UNITED STATES OF AMERICA 93 FERC ¶ 61,017
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: James J. Hoecker, Chairman;
William L. Massey, Linda Breathitt,
and Curt Hébert, Jr.

Morgan Stanley Capital Group, Inc.
v. Docket No. EL00-90-000
New York Independent System Operator, Inc.

ORDER ON COMPLAINT

(Issued October 5, 2000)

On July 5, 2000, Morgan Stanley Capital Group, Inc. (Morgan Stanley) filed a complaint under section 206 of the Federal Power Act (FPA)[1] against the New York Independent System Operator (NYISO). Morgan Stanley claims that the NYISO impedes development of the New York marketplace, imposes financial harm on market participants, and unjustly discriminates against power marketers by excluding non-"physical" entities from bidding into the NYISO-administered day-ahead and real-time markets for power. Morgan Stanley requests that the Commission direct the NYISO to allow bids from non-physical entities at all points in the NYISO market and make the corresponding modifications to its market rules and software by August 1, 2000.

As discussed in the body of this order, we deny the requested relief.

I. Morgan Stanley's Complaint

Morgan Stanley's complaint takes issue with Article 4 of the NYISO Services Tariff, which sets forth totally "physical" day-ahead and real-time markets, i.e., markets that are limited to entities that either physically consume or supply energy (referred to herein as "physical entities"). In this marketplace, only entities capable of supplying power, such as generators, may submit bids to sell power. Similarly, only entities that will consume power, such as Load-Serving Entities (LSEs), can submit bids to purchase power. A non-physical entity like a power marketer, which does not generate or consume power, may participate indirectly in the bidding process by coordinating with generators or LSEs to incorporate its transactions into their bids. Morgan Stanley requests that a power marketer be

[1]16 U.S.C § 824e (1994).

permitted to bid to purchase energy, or permit a power marketer to bid to sell energy, in the day-ahead and real-time markets for any location on the NYISO system. It states that the Market Structures Working Group, an internal NYISO committee, has identified the restriction on bidding by non-physical entities as a problem and is concerned about this continuing restriction. Nevertheless, Morgan Stanley states that despite promises by the NYISO to address the issue, nothing has been done to change the NYISO rules and that, therefore, Commission action is necessary to avoid further delays by the NYISO.

Morgan Stanley contends that a marketplace restricted to physical entities harms power marketers by limiting them from hedging the risk from price swings between the day-ahead and real-time markets, impedes the overall efficiency of the markets by reducing liquidity between them, and produces distorted price signals. It argues that allowing only bids from physical entities is the primary reason that prices in the day-ahead and real-time markets have not converged, as Morgan Stanley expects would otherwise happen. Morgan Stanley claims that the day-ahead market has been generally the lower-priced market over a consistent period of time, and notes that prices between the two markets may differ greatly, as during the week of June 11-17, 2000, when prices diverged by as much as $69.82/MW. Morgan Stanley argues that the suppression of non-physical purchasers in the markets gives market power to LSEs that can be exploited by underbidding in the day-ahead market to depress its prices, or hedging, against high prices in the real-time market. Morgan Stanley argues that allowing bidding by non-physical entities all over the NYISO control area will eliminate this problem, as a greater number of participants will create more arbitrage between the prices in the day-ahead and real-time markets.

Aside from its purported effects on the markets, Morgan Stanley argues that allowing only physical bidding violates Commission requirements. It states that by denying non-physical entities direct access to the day-ahead and real-time markets, the NYISO's rules unduly discriminate and disadvantage non-physical entities, and grant undue preference to generators and LSEs, in violation of Section 205 of the Federal Power Act. Morgan Stanley argues that excluding certain market participants from the markets fails to reflect the ISO principles established in Order No. 888,[2] which

[2] Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Order No. 888, 61 Fed. Reg. 21,540 (1996), FERC Statutes and Regulations, Regulations Preambles January 1991-June 1996 ¶ 31,036 (1996), order on reh’g, Order No. 888-A, 62 Fed. Reg. 12,274 (1997), FERC Statutes and Regulations ¶ 31,048 (1997), order on reh’g, Order No. 888-B, 81 FERC ¶ 61,248 (1997), order on reh’g, Order No. 888-C, 82 FERC ¶ 61,046 (1998), aff'd in pertinent part, Transmission Access Policy Study Group, et al., v. FERC., Nos. 97-1715 et al. (D.C. Cir., June 30, 2000).

expect that an ISO's trading rules should promote efficient trading and efficiency in the market and should accommodate transactions made in a free and competitive market.[3]

II. Notice of Filings, Interventions, Protest, and Comments

Notice of Morgan Stanley's complaint was published in the Federal Register, 65 Fed. Reg. 42,999 (2000), with protests, answers, and motions to intervene required to be filed on or before July 17, 2000. Timely motions to intervene or protest were filed by Enron Power Marketing, Inc., Public Service Electric and Gas Company, PSEG Energy Resources & Trade LLC and PSEG Power New York, Inc., PPL EnergyPlus, LLC, Dynegy Power Marketing, Inc., NRG Power Marketing, Inc., Sithe Power Marketing, L.P. and Sithe/Independence Power Partners, L.P., Niagara Mohawk Energy Marketing, Inc., Southern Energy Bowline, LLC, et al; 1st Rochdale Cooperative Group, Ltd., and Coordinated Housing Services, Inc., Keyspan-Ravenswood, Inc., Consolidated Edison Company of New York, Inc., Orion Power New York GP, Inc., Member Systems, Merrill Lynch Capital Services, Inc., Duke Energy Trading and Marketing, LLC, and American Electric Power Service Corporation. A motion to intervene out of time was filed by PG&E National Energy Group, PG&E Generating, and PG&E Energy Trading-Power, L.P.

Several intervenors filed comments in support of Morgan Stanley's complaint, agreeing that denying non-physical entities access to the day-ahead and real-time markets has a negative impact on the New York ISO marketplace. PPL Energy Plus states that the lack of liquidity and convergence in prices serve to lessen the already shaky confidence in the NYISO marketplace. American Electric Power Service Corp. (AEP Service Corp) states that excluding non-physical entities increases the likelihood and frequency of market swings by restricting the number of players and trades in the marketplace. It also claims that arrangements between power marketers and LSEs to submit bids into the markets for power marketers usually come at an extra cost as LSEs generally charge a fixed fee and a percentage of the transaction from the power marketer.

Enron Power Marketing also supports Morgan Stanley's complaint, but requests that, rather than addressing the problems in a piecemeal fashion, the Commission convene a technical conference to

[3]Morgan Stanley also claims that excluding certain market participants is contrary to Order No. 2000, in which the Commission stated that, among its minimum functions, a regional transmission organization must monitor the markets, identify design flaws, and report these to the Commission. Regional Transmission Organizations, Order No. 2000, 65 Fed. Reg. 809 (January 6, 2000), FERC Statutes and Regulations ¶ 31,089 (1999), order on reh'g, Order No. 2000-A, 65 Fed. Reg. 12,088 (March 8, 2000), FERC Statutes and Regulations ¶ 31,092 (2000).

examine all of the problems in New York, including those raised in other recent complaints against the NYISO.

Consolidated Edison Company of New York, Inc. (ConEd), and Member Systems oppose Morgan Stanley's complaint. ConEd argues that there are more urgent problems facing the NYISO that need to be resolved first. It contends that the Commission should not at this time entertain requests that would detract from the NYISO's efforts to correct the pricing abnormalities in New York, as it has been ordered to do in recent dockets. Member Systems caution that changes must proceed slowly and argue that implementing bidding by non-physical entities must be accomplished consistent with the implementation of any related software changes and in the context of other changes made by the NYISO to address existing problems.

Member Systems also state that Morgan Stanley is improperly seeking to circumvent the established NYISO governance process. Member Systems state that the NYISO's Business Issues Committee has voted to request that the NYISO implement changes to accommodate more flexible bidding, as was recommended by the Market Structures Working Group. Member Systems contend that the Commission should refrain from intervening at this stage and should permit the NYISO governance processes, which are already under way, to address this issue.

On July 17, 2000, the NYISO filed an answer to Morgan Stanley's complaint. The NYISO states that it reached a consensus with market participants, through its stakeholder committee process, to defer the issue until after its first summer of operation, thereby giving the NYISO and market participants time to focus on reliability concerns and market design flaws, as well as carefully consider all necessary market, software, and tariff changes needed to implement non-physical bidding. It notes that its internal working groups and committees are working on a proposal to implement bidding by non-physical entities that could begin as early as October 2000. It argues that Morgan Stanley's complaint should thus be rejected because it unilaterally attempts to overturn decisions made by the NYISO and its market participants. The NYISO adds that Morgan Stanley did not participate in any of the committee meetings. Furthermore, the NYISO asserts that Morgan Stanley has not shown that allowing only physical entities to bid is damaging market participants or distorting the markets.

The NYISO argues that Morgan Stanley's request for immediate action ignores the time required to modify and test the NYISO's software prior to implementation of non-physical bidding to minimize any unexpected problems. The NYISO contends that, unless done carefully, the introduction of bidding by non-physical entities could significantly harm system reliability, as well as lead to pricing anomalies and inefficiencies. For example, if a power marketer bid load in at a location where it could not be physically served, the market models would not be able to reach a solution and produce meaningful prices. Similarly, the NYISO notes that if a power marketer bid power that it could not physically supply into the day-ahead market, the NYISO's current market model might commit insufficient resources for the following day, thus compromising the reliability of the system.

The NYISO disputes Morgan Stanley's position that the difference in prices between the day-ahead and real-time markets is a sign of a market flaw and that including non-physical entities will cause the prices to perfectly converge. It states that the volatility of real-time market prices is in large measure a result of the unpredictable occurrence of physical events affecting real time transactions, such as weather changes or transmission or generation outages. The NYISO states that Morgan Stanley has provided no factual support for its implicit assertions that the number of bidders or the volumes being bid into the day-ahead and real-time markets is too small for proper market performance, and that additional bids by non-physical entities would always lead to convergence between both markets. The NYISO argues that price divergences that are the result of rational economic choices are not flaws, but a reflection of the cost of doing business in energy markets with significant risk.

On July 28, 2000, Morgan Stanley filed an answer to the NYISO's answer. Morgan Stanley objects to the NYISO's decision to defer implementation until at least October. It argues that the NYISO's decision-making process has failed to give sufficient priority to the issue of bidding by non-physical entities and continues to delay implementation.

III. Discussion

A. Procedural Matters

Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.214 (2000), the timely, unopposed motions to intervene of the entities listed above serve to make them parties to this proceeding. At this early stage of the proceeding, given the lack of undue prejudice or delay and given the parties' interests, we also find good cause to grant under Rule 214 the unopposed, untimely motion to intervene in these proceedings.

Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18 C.F.R. 385.213(a)(2) (2000), prohibits the filing of an answer to an answer unless otherwise permitted by the decisional authority. However, we find the answer filed by Morgan Stanley on July 28, 2000, to be helpful in the development of the record in this proceeding, and accordingly we accept it.

B. Morgan Stanley's Complaint

We note that the disagreement between the parties in this proceeding arises not over whether bidding by non-physical entities should be implemented but, rather, when it should be implemented. Morgan Stanley requests that the necessary filing be made with the Commission by August 1, 2000, whereas the NYISO states that a plan is already in development which could be ready sometime in the Fall 2000. We will deny Morgan Stanley's request for an implementation date of August 1, 2000.

In New York Independent System Operator (NYISO),[4] we directed the NYISO to address market design flaws in its market rules and software and file a report on its progress towards resolving these issues by September 1, 2000. We found that those flaws had possible consequences during the summer months that were too serious to ignore. Morgan Stanley has not demonstrated here that there is an overriding immediate need to design and implement a non-physical bidding structure by August 1, 2000, that should take priority over correcting the flaws identified in NYISO.

We are concerned that the changes necessary to accommodate bidding by non-physical entities, especially with regard to the NYISO's software, be carefully conceived. It is imprudent to introduce sudden overrides and quick fixes that could serve to disrupt efforts to correct the market flaws already identified or create new problems. Instead, we find it is important in this case to adopt a balanced, considered approach to needed corrections and changes to the NYISO's software. We will require the NYISO to file a report on its development of a plan to implement bidding by non-physical entities on, or before, January 1, 2001.

The Commission orders:

(A) Morgan Stanley's complaint is denied as discussed in the body of this order.

(B) On or before January 1, 2001, the NYISO shall file a report on its development of a plan to implement bidding by non-physical entities.

By the Commission. Commissioner Hébert dissented with a separate statement attached.

(S E A L)

Linwood A. Watson, Jr.,
Acting Secretary.

[4] 92 FERC ¶ 61,073 (2000).

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HÉBERT, Commissioner *dissenting*

Barely two weeks ago, we sat in San Diego and heard the Chairman proclaim that FERC would "do what it takes" to overcome price increases there, and listened as others declared the need for a "remedy." Today, the majority passes up an opportunity to hold the New York Independent System Operator (New York ISO)'s feet to the fire to overcome price increases in that State in time for next summer. Rather than order a change in the rules restricting the market, a goal we all supposedly endorse, the majority coddles the New York ISO and merely requires a progress report by January 1. Apparently, "doing what it takes" excludes forcing an ISO to make decisions. I refuse to take this path of timidity. I dissent.

Morgan Stanley Capitol Group, Inc. (Morgan Stanley) complains, rightly in my opinion, that the New York ISO improperly limited participation in the market to entities that own generators, or themselves consume electricity. Anyone can figure out that allowing marketers to sell increases supplies. Anyone can figure out also that including arbitragers in the buying end increases hedging and smooths out price volatility. This gives us a simple way to ensure that next summer, New Yorkers, especially residents of New York City can avoid a repeat of this year's drastic price increases.

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Marketers stand ready to send supplies they control (from generators others own) to the market. More supply lowers price. Arbitragers stand ready to buy. Arbitrage helps smooth price fluctuations. Consumers want to see more supplies, whether or not the seller own a generator. If a seller fails to deliver, the New York ISO can impose penalties as deterrence. Consumers want to see stable prices, whether or not arbitragers, rather than direct consumers, purchase in the market.

Strikingly, to me, the majority's irresolution stands in the face of the New York ISO seeing the wisdom of changing the rule. Its response agrees on the concept, but disputes the timing of the Morgan Stanley request for relief. Morgan Stanley asks for August 1; the ISO offers to begin by October 1. How long we think it takes for the ISO to obtain new software determines the date. Now that we have reached September, an August 1 date becomes moot. October 1 becomes moot to some extent, too. I think we should require the New York ISO file an amendment January 1, for the new market rules

to become effective next summer. On May 31, when we ordered the New York ISO to repair the reserve market and set a deadline of September 1. *New York Independent System Operator, Inc.,* 91 FERC ¶ 61, 218 (2000). We should do the same thing here. Requiring a report in January creates unnecessary delay; the majority concocts a recipe of paralysis by analysis.

I do not understand today's decision. Neither will consumers in New York when they see their bills. I respectfully dissent.

Curt L Hébert, Jr.
Commissioner