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April 7, 2008

SENT VIA ELECTRONIC FILING

Honorable Kimberly D. Bose, Secretary

Federal Energy Regulatory Commission

888 First Street, N.E.

Room 1-A209

Washington, D.C. 20426

Re: Docket No. EL07-39-000 - New York Independent
System Operator, Inc.

Dear Secretary Bose:

For filing, please find the Request for Rehearing 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

Attachments

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

New York Independent System) Docket No. EL07-39-000
Operator, Inc.)

REQUEST FOR REHEARING
OF THE PUBLIC SERVICE COMMISSION
OF THE STATE OF NEW YORK

Pursuant to Rule 713 of the Federal Energy Regulatory Commission's (FERC or Federal Commission) Rules of Practice and Procedure, the New York State Public Service Commission (NYPSC) hereby submits its Request for Rehearing of FERC's Order Conditionally Approving Proposal, issued March 7, 2008 (March 7 Order).

EXECUTIVE SUMMARY

The NYPSC seeks rehearing of the determination in the March 7 Order to prohibit the self-supply of new Installed Capacity (ICAP) resources by Load-Serving Entities (LSEs) unless the mandatory minimum bids associated with such resources clear the market. While the Federal Commission adopted the minimum bid requirement out of a concern that uneconomic entry could artificially depress capacity prices, the requirement unnecessarily interferes with the State's authority to set and

enforce standards for resource adequacy.¹ To avoid a jurisdictional conflict, the Federal Commission should harmonize its concern with the NYPSC's legitimate interest in ensuring that new resources, including self-supplied resources, which are deemed appropriate from a public policy perspective, will contribute to resource adequacy requirements. Specifically, the Federal Commission should direct the New York Independent System Operator, Inc. (NYISO) to establish provisions whereby new ICAP resources may be self-supplied by LSEs, but any such resources that are deemed uneconomic would not be allowed to depress ICAP prices. This approach was employed in ISO-New England, Inc. (ISO-NE) and in PJM Interconnection, L.L.C. (PJM), and should be utilized for the NYC ICAP market.

The Federal Power Act (FPA) preserves state jurisdiction to "set and enforce compliance with standards for [the] adequacy...of electric facilities."² In New York State, one of the primary standards for determining the adequacy of electric facilities is referred to as the Installed Reserve

¹ See, New York State Public Service Law §65 (providing the NYPSC with jurisdiction to ensure "such service, instrumentalities and facilities as shall be safe and adequate and in all respects just and reasonable").

² 16 U.S.C. §824o(i)(2).

Margin (IRM), which measures the level of electric resources sufficient to ensure safe, adequate, and reliable service.³

To enforce compliance with the IRM, the NYPSC requires all LSEs in New York State to demonstrate that sufficient levels of electric resources are committed to meet the statewide IRM, as well as any local resource adequacy requirements.⁴ Resources that are committed to meet the IRM are referred to as ICAP.⁵

LSEs may satisfy their IRM obligations by committing ICAP resources they own or have obtained through a bilateral contract, a practice commonly referred to as self-supplying ICAP. Current ICAP market rules, however, only allow LSEs to count this self-supply in meeting their IRM obligations when

³ The NYPSC approved the current IRM for the New York Control Area of 15.0% of forecasted peak load. See, Case 07-E-0088, et al., Installed Reserve Margin, Order Adopting an Installed Reserve Margin for the New York Control Area For The 2008-2009 Capability Year (issued February 29, 2008). The NYPSC has also adopted standards for the adequate level of renewable electric facilities in New York State. Case 03-E-0188, Proceeding on Motion of the Commission Regarding a Retail Renewable Portfolio Standard, Order Regarding Retail Renewable Portfolio Standard (issued September 24, 2004).

⁴ See, Case 05-E-1180, New York State Reliability Council - Reliability Rules, Order Adopting Third Modification to New York State Reliability Rules (issued December 24, 2007), Appendix A, p. 14, Reliability Rule A-R2 (adopting LSE ICAP requirements).

⁵ ICAP resources are required to bid their energy product into the Day-Ahead Energy Market that is administered by the New York Independent System Operator, Inc. (NYISO), and receive payments for their energy product if their bids are selected by the NYISO.

their ICAP resources "clear" the market. LSEs ensure their self-supplied ICAP resources will clear the market by bidding those resources into the market at zero.

The March 7 Order explicitly recognizes that the NYPSC's authority to ensure resource adequacy includes determining "whether or what types of generation facilities should be built" to achieve the IRM.⁶ The March 7 Order, however, may frustrate this explicit reservation of State authority by establishing rules that prevent new facilities selected by the NYPSC for reliability or other legitimate public policy purposes (e.g., environmental compatibility, fuel/resource diversity) from being counted toward the IRM in certain cases.

Prior to the changes introduced by the March 7 Order, LSEs were assured that they could self-supply ICAP resources if they bid them into the ICAP market at zero. This rule ensured that the ICAP cleared the market and was credited toward the IRM on behalf of the LSE that owned or had already paid for it. However, by establishing a mandatory minimum bid requirement for new resources, the March 7 Order created a situation where an LSE could build or enter into a contract for certain facilities

⁶ March 7 Order at ¶¶ 111-12 (distinguishing the NYPSC's interests from the Federal Commission's interest in the pricing methodology).

necessary to achieve the State's resource adequacy standards, yet the ICAP associated with the facility could not be self-supplied and counted toward the IRM because it might not clear the market. When this occurs, a source of ICAP identified as appropriate to achieve the State's resource adequacy standards is excluded from meeting the IRM, and the NYPSC's authority to determine the types of resources necessary to achieve the IRM is preempted. Moreover, in these circumstances, LSEs and ultimately ratepayers, could be forced to pay unjust and unreasonable prices because they would be paying twice to meet resource adequacy requirements: once for any State-selected facilities that do not clear the auction due to the imposition of the mandatory minimum bid requirement and again for ICAP that clears the auction.

The NYPSC also seeks rehearing of the Federal Commission's determination to eliminate the revenue caps applicable to pivotal suppliers. These caps, set at \$105/kW-year, have functioned for several years as a significant deterrent to the exercise of market power by pivotal suppliers through physical withholding of ICAP (e.g., retirement, mothballing, or de-rating of generation units), and helped ensure ICAP prices remained just and reasonable.

By eliminating the revenue caps, the only measures to ensure prices remain at just and reasonable levels will be newly

structured bid caps imposed on pivotal suppliers and market forces. While these measures should address problems associated with economic withholding by pivotal suppliers, they do not address existing conditions that render the relevant markets uncompetitive, and the prices that may result due to physical withholding. In such a situation, where competitive market forces are not sufficient to ensure that actual prices are just and reasonable, the Federal Commission would fail to meet its statutory mandate to ensure just and reasonable prices.⁷

In this case, there is no record to demonstrate that the market for ICAP in NYC is sufficiently competitive to preclude the exercise of market power via physical withholding, or that the market can be relied upon to keep prices at just and reasonable levels.⁸ As the Commission has already acknowledged in the March 7 Order, "suppliers may attempt to physically withhold in order to affect market prices."⁹ Therefore, there is no basis for the Commission's decision to remove the revenue

⁷ See, Farmer Union Cent. Exchange, Inc. v. FERC, 734 F.2d 1486, 1510 (D.C. Cir. 1984) (supporting the proposition that FERC can not meet its statutory mandate without empirical proof that "existing competition would ensure that the actual price is just and reasonable").

⁸ Id. at 1501; see also, Elizabethtown Gas Co. v. FERC, 10 F.3d 866, 870-871 (upholding market based rates established on a determination that the market was "sufficiently competitive to preclude...exercising significant market power").

⁹ March 7 Order at ¶50.

caps for pivotal suppliers, since the Commission's determination was based on the erroneous finding that pivotal suppliers cannot "affect the market price."¹⁰ Accordingly, the Commission should reinstate the revenue caps for pivotal suppliers to ensure prices are just and reasonable.

STATEMENT OF ISSUES

- 1) Whether the Federal Commission impermissibly exerted jurisdiction over resource adequacy matters reserved to the NYPSC under the Federal Power Act §824o(i)(2), by preventing new ICAP resources from being counted towards the State's resource adequacy requirement under certain conditions.
- 2) Whether the Federal Commission failed to set just and reasonable rates in accordance with applicable case law,¹¹ by eliminating tariff provisions (revenue caps) that address uncompetitive market conditions that allow the exercise of market power through physical withholding.

DISCUSSION

I. The Federal Commission Impermissibly Exerted Jurisdiction Over Resource Adequacy Matters Reserved To The NYPSC By Preventing New ICAP Resources From Being Counted Towards The State's Resource Adequacy Requirement Under Certain Conditions

The March 7 Order accepted the NYISO's proposal to mitigate net buyers (i.e., Consolidated Edison Company of New York, Inc. and the New York Power Authority) "in order to prevent uneconomic entry that would reduce prices in the NYC

¹⁰ March 7 Order at ¶49.

¹¹ See, Farmers Union Cent. Exchange, Inc. v. FERC, 734 F.2d 1486, 1510 (D.C. Cir. 1984); see also, Elizabethtown Gas Co. v. FERC, 10 F.3d 866, 870-871 (D.C. Cir. 1993). This precedent is discussed in detail below.

capacity market below just and reasonable levels."¹² To ensure ICAP prices are not "depressed," the Federal Commission applied a mandatory minimum bid requirement to new ICAP resources being bid into the ICAP market by net buyers. The NYPSC opposed this new mitigation measure because it prevents new resources, which are preferable from a public policy perspective (e.g., increased fuel diversity or improved environmental characteristics), from being counted towards meeting New York's resource adequacy requirements (i.e., the IRM) when such resources do not clear the ICAP market because the clearing price is below the minimum bid requirement.¹³

In the March 7 Order, the Federal Commission rejected the NYPSC's concern that the new mitigation would conflict with New York's resource adequacy requirements and goals. The Federal Commission attempts to distinguish its decision from the NYPSC's interest in resource adequacy, by stating that "[t]he issue before [FERC] in this proceeding is not how to meet the resource adequacy requirements of New York State, but how prices for capacity in the wholesale markets should be determined in

¹² March 7 Order at ¶100. Although the term "net buyer" is not specifically defined in the March 7 Order, we interpret it to refer to LSEs that have ICAP obligations greater than the amount of ICAP resources they self-supply.

¹³ See NYPSC Protest, filed November 19, 2007.

order to remedy identified flaws in the ICAP market."¹⁴ The Federal Commission, however, failed to recognize that the pricing regime it adopted has a direct and adverse impact on the way in which New York's resource adequacy requirements are met.

Prior to the March 7 Order, LSEs were assured that their capacity resources would be counted toward the IRM by bidding in their capacity resources at zero so that the capacity "cleared" the ICAP market.¹⁵ Thus, this provision has a direct impact on which resources can be recognized in achieving and enforcing compliance with the IRM. By eliminating the ability of LSEs to ensure that the ICAP they own, or have purchased through a bilateral transaction, can count toward the IRM (i.e., self-supply), the Federal Commission has, by definition, intruded upon the ability of the NYPSC to determine how to meet the resource adequacy requirements.

Furthermore, the March 7 Order would create a situation where LSEs could be forced to pay twice to meet resource adequacy requirements: once for any State-selected facilities that do not clear the auction due to the imposition of the mandatory minimum bid requirement and again for the ICAP

¹⁴ March 7 Order at ¶111.

¹⁵ Self-supplied ICAP can be counted toward the IRM only if it clears the ICAP market.

that clears the auction. Such an outcome is unjust and unreasonable.

To address the concerns of both the Federal Commission (i.e., preventing the depression of prices through uneconomic entry) and the NYPSC (i.e., determining the types of resources that are appropriate to meet the IRM), a compromise approach is necessary. In particular, we recommend that a new provision be adopted whereby LSEs may self-supply new ICAP resources, but will be unable to inappropriately lower ICAP prices, similar to measures adopted in ISO-NE or PJM.

As part of the Settlement Agreement approved by the Federal Commission for ISO-NE, rules were adopted for the ICAP market so that loads may "self-supply their own capacity," but may not do so for the "purpose of depressing capacity prices."¹⁶ A settlement was also adopted in PJM that addressed the "concern that net buyers might have an incentive to depress market clearing prices by offering some self-supply at less than a

¹⁶ ER03-563-030 et al., Devon Power LLC, Order Accepting Proposed Settlement Agreement (issued June 16, 2006) at ¶109. Where the ISO-NE Market Monitor determines that a bid is "out-of-market" (i.e., uneconomic), the capacity clearing price may be reset under certain market conditions, including: "1) new capacity is needed, either system-wide or in an import constrained zone; 2) there is adequate supply in the auction; and 3) at the auction clearing price, purchases from out-of-market capacity are greater than the required new entry." Id.

competitive level.”¹⁷ When ICAP is self-supplied, but is deemed “out-of-market” or uneconomic based on market conditions, the rules in ISO-NE and PJM ensure that the ICAP clears the market, although it is subject to mitigation that is reflected in the market clearing price. This eliminates the incentive for LSEs to depress prices, while allowing them to self-supply.

The settlements approved in ISO-NE and PJM clearly recognized the need to allow LSEs to self-supply their capacity, while simultaneously addressing concerns that doing so may depress market clearing prices. There is no reason preventing implementation of similar provisions for the NYC ICAP market to ensure that LSEs may count their capacity toward the IRM requirement. Provisions should also be adopted to exempt certain types of new ICAP resources from mitigation, as was done in PJM, including, but not limited to, resources that are

¹⁷ ER05-1410-001 et al., PJM Interconnection, L.L.C., Order Denying Rehearing and Approving Settlement Subject To Conditions (issued December 22, 2006) at ¶103. The applicable mitigation measures were contained in Section II.J.5 of the Settlement Agreement that was filed on September 29, 2006.

developed in response to a state mandate to resolve a projected capacity shortfall.¹⁸

As the Federal Commission recognized in the March 7 Order, the "logic" for adopting "similar provisions to prevent uneconomic entry by net buyers in...both PJM and ISO-New England," "is no different for the NYC market."¹⁹ Therefore, the Federal Commission should apply the same logic to ensure net buyers in NYC may self-supply their capacity. Adopting mechanisms similar to ISO-NE or PJM for the NYC ICAP market would address the concerns of both the FERC and the NYPSC.

II. The Commission Failed To Ensure ICAP Prices Will Be Just And Reasonable By Eliminating Tariff Provisions (Revenue Caps) That Address Uncompetitive Market Conditions That Allow The Exercise Of Market Power Through Physical Withholding

The March 7 Order plainly acknowledged the ability of pivotal suppliers to exercise market power by physically withholding ICAP from the market through strategies like retiring, mothballing, or de-rating units (e.g., by reducing

¹⁸ See, ER05-1410-000, Settlement Agreement and Explanatory Statement, at p. 26-27, filed September 29, 2006. Although an exemption was established in the March 7 Order for Special Case Resources, which the FERC identified as "a valuable tool for the maintenance of reliability [that] fulfills this role in an environmentally benign way," the Commission should recognize that there are other types of resources that are equally valuable from a public policy perspective that also warrant an exemption from mitigation. March 7 Order at ¶120.

¹⁹ March 7 Order at ¶104.

maintenance) "in order to affect market prices."²⁰ However, the March 7 Order appears to contradict this finding by eliminating the revenue caps that mitigated the ability of pivotal suppliers to exert market power, based on a determination that the "NYISO's proposal removes the ability of [pivotal] suppliers to affect the market clearing price."²¹ According to the March 7 Order, "[t]here is no reason to deny [pivotal] suppliers the market clearing price when the ability of those suppliers to affect the market price has been eliminated."²²

The revenue cap historically set at \$105/kW-year mitigated the ability of pivotal suppliers to physically withhold ICAP. While DGOs could still attempt to physically withhold ICAP to drive prices up to the \$105/kW-year revenue cap, the cap discouraged pivotal suppliers from withholding significant amounts of ICAP to drive prices above \$105/kW-year, since they could not profit on such withholding. However, by eliminating the revenue cap, the March 7 Order creates a significant incentive for pivotal suppliers to exercise market power by physically withhold ICAP, and in fact rewards such behavior, because the revenues they will receive on the

²⁰ March 7 Order at ¶¶50-51 (recognizing "the possibility that suppliers may attempt to physically withhold in order to affect market prices").

²¹ March 7 Order at ¶49.

remaining ICAP sold in the market at higher prices will be greater than the ICAP, energy, and ancillary services revenues those suppliers will forgo on the units physically withheld.²³

Contrary to the Federal Commission's finding, elimination of the revenue caps will have a devastating impact on market clearing prices. As we indicated in our November 19, 2007 Protest in this proceeding, the physical withholding of 100 MW of ICAP would increase a pivotal supplier's profits by approximately \$7 million per year.²⁴ In total, we estimated that consumers could pay over \$200 million per year in additional costs.²⁵ As Dr. Paynter explained in his affidavit,

the DGOs' market power cannot be limited simply by mitigating auction bids as proposed by the NYISO. The DGOs are very large suppliers in a very constrained market where few sites are readily available to new entrants. The DGOs are therefore in a strong position to limit or reduce supply. If a reduction in supply leads to a larger (percentage) increase in the market price, they will have an incentive to exercise that market power, whether via economic or physical withholding. Fortunately, the current revenue cap on divested generation provides strong (although not complete) mitigation against DGO market power, including physical market power, by preventing divested generating units (DGUs) from profiting from price increases above the DGO revenue cap of \$105 per kW-year.²⁶

²² Id.

²³ See, NYPSC Protest, filed November 19, 2007, Paynter Aff. at ¶6.

²⁴ Id. at ¶6.

²⁵ Id. at ¶14.

²⁶ Id. at ¶¶9-10.

Therefore, it is critical that the Commission reinstate the \$105 revenue caps on pivotal suppliers in order to avoid creating additional incentives for physical withholding and to ensure prices are just and reasonable.

If the revenue caps are eliminated, the remaining market mitigation measures will not be sufficient to ensure prices remain at just and reasonable levels. Bid caps and market forces alone will not yield competitive price outcomes where pivotal suppliers retain the ability to exercise market power by engaging in physical withholding. As such, the Federal Commission cannot meet its statutory mandate to ensure just and reasonable prices.

In Farmers Union Cent. Exchange, Inc. v. FERC, the D.C. Circuit Court of Appeals struck down the Federal Commission's attempt to rely on market forces to satisfy the just and reasonable standard where it "failed to demonstrate that market forces could be relied upon to keep prices at reasonable levels."²⁷ As the Court indicated, "[r]ates that permit exploitation, abuse, over-reaching or gouging are by

²⁷ 734 F.2d 1486, 1510 (D.C. Cir. 1984); see also, Federal Power Comm'n v. Texaco Inc., 417 U.S. 380 (1974) (holding that the Federal Power Commission had violated its statutory duty to set "just and reasonable rates" when it relied exclusively on the free market as a final measure of reasonable prices).

themselves not 'just and reasonable.'"²⁸ In contrast, a decision to rely on market-based rates can be upheld by the Courts where a market is "sufficiently competitive to preclude [suppliers] from exercising significant market power".²⁹

In this case, the Federal Commission has not demonstrated that the market for ICAP in NYC is sufficiently competitive to preclude the exercise of market power via physical withholding, or that the market can be relied upon to keep prices at just and reasonable levels. To the contrary, the Commission specifically recognized that "suppliers may attempt to physically withhold in order to affect market prices."³⁰ Thus, there is no basis for the Commission's decision to remove the revenue caps for pivotal suppliers, since prices will otherwise be subject to the type of market power, exploitation, abuse, over-reaching or gouging that is per se unjust and unreasonable.

Although the Commission directed the NYISO to address the issue of physical withholding in a compliance filing, this leaves the NYISO's tariff devoid of any measures to address uncompetitive market behavior (i.e., physical withholding) and

²⁸ Id. at 1502.

²⁹ Elizabethtown Gas Co. v. FERC, 10 F.3d 866, 870-871 (D.C. Cir. 1993).

³⁰ March 7 Order at ¶50.

the resulting prices will be unjust and unreasonable.

Therefore, the Commission should reinstate the revenue caps for pivotal suppliers to ensure prices are just and reasonable.

CONCLUSION

In accordance with the above discussion, the Commission should grant the NYPSC's Request for Rehearing, and grant the relief requested herein.

Respectfully submitted,



Peter McGowan
Acting General Counsel
Public Service Commission
of the State of New York

By: David G. Drexler
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(518) 473-8178

Dated: April 7, 2008
Albany, New York

CERTIFICATE OF SERVICE

I, Ruth Tarrance, do hereby certify that I will serve on April 7, 2008, the foregoing Request for Rehearing of the Public Service Commission of the State of New York upon each of the parties of record indicated on the official service list compiled by the Secretary in this proceeding.


Ruth Tarrance

Dated: April 7, 2008
Albany, New York