concur in a joint filing to amend the MMP to include the Penalty Program, because it (1) is not needed to deter market power abuses, (2) will harm the competitive market by creating unnecessary uncertainty for market participants, (3) contravenes principles of due process by imposing penalties on innocent market parties, (4) discriminates against generators because the additional penalties are not applied to load serving entities (“LSEs”) or transmission owners (“TOs”), and (5) improperly intrudes on the jurisdiction of the Federal Energy Regulatory Commission (“FERC”) to grant and revoke market-based rate authority.

I. THE PENALTY PROGRAM

The Penalty Program imposes draconian penalties in an overly broad manner. Under the Penalty Program, which applies to both the day-ahead and real-time energy markets, the current formula for calculating the financial obligation for physical withholding of generation (Section 4.3 of the MMP) would be eliminated and replaced by formulas that dramatically increase the level of penalties for

¹ IPPNY is a not-for-profit trade association representing more than 100 companies involved in the development, operation, marketing and sale of electric power in New York.

² These members (collectively, the “Appellants”) are identified on Attachment 1.

³ The Management Committee narrowly approved the controversial Penalty Program by a 60.66 percent vote.

mitigation actions. It provides that a generator whose bid for any segment of its supply curve exceeds its reference price (“RP”) by an amount sufficient to cause it to exceed the conduct and impact thresholds established in the MMP (the “Thresholds”) and which consequently has its bids mitigated by the MMU⁴ can be penalized in an amount equal to twice the location-based marginal price (“LBMP”) multiplied by the number of megawatts mitigated during the mitigated hours (“Mitigated MWHrs”).

A second mitigation within 24 months of the first applied to the same entity as the initial mitigation, “*or to an affiliate, parent, etc.*” (collectively, “Affiliates”), can result in a penalty equal to the Mitigated MWHrs multiplied by three times the LBMP. In addition, the identity of the subject generator and all of its Affiliates may be disclosed publicly together with the fact of the generator having been penalized by the NYISO.

A third mitigation within 24 months of the second applied to the same generator, or to any of its Affiliates, calls for a penalty equal to four times the LBMP multiplied by the Mitigated MWHrs. Moreover, upon such third occurrence, the NYISO may essentially revoke the generator’s (and each of its Affiliates’) ability to submit market-based bids into the NYISO-administered markets by requiring it, as well as each of its Affiliates, to submit bids equal to its RPs for not only the mitigated unit, or portion thereof, but also for all of its units. In the event the NYISO determines it appropriate to require the generator and its Affiliates to submit to this default bid process, the Penalty Program requires that the NYISO impose this procedure for a six-month period.

II. ARGUMENT

IPPNY recognizes the legitimate concerns of those involved with the evolving New York electricity market. A confluence of events, including rapidly rising fuel prices, a scarcity of supplies under certain conditions and uncertainties relating to new market rules and procedures, has resulted in increasing electricity prices. While it is tempting to impose new market rules to depress electricity

⁴ Other than mitigation imposed pursuant to the proposed Automatic Mitigation Process.

prices, California's current experience demonstrates that short-term solutions are not in the best long-term interest of consumers, the environment or the State's economy. Extreme caution must be exercised before interfering with the proper functioning of the market and distorting price signals sent to market participants. Applying the Penalty Program to the New York market, in addition to the long and ever growing list of price control mechanisms that have come to burden the New York marketplace, will be counterproductive, as it will increase market uncertainty, decrease liquidity and tend to drive suppliers away from New York during precisely those times when supplies are needed most. For the reasons discussed below, the Board should reject the Penalty Program.

- A. THE BOARD SHOULD REJECT THE MANAGEMENT COMMITTEE'S REQUEST TO SEEK FERC APPROVAL OF THE PENALTY PROGRAM, BECAUSE THE EXISTING MARKET MITIGATION PLAN IS ADEQUATE TO DETER MARKET POWER ABUSES AND THE NYISO'S INDEPENDENT MARKET ADVISOR HAS FOUND THAT THE MARKET IS OPERATING IN A MANNER CONSISTENT WITH WORKABLE COMPETITION.

The proponents of the Penalty Program approved by the Management Committee state that the goal of the Penalty Program is to provide a deterrent to market participants that engage in conduct that warrants mitigation and that receive the benefits of such conduct until it is detected and mitigated.⁵ The proponents justify the Penalty Program on the purely speculative claim that "[t]here appears to be no deterrent to engaging in such conduct." However, the proponents wholly have failed to adduce any evidence that the existing MMP has not deterred market power abuses. Nor have the proponents made any showing that a market party's conduct caused or contributed to a material increase in prices in New York's energy market.

The real cause of higher energy prices has been known since last fall. In a preliminary assessment released in October 2000, the NYISO's independent Market Advisor confirmed that higher electricity prices in New York are not caused by market power problems. The Market Advisor

⁵ Penalties for Conduct that Results in the Application of Market Mitigation, Proposal of NYS Consumer Protection Board, April 18, 2001 Management Committee.

primarily attributed higher wholesale electricity prices to: (1) substantial increases in natural gas and oil prices, and (2) the outage of Consolidated Edison Company of New York's ("Con Edison") Indian Point 2 facility, a 1,000 MW nuclear reactor in eastern New York.⁶ The Market Advisor subsequently confirmed this analysis in the annual assessment for the 2000 New York electric markets presented to the Joint Board of Directors/Management Committee meeting on April 17, 2001, finding that, absent the rise in fuel prices and the outage of Con Edison's Indian Point 2 facility, prices in eastern New York in 2000 would have been 38 percent lower.

The proponents' claim that additional mitigation measures are necessary to deter market power abuses is especially unconvincing, because the NYISO's MMU, the entity charged with protecting the market from market power abuses, has made no findings that the existing mitigation measures are inadequate to deter the exercise of market power in New York. In fact, the NYISO's Market Advisor, on April 17, 2001, found that the existing mitigation measures have allowed the NYISO to remedy conduct resulting in material price increases and that "changes in the mitigation plan are not necessary at this time."⁷ The Market Advisor found that, except for several isolated instances, suppliers bid in a manner consistent with workable competition. The Market Advisor stated:

The market mitigation plan is premised on the presumption that the New York market design provides generators a strong incentive to offer their resources at marginal costs. Hence, the plan tracks each resources' historically accepted offers (i.e. reference price) as a measure of the units' marginal costs. . . . The 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.*⁸

⁶ David B. Patton, Ph.D., New York Market Advisor, Preliminary Market Assessment of the New York Electric Markets, Presented to NYISO Board and Management Committee (October 17, 2000).

⁷ Annual Assessment of the New York Electric Markets 2000, Presented to Joint Board of Directors/Management Committee Meeting (April 17, 2001) Slide 3. The Market Advisor stated that the Automatic Mitigation Plan was necessary, but only to speed the implementation of existing mitigation measures.

⁸ *Id.*, slide 36-37 (emphasis added).

Consistent with the Market Advisor's findings, the NYISO recently argued to FERC that additional mitigation measures are not needed. In a protest of Con Edison's request to FERC to expand the scope of the in-City mitigation measures, the NYISO stated 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 in New York City, pursuant to its existing Market Mitigation Measures."⁹ Thus, the Board should reject the Penalty Program because the NYISO already has the tools in place to adequately deter market power abuses in New York. The Board should not take any action to impose additional market mitigation penalties unless there is clear evidence that the existing penalties fail to deter market power abuses.

B. IF IMPLEMENTED, THE PENALTY PROGRAM WILL HARM THE COMPETITIVE MARKET BY CREATING ADDITIONAL UNNECESSARY UNCERTAINTY FOR MARKET PARTICIPANTS AND WILL LIKELY REDUCE SUPPLIES AT THE TIMES THEY ARE NEEDED MOST.

Pursuant to the Penalty Program, penalties can be applied to conduct that occurred up to 14 days prior to the implementation of mitigation by the NYISO for physical withholding and up to five days prior to the implementation of mitigation by the NYISO for all other mitigation actions. The result is that for not less than five days and perhaps as long as a 14-day period, each generator will be uncertain as to whether its operation was profitable in accordance with its bid or will in fact have resulted in potentially severe operating losses. This uncertainty discourages suppliers from selling energy in New York and investing in new generation, exacerbating supply problems.

Moreover, the extent of the penalties, particularly for a second or third mitigation, is severe. Generators may well find the penalties so severe and the risk that penalties will be imposed so uncertain that they will choose other markets in which to sell their energy. The severity of the penalties, especially after a generator (or one of its Affiliates) has already been mitigated during the past 24 months, may

⁹ Docket No. ER01-1385-000, Consolidated Edison Company of New York, Inc., 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 (April 4, 2001) at 1.

distort the scarcity prices that are necessary to encourage the development of new capacity in the market and the continued importation of external supplies into the NYISO-administered markets.

Once a generator has been mitigated, it and its Affiliates will likely be much more conservative in future bidding in the energy markets, which will equate to a reduction in supplies available to the market. This effect will be exacerbated during times of highest demand, when supplies are needed most. For example, generators will be much less likely to offer into the market capacity in excess of their upper operating limit if they risk the potential of incurring these draconian penalties. Non-ICAP suppliers also will be more likely to sell their energy outside New York, perhaps even at lower prices, to ensure they do not become a victim of these extreme penalties. Likewise, a generator who would otherwise be willing to take extraordinary actions to keep in service a unit that is scheduled for a maintenance outage or that is experiencing a malfunction will not be inclined to take those extreme efforts if it risks being severely penalized as a result of submitting a legitimate bid in excess of the applicable Thresholds.

Finally, as the Board is aware, as of the current date, the NYISO has not satisfactorily developed a full complement of rational RPs for each unit. This lack of proper RPs introduces a second level of risk and uncertainty into the market relative to the application of the Penalty Program. During times of supply shortages, the NYISO should do everything possible to ensure that markets function in a manner that encourages maximum participation by suppliers. The Penalty Program would have exactly the opposite effect.

C. THE PENALTY PROGRAM VIOLATES PRINCIPLES OF DUE PROCESS AND FUNDAMENTAL FAIRNESS BECAUSE IT PUNISHES INNOCENT GENERATORS, RESTRICTS THE RIGHT TO APPEAL TO FERC AND IMPOSES PENALTIES BEFORE FERC RULES ON AN APPEAL OF A MARKET MITIGATION DETERMINATION.

The Penalty Program, as written, violates principles of due process and fundamental considerations of fairness, because it can result in an innocent party -- an entity who has never submitted a bid in excess of its RP, never engaged in physical withholding and never colluded with others to effectuate such conduct or to exercise market power in an abusive manner -- effectively losing its

FERC-granted authority to submit market-based bids into NYISO-administered markets for a six-month period of time. Because the default bid procedure applies not solely to the generation owner that was mitigated, but to all Affiliates thereof, the Penalty Program can penalize innocent market participants and is consequently overly broad in its application.

It is fundamentally unfair to penalize a market participant by stripping it of its market-based rate authority without any evidence that it has engaged in an abuse of market power. Clearly, the mere fact that an entity has submitted a bid in excess of an administrative threshold does not constitute proof that all of its Affiliates have attempted to exercise market power in an improper manner. Accordingly, the NYISO should reject the Management Committee's request to seek FERC approval of the Penalty Program.

The Penalty Program also appears to require parties to arbitrate disputes concerning the application of penalties before appealing the decision to impose such penalties to FERC. The Board should make clear that nothing in the Penalty Program contravenes the rights of market parties to file complaints with FERC under Section 206 of the Federal Power Act.

The Penalty Program also appears to allow the imposition of penalties while a market party files an appeal with FERC. Since the penalties proposed in the Penalty Program are so severe, the Board should not allow them to be imposed until market parties have exhausted all rights to appeal the mitigation action.

D. THE PENALTY PROGRAM DISCRIMINATES AGAINST GENERATORS BECAUSE THE PENALTIES ARE NOT APPLIED TO LOADS AND TO TRANSMISSION OWNERS.

Appellants on the Penalty and Public Disclosure Task Force attempted to develop a more even-handed approach that would have applied the new penalty program to LSEs and TOs in addition to generation. As is true when applied to the supply side, the MMP requires the MMU to monitor and prospectively correct LSE conduct. Notwithstanding this fact, the proponents of the Penalty Program dismissed the suggestion that the Penalty Program should apply equally to LSEs and TOs.

If the NYISO is going to penalize conduct of one side of the market (generation), then it must penalize conduct of the other side to the same (load and transmission operators) extent. If the proponents truly believe that the existing MMP does not sufficiently deter market power abuses, because it fails to address the effects of conduct that warrants mitigation until such conduct is detected and mitigated, which IPPNY disputes as discussed above, then the increased penalties imposed upon generators must necessarily be applied to LSEs and TOs.

During tight supply situations, there is an increasing potential for the exercise of market power by withholding load in an effort to depress day-ahead prices. The potential for loads to depress day-ahead prices via improper load bidding will also be greatly enhanced this summer due to the NYISO's implementation of zonal price capped load bidding, particularly in the absence of the countervailing potential of virtual load bidding. Thus, any penalty program applied to generators must be applied equally to LSEs.

Finally, TOs can have a dramatic impact on prices in the various markets by virtue of their scheduling of transmission line outages. By announcing an outage and then not carrying through with it, TOs can cause wide price swings and effectively exercise market power, particularly in load pockets. Accordingly, if penalties of the magnitude contemplated by the Penalty Program are to be imposed on the markets, they should be imposed on all parties, including the TOs and LSEs, and not solely on the generators.

E. THE PENALTY PROGRAM IMPROPERLY INTRUDES ON FERC'S AUTHORITY TO GRANT AND REVOKE MARKET-BASED RATE AUTHORITY.

The MMP currently provides that, when mitigation is triggered, the NYISO may substitute a default bid for no more than six months after the occurrence of the conduct giving rise to the measure, or at such earlier time as may be specified by the NYISO. However, such a measure is limited to supplanting the bids submitted for the individual electric facility. Thus, while FERC has allowed default bids to be imposed for up to six months without its prior approval, default bids would only be applied to

the individual generating unit that exercised market power. The Penalty Program improperly would broaden the application of the default bids to the entire fleet of generators affiliated with the mitigated party commencing with the third mitigation action. This broad and excessively harsh penalty effectively withdraws the market-based rate authority for a corporate family's entire fleet of generators. Since only FERC has the power to grant and withdraw market-based rate authority, only FERC should have the authority to impose such a penalty.

CONCLUSION

For the foregoing reasons, the Board should reject the proposed Penalty Program.

Respectfully submitted,

Glenn D. Haake
General Counsel
Independent Power Producers
of New York Inc. On behalf of the
Appellants

Attachment 1

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