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November 19, 2007

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 Protest 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,

A handwritten signature in cursive script, appearing to read 'David G. Drexler'.

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.)

**PROTEST OF THE PUBLIC SERVICE COMMISSION
OF THE STATE OF NEW YORK**

Pursuant the Federal Energy Regulatory Commission's (FERC or Commission) Rules of Practice and Procedure (Rule 211) and "Order Establishing Paper Hearing and Referring Certain Matters For Investigation," the New York State Public Service Commission (NYPSC) hereby submits its Protest in opposition to the New York Independent System Operator, Inc.'s (NYISO) October 4, 2007 filing (October 4 Filing).¹

INTRODUCTION AND EXECUTIVE SUMMARY

This proceeding was initiated because the exercise of market power in New York City (NYC) adversely affects the sale of Installed Capacity (ICAP), a product created to ensure compliance with New York's standard for resource adequacy. Various generation owners in NYC (i.e., pivotal suppliers)

¹ Docket No. EL07-39, New York Independent System Operator, Inc., Order Establishing Paper Hearing and Referring Certain Matters For Investigation (issued July 6, 2007) (providing for a 45 day comment period).

possess market power in that they can raise market prices to their benefit by withholding some of their ICAP from the market. As a result of economic withholding, consumers have been paying unjust and unreasonable prices for ICAP, which are in excess of what a competitive market would otherwise yield. Estimates indicate that since the 2006 summer capability period, consumers have paid as much as \$267 million in additional costs attributable to economic withholding. Approximately \$110 million of this amount was incurred after the Commission's refund effective date of May 12, 2007.

Market power can be exercised through economic withholding because the NYISO's existing market mitigation measures are inadequate. To address this deficiency, lower bid caps of \$82/kW-year were initially proposed for pivotal suppliers on December 22, 2006. While those caps would have resulted in market clearing prices nearer to a competitive outcome than those produced by the current \$105/kW-year bid cap, the Commission rejected the proposed cap, finding it lacked sufficient justification.

Looking to formulate a comprehensive solution to the problems facing the NYC ICAP market, the Commission directed the NYISO to file a proposal that "will provide a level of compensation that will attract and retain needed generating

capacity..., while not over compensating generators.”² The NYISO responded to the Commission’s directive in the October 4 Filing, and proposed to address the economic withholding of ICAP in NYC by introducing new metrics to evaluate the appropriateness of bids of pivotal suppliers, which effectively reduce the bid caps for pivotal suppliers. The positive aspects of that proposal, however, are thwarted by other aspects of the NYISO filing that are unreasonable and contrary to the public interest. These include: lifting the existing revenue caps applicable to pivotal suppliers that may exercise market power; setting a bid floor for new ICAP resources that will act as a barrier to new entry and unreasonably raise prices; and, failing to issue refunds for consumers that purchased ICAP at prices based on the exercise of market power.

As an initial matter, we note that the October 4 Filing was submitted as a “compliance filing,” and was therefore not vetted through the NYISO stakeholder process. Despite the lack of proper vetting by market participants, the NYISO takes the unprecedented step of unilaterally proposing extensive revisions to the NYC ICAP market. However, many of these

² Id. at ¶13.

revisions raise potentially significant consequences for the market that must be addressed by interested parties.³

The NYPSC agrees with the NYISO's proposal to effectively lower the bid caps for pivotal suppliers, which would, if it were the only change to the existing ICAP market, mitigate their ability to engage in withholding. The NYISO, however, would remove the revenue caps on pivotal suppliers. Since the NYC market is highly concentrated and those caps are necessary to mitigate against physical withholding of ICAP through the retirement, mothballing, or de-rating of generation units, their elimination would countermand the positive effects of the measures to prevent economic withholding. In addition, removal of the revenue caps would create significant new market power problems in NYC, and would compel consumers to pay potentially hundreds of millions of dollars in additional ICAP costs, without receiving any further benefits. This outcome contradicts the Commission's directive to ensure that generators are not over-compensated.⁴

³ See, Paynter Aff. at ¶34.

⁴ Although the Commission seeks to determine an appropriate level of compensation for ICAP, it should be recognized that there is no statutory entitlement to ICAP payments. See, Sithe New England Holdings v. FERC, 308 F.3d 71, 77 (1st Cir. 2002) (indicating that ICAP payments "are simply not part of the compensation to sellers required by the [Federal Power Act]").

The NYPSC also opposes the NYISO's proposal to address the illusory problem of "uneconomic entry" by imposing a bid floor on new entrants. This proposal would deter new entry by preventing such resources from receiving ICAP payments in some situations. Moreover, the proposal would interfere with New York's ability to achieve legitimate public policy goals. New York would in effect be prevented from promoting the construction of certain types of new capacity resources that increase fuel diversity or improve the environment, since these resources, which may have somewhat higher costs than existing units, could not be counted toward meeting New York's resource adequacy needs. The proposal ensures that existing units would receive ICAP payments, even if those units are dirtier and less efficient. This outcome is contrary to the public interest.

Finally, we disagree with the NYISO's contention that consumer refunds are not appropriate. The evidence clearly demonstrates that consumers have paid prices that are the result of anticompetitive behavior, and are therefore unjust and unreasonable. Because consumers were harmed and suppliers should not be allowed to profit from such behavior, we suggest a reasonable method for calculating consumer refunds, which would recover the amounts generators were over-compensated.

The NYPSC has a unique interest in this proceeding because the matters raised here have a significant impact on

generation resource adequacy, a matter traditionally reserved to the States. Given the overlap in State and Federal jurisdictional responsibilities, we respectfully request that the Commission recognize the NYPSC's authority over resource adequacy standards, including the enforcement of such standards,⁵ and accept the modifications to the October 4 Filing identified herein. These changes would not adversely impact matters within FERC's jurisdiction, such as establishing just and reasonable wholesale energy rates.⁶ This approach will ensure that each entity may perform its statutory responsibilities, without potentially overstepping its jurisdictional boundaries.⁷

⁵ The Federal Power Act reserves jurisdiction to the States to "set and enforce compliance with standards for [the] adequacy...of electric facilities." 16 U.S.C. §824o(i)(2).

⁶ 16 U.S.C. §§824 and 824d. The Commission has previously reviewed matters regarding resource adequacy standards "for purposes of determining whether [they] would have any adverse effect on [its] jurisdictional matters." Docket No. ER00-1671, New York State Reliability Council, Order Accepting for Filing Revised Installed Capacity Requirement, 90 FERC ¶61,313 (issued March 29, 2000) (concluding that "the revision does not appear to have an adverse effect on matters within [FERC's] exclusive jurisdiction).

⁷ We note that the Commission previously recognized the role of the NYPSC in developing the ICAP "Demand Curve" to ensure it will "adequately and reliably serve customers' needs over the short and long term," and found that the NYPSC is "better placed to establish the appropriate ICAP quantity New York requires to serve those customers." Docket No. ER03-647, New York Independent System Operator, Inc., Order Conditionally Accepting for Filing Tariff Revisions (issued May 20, 2003).

BACKGROUND

To ensure the availability of adequate generation capacity reserves to meet New York State's (NYS) reliability needs,⁸ Load Serving Entities (LSEs) in NYS are required to demonstrate that they have procured sufficient amounts of installed generation capacity (i.e., ICAP) to meet NYS's IRM,⁹ and Locational Capacity Requirements (LCR), as applicable. LSEs currently meet the LCR by buying "ICAP," which is merely a commitment by a generator to bid energy it can produce into the Day-Ahead Energy Market, also administered by the NYISO. In exchange for committing to bid energy from this capacity into the energy market, generators are compensated as suppliers of ICAP.¹⁰ LSEs must demonstrate compliance with their ICAP requirements by either self-supplying (e.g., bidding into the

⁸ New York has implemented an Installed Reserve Margin (IRM) requirement that is designed to ensure that sufficient margins of reserve generation are installed, so that the probability of disconnecting firm load, due to resource deficiencies, will occur no more than once every ten years. The NYPSC approved the current IRM for the New York Control Area of 16.5% 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 (issued March 8, 2007).

⁹ The NYPSC's authority to approve and set the IRM is currently the subject of our Petition for Rehearing in Docket No. ER07-429, New York State Reliability Council, Order Granting Rehearing for Further Consideration (issued May 4, 2007).

¹⁰ Generators are compensated separately from the ICAP market for their energy product that may ultimately be produced if their bids are selected by the NYISO.

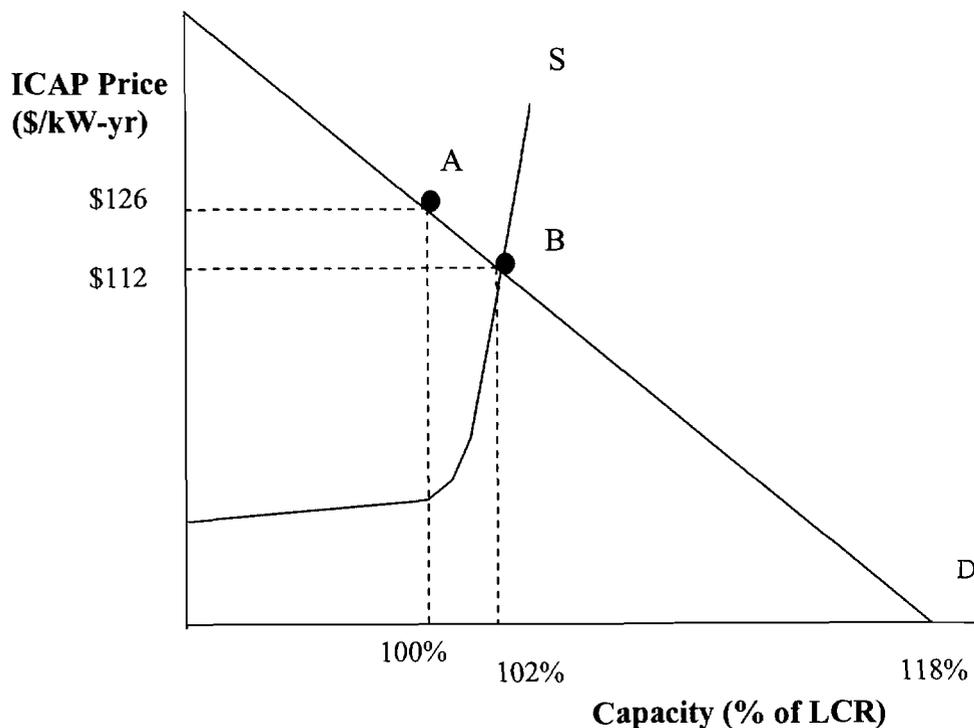
market LSE-owned generation or ICAP obtained through a bilateral contract), or by purchasing ICAP through the NYISO-administered auctions.

Through these auctions, conducted for periods up to six months in advance of the date ICAP is supplied, ICAP suppliers are aligned with LSE's needs. Participation in these auctions is generally voluntary, but the NYISO conducts a monthly spot auction in which LSEs are obligated to purchase any remaining ICAP they need at prices determined under the ICAP "Demand Curve."¹¹

The Demand Curve, which is set administratively (Figure 1: Line D), determines the quantity and price of ICAP commitments that LSEs are required to procure in the spot auction based on bids to supply ICAP (Figure 1: Line S).

¹¹ If sufficient amounts of ICAP cannot be procured in the spot market to meet the LCR, the NYISO attempts to procure additional resources to make up any deficiency, but at a price that is capped at the spot auction clearing price.

Figure 1: The “Sloped” ICAP Demand Curve



The point on the Demand Curve at which supply meets the LCR (Figure 1: Point A) (i.e., the reference point) corresponds to a price that is based on the cost of constructing a new generating peaking unit, net of expected energy and ancillary services revenues. As quantities of ICAP are procured above the reference point, the price gradually diminishes (Figure 1: Point B). On the other hand, the price gradually increases if the ICAP procured falls below the reference point. This design is intended to send a price signal that additional ICAP resources are needed when available ICAP falls below the LCR, while

signaling that additional resources are not needed when ICAP is available in excess of the LCR.

The supply of ICAP in NYC is dominated by three large generation owners, which own units that were sold in 1998 through the divestiture plan implemented by Consolidated Edison Company of New York, Inc. Each of these Divested Generation Owners (DGOs) is a "pivotal supplier" in the sense that supply from each is needed to meet the LCR and avoid the capacity deficiency that would occur in the absence of any of them.¹² As such, DGOs have the ability and incentive to artificially raise prices by exercising market power. To address this situation, the Commission applied mitigation measures to the Divested Generation Units (DGUs), prior to their purchase, which limited the ability of DGOs to exercise market power.¹³ These measures included, among other things, bid and revenue caps, a "must-offer" requirement, and a ban on entry into bilateral contracts.

Despite the imposition of these mitigation measures, and the subsequent establishment of the ICAP Demand Curves, which are designed, in part, to reduce incentives to withhold,

¹² The Divested Generation Owners are USPower Gen, NRG, and KeySpan.

¹³ Docket No. ER98-3169, Consolidated Edison Co. of New York, Inc., Order Accepting Market Power Mitigation Measures, as Modified, for Filing, 84 FERC ¶61,287 (issued September 22, 1998).

DGOs are still able to exercise market power. When the sloped Demand Curve was introduced, the Commission and market participants both expected ICAP prices to move in response to the amount of supply available.¹⁴ For instance, in 2006, when approximately 1,000 MW of new capacity entered service and was offered into the NYC ICAP market, the expectation was that capacity prices would decline, both in NYC and in the statewide market. This was due to the structure of the Demand Curve, which yields declining prices as more capacity is procured. The NYC ICAP spot market, however, continued to clear at the highest of the DGOs' bid/revenue caps,¹⁵ notwithstanding the additional capacity that had entered into service. The explanation for this outcome is that there was a significant increase in

¹⁴ Docket No. ER03-647, New York Independent System Operator, Inc., Order Conditionally Accepting for Filing Tariff Revisions, 103 FERC ¶61,201, at 61,754 (issued May 20, 2003).

¹⁵ All of the DGOs have bid/revenue caps based on a \$105/kW-year level (depending on Dependable Maximum Net Capability), which was approved by the Commission in 1998. *Consolidated Edison Co. of New York, Inc.*, 84 FERC ¶61,287, at 62,357-358 (September 22, 1998). The individual DGUs' caps are differentiated based on their expected summer and winter Unforced Capacity (UCAP) levels.

economic withholding in the NYC market, adversely affecting both the NYC and statewide capacity markets.¹⁶

In response to the NYC ICAP market dysfunction, the NYISO filed revisions to its Market Administration and Control Area Services Tariff on December 22, 2006, seeking to mitigate the on-going exercise of market power by reducing the DGUs' bid caps from \$105/kW-year to \$82/kW-year, with conduct and impact based tests.¹⁷ In an Order dated March 6, 2007, the Commission rejected the NYISO's proposed mitigation measure, finding there was insufficient "economic justification" and "cost support" for the revised bid cap.¹⁸ In that same order, the Commission instituted an investigation into the "justness and reasonableness of the New York ISO's in-city ICAP market, and whether and how market rules should be revised to provide a level of compensation that will attract and retain needed

¹⁶ Docket No. ER07-360, New York Independent System Operator, Inc., NYISO Filing dated December 22, 2006, Affidavit of NYISO Market Monitor, Dr. David B. Patton, pp. 4-5. Dr. Patton concluded that "the ICAP Spot Market Auctions during the 2006 Summer Capability Period have been characterized by economic withholding of Capacity to exercise market power to the maximum extent allowed by the existing offer cap for the DGOs."

¹⁷ Id.

¹⁸ Docket No. ER07-360, et al., New York Independent System Operator, Inc., Order Rejecting Proposed Tariff Revision and Instituting Hearing and Settlement Judge Procedures (issued March 6, 2007).

infrastructure and thus promote long-term reliability while neither over-compensating nor under-compensating generators.”¹⁹ After affording an opportunity for parties to develop a consensual resolution, which ultimately did not occur, the Commission directed the NYISO to make the October 4 Filing.²⁰

DISCUSSION

I. The Proposed Supplier-Side Mitigation Measures Are Reasonable And Should Be Approved To Ensure That Generators Are Not Over-Compensated

The NYISO proposes to address the DGOs’ market power by continuing the must-offer requirement (at least with respect to the DGUs that have not been physically withheld), and applying a default bid cap at the expected ICAP Demand Curve clearing price that would prevail if all qualified ICAP were sold. Pivotal suppliers would be allowed to obtain a higher bid cap if they demonstrate to the NYISO why a particular unit has

¹⁹ Id. at ¶17.

²⁰ Docket No.EL07-39, New York Independent System Operator, Inc., Order Establishing Paper Hearing and Referring Certain Matters for Investigation (issued July 6, 2007).

"going-forward" costs, net of energy and ancillary services revenues, above the default amount.²¹

The NYISO indicates that a competitive offer price for existing generators should approximate net "going forward" costs.²² According to the NYISO's Market Monitor, "[a] competitive capacity offer price for most, [if not all], units is close to zero because the incremental cost of supplying capacity for an existing unit are typically very low."²³ In fact, "for most NYC units, net going-forward costs are negative."²⁴ Market participants that own or control less than 500 MW of ICAP would be exempt from the pivotal supplier test.

The NYPSC supports the proposed mitigation measures, which would effectively lower the DGUs' bid caps from \$105/kW-year to the higher of \$0 (i.e., DGUs act as price takers under the Demand Curve), or net "going-forward" costs, which are

²¹ NYISO Filing at pp. 21-25. Going-forward costs are the "costs that could be avoided if a unit is mothballed rather than being maintained as an active market participant in order to provide capacity." Examples of such avoidable costs include "labor for routing operations and maintenance, routine materials and contract services, administrative and general costs, and insurance."

²² Id. at p.23.

²³ Id. at Attachment 1 (Affidavit of Dr. David B. Patton), ¶44.

²⁴ Id. at p.23.

estimated to be close to \$0. This approach is reasonable since it will "serve to bring prices to the competitive level by preventing the resources from being withheld," and ensure that the Demand Curve can operate as intended.²⁵

II. The Commission Should Retain The Existing Revenue Caps That Mitigate Against Physical Withholding And Prevent The Divested Generation Owners From Being Over-Compensated

The implementation of more stringent bid caps on the DGUs, the NYISO asserts, justifies the elimination of the existing revenue caps applicable to those units. The NYISO theorizes that deleting the price caps will have "no effect on auction outcomes," and is appropriate since "all participants in a market for the same product should be eligible to receive the market-clearing price."²⁶ This theory fails to comport with reality.

The October 4 Filing acknowledges that "it is appropriate to have market rules that mitigate attempts to exercise market power," such as physical withholding, to the extent that market power exists.²⁷ However, the NYISO does not

²⁵ "The ICAP Demand Curves are premised on the assumption that capacity will not be withheld." Id. at p.24. We disagree, however, with the NYISO's contention that the proposed seller market power mitigation measures will prevent physical withholding, which we discuss below.

²⁶ Id. at pp.27-28.

²⁷ Id. at Attachment 1 (Affidavit of Dr. David B. Patton), ¶7.

address the ability of DGOs to exercise market power by physically withholding ICAP from the market through strategies like retiring, mothballing, or de-rating DGUs (e.g., by reducing maintenance).²⁸

The current revenue cap of \$105/kW-year acts as a disincentive for DGOs to physically withhold ICAP, by preventing them from profiting on ICAP clearing prices that exceed \$105/kW-year.²⁹ However, eliminating the price caps would create a significant incentive for DGOs to physically withhold ICAP. The resulting decline in available capacity would increase the price for ICAP on the Demand Curve, while DGOs would no longer be constrained by a revenue cap set at \$105/kW-year. This strategy would be profitable for DGOs because the revenues they would receive on the remaining ICAP sold in the market at higher prices would be greater than the ICAP, energy, and ancillary services revenues the DGOs would forgo on the units physically withheld.³⁰

Moreover, physical withholding could threaten reliability, since DGOs would have a perverse incentive to reduce maintenance and drive capacity below the minimum LCR in

²⁸ See, Paynter Aff. at ¶1.

²⁹ DGOs may still attempt to physically withhold ICAP to drive prices up to the \$105/kW-year revenue cap.

³⁰ See, Paynter Aff. at ¶6.

order to increase prices.³¹ At the same time, DGOs would have an incentive against adding new capacity, thereby discouraging efficient expansion at existing sites.³² This is particularly troublesome in NYC, where DGOs control many of the available generation sites.³³

Contrary to the NYISO's suggestion, elimination of the revenue caps could have a tremendous impact on "auction outcomes" and consumer payments. For example, the physical withholding of 100 MW of ICAP would increase DGOs' profits by approximately \$7 million.³⁴ In total, we estimate that consumers could potentially pay over \$500 million per year in additional costs.³⁵ As Dr. Paynter explains in the attached 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

³¹ Id. at ¶7.

³² Id. at ¶¶8, 12.

³³ Id. at ¶8.

³⁴ Id. at ¶6.

³⁵ Id. at ¶2.

divested generating units (DGUs) from profiting from price increases above the DGO revenue cap of \$105 per kW-year.³⁶

Therefore, it is critical that the Commission retain the \$105 revenue caps on DGUs in order to avoid creating any additional incentives for physical withholding and to ensure DGOs are not over-compensated.³⁷

We also reject the NYISO's contention that all market participants should receive the market-clearing price. This suggestion ignores the reason behind imposing the revenue cap in the first place (i.e., to protect consumers from paying excessive prices as a result of market power).³⁸ The NYISO's proposal is patently unreasonable under the present circumstances, where DGOs in NYC maintain the ability and incentive to exercise market power.³⁹ Denying the DGOs the market clearing price would be consistent with the Commission's previous finding, which predicated the eligibility for market clearing prices on a demonstration that proposed mitigation

³⁶ Id. at ¶¶9-10.

³⁷ Dr. Patton indicates that the incremental costs of supplying capacity for an existing unit are close to zero. October 4 Filing, Attachment 1 (Affidavit of Dr. David B. Patton), ¶44.

³⁸ See, Paynter Aff. at ¶¶13-14.

³⁹ It is reasonable to assume that DGOs would attempt to physically withhold ICAP, as evidenced by their engaging in economic withholding to date.

measures "will eliminate the exercise of market power."⁴⁰ That predicate is not present here. As a result, it would be unreasonable to permit DGOs to exercise market power by physically withholding capacity and increase prices, while allowing them to keep the ill-gotten gains of their anticompetitive behavior by receiving the market clearing price.

III. The Commission Should Reject The Proposed Minimum Bid Requirements For New ICAP Supplies, Which Could Interfere With New York's Standards For Resource Adequacy And The Ability To Self-Supply ICAP

In response to concerns that uneconomic entry may depress prices in NYC, the NYISO proposes to establish a bid floor requirement for all new ICAP resources within the first three years of entering the market.⁴¹ According to the NYISO's proposal, new capacity resources that do not clear the market would be deemed "uneconomic," and "could not be used to meet capacity obligations (including certifying capacity acquired in bilateral contracts) or sold in [the auctions]." The minimum bid would be equivalent to 75% of the Cost-Of-New-Entry (CONE), net of energy and ancillary services revenues.⁴² Resources would

⁴⁰ Docket No. ER06-451, Southwest Power Pool, Inc., Order on Proposed Tariff Revisions, 114 FERC ¶61,289, at ¶203 (issued March 20, 2006).

⁴¹ Existing generation and Special Case Resources would be exempt from this measure.

⁴² October 4 Filing at pp.28-29.

be exempt from this minimum bid requirement if the NYISO forecasts that ICAP prices will be higher than 75% of CONE. In addition, investors could seek a lower bid cap by demonstrating to the NYISO that their entry costs are below 75% of CONE. The NYISO claims that this safeguard is included so that investors do not face a risk that there "may be a barrier to new entry."⁴³

While the NYISO claims that its proposal mimics "legitimate competitive expectations," the proposal is undesirable and undermines the public interest. One consequence is that it prevents new resources, which are preferable from a public policy perspective (e.g., increased fuel diversity or improved environmental characteristics), from counting towards meeting NYS's resource adequacy requirements or receiving ICAP payments when excess capacity causes clearing prices to fall below the minimum bid requirement.⁴⁴ In this situation, the proposal merely ensures that existing resources would continue to receive ICAP payments, and discourages new entrants since

⁴³ Id. at p.30.

⁴⁴ The NYPSC is currently pursuing a "Renewable Portfolio Standard" (RPS), which is designed to increase the proportion of electricity attributable to renewable resources to at least 25 percent of electric energy used in NYS by 2013. The objectives of RPS, among others, are to improve New York's environment, and increase energy security and independence. See, 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); see also, Paynter Aff. at ¶¶22, 28-33.

they would not receive ICAP payments.⁴⁵ As Dr. Paynter indicates, “[n]ew entrants (or their financiers) would have to factor into their CONE the risks of the loss of all ICAP payments for 3 years. This can only add to the cost and difficulties of financing new generation in NYC, thus creating a new barrier to entry.”⁴⁶ Nothing the NYISO proposes ameliorates this artificial barrier to new entry.

Moreover, the concern that uneconomic entry may depress prices is already addressed by the Demand Curve, which requires LSEs to purchase all quantities of ICAP that clear the auction at administratively-determined prices.⁴⁷ While LSEs may bid in new capacity resources at low prices (or zero) to ensure it is counted toward their ICAP requirements,⁴⁸ and this may cause prices to decline as additional ICAP clears the market, it also leads to increased purchases of ICAP that offset the price

⁴⁵ See, Paynter Aff. at ¶¶26-27.

⁴⁶ Id. at ¶27.

⁴⁷ Dr. Patton concludes that LSEs are not able to exercise market power “given the auction design because the quantity that the LSEs must obtain is determined by the demand curve.” October 4 Filing, Attachment 1 (Affidavit of Dr. David B. Patton), ¶62.

⁴⁸ The NYISO’s proposal to mitigate the bids of new entrants could prevent LSEs from self-supplying ICAP that they either own or have purchased, thereby preventing it from being counted towards meeting the State’s resource adequacy standard and requiring consumers to pay twice for capacity. See, Paynter Aff. at ¶¶22-23.

decline.⁴⁹ Ultimately, it is the Demand Curve, which has been approved as "just and reasonable,"⁵⁰ that sets the price of ICAP. Therefore, the Commission should not adopt the NYISO's proposal, since the Demand Curve ensures that existing generators that clear the market are appropriately compensated.

IV. The Commission Should Order The NYISO To Collect Refunds From Generators That Were Over-Compensated

Despite the NYISO Market Monitor's findings that clearing prices were the result of economic withholding and that competitive outcomes would have produced lower market clearing prices, the NYISO claims that refunds should not be issued for two reasons. The first is that parties have long been aware of the existing price caps and the Commission expected that DGOs would bid at those caps. Second, the NYISO maintains that refunds "may have a deleterious influence on perceptions of market credibility and regulatory uncertainty."⁵¹

Both of the NYISO's arguments are undermined by the fact that the Commission set a refund effective date (i.e., May

⁴⁹ It is also unlikely that buyers could "profit from a long-term strategy of depressing the market price." See, Paynter Aff. at ¶33.

⁵⁰ Docket No. ER03-647, New York Independent System Operator, Inc., Order Conditionally Accepting for Filing Tariff Revisions (issued May 20, 2003) (finding that "the ICAP Demand Curve is a just and reasonable proposal").

⁵¹ October 4 Filing at p.33.

12, 2007),⁵² which put all parties on notice that the rules governing ICAP purchases, especially the prices for ICAP, were subject to refund. A refund effective date should have specifically signaled to market participants that there is some regulatory uncertainty. Under such circumstances, there could not have been a reasonable expectation that prices resulting from economic withholding would not be revisited.

By requiring the Commission to set a refund effective date that is only applicable on a prospective basis, the Federal Power Act balances the needs of market participants to ensure their transactions will not be undone retroactively, with affording some relief to consumers that are paying prices that are ultimately determined to be unjust and unreasonable.⁵³ Taking the NYISO's rationale to its logical outcome dictates that refunds would never be appropriate, since market certainty would always trump the impacts of anti-competitive behavior.

The October 4 Filing provides a reasonable method for calculating refunds in order to ensure generators are not over-

⁵² The refund effective date commenced 60 days from the Notice of Institution of Proceeding and Refund Effective Date, which was published in the Federal Register on March 13, 2007.

⁵³ See, Anaheim v. FERC, 723 F.2d 656, 663 (9th Cir. 1984) (noting that "Congress' primary purpose in enacting the Federal Power Act was protection of consumers from excessive rates and inadequate service").

compensated. The NYISO's Market Monitor, Dr. David B. Patton, indicated that

the competitive price in New York City would have been between \$5 and \$6 per kW-month during the Summer Capability Period. Hence, even if all suppliers offered at zero, the price would clear at approximately \$5.60. Likewise, setting the reference levels anywhere below \$5.60 will produce the competitive result (*i.e.*, all capacity will be sold and the price will be \$5.60).⁵⁴

Given that a competitive market would have cleared at \$5.60/kW-month, while the actual clearing price was 12.72/kW-month, it is apparent that consumers over-paid approximately \$7.12/kW-month for each unit of ICAP that was sold. Multiplying the total amount of ICAP that cleared the market at \$12.72/kW-month over the 2007 summer capability period, and subtracting that from the total amount of ICAP that would have cleared at a price of \$5.60/kW-month (*i.e.*, an additional 756 MW that was economically withheld), results in a total refund of \$110 million (\$87.2 million for the NYC auction and \$22.8 million for the rest-of-state auction).

Although this refund amount represents the maximum amount legally permissible under the refund effective date, it is reasonable. Generators already retain over-compensation in the amount of \$157 million accrued during the 2006 capability period (*i.e.*, \$119 million in the NYC market and \$38 million in

⁵⁴ October 4 Filing, Attachment 1 (Affidavit of Dr. David B. Patton), ¶53.

the rest-of-state market), and forcing them to disgorge all of their overpayments unfairly extracted after the refund date still leaves them with substantial profits from their exercise of market power.

Since the Commission has posited whether generators are being over- or under-compensated, and the evidence presented by the NYISO's Market Monitor clearly indicates that generators have indeed been over-compensated,⁵⁵ it is incumbent upon the Commission to issue refunds to consumers. Therefore, the Commission should direct the NYISO to collect refunds from generators for the period following commencement of the refund effective date, until such time as new mitigation measures are put in place.

CONCLUSION

In accordance with the above discussion, the Commission should accept the proposed mitigation measures for

⁵⁵ The NYISO's Market Monitor indicates that "economic withholding will lead to prices rising above the competitive levels that would otherwise prevail under the ICAP Demand Curve and, therefore, results in *over-compensation* of generators." October 4 Filing, Attachment 1 (Affidavit of Dr. David B. Patton), ¶23 (emphasis added).

pivotal ICAP suppliers, while rejecting the other portions of the NYISO's October 4 Filing.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Peter McGowan". The signature is written in a cursive, flowing style.

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

By: David G. Drexler
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Dated: November 19, 2007
Albany, New York

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

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

AFFIDAVIT OF THOMAS S. PAYNTER

New York State Department of Public Service
New York State Public Service Commission
Three Empire State Plaza
Albany, New York, 12223-1350

November 19, 2007

I, Thomas S. Paynter, having been duly sworn, depose and state the following:

I. Qualifications and Purpose

My name is Thomas S. Paynter. My business address is Three Empire State Plaza, Albany, New York 12223-1350. I am employed by the New York State Department of Public Service as a Principal Economist in the Office of Regulatory Economics. My current responsibilities include analyzing competitive issues, efficient pricing, marginal costs, and regulatory policies. I am a member of a staff team responsible for analyzing and commenting upon the pricing rules of the New York Independent System Operator (NYISO), which operates the New York transmission system. I have participated in numerous NYISO committee meetings related to energy and transmission pricing, installed capacity reserves, operating reserves, and market power issues. I also testified before the Commission at the March 2005 Technical Conference in Docket ER05-428 regarding market power and the Demand Curve in the NYISO's statewide capacity market.

I received a Ph.D. in Economics from the University of California at Berkeley (1985), with fields in econometrics and labor economics. I have a B.A. in Physical Science and in

Economics, also from the University of California at Berkeley (1975). I am a member of the American Economic Association.

From 1983 to 1986, I was an Assistant Professor of Economics at Northern Illinois University, where I taught graduate and undergraduate courses in economic theory. From 1986 to 1990, I was employed by the Illinois Commerce Commission as a Senior Economic Analyst in the Policy Analysis and Research Division and served as a member of the Electricity Subcommittee of the National Association of Regulatory Utility Commissioners. I also authored an article concerning coordination and efficient pricing for independent power producers, "Coordinating the Competitors," published by The Electricity Journal in November 1990.

I joined the New York Department of Public Service in November of 1990. I have testified in numerous rate cases and other proceedings before the New York Public Service Commission. I also testified before the New York State Board on Electric Generation Siting and the Environment regarding transmission congestion and competitive markets in siting cases for the Athens Generating Station, Case 97-F-1563, and for the Brookhaven Generating Station, Case 00-F-0566.

II. Testimony

In this affidavit I discuss the NYPSC's primary issues of concern with respect to the NYISO's proposals regarding the

revenue cap on divested generation and the bid floor for new entry.

A. Revenue Cap on Divested Generation

1. The NYISO has proposed the removal of the revenue cap on Divested Generating Units (DGUs), stating that "Deleting the revenue cap will have no effect on auction outcomes, and thus on the efficacy of the price signals produced by the ICAP Demand Curves in combination with the proposed mitigation measures." (NYISO at 27-28) However, the NYISO has failed to consider the potential for Divested Generation Owners (DGOs) to exercise physical market power via the retirement, moth-balling, or derating of units. The only mitigation measure for physical withholding that would remain, under the NYISO's proposal, is the must offer requirement, i.e. DGOs must offer into the market all of the UCAP that they have. The weakness of this mitigation measure is that it cannot mitigate truly physical withholding that is exercised via the retirement, mothballing, or derating of units. The analysis below demonstrates that, absent the revenue caps, DGOs would be able to profitably exercise market power by such physical means, despite the NYISO's proposed mitigation measures. Moreover, the exercise of physical market power could threaten the reliability of the NYC system, since the DGOs

would have a perverse incentive to reduce NYC capacity even below the minimum locational capacity requirement (LCR), in order to increase prices for their remaining supply.

2. In evaluating NYC's highly concentrated capacity market, it is essential to note that the current surplus of capacity is expected to end abruptly with the retirement of NYPA's Poletti 1, an 890-MW oil/gas-fired steam unit which entered service in 1977. NYPA's siting permit requires the retirement of Poletti 1 by January 31, 2010. The retirement of Poletti 1 could increase NYC's ICAP price by as much as \$96 per kW-year under the NYISO's draft proposed NYC ICAP Demand Curve for 2010 (NYISO draft proposal).¹ At that point, NYC's in-City capacity is forecast to drop below the current NYC locational capacity requirement (LCR). If the supply does drop below the LCR, the NYC ICAP price would jump to a level above the reference price on the NYC Demand Curve, i.e. above \$140 per kW-year under the NYISO's draft proposal. Thus, the capacity prices forecasted for the next few years under the NYISO's proposed mitigation measures are expected to remain

¹ Under the NYISO's draft proposed Demand Curve for 2010, the NYC ICAP price increases by about \$0.90 per kW-month for each 100 MW decrease in supply. A decrease of 890 MW of capacity therefore implies an increase in the NYC ICAP market price of about \$8 per kW-month (\$0.90 times 8.9), or \$96 per kW-year.

relatively low only temporarily. Indeed, without the hedge provided by the DGU revenue cap, the retirement of Poletti 1 could increase NYC's annual capacity costs by over \$500 million.²

3. Despite the impending tightening of the NYC capacity market, merchant investment in NYC capacity has been limited, and most proposals for new generation in NYC have indicated a need for long-term contracts. (See 2007 CRPP) The New York Power Authority (NYPA) has recently responded to this situation by issuing a Request for Proposals (RFP) for up to 500 MW of new capacity to enter service in the 2010-2012 timeframe.
4. Consider first the competitive outcome in 2010 under the current NYC ICAP market design (assuming all capacity clears the market). Absent additional supply, the NYC supply could fall below the LCR. However, if enough supply is added (or demand reduced) to just meet the LCR, the competitive market price would just equal the Demand Curve reference price of about \$16 per kW-month in summer (NYISO draft proposal); the winter price would be lower, because of greater generating capacity in the winter (due to more efficient generation unit cooling). The summer and winter

² \$96 per kW-year increase times approximately 5.6 million kW of DGU capacity yields an increase of approximately \$540 million.

revenues would cover the cost of a new capacity resource, estimated to be about \$140 per kW-year (based on the NYISO's draft proposal), including an allowance for expected levels of excess capacity in future years.

5. Under the NYISO's proposed mitigation measures, the DGOs would be required to bid in the auctions, and their bids would be effectively mitigated to no more than net going-forward costs, which Dr. Patton has estimated to be less than \$10 per kW-year (or about \$1 per kW-month) (Patton affidavit at 51).³ Given such bids, all of the DGO supply would clear in the NYC spot capacity auction, with the price being set by the NYC Demand Curve at approximately \$16 per kW-month (summer), or about \$140 per kW-year.
6. Now consider the position of a DGO with a supply of 2,000 MW, and assume it has 100 MW of combustion turbine capacity with a net going forward cost of \$0 (i.e. net energy and ancillary services revenues just cover going-forward costs). Selling all of its capacity at \$140 per kW-year, it would expect to earn about \$280 million per year from the capacity market (\$140 per kW times 2,000,000 kW).

³ Technically, the NYISO proposes to mitigate bids to the clearing price that would prevail if all qualified ICAP were sold (i.e. mitigated to \$0 bids), unless a generator justifies a higher bid based on its net going forward costs; this mechanism should yield a price no higher than if all qualified ICAP supply were mitigated to net going-forward costs.

Suppose, however, the DGO retires or mothballs these 100 MW of combustion turbines, thus foregoing \$14 million per year in profits (\$140 per kW-year times 100,000 kW). Under the proposed NYC ICAP Demand Curve for 2010, the reduction in supply of 100 MW would increase the NYC ICAP market price by about \$0.90 per kW-month, or about \$11 per kW-year. The DGO's remaining 1,900 MW would thereby earn an additional \$21 million per year (\$11 per kW-year times 1.9 million kW yields \$20.9 million per year). Consequently, the physical withholding of 100 MW of economic capacity would increase that DGO's profits by about \$7 million per year (\$21 million less \$14 million from foregone sales). Thus, even if the market price were at the reference price, sufficient to cover the cost of a new entrant, the DGOs would have a perverse incentive to retire or mothball units in order to drive up the market price. The ability of DGOs to exercise physical market power would trump the NYISO's proposed bid mitigation: retirement is equivalent to an infinite bid. In theory, the NYISO might add regulations that attempt to preclude retirements or mothballing of units. However, it is difficult to overcome perverse incentives through such behavioral rules, because DGOs will naturally search for ways around those rules.

7. Besides retirement or mothballing, DGOs could exercise physical withholding by other means such as derating units (e.g. by reducing maintenance). The NYISO actually pays for Unforced Capacity (UCAP), which is ICAP adjusted for availability. This is intended to provide an incentive for suppliers to improve availability, and indeed (under the current revenue caps) NYC suppliers have increased availability to about 95%. But absent the revenue caps, DGOs would have a perverse incentive to reduce their availability as a way of intentionally derating their units, thereby reducing UCAP supplies and increasing UCAP prices. For example, if a DGO with 2,000 MW of capacity were to reduce its availability from 95 percent to 90 percent, the effect would be a reduction of 100 MW of capacity (5 percent of 2,000 MW), which as shown above would prove profitable (because the percentage increase in price would exceed the percentage decrease in quantity). Thus the NYISO's carefully crafted maintenance incentive would be perverted into a maintenance disincentive as a result of the DGO's market power.
8. Finally, consider the likelihood of a DGO adding new capacity under these circumstances. While the market price of about \$140 per kW-year would be adequate to cover the cost of a new 100-MW generator, the new capacity would

reduce the price received by all of the DGO's other capacity by about \$11 per kW-year. A DGO with 2,000 MW of existing supply would therefore suffer a revenue loss of about \$22 million per year (\$11 per kW-year times 2 million kW) from adding 100 MW of supply. This is an effective penalty of about \$220 per kW-year (\$22 million per year divided by 100,000 kW). Consequently, the DGO's effective cost of new entry would not be \$140 per kW-year, but rather as much as \$360 per kW-year (\$140 to cover the cost of the new plant, plus \$220 to offset the reduction in capacity revenues from the DGO's existing plants). As a result, existing DGOs would be naturally reluctant to add new capacity. This is especially worrisome given that the DGOs control many of the available generation sites in NYC.

9. These examples illustrate that 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.

10. 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. Thus, the revenue cap helps mitigate physical as well as economic market power over the most critical portion of the Demand Curve, where the high capacity price signals that the market is very tight and where the withholding of supply to exert market power could threaten the reliability of the system.
11. Consider the position of the DGO as above, but with the current revenue cap retained. The DGO would earn \$105 per kW-year on its divested generation which, although less than the cost of new entry, is well above the estimated net going-forward costs of the DGUs. Moreover, if the DGO retires or mothballs 100 MW of capacity in order to increase the market-clearing price, its divested generation will not earn any additional capacity revenues. As a result, the DGO will simply lose \$10.5 million per year in capacity revenues (\$105 per kW-year times 100,000 kW). Similarly, if the DGO reduces its maintenance and allows its availability to drop from 95 percent to 90 percent, it will lose 100 MW worth of (UCAP) capacity sales without

enjoying any offsetting increase in price. Thus the DGO has a strong incentive to maintain and supply all of its available capacity.

12. Moreover, under the revenue cap the DGO is much more likely to invest in new capacity (as long as the market price is above the revenue cap). If the market is tight and a DGO invests in a new 100 MW generator, the DGO will receive the full market-clearing price for that new supply, reflecting the estimated cost of new entry. (The revenue cap only applies to the old, divested generating units, not to new capacity such as KeySpan's Ravenswood 4, which would receive the market price.) Moreover, even if the new unit reduces the market price by \$11 per kW-year, this should not reduce the price below the DGU revenue cap of \$105 per kW-year, so the divested generation will not be penalized by the decline in the market price. As a result, the DGO with 2,000 MW of existing divested capacity will have the same incentive to add capacity (when needed) as a completely new entrant. Thus, retaining the DGO revenue cap will encourage efficient expansion at existing sites.
13. The only remaining argument against retention of the DGU revenue cap is that "in general all participants in a market for the same product should be eligible to receive the market-clearing price." (NYISO at 27) However, this

argument begs the question of why revenue caps were imposed on DGUs in the first place.

14. At the time of divestiture, the Commission imposed capacity revenue caps on the DGUs to mitigate their evident market power. The DGOs purchased those units with full knowledge of those revenue caps. The caps presumably reduced the purchase price of the units, to the detriment of NYC loads (since the payments were used to reduce Con Ed's ratebase), but the NYC loads accepted a lower price in exchange for protections provided by the DGU revenue caps. The removal of those caps would present the DGOs with a windfall. Assuming the DGU revenues would increase from \$105 to the CONE of about \$140 per kW-year, DGOs could receive a windfall of over \$200 million per year (an increase of \$35 per kW-year times 6 million kW yields \$210 million per year).
15. Moreover, generation markets are distorted by other factors besides market power. In particular, environmental regulations have been imposed in a manner that significantly distorts generation markets. For example, new plants are subject to "New Source Performance Standards" (NSPS) which generally impose stricter environmental regulations than are imposed on existing plants. The rationale is that the cost of retrofits to

existing plants would be prohibitive. However, the impact of NSPS is to increase the cost of new plants relative to older plants. This has the unfortunate side effect of inefficiently discouraging new entry and encouraging the retention of older, dirtier plants. In effect, new plants are in a different "tier" than older plants, which are allowed to produce more (unpriced) pollution. In this case, paying all suppliers the same market price merely perpetuates these inefficiencies.

16. NYC generation in particular is subject to pervasive environmental regulations. Typically, each plant is required to meet certain environmental conditions at the time of its siting. Over time, environmental standards have generally been tightened, so that new plants have had to meet stricter standards than older plants. Yet the plant-specific nature of these environmental standards often fails to provide a simple, consistent price signal to the market. Thus, there is no single "environmental adder" to capture all of the environmental impacts.
17. Recently NYC has indicated an interest in replacing old, relatively "dirty" generation with new, cleaner plants. If carried out properly, this could improve the efficiency of the NYC generating market, by overcoming the market

distortions introduced by previous environmental regulations.

18. The current revenue caps on DGUs should not impede this goal. If DGOs add new capacity that meet current environmental standards (such as KeySpan's Ravenswood 4 unit, added in 2004), that new capacity is not subject to the DGU revenue caps and is free to earn the full market price. Moreover, as shown above, removing the revenue caps would actually discourage DGOs from adding new capacity, because they would make more profits by restricting supply.
19. As long as the DGOs' old units (DGUs) remain subject to the revenue caps, DGOs should have the proper incentives to add new capacity or repower existing capacity based on the economics of that project, rather than distorted by market power. Since DGOs own prime sites for generation, their participation could lower overall costs to achieve the desired environmental benefits. Therefore, in principle, DGOs should be allowed to participate in RFPs to provide new capacity.

B. Bid Floor for New Entry

20. NYC suppliers have expressed a concern that large buyers might exert monopsony power to artificially depress capacity prices in NYC, by promoting "uneconomic entry." According to this theory, "a buyer could build a plant that

would lose money in the capacity market, but would more than recoup those losses by lowering capacity auction prices by increasing supply and moving the market down the ICAP Demand Curve." (NYISO filing at 28) To address this concern, the NYISO has proposed a 3-year bid floor for new plants equal to 75 percent of the estimated Cost of New Entry (CONE). For example, if CONE were estimated to be \$140 per kW-year, the new entrant would not be allowed to bid less than \$105 per kW-year (75 percent of \$140).

21. While the NYISO's proposed bid floor would not apply to existing generators, it is instructive to consider what would have happened if this proposal had been applied to the most recent new entrants, NYPA's new Poletti unit and Astoria SCS, which added about 500 MW each in 2006. The new units were built by or under contract to buyers (NYPA and Con Ed), who covered their capacity costs and used the capacity as self-supply in the NYC ICAP market (effectively bidding \$0 and acting as price-takers, with the buyers taking the risk of the contract price ending up above the spot market price).
22. If the NYISO's proposed bid floor had been imposed on those new entrants, they would not have been allowed to bid \$0 or be treated as self-supply. Instead, the NYISO would have imposed a floor of 75 percent of CONE, or about \$100 per

kW-year, from 2006 until 2009. Meanwhile, the bids of the DGOs would have been effectively capped at their net going forward costs, i.e. near \$0, ensuring that all of the DGO supply would be sold. As a result, the new entrants would have set the clearing price at their bid floor of about \$100 per kW-year. However, at that price, most of the new capacity would not have sold, and thus would not have counted as NYC supply. Instead, the buyers (NYPA and Con Ed) would have had to purchase DGO capacity at a cost of about \$100 per kW-year, while simultaneously having to cover the contract costs of their new plants (which, although built for the purpose of self-supply, would not have counted towards meeting the NYISO's capacity requirements).

23. The intent of NYISO's proposed bid floor is to deter "uneconomic" entry by penalizing buyers who add capacity when it is not needed for reliability (i.e., when the capacity additions would drive the market price below 75 percent of CONE). In this case, the bid floor would have effectively required NYPA and Con Ed to pay twice for capacity: once for their new plants (at their contract cost) and again for the DGO capacity. The penalty would have been quite substantial: perhaps 600 MW of additional DGO capacity would have been purchased, at a cost of about

\$60 million per year (\$100 per kW-year times 600,000 kW) for three years.⁴ In 2009, the new entrants would have been allowed to bid \$0, which would have finally dropped the market price to the competitive level (assuming the NYISO's DGO mitigation measures were imposed and DGOs did not retire or mothball any units). However, in 2010 the competitive price would have increased by about \$96 per kW-year, to a level possibly higher than CONE, with the retirement of Poletti 1.

24. The above illustration suggests that the NYISO's proposed bid floor could indeed penalize buyers who added capacity when not needed immediately for reliability. However, the NYISO's proposal has a number of serious side effects: It would create a new barrier to entry in NYC; and it could interfere with legitimate merchant or State public policy reasons to add generation for reasons other than simply maintaining reliability; it could prevent prices from declining to legitimate competitive levels for three years, by enforced withholding; and, it would shift the costs of withholding from incumbents to new entrants.

⁴ The buyers could have benefited from a slightly lower ICAP price (about \$100 instead of \$105 per kW-year), which could have saved NYC loads in total about \$30 million per year (\$5 per kW-year times 6,000,000 kW at NYC market price). Thus the net cost to NYC buyers could have been about \$30 million per year, for three years.

25. The above example shows how the proposed price floor would tend to support the price paid to existing suppliers at no lower than 75 percent of CONE. By 2010, the NYISO's draft proposal estimates that NYC CONE will reach \$140 per kW-year, at which point the price floor would reach \$105 per kW-year (75 percent of \$140). Thus, the NYISO's proposed mitigation measures could effectively ensure that after 2010, prices paid to incumbent NYC suppliers never fall below \$105 per kW-year, regardless of the level of excess capacity.
26. Moreover, DGOs would no longer have to bear the costs of withholding in order to keep prices high. Those costs would be shifted to new entrants, who could be forced to withhold their supply in order to keep prices from falling below 75 percent of CONE.
27. New entrants (or their financiers) would have to factor into their CONE the risks of the loss of all ICAP payments for 3 years. This can only add to the cost and difficulties of financing new generation in NYC, thus creating a new barrier to entry in a market that is already heavily constrained, and in which incumbent suppliers own many of the suitable sites for new generation.
28. Finally, the NYISO has implicitly assumed that no new generation should be added in NYC unless that new entrant

is needed to meet reliability requirements. However, there may be a need for baseload generation, which must be added in large increments due to economies of scale; this could create temporary excess capacity. Moreover, there are other reasons to add generation. For example, State public policy may support new generation for environmental reasons, or to improve fuel diversity (important for long-term reliability). Even merchants may wish to add generation that is not strictly needed for reliability, if that generation is more efficient or if the merchant anticipates economies of scale in adding future capacity (e.g. the first 500 MW may have a relatively high capacity cost, but the plant could be expanded later at a much lower capacity cost). The NYISO's proposal would interfere with all of these other legitimate reasons for adding generation, by placing their capacity payments at risk. This is especially troubling for NYC, where ICAP prices are very high, and where ICAP payments can make or break a new project. Moreover, implementation of the NYISO's proposal would be problematic, because contract payments could be backloaded or tied to energy purchases, spark spreads, etc., in order to justify lower "capacity" costs.

29. Given the serious side effects of the NYISO's proposed bid floor on new entrants, and the difficulties of enforcing it

fairly, the most basic question is whether this proposal is really needed.

30. In fact, most of the buyer's supposed "monopsony" market power would be eliminated if the NYISO simply retains the current revenue cap on DGUs. For example, consider NYPA's recent proposal to add 500 MW after the retirement of Poletti 1. Since annual load growth in NYC is only forecasted at about 200 MW, the addition of 500 MW could create a temporary surplus of 300 MW. Such a surplus could temporarily depress the NYC ICAP market price by about \$30 per kW-year, from about \$140 to about \$110 per kW-year. However, this price reduction would not impact the price paid to the DGUs, which would remain unchanged at \$105 per kW-year. Nor would buyers save anything on self-supplied capacity, or capacity for which buyers had signed long-term contracts. So buyer's savings would be limited to the relatively small amount of merchant capacity. The buyer would be deciding on the new project based on its merits, not on whether it would depress the price in the spot auction.
31. Thus, the only circumstance in which buyers might, in theory, profit from "uneconomic entry" is when there is so much excess that the market price would be depressed below

the DGU revenue cap.⁵ This would be a very expensive proposition, because the buyer would have to pay the full, above-market cost of the plant. Moreover, the buyer would have to continue to add capacity, at above-market costs, in order to keep pace with load growth and sustain the suppression of the market price below the DGU revenue cap.

32. However, even if buyers could conspire to engage in "uneconomic entry," DGOs could readily thwart that strategy by engaging in "uneconomic exit," i.e. physical withholding of economic capacity. That is, if the market price is systematically depressed below the DGU revenue cap, each DGO has an incentive to reduce its capacity (via retirement, mothballing, or reduced maintenance) in order to push the price back up.⁶ As a result, the buyers' attempt to keep the price systematically below the DGO revenue cap will fail—the buyers' supposed market power will be offset by the sellers' countervailing market power. The net effect of the buyer's strategy would simply be to

⁵ The current excess supply would be expected to depress the market price below the DGU revenue cap, but only temporarily. As discussed above, the scheduled retirement of Poletti 1 should eliminate this excess.

⁶ That capacity would be "economic" because even the depressed market price would still be well above that capacity's net going-forward costs. Nevertheless, the DGO would prefer to retire that capacity in order to manipulate the price.

replace lower-cost existing capacity with higher-cost new capacity. That is not a profitable strategy for buyers.

33. The above analysis demonstrates that buyers cannot expect to profit from a long-term strategy of depressing the market price. As long as the market price is above the DGU revenue cap, depressing the market price simply does not offer much savings to buyers (because the price reduction would only apply to a small number of MWs). And once the market price is below the DGU revenue cap, the DGOs have the incentive and the ability (despite the NYISO's supplier mitigation measures) to counter the buyer's strategy. While buyers might choose to build new generation in excess of minimum requirements for other public policy reasons, they cannot expect to profit from a strategy of "uneconomic entry." Therefore, the NYISO's concerns are unfounded, and its proposed bid floor on new entry is unnecessary.

34. Regarding the details of how new capacity in NYC should be selected or how it should be financed, this docket is not the appropriate venue. The market participants and state and local governments and agencies should address those complex issues in the first instance. However, the Commission must avoid making premature decisions in this docket that could interfere with those efforts. In particular, the Commission should reject the NYISO's

proposals to remove the revenue caps and to impose bid floors on new entrants, for the reasons discussed above. The Commission should therefore limit its decision in this docket to the original issue of supplier mitigation measures.



THOMAS S. PAYNTER

Sworn to before me this
19 day of November 2007.



Notary Public

David Drexler

Registered in Albany County, NY

#02DR6041385

Expires 5/8/10

CERTIFICATE OF SERVICE

I, Ruth Tarrance, do hereby certify that I will serve on November 19, 2007, the foregoing Protest 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.

Date: November 19, 2007
Albany, New York


Ruth Tarrance