# STATE OF NEW YORK DEPARTMENT OF PUBLIC SERVICE

**THREE EMPIRE STATE PLAZA, ALBANY, NY 12223-1350**

**Internet Address: http://www.dps.state.ny.us**



February 28, 2003

Honorable Magalie R. Salas,
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Room 1-A209
Washington, D.C. 20426

Re: Docket No. RM01-12-000 - Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electric Market Design

Dear Secretary Salas:

For filing, please find the Reply Comments of the New York State Public Service Commission in the above-entitled proceeding. Should you have any questions, please feel free to contact me at (518) 473-8178.

Very truly yours,

David G. Drexler
Assistant Counsel

Attachment

**UNITED STATES OF AMERICA**
**BEFORE THE**
**FEDERAL ENERGY REGULATORY COMMISSION**

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| Remedying Undue Discrimination Through<br>Open Access Transmission Service and<br>Standard Electric Market Design | )<br>) Docket No. RM01-12-000<br>) |

**REPLY COMMENTS OF THE NEW YORK STATE**
**PUBLIC SERVICE COMMISSION ON**
**THE STANDARD MARKET DESIGN**
**PROPOSED RULEMAKING**

On July 31, 2002, the Federal Energy Regulatory Commission (FERC or Commission) issued a Notice of Proposed Rulemaking (NOPR) for establishing a national Standard Market Design (SMD). The New York State Public Service Commission (NYPSC) filed initial comments generally supporting the SMD NOPR on November 15, 2002 and on January 31, 2003. The NYPSC submits these reply comments pursuant to the SMD NOPR, the October 2, 2002 "Notice of Conferences and Revisions to Public Comment Schedule," and the December 20, 2002 "Notice on Requests for Additional Time."

## OVERVIEW AND EXECUTIVE SUMMARY

The NYPSC supports the provisions outlined in the NOPR for establishing an effective framework for market monitoring and mitigation. It is essential that Independent Transmission Providers (ITPs) have the necessary tools for responding to attempts to exercise market power during the transition to competitive wholesale markets. This is especially true given that the exercise of market power can occur suddenly and have a significant financial impact on customers. We urge the Commission to maintain its commitment to effective market monitoring and mitigation rules, notwithstanding the criticisms of parties that stand to benefit from weaker rules.

Contrary to the assertions of at least one party, bid caps are necessary in areas that are unconstrained most of the time. Even unconstrained areas may be subject to the exercise of market power during periods when supplies are especially tight. We recommend that ITPs be given authority to mitigate in constrained areas as well as unconstrained ones.

It has also been suggested that the safety-net bid cap be eliminated or adjusted automatically based on certain conditions. While the NYPSC believes that conditions will emerge that will permit the phase-out or elimination of the safety-net bid cap for many geographic markets, the decision to do so should not be tied to an overly-simplistic automatic trigger. Rather, the Commission should evaluate a number of conditions present in specific markets as part of a periodic process for revisiting the need for safety-net bid caps.

Several parties opposed allowing the ITP to implement Automated Mitigation Procedures (AMP), which would provide ITPs with the option of establishing predetermined triggers to automatically mitigate "unanticipated and sustained market conditions that would give the ability and the incentive to exercise market power"[1] via computers rather than manually. New York's experience with an AMP has shown that it allows objective criteria to discern between market power and true scarcity conditions and has worked well. Mitigation measures, including the AMP, have not discouraged the entry of new generation. Rather, market conditions such as excess supply and a lack of capital have put new generation proposals on hold. Until effective competition exists, the Commission should reject arguments opposing or weakening existing mitigation measures.

In addition, we respond to several parties' comments on resource adequacy.[2] We oppose a requirement that new generation should be financially responsible for ensuring the deliverability of existing generation because this would handicap developers of cleaner, more efficient generation in a non-competitive manner. We suggest, instead, that market-based incentives applicable to all market participants would be preferable to deliverability requirements applicable to new generation only. This issue, moreover, should be addressed regionally rather than as part of the SMD.

We also do not support imposing strong penalties on Load Serving Entities (LSEs) that fail to meet capacity requirements.

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[1] SMD NOPR at ¶ 415.

[2] The NYPSC filed extensive comments on November 15, 2002 opposing the SMD's proposal and recommending an alternative approach to ensuring resource adequacy (i.e., demand curve).

Such penalties provide a one-sided inducement to buyers and open up the potential for the exercise of market power generators.

Further, we are opposed to the North American Electric Reliability Council’s proposal to establish minimum resource adequacy standards. This proposal fails to recognize the important role that states play, including their jurisdiction over reliability and their ability to assess resource needs at the local level.

Finally, we respond to arguments that FERC should preempt the NYPSC’s decision to equalize full service rates for retail customers. The Federal Power Act does not permit the Commission to exercise jurisdiction over retail distribution rates.

## DISCUSSION

### I. Market Power Mitigation and Monitoring (SMD § IV.I.)

As we noted in our November 15, 2002 SMD comments, New York’s markets currently suffer from various structural flaws, including a lack of sufficient price-responsive load and the presence of transmission-constrained load pockets. Because these conditions permit the abuse of market power, it is essential that adequate market monitoring and mitigation measures be put in place to curb such abuse.

#### A. Bid Caps Are Necessary In Unconstrained Regions

Allegheny Energy Supply Company, LLC, et al. (Allegheny) states that “[t]he Commission should not rely upon price or bid caps outside of transmission constrained areas."[3] Allegheny did not offer a rationale for only applying mitigation measures inside constrained areas. Instead, it presents arguments against mitigation in general.

"Unconstrained areas" are not synonymous with "the inability to exert market power." Indeed, there are instances when a large, fairly unconstrained control area, such as upstate New York, may still be subject to potentially harmful market abuse. For example, on very hot summer days when supplies are tight everywhere, one or more suppliers with large market shares may be able to profitably withhold a portion of their supply. The Commission should not tolerate this type of abuse and should therefore apply market-wide mitigation until an adequate showing can be made, as discussed below,[4] that effective competition exists. Furthermore, until such showing is made, it may be appropriate to apply a higher bid cap in areas where there is little constraint.[5]

### B. Elimination of Safety-Net Bid Caps Should Be Tied To Effective Competition

Several parties suggest that the safety-net bid cap be eliminated or adjusted automatically depending on conditions. Among these parties is Calpine Corporation (Calpine), which states

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[3] Allegheny Comments at 31 (November 15, 2002).

[4] See infra Part I.B.

[5] For example, the NYISO employs higher bid caps for triggering the AMP in upstate New York, which experiences little constraint, than in New York City, which tends to be a highly-constrained area.

that “[t]he Commission should establish a defined level of demand responsiveness which would trigger the elimination of [any safety-net bid cap.]"[6] Mirant Americas, Inc., et al. (Mirant) recommends that “the safety-net bid cap should be increased at Commission determined intervals and amounts every year.”[7]

While conditions should emerge that will permit the phase-out or elimination of the safety-net bid cap for many geographic markets, the decision to do so should not be tied to an overly-simplistic automatic trigger, such as Calpine and Mirant suggest; nor should the cap’s elimination be reviewed every year. Instead, the Commission should identify factors that necessitate a safety-net bid cap and review the status of those factors.

The ability to exercise market power at peak times, and thus the need for a safety-net bid cap, depends on several factors. Among those factors are: 1) the short-run price elasticity of demand, which depends on the amount of price responsive demand; 2) the short-run price elasticity of supply, which depends on the system’s reserve margin at peak periods; and 3) the market’s concentration, as measured by the market shares of the largest firms and by the Herfindahl-Hirschman Index (HHI). There may also be other factors. Thus, the Commission should consider these factors in any decision to eliminate bid caps.

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[6] Calpine Comments at 18 (November 15, 2002).

[7] Mirant Comments at 47 (November 15, 2002).

In addition, some parties interpret the SMD NOPR as requiring an annual review of whether a bid cap is needed.  For instance, Allegheny states its support for "the Commission's plan to reexamine market mitigation measures annually, and to reconsider whether they should be continued."[8]  Presumably, this interpretation stems from the statement in the SMD NOPR that the ITP market monitor will update a competitive market analysis "annually to review the continuing effectiveness of the market power mitigation."[9]

Although a periodic review of bid caps makes sense, it should occur less frequently than every year.  It often takes several years for sufficient structural changes to occur within a market. For example, it usually takes three to four years for new generation to be completed and to affect market concentration and HHI's.  Given that it takes several years for market conditions to materially change, an annual review would require substantial effort and dedication of resources at a time when many other aspects of the market need to be refined and improved.  Thus, we recommend that the Commission establish a regular review at an interval of once every three to four years.

[8] Allegheny Comments at 32 (November 15, 2002).

[9] SMD NOPR at ¶ 403.

## C. **Independent Transmission Providers Should Be Permitted To Implement Automated Mitigation Procedures**

The SMD NOPR identified the AMP as a voluntary component that ITPs would be allowed to include in their market power mitigation plans, as needed. The AMP would allow the ITP to establish predetermined conditions or triggers for "limiting bids from individual suppliers into the day-ahead and real-time spot markets if those bids are high due to withholding rather that scarcity."[10]

Several parties object to an AMP based on claims that it is unnecessary with a safety-net bid cap, fails to allow scarcity pricing, discourages new entry, and fails to reflect current market conditions. These arguments lack merit and should be rejected.

### 1. **A $1000 MWh Safety-Net Bid Cap Does Not Obviate the Need For Automated Mitigation Procedures**

Mirant argues that "a $1,000/MWh safety-net bid cap is sufficient to limit the impact of true scarcity,"[11] and thus, an AMP mechanism is not needed. However, this argument fails to recognize that market power can be exerted well below the $1,000/MWh bid cap.

Without effective competition, market power could drive prices from $100 to $700. A $1,000/MWh bid cap alone would do nothing to mitigate this market power. As such, mitigation measures other than the $1,000/MWh bid cap are needed. One such measure is the

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[10] SMD NOPR at ¶ 402.

[11] Mirant Comments at 48 (November 15, 2002).

AMP, which is more narrowly tailored to conditions that may give rise to an exercise of market power.

### 2. **Automated Mitigation Procedures Properly Distinguish Between High Prices Associated With Market Power And High Prices Associated With Scarcity**

At least one party, NRG Energy, Inc. (NRG), claims that the AMP is "likely to improperly be applied to competitive scarcity prices rather than to the abuse of market power."[12] However, the NYISO's AMP is designed to mitigate high prices resulting from the exercise of market power, while allowing high prices that result from true scarcity.

In the Commission's Order Approving Extension of Automatic Mitigation Procedures, FERC stated that its "review of the AMP indicates that it appropriately attempts to distinguish between market power and scarcity."[13] So long as there is a single megawatt in the system that is part of a valid bid at or near the $1000 MWh safety-net bid cap, prices will reach the $1000 level on a day in which there is a true shortage, even with the AMP in place. What the AMP does is prevent artificially induced high prices on hot days when the market is not truly in a shortage situation, yet is vulnerable to market power. Furthermore, the NYISO has filed for Commission approval to allow price responsive demand to set the market clearing-price when it is on the margin, at levels well

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[12] NRG Comments at 9 (November 15, 2002).

[13] New York Independent System Operator, Inc., Order Approving Extension of Automatic Mitigation Procedures Subject to Conditions, Docket No. ER01-3155-000, issued November 27, 2001.

above the running-cost of combustion turbines.[14] Such a mechanism will increase the frequency of scarcity prices during true scarcity and will produce additional scarcity rents for generators. Therefore, the Commission should uphold its finding that the AMP in New York properly distinguishes between high prices associated with market power and high prices associated with scarcity.

### 3. **The Automated Mitigation Procedures Have Not Deterred The Entry of New Generation**

PSEG Companies (PSEG) suggest that an AMP will remove the "remaining incentives for the construction of new generation."[15] In support, PSEG points to the NYISO, "where energy prices have resulted in numerous generation projects being cancelled or delayed notwithstanding credible predictions of an impending supply storage."[16]

PSEG's arguments are faulty. The real reasons for the cancellation of generation projects in New York are because there is currently excess supply upstate and because of the extreme financial straits facing market participants throughout the entire country. This financial situation was brought about by a number of

[14] See, New York Independent System Operator, Inc.'s Filing of Services Tariff Revisions to Extend and/or Amend the NYCA Demand Response Programs And Request For Waiver of Notice Period to Prevent a Lapse of The Emergency Demand Response Program, Docket No. ER03-303-000 (December 20, 2002).

[15] PSEG Comments at 41 (November 15, 2002).

[16] Id.

factors having nothing to do with the FERC-approved NYISO mitigation measures.

### 4. The Automated Mitigation Procedures Use Reference Levels That Reflect Current Market Conditions

As the Electric Power Supply Association, et al. (EPSA) correctly notes, the AMP is tied to unit-specific reference levels. However, it is incorrect, as EPSA suggests, that these levels do not reflect current market conditions.[17]

Reference levels are typically based on historical data, such as the average of a generator's accepted bids over the previous 90 days. They are not prone to changes in market conditions. The competitive bids of generators are based on marginal costs, which, other than fuel costs, do not tend to change as a function of market conditions. As for the fuel cost component, the NYISO continuously updates the fuel price input to reflect current prices. The other components related to costs, such as heat rate and variable operation and maintenance expenses, are quite stable and do not vary with changes to market conditions.[18]

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[17] EPSA Comments at 62 (November 15, 2002).

[18] As we noted in our November 15, 2002 SMD Comments, reference levels for fossil-fueled units do not need to track opportunity costs given that "current trading of power between markets generally yields prices that reflect the marginal costs in adjacent markets." In contrast, permitting the use of a temporal opportunity cost component is appropriate for hydro facilities "because it enables generators to submit off-peak bids that are relatively high to reflect the opportunity of saving the water for use during peak periods." NYPSC Comments at 19, fn 27 (November 15, 2002).

## II. **Resource Adequacy** (SMD § IV.J)

The NYPSC filed extensive comments regarding resource adequacy issues on January 31, 2003. In our comments, we explained why the resource adequacy component of the SMD NOPR would not induce new generation, but would instead encourage the exercise of market power and impair retail access. As an alternative, we argued for regional flexibility and urged FERC to approve a Resource Demand Curve approach for New York. We disagree with parties' arguments that could negatively affect the New York Control Area (NYCA).

### A. **Large Penalties On Loads To Encourage Them To Purchase Capacity Without Any Requirement That Suppliers Sell Capacity Could Induce Market Power**

In commenting on the SMD NOPR's proposed penalty structure, the New York Independent System Operator, Inc. (NYISO) stated in its January 10, 2003 comments, that it has found that penalties greater than the levelized costs of a combustion turbine provide a strong deterrent to LSEs that might otherwise avoid acquiring their capacity requirements.[19] We urge FERC to reject this argument because the potential for the exercise of market power would be created by severe penalties of this kind.

A severe penalty that is assessed on the buyers in the capacity market is effective in producing a strong desire by LSEs to buy capacity. However, because both sellers and buyers must agree to a capacity contract, sellers must be similarly willing and

[19] NYISO's Comments at 18 (January 10, 2003).

interested in selling capacity. Under the proposal in the NOPR, the penalty is a one-way inducement, i.e., a requirement is placed solely on buyers but not on sellers. Consequently, in an environment in which the overall market's demand for capacity is extremely tight, the potential exists for a seller to withhold capacity.

A seller that withholds some of its supply, either via physical or economic withholding, and thereby creates a contrived deficiency, can find it profitable to do so if the contrived deficiency causes a substantial price increase in the capacity market. The presence of severe penalties creates exactly the environment that will create large price increases in reaction to the presence of a contrived deficiency. Thus, the exercise of market power is much more likely and when it does occur, much more costly per event.

Currently, the NYISO does not have any market power mitigation measures in place for the capacity market. So long as no such mitigation measures exist, FERC should be extremely cautious in supporting policies that invite the exercise of market power. Instead, a policy of more moderate penalties should be pursued for LSEs that fail to meet their capacity purchase requirements until such time as either greater comfort exists that market power cannot be exercised or workable mitigation measures are in place.

The NYPSC addressed this market power problem in our January 31, 2003 comments regarding the proposed Resource Demand Curve.[20] A central feature of the proposal, which generators in New York support, is a gradually sloped demand curve in place of a severe deficiency penalty. By valuing generating capacity in excess of the minimum reserve requirements, this feature introduces a price elasticity of demand into the market since it enables the system as a whole to acquire a little more or a little less capacity in response to the market price. In our comments, we established how the Resource Demand Curve mitigates market power in the capacity market by eliminating the link between the withholding of capacity and severe price rises, thereby removing the financial motivation for withholding of capacity.[21]

### B. The States And Not The North American Electric Reliability Council Have Exclusive Jurisdiction To Establish Minimum Reserve Margins

We take issue with NERC's proposal that it, and not the states or FERC, should develop minimum standards for determining resource adequacy.[22] In seeking to expand its historic role of addressing electric system operation issues and reporting the status of planning activities, NERC incorrectly fails to address the states'

[20] See, NYPSC Comments, Appendix A at 22-24 (January 31, 2003).

[21] Id.

[22] NERC Comments at 32-33 (November 15, 2002).

exclusive jurisdiction to set minimum reserve margins.[23]

Further, it would be inefficient for NERC to establish national standards when, as it admits, there must be flexibility to address local conditions within each ITP area. It is far more efficient for state-level planners, in the first instance, to develop minimum reserve margins for their particular control areas. The states have consistently fulfilled their reliability obligations in the past and there is no reason to expect them not to do so in the future.

### C. **Properly Designed Market Incentives Are Superior To Deliverability Requirements For Addressing Generation Pockets**

The Long Island Power Authority (LIPA) asserts that the final SMD rule must include a "deliverability" requirement to prevent the creation of (1) new generation pockets that would have the effect of reducing, rather than increasing, the availability of energy to the regional market and (2) transmission constraints that would increase the reserve requirement within the Locality[24] in which the generation pocket is located.[25] LIPA proposes that the output of a new generation resource wishing to satisfy a resource adequacy

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[23] See, NYPSC Comments at 15-20 (January 31, 2003).

[24] Localities are areas that are transmission-constrained from the rest of the NYCA and must have a certain minimum amount of installed capacity within their borders. In the NYCA, New York City and Long Island are considered Localities.

[25] LIPA Comments at 2-3, 10-11 (January 29, 2003).

requirement within a Locality be fully deliverable to loads within that Locality.[26]

Further, LIPA argues that the requirement "should prevent the construction of generation with capacity qualifying for resource adequacy in an area that 'shuts in' the output of electrically neighboring generation because the new generation creates a bottleneck on the existing transmission system."[27] In other words, new capacity should not be permitted to hamper the ability of existing capacity within a Locality to satisfy that Locality's resource adequacy requirement. The NYPSC disagrees. Market-based incentives applicable to all market participants rather than deliverability requirements applicable to new generation only is the preferable approach. Imposing a deliverability requirement only on new generation, as LIPA suggests, would make it more difficult to site new generation in New York.

In a recent generator licensing proceeding, the New York State Board on Electric Generation Siting and the Environment rejected the arguments of LIPA that were similar to those made here. The Siting Board stated:

> [I]t would be counter-productive to handicap developers of generating facilities by considering the costs of new transmission systems in deciding whether to grant them Certificates. The fact that LIPA or other generation owners may need to

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[26] Id. at 2.

[27] Id. at 3.

> undertake measures to increase their competitiveness is a function of the marketplace that is expected to provide lower-cost and less-polluting electricity to consumers on Long Island.[28]

Proper market-based incentives would allow new and existing generators to compete on an equal footing for the ability to serve the energy and capacity needs of a Locality. Developers considering the construction of new capacity in areas that are potential generation pockets would compete with existing generators to sell energy, ancillary services, and a resource adequacy product such as unforced capacity. Under an incentive-based approach, developers would receive proper economic signals on which to base their siting decisions. If rules are properly established, then the most efficient resources would reliably serve those needs while excess and/or less efficient resources may retire.

Finally, the New York Reliability Council's Installed Capacity Subcommittee (ICS) has discussed how to address generation pockets and we expect those discussions to continue. In the ICS discussions, approaches other than a deliverability requirement have been advanced and some of these may be superior to LIPA's proposal. Limiting the amount of generation pocket capacity that can be counted toward an LSE's unforced capacity requirement

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[28] Case 00-F-0566, Application of Brookhaven Energy Limited Partnership for a Certificate of Environmental Compatibility and Public Need to Construct and Operate a 580 Megawatt Electric Generating Facility in the Town of Brookhaven, Suffolk County, Opinion and Order Granting Certificate of Environmental Compatibility and Public Need (issued August 14, 2002), at 65.

through the existing capacity auction process is just one promising resolution. Accordingly, like many other aspects of resource adequacy, this issue should not be decided through the SMD process, but should be left to regional solutions.

## III. Jurisdiction Over Distribution (IV.E)

After unsuccessfully challenging a retail rate design of the NYPSC[29] in state court, the County of Westchester, New York (COW), and the County of Westchester Public Utilities Service Agency (COWPUSA) ask the Commission to preempt the same decision.[30] The NYPSC's decision, which establishes a Monthly Adjustment Clause (MAC) to equalize full service rates for retail customers of Consolidated Edison Company of New York, Inc. (Con Edison), neither "socializes" transmission congestion costs nor interferes with federal jurisdiction over unbundled transmission rates. It simply offsets different commodity costs in Westchester County and New York City by different retail distribution rates.[31]

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[29] County of Westchester v. Helmer, 296 A.D.2d 68 (3rd Dept. 2002), leave denied, ___N.Y.2d___, 2002 N.Y. Lexis 3484 (2002).

[30] County of Westchester, et.al., Comments at 2-4 (November 15, 2002).

[31] The NYPSC is currently revisiting the issue.

COW and COWPUSA's position not only treats the Commission as an appellate court to New York's courts,[32] but also ignores the fact that the NYPSC has jurisdiction over retail energy and distribution rates.[33] COW and COWPUSA claim that the Commission should exercise its supposed jurisdiction over bundled retail transmission to preempt the NYPSC's MAC mechanism, but the Commission does not have jurisdiction over distribution charges or the MAC charge, which gives rise to the equalization.[34] The MAC is a charge for distribution service and falls within the power reserved to the states under FPA § 201(a)&(b)(1), 16 U.S.C. § 824(a)&(b)(1).

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[32] COW and COWPUSA's arguments about alleged conflicts between the NYPSC decision and Locational Marginal Pricing are very similar to the arguments they made in the state court proceeding. The state court's decision should be given res judicata and collateral estoppel effect. Kramer v. Chemical Construction Corp., 456 U.S. 461 (1982). Moreover, the 11th Amendment to the United States Constitution does not permit a federal commission to adjudicate a complaint against a state administrative agency. Federal Maritime Comm'n v. South Carolina State Ports Authority, 535 U.S. 743, 122 S. Ct. 1864 (2002).

[33] New York v. Federal Energy Regulatory Comm'n, 535 U.S. 1,_, 122 S. Ct. 1012, 1026 (2002); Federal Power Comm'n v. Southern California Edison Co., 376 U.S. 205, 215-16 (1964).

[34] See, New York v. FERC, 535 U.S. at ___, 122 S. Ct. at 1025-26; Connecticut Light & Power Co. v. Federal Power Comm'n, 324 U.S. 515 (1945).

## CONCLUSION

We support the Commission's SMD initiative and for all the reasons herein we urge the Commission to adopt the NYPSC's recommendations.

Respectfully submitted,

Dawn K. Jablonski
General Counsel

By: David G. Drexler
Assistant Counsel

Saul A. Rigberg
Assistant Counsel

Jonathan Feinberg
Assistant Counsel

Public Service Commission
Of the State of New York
3 Empire State Plaza
Albany, New York 12223-1350
(518)473-8178

Dated: February 28, 2003
Albany, New York

CERTIFICATE OF SERVICE

I, Karen Houle, do hereby certify that I will serve on February 28, 2003, the foregoing Reply Comments of the Public Service Commission of the State of New York by depositing a copy thereof, first class postage prepaid, in the United States mail, properly addressed to each of the parties of record, indicated on the official service list compiled by the Secretary in this proceeding.

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Karen Houle

Date: February 28, 2003
Albany, New York