

**NOTICE OF APPEAL OF CAPACITY SUPPLIERS
TO THE MANAGEMENT COMMITTEE FROM THE
BUSINESS ISSUES COMMITTEE'S DENIAL OF MOTION #1
AT THE SEPTEMBER 4, 2002 SPECIAL BIC MEETING**

I. INTRODUCTION AND SUMMARY

KeySpan-Ravenswood, LLC (“Ravenswood”) and AES New York LLC (collectively the “Capacity Suppliers”) appeal the decision of the Business Issues Committee (“BIC”) on September 4, 2002 to reject the proposal outlined in Motion #1. The proposal in Motion #1 called for the NYISO to temporarily determine the amount of Installed Capacity used to calculate the Unforced Capacity that an entity’s Resource is permitted to supply to the NYCA ICAP market based on that Resource’s Summer DMNC rating for the Winter 2002-2003 Capability Period. Capacity Suppliers request that the Management Committee approve the proposal presented to the BIC on September 4, 2002, and implement it prior to the Winter 2002/2003 capability auctions.

As explained in more detail below, the proposal to temporarily use Summer DMNC ratings for the Winter 2002-2003 Capability Period will benefit the wholesale energy market and customers because it will:

- (1) maintain short and long term system reliability;
- (2) limit unnecessary energy price volatility; and
- (3) improve market price signals.

The BIC’s decision ignores the urgent need to make some immediate modifications to the NYISO’s capacity market design 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. Furthermore, leaving the market as is could lead to unintended energy price volatility because suppliers’ costs are being shifted to the energy market unnecessarily. In addition, the BIC gave little or no weight to the NYISO staff support of the proposal. The BIC ignored the

fact that the current market signals indicate there is a significant excess of capacity in the summer as well as the winter, even though those signals contradict actual system operations and the countless reports citing the need to maintain existing supply resources and develop new supply resources.

II. BACKGROUND

A key question facing the NYISO, and all other markets, is how much capacity is required to reliably meet customers' needs. Prior to competitive markets, installed capacity (ICAP) was the unit of measure for a generation resource, and it reflected 100% of the dependable maximum net capability (DMNC) of a unit, temperature adjusted to the summer peak demand day. Computer models were created to simulate supply, demand and operating conditions. Based on these computer models and the numerous assumptions therein, it was determined that a *minimum* of 118% of ICAP was required for the State *on an annual basis* to meet the summer peak load demand. A specific locational requirement is also required in New York City and on Long Island. Utilities met their annual requirements with a mix of resources. Utilities recognized that the "excess" capacity of certain resources in the winter was simply a necessary byproduct of meeting their needs in the summer. Rates reflected this reality, and the cost to customers were based on the peak summer needs, and not on an assumption that costs in the winter could somehow be avoided or capacity resources removed from the system.

Even after competitive markets were implemented, the same computer model was used to determine how much generation was required to meet reliability requirements. The NYISO implemented a market where ICAP continued to be the unit of measure, however, it procured the product in six month strips instead of on an annual basis. In time, the NYISO revised the capacity market in several respects, and now administers a UCAP market with monthly auctions. The summer peak load continues to be the critical load and the basis for all capacity requirements; it sets the capacity requirement year-round. A sufficient amount of capacity must

be available year-round, not simply in certain months, to meet reliability needs. Fluctuations in supply over periods shorter than a year do not reflect the true system operating requirements or correct market signals.

PJM experienced problems with shorter capacity procurement periods, and moved from daily periods to three, four and five month procurement periods. In addition, PJM uses summer capability ratings year-round. Furthermore, the Joint Capacity Adequacy Working Group (JCAG) is reviewing the benefits of longer procurement periods and using summer capability ratings year-round. JCAG proposed that PJM, NYISO and ISO-NE converge in this direction as soon as possible. Finally, the FERC standard market design notice of proposed rule making (SMD NOPR) calls for longer-term future adequacy plans probably of 1-year minimum duration and 3-5 years into future.

Again, there have been countless calls for additional installed generation resources in New York State. The New York Power Authority and Long Island Power Authority responded with emergency actions to install additional generation over the last two seasons. In addition, Consolidated Edison Company of New York, Inc. even brought back from retirement a facility to meet reliability needs. Finally, emergency demand response programs continue to be activated in both the summer and winter to prevent system overloads. Even with these resources, and even though resources are performing better than they have in years, the NYISO continues to call for additional supply. The bottom line is no one is in fact comfortable with merely a 118% margin of ICAP. Nevertheless, the current market significantly discounts ICAP on a seasonal basis without corresponding values reflected during critical periods. Reliability concerns based on actual system operations that are not revealed in a computer simulation warrant more capacity being procured than what the market is currently purchasing. Although studies assume all winter DMNC capacity is available in the winter, *and* is also available in the following summer at its summer DMNC, the market effectively drives a significant amount of capacity out of the market

in both the winter and summer because it is not purchased to meet the minimum 118% or locational requirements in the winter.

The actual need for additional capacity is in direct conflict with the market signal from the NYISO capacity market. The market indicates additional capacity is not required. This makes no sense when viewed in light of how the system is actually performing. If this signal is not corrected, the NYISO will not be able to maintain system reliability because existing resources will become unavailable either due to increased forced outages due to reduced investment, permanent retirement or temporary shutdown. Numerous development projects are already on hold or being cancelled. Existing facilities, both within the State and outside the State, are considering temporary/permanent retirement and have to evaluate whether to invest for continued operations or improved performance based on current market signals.

Neither the current monthly signals nor the winter signals send the correct market signal that additional resources are required.

III. ARGUMENT

Using the summer DMNC ratings of installed generating facilities for the winter capability period will benefit the wholesale energy market because it will: (i) maintain short and long term system reliability; (ii) limit unnecessary energy price volatility; and (iii) improve market price signals. The following is a summary of market conditions today:

Supply Side

- The NYISO reports additional installed generation is required in addition to the existing supplies.
- Continued activation of emergency programs further supports additional resources being added.
- Construction of new facilities is very expensive.
- Construction projects are on hold or being cancelled.
- Limited capacity revenues limit capital investments to maintain or improve performance.
- Existing facilities are considering permanent/temporary shutdown.

Demand Side

- Record peak demand (MW) continues to grow.
- Record peak consumption (MWh) continues to grow.
- Existing energy markets do not reflect scarcity prices during scarcity conditions.
- Existing capacity market procures much less than all available capacity.
- The demand signal is that a significant surplus in supply exists today.

Even with these conflicting signals from the supply and demand sides of the market, modifications to the market that would bring these signals closer together are not being made in a timely manner. Many additional energy mitigation measures have been implemented, yet corresponding changes to the capacity market have not kept pace.

The capacity market needs to be changed before the Winter 2002/2003 Capability Period auctions so that: (i) the generation needed to provide reliability is procured; (ii) market signals begin to encourage new development; (iii) market signals prevent existing facilities from retiring prematurely; (iv) the need for capacity resources in the winter is not overly discounted; and (v) there are more accurate long term price signals.

Implementing the use of summer DMNC ratings this winter is a much-needed interim step toward meeting these needs, and the first step toward a reliable market with longer term capacity markets based on summer DMNC ratings with annual deficiency prices.

Although some market participants have referred to and relied upon various computer modeling programs that show the current resources available to New York State provide a loss of load expectation of one day in ten years, actual experience indicates even more resources are required. Notwithstanding the computer analysis, and the purported conclusions that more capacity resources are available to the New York market than are required for reliability, emergency demand response programs continue to be called in both the summer and winter to meet the energy needs of New York State. Therefore, the actual operation of the market indicates there are not sufficient resources being procured, and the computer model should not be

used as a hard and fast barrier to changes to the market in light of actual experience, evidence and good utility practice.¹

In addition, if capacity markets are not modified in the short term as well as long term, significant energy price volatility could occur. Resources that have unsold capacity will look to the infrequent hours of scarcity to recover all their fixed costs. This type of price volatility is not the market design that the NYISO, Federal Energy Regulatory Commission (FERC) or customers are interested in implementing. Nevertheless, if a resource only has a limited number of hours in which it can recover its costs, it will legitimately seek recovery of these costs during those limited hours, causing significant price spikes. Modifications to the capacity market should be preferred by all market participants and the NYISO, instead of the potential price spikes and the seemingly endless debates and litigation associated with them.

Finally, if capacity markets are not modified as suggested in the short term as well as long term, supply resources will yet again receive the wrong price signal, specifically that additional resources are not required and existing resources face financial risks due to the inability to cover fixed costs and should retire. Regardless of how much additional supply a report or newspaper article claims is required, if the correct price signal is not in the market, the supply will not be provided. This will threaten reliability both in current capital investment decisions that are postponed and potential premature retirement.

Accordingly, the capacity market needs to begin to change to reflect the reality of the needs of customers, the electric system and installed generation resources. Otherwise, additional installed generation resources will not be developed and existing installed generation resources

¹ If UCAP models had been relied upon, the emergency generation installed by NYPA prior to the summer of 2001 would not have been justified. The 408 MW of additional emergency generation could only be justified on an ICAP basis. In addition, during regulatory proceedings related to their construction, it was recognized the 118% and locational requirements were merely minimums and should not be used to thwart additional supply.

will retire prematurely. In the end, customers will be harmed if the market is not corrected.

Motion #1 is an interim change that will benefit the market and consumers, and it should be implemented by the Management Committee ahead of the Winter 2002/2003 Capability Period auctions.

A. RELIABILITY

The existing capacity market in New York State, although an integral and important part of the market, currently sends a signal that new installed resources are not required. Moreover, it also sends a signal that many existing installed resources are not required. This is contrary to what the NYISO and other energy planners claim is the case. According to the NYISO, both existing installed resources and new installed resources are required to meet the current energy needs of New York State.

Using the summer DMNC ratings of installed generation resources in the winter capability period will provide otherwise unsold resources with the proper incentive to remain in the market. Using winter DMNC ratings causes many resources to remain unsold, and is a signal that the resources are not required for reliability. However, as noted above, this is not the case. Notwithstanding computer models to the contrary, every installed generation resource in New York State is currently required for at least an entire year to meet the reliability needs of the electric system. If there were an excess of generation resources available to the New York market, as purported by the computer models, there would not be a need for emergency demand response programs to be activated. In addition, there would be no need for the development of emergency generation projects by State Public Authorities. Clearly, there were insufficient capacity resources procured for New York State last summer and winter as reflected by the need to activate emergency demand response programs, develop emergency generation and rely on non-UCAP resources to meet load requirements.

As a general matter, capacity requirements are not merely a monthly or even a six-month requirement. At a minimum, capacity is an annual requirement and should eventually be made even longer (e.g., three years). An installed generation resource cannot financially survive based on market indications it is only required for one or six months at a time. Accordingly, using summer DMNC ratings this winter is a good first step toward a longer-term capacity market based on summer DMNC ratings with annual deficiency prices.

Using summer DMNC based UCAP in the winter will allow a more optimal mix of base load, cycling, and quick start units to be procured in the winter months (i.e., more peaking capacity) and at the same time provide for more flexible and lenient outage scheduling.

B. ENERGY PRICE VOLATILITY

The current NYISO capacity market leaves significant amounts of installed generation resources unsold. Consequently, certain existing marginal units are unable to recover any fixed costs, nor a reasonable return on their investment in the capacity market. Therefore, such resources need to find other sources of revenue to justify continued operation and investment. The energy market is the likely candidate for seeking these revenues.

Seeking recovery of large amounts of capacity revenues (100% in the case of an unsold resource) from the energy market is a very risky proposition due to mitigation measures, and will likely result in extremely volatile energy prices, or even worse, increased uplift costs, which cannot be hedged. This is because generation resources have the right to seek recovery of all their costs plus a reasonable return (considering market risk) in the market. Due to the high risk of operating a facility without capacity revenues, the expected return for that facility will likely be very high. When energy is required for reliability from a resource with unsold capacity, it will seek those capacity revenues and the associated high risk return. If there are only a few energy transactions expected, the generating facility will seek all the costs during the potentially

infrequent energy transactions, thereby driving up the unit cost (i.e. reference price) of energy during these events. Although economically justified, such a price spike is not politically acceptable and we expect significant negotiations would be required to obtain “approval” of such a reference price. In addition, even after the reference price is “approved” and input into the NYISO unit commitment model, the generating facility would likely be committed to run out-of-merit because it would likely be rejected by the computer dispatch based on price. To maintain reliability, the NYISO would then have to call the generation facility out-of-merit and it would result in all the costs being added to uplift. Although this would limit price volatility, it distorts market price signals.

C. PRICE SIGNALS

The current price signals in the NYISO capacity and energy markets indicate that certain installed generation capacity is not required. Certain existing marginal units are unable to recover their fixed costs plus a reasonable return on their investment in the capacity market. Many resources obtain limited revenues from the capacity market while some resources go unsold. Accordingly, these resources need to evaluate other opportunities such as increased energy prices, shutting down or, where possible, leaving New York State. Unfortunately, energy prices are mitigated to such a great extent that the first option may not be feasible. Therefore, the capacity and energy markets price signal indicates existing installed generation should shut down or relocate and new installed generation is not required. Again, this is contrary to NYISO reports and actual market conditions. Nevertheless, many generation development projects in New York are either on hold or have been cancelled.

This is in stark contrast to the actual workings of the NYISO market. During both the summer and winter capability periods there were calls for emergency demand response to meet the needs of customers in New York State. This is in direct conflict with the signals installed generation facilities and generation development are getting from the market (i.e. retire existing

units and do not build new units). If sufficient resources exist already (as the market signals indicate), why is there a need to activate emergency demand response programs? More generation resources are required in New York State, and the proper price signals need to exist as soon as possible. The use of summer DMNC ratings this winter will provide the necessary price signal to existing installed generation facilities to remain in the market until longer term modifications can be implemented.

IV. CONCLUSION

Capacity Suppliers respectfully request the Management Committee to reverse the erroneous decision made by the BIC and approve the proposal presented to the BIC on September 4, 2002, and implement it prior to the Winter 2002/2003 Capability Auctions. The actual operation of the market indicates there are not sufficient resources being procured in the market, yet the market signals reflect excess supplies. Accordingly, the capacity market needs to begin to change to reflect the reality of the needs of customers, the electric system and installed generation resources. Otherwise, additional installed generation resources will not be developed and existing installed generation resources will either retire or relocate. Using summer DMNC ratings in the winter is a much-needed interim step toward a modified capacity market and a more reliable electric system.

Dated: September 18, 2002

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