122 FERC ¶ 61,211
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Suedeen G. Kelly, Marc Spitzer,
Philip D. Moeller, and Jon Wellinghoff.

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

ORDER CONDITIONALLY APPROVING PROPOSAL

(Issued March 7, 2008)

1. In this order, the Commission accepts New York Independent System Operator, Inc.'s (NYISO's) proposals to strengthen the mitigation of market power in the New York City (NYC) Installed Capacity (ICAP) market. The Commission finds that NYISO's proposals improve the mitigation that exists today and are otherwise just and reasonable because they prevent sellers with market power from artificially raising capacity prices and prevent net purchasers from artificially depressing capacity prices with uneconomic generation.

I. Background

2. The instant filing addresses market power mitigation for the NYC ICAP market (the in-City market).[1] The in-City market reflects the obligation placed on all load serving entities (LSEs) in NYC to procure sufficient ICAP to meet certain minimum requirements. These requirements for each load serving entity are determined by forecasting each entity's contribution to peak load, plus an additional amount (reserve margin) to cover the additional Installed Capacity required by the New York State

[1] The market for this capacity, which is "[t]he capability to generate or transmit electrical power, measured in megawatts ("MW")," is distinct from the market for "energy," which is "[the] quantity of electricity that is bid, produced, purchased, consumed, sold, or transmitted over a period of time, and measured or calculated in megawatt hours." *Compare* New York ISO FERC Electric Tariff, Original Vol. No. 2, Art. 2, Third Revised Sheet No. 29, § 2.18 (defining Capacity) *with* New York ISO FERC Electric Tariff, Original Vol. No. 2, Art. 2, Fourth Revised Sheet No. 36A, § 2.49 (defining Energy).

Reliability Council in order for the New York Control Area to meet Northeast Power Coordinating Council reliability criteria.[2]

3. In 1998, Consolidated Edison, Inc. (ConEd) divested most of its generators in three bundles – creating a high degree of market concentration for generation in NYC. To mitigate the market power of the owners of this divested generation, Con Ed proposed – and the Commission accepted – a $105/kW-year offer and revenue cap on sales of ICAP from these units.[3] The three companies that purchased ConEd's units were KeySpan-Ravenswood, LLC (KeySpan), NRG,[4] and Astoria Generating Company, L.P. (Astoria) (collectively, the Divested Generation Owners, or DGOs).

4. Under the existing rules as accepted in the 1998 Divestiture Order, each DGO may offer capacity at a price not exceeding its particular offer cap, and each DGO may not collect a price for capacity that exceeds each DGO's revenue cap. If the DGOs are pivotal, i.e., at least a portion of their capacity must be accepted to meet demand, the spot market clears at a price at least as high as the highest DGO offer cap. Prior to 2006, the amount of qualified in-City capacity generally corresponded to prices on the demand curve higher than the DGOs' offer caps; however, the market rules prevented the price received by each DGO from exceeding its revenue cap.

5. In early 2006, approximately 1000 MW of new capacity entered the in-City market, involving two specific units. The first was brought online in January 2006 by the New York Power Authority (NYPA) with 500 MW of capacity (NYPA Unit). The second, built pursuant to a power purchase agreement with net buyer[5] ConEd, was brought online in April 2006 with 500 MW of capacity (ConEd Unit). While each of the DGOs continued to offer their capacity under the existing mitigation at a price equal to its cap, since 2006 the spot price of capacity has cleared at the highest DGO's cap. This is because the approximately 1000 MW of new capacity was insufficient to render the DGOs non-pivotal.

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[2] *See* New York ISO FERC Electric Tariff, Original Vol. No. 2, Art. 2, Fourth Revised Sheet No. 53A, § 2.120a (defining Installed Reserve Margin).

[3] *Consol. Edison Co. of N.Y., Inc.* 84 FERC ¶ 61,287 (1998) (1998 Divestiture Order).

[4] NRG consists of NRG Power Marketing Inc., Arthur Kill Power LLC, Astoria Gas Turbine Power LLC, Dunkirk Power LLC, Huntley Power LLC, and Oswego Harbor Power LLC.

[5] A net buyer of capacity is a market participant whose capacity purchase obligation as an LSE outweighs the amount of capacity supply it owns or controls.

6. On March 6, 2007, the Commission issued an order rejecting proposed tariff revisions filed by NYISO that would have reduced the DGOs' mitigation reference price to $82/kW-year.[6] In the March 6, 2007 Order, the Commission instituted a proceeding pursuant to section 206 of the Federal Power Act (FPA) to investigate "the justness and reasonableness of the [in-City market], and whether and how market rules need to be revised to provide a level of compensation that will attract and retain needed infrastructure and thus promote long-term reliability while neither over-compensating nor under-compensating generators."[7] The hearing was held in abeyance to provide time for settlement judge procedures.

7. Following unsuccessful attempts at settlement, on May 4, 2007, the Independent Power Producers of New York, Inc. (IPPNY) filed a request to establish a paper hearing in the instant proceeding, augmented by a technical conference, if needed, to investigate the in-City market rules. On July 6, 2007, the Commission issued an order[8] instituting a paper hearing, and directed NYISO to submit a proposal for a revised in-City ICAP market within 90 days; the July 6, 2007 Order also directed the Office of Enforcement to investigate "allegations of possible market manipulation by certain in-City sellers of ICAP."[9] New York State proceedings also addressed issues related to in-City market power.[10]

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[6] *New York Indep. Sys. Operator, Inc.,* 118 FERC ¶ 61,182 (2007) (March 6, 2007 Order).

[7] *Id.* at P 17.

[8] *New York Indep. Sys. Operator, Inc.,* 120 FERC ¶ 61,024 (2007) (July 6, 2007 Order).

[9] *Id.* at P 17.

[10] In approving National Grid PLC's acquisition of KeySpan, the New York State Department of Public Service required KeySpan's in-City generation to bid into the in-City capacity market at $0/kW-month (i.e., as a price taker), or by a bid reflecting KeySpan's marginal cost of maintaining the unit and being ready to provide energy net of energy and ancillary services revenues. This bidding requirement would commence with the March 2008 spot auction and last up to four years or until National Grid is able to sell KeySpan's in-City generation. *New York State Department of Public Service*, Case 06-M-0878, *Joint Petition of National Grid PLC and KeySpan Corporation for Approval of Stock Acquisition and other Regulatory Authorizations, Order Authorizing Acquisition Subject to Conditions* at 138 (September 17, 2007) (New York State Proceeding).

II. NYISO Proposal

8. On October 4, 2007, in compliance with the July 6, 2007 Order, NYISO filed revised market rules for the in-City market. Specifically, NYISO proposes to retain the existing ICAP market structure, including the current set of ICAP auctions[11] and the use of ICAP Demand Curves,[12] while refining mitigation measures in order to prevent the exercise of market power by both capacity suppliers and net capacity buyers.

III. Notice of Filing, Interventions, Protests and Answers

9. The July 6, 2007 Order stipulated that initial comments on NYISO's filing would be due 45 days after its submission, with reply comments due 20 days after that. Initial comments on NYISO's filing were due on or before November 19, 2007 and reply comments due on or before December 10, 2007, subsequently extended to December 12, 2007.

10. Comments were filed by Astoria, the City of New York, ConEd, Consumer Power Advocates, Dynegy Northeast Generation, Inc. (Dynegy) and Coral Power, LLC (Coral Power), East Coast Power, LLC (East Coast Power), Energy Curtailment Specialists, Entergy Nuclear Power Marketing, LLC and the Mirant Parties (Entergy/Mirant),[13] FPL Energy, LLC (FPL Energy), Hudson Transmission Partners, LLC (Hudson Transmission), IPPNY, KeySpan, Long Island Power Authority (LIPA), Multiple Intervenors,[14] NRG, New York State Consumer Protection Board (NY Consumer Board), NYPA, New York State Public Service Commission (NYPSC), New York Transmission Owners (NY Transmission Owners), and Webenergy.net Inc., d/b/a ConsumerPowerline (ConsumerPowerline).

11. Reply comments were filed by Astoria, the City of New York, ConEd, Dynegy and Coral Power, Entergy/Mirant, IPPNY, KeySpan, LIPA, Multiple Intervenors, NRG, NY Consumer Board, NYISO, NYPA, NYPSC, and NY Transmission Owners.

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[11] NYISO operates six-month strip auctions, monthly auctions, and spot auctions.

[12] The Demand Curves attempt to replicate normal demand for capacity. There are four ICAP Demand Curves, all applied to spot auctions: one for the statewide market and one for each locality.

[13] The Mirant Parties consist of Mirant Energy Trading, LLC, Mirant New York, Inc., Mirant Lovett, LLC, and Mirant Bowline, LLC.

[14] Multiple Intervenors is an unincorporated association of approximately 50 large, industrial, commercial, and institutional energy consumers with manufacturing and other facilities located throughout New York State.

IV. Discussion

A. Procedural Matters

12. Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.214 (2006), the notices of intervention and timely, unopposed motions to intervene serve to make the entities that filed them parties to Docket No. EL07-39-000. Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(2) (2006), prohibits an answer to a protest or to an answer unless otherwise ordered by the decisional authority.

B. ICAP Demand Curves

13. NYISO proposes to maintain the current ICAP Demand Curve structure. NYISO submits that the ICAP Demand Curves have been extensively scrutinized and approved by the Commission, and have also withstood scrutiny in the U.S. Court of Appeals for the D.C. Circuit.[15] Moreover, NYISO states that the ICAP Demand Curves are subject to a periodic review process by both independent experts and the stakeholders to ensure that they are structured to send appropriate price signals for the efficient development of capacity. NYISO claims that to date, the price incentives from this structure have resulted in sufficient capacity, both statewide and in each control area locality.

14. NYISO claims that it is appropriate to continue use of the ICAP Demand Curves because they have been successful in achieving their intended objectives, including: (1) producing more stable and predictable capacity auction prices; (2) providing the proper market signals for new entry and existing capacity; (3) recognizing the reliability value of capacity above the minimum requirements; (4) recognizing the reliability value of capacity in certain local areas; and (5) reducing incentives for the exercise of market power.

Comments and Reply Comments

15. Parties such as KeySpan claim that the peculiar conditions in the in-City market pose particular risks to generators that are not accurately reflected in the proposed reset Demand Curve.[16] KeySpan states that since NYISO's proposed demand curves are established on unrealistic assumptions, even if the NYISO's mitigation measures were

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[15] *New York Indep. Sys. Operator, Inc.,* 103 FERC ¶ 61,108 (2003), *aff'd sub nom. Electricity Consumers Resource Council v. FERC,* 407 F.3d 1232 (D.C. Cir. 2005).

[16] The reset ICAP Demand Curves were submitted in a filing on November 31, 2007.

fully effective, it would not lead to sufficient prices to attract and retain needed capacity investment.

16. NYISO contends that the use of ICAP Demand Curves and the specific parameters of the curve for the in-City market should not be decided in this docket since NYISO recently filed the results of a comprehensive review process to update the ICAP Demand Curves in Docket No. ER08-283-000. Any issues as to the parameters of the in-City market Demand Curve should be resolved in that docket.

Commission Determination

17. The Commission agrees with NYISO that issues related to the specific parameters of the ICAP Demand Curve are beyond the scope of this proceeding, and thus we will not address such concerns here. As NYISO mentioned, it recently filed in Docket No. ER08-283-000 the results of a comprehensive review process to update the ICAP Demand Curve. Keyspan participated in that proceeding and thus had the opportunity to raise any issues it had with NYISO's proposed revisions to the ICAP Demand Curves in that docket. On January 29, 2008, the Commission accepted NYISO's revised tariff sheets updating its ICAP Demand Curve for the Capability Periods beginning in 2008, 2009 and 2010, finding the revisions to be just and reasonable.[17]

C. Supplier Mitigation

18. NYISO proposes to apply its mitigation measures to capacity that meets both of the following criteria: (1) all in-City capacity that is owned or controlled by any entity that possesses market power at the time of each ICAP Spot Market Auction, as measured by a pivotal supplier test[18] and (2) those market participants owning or controlling more than 500 MW of Unforced Capacity (UCAP).[19]

19. To avoid overly broad application of supplier mitigation, NYISO proposes to only apply mitigation to NYC capacity that is owned or controlled by any entity that possesses

[17] *New York Indep. Sys. Operator, Inc*., 122 FERC ¶ 61,064 (2008) (2008 ICAP Demand Curves Order).

[18] A generator is pivotal when demand cannot be met without some contribution of supply by the seller or its affiliates. *See Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities,* Order No. 697, 72 Fed. Reg. 39,904 (July 20, 2007) FERC Stats. & Regs.¶ 31,252 (2007).

[19] NYISO converts ICAP requirements to UCAP for each unit based on its generation performance data and its equivalent forced outage rate (EFORd), a probabilistic availability measure.

market power at the time of each ICAP Spot Market Auction, as measured by a pivotal supplier test. According to NYISO, two pivotal supplier tests would be applied, one based on the ownership of resources, and the second based on control of resources. The pivotal supplier tests would involve a straight-forward monthly comparison in the ICAP Automated Market System (AMS) of the available capacity either owned or controlled by each supplier, as compared to the locational capacity requirement, to determine if the requirement can be met without a supplier's capacity.

20. In addition, NYISO proposes that market participants owning or controlling less than 500 MW of capacity UCAP not be subject to supplier mitigation. NYISO concludes that such participants cannot profit from a withholding strategy, given the slope of NYC ICAP Demand Curve and total NYC capacity supply. NYISO's independent market monitor points out that withholding is profitable in cases where the percentage increase in price received by the supplier exceeds the percentage decrease in quantity of units sold by the supplier. The market monitor's analysis shows that given the assumption that all competing supplies are sold and assuming the demand curve parameters from the Summer 2007 ICAP spot auction, a supplier would have to own at least 590 MW of UCAP to profitably withhold capacity. In its filing, NYISO proposes a threshold of 500 MW to ensure that the supplier mitigation is not applied to suppliers too small to profitably withhold.

21. To mitigate seller market power, NYISO proposes to subject pivotal suppliers to a must-offer requirement and offer cap. Under the must-offer requirement, to the extent that units subject to mitigation are not sold in the six-month strip auctions[20] or monthly auctions,[21] or certified against a load serving entity's (LSE's) requirement, they must be offered into the spot auction. NYISO claims that without this measure, suppliers will be able to circumvent mitigation by physically withholding resources. The offer cap is proposed as the higher of: (1) the price on the in-City market Demand Curve if all qualified UCAP clears the market, that is, the price resulting from all capacity being offered as price takers (the default mitigation reference level); or (2) a market-clearing price that covers the net going forward costs of the marginal unit, that is, the costs it could avoid by being mothballed rather than staying in the market to provide capacity.

22. NYISO proposes to set the default mitigation reference level at the expected ICAP Demand Curve clearing price calculated on the assumption that all qualified UCAP in the

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[20] Strip auctions are voluntary and encompass six month periods (Nov – Apr, May – Oct), where the amount of capacity offered each month of the commitment period = $\kappa / 6$, where κ is the size of the capacity obligation. Strip auctions are held twice a year.

[21] Monthly auctions for ICAP are held each month for the following month and may also include any month before the end of the capability period. Monthly auctions are voluntary.

in-City market were sold. In order to protect against adverse impacts from the automatic application of the default reference level, NYISO proposes a "by-exception" consultation process. Any generator that believes it can justify a reference level above the default would be entitled to use its reference level based on the net going forward costs for the particular unit, if it can justify the higher reference level in consultations with the NYISO's Market Monitoring and Performance unit and the independent Market Advisor. NYISO suggests that one class of going forward costs that could be considered are additional costs that may be avoided if a generator retires permanently rather than mothballing (e.g., property taxes). NYISO states that if a reference level adjustment is granted and the unit does not clear in the spot auction, the NYISO and the Commission should expect the permanent retirement of the unit.

23. To avoid efforts to evade the application of the offer cap, suppliers subject to mitigation will be required to offer the resources into the spot capacity market at or below its reference level. Offers above the reference level would be reset to the reference level. To the extent that capacity from units subject to mitigation was not sold in a bilateral transaction, the Capability Period Auction or Monthly Auctions, or certified to satisfy a sale or against an LSE's obligation, it must be offered into the ICAP Spot Market Auction.

24. With the implementation of the new form of supplier mitigation, NYISO proposes to remove the revenue cap and the ban on sales of DGO capacity in bilateral contracts. [22]

i. Adequacy of Supplier Mitigation

25. Multiple Intervenors, NY Consumer Board, the City of New York, and NYPSC generally support the proposed supplier mitigation measures.

26. Suppliers, such as Astoria, claim that the supplier mitigation measures do not provide for adequate cost recovery for pivotal suppliers. Astoria argues that NYISO's going forward cost proposal is flawed because it relies on mothballing of a unit as the presumptive case when retirement would be the favored alternative.

27. KeySpan supports eliminating mitigation that applies only to DGOs. KeySpan states that the NYISO filing fails to analyze the levels of compensation that would likely result under the NYISO proposal and, therefore, it does not meet the standard that the Commission set for this hearing. KeySpan notes that NYISO assumes that the level of compensation to be realized under its proposal will be adequate because it assumes that the Demand Curve, on which the mitigation rules would operate, will produce such a result. KeySpan states that on the core issue of whether its proposal meets the

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[22] The current mitigation rules prohibit DGOs from entering into bilateral capacity contracts to prevent the DGOs from circumventing the revenue cap.

Commission's standard of revenue adequacy, the NYISO relies on interdependent assumptions, each being premised on the other, without proof.

28. KeySpan points out that there is no independent demonstration of why $5.60/kW-month[23] is a just and reasonable price for 2007 or how market mitigation rules that would cap prices at such a level would be sufficient to meet the Commission's standard of revenue adequacy sufficient to retain and attract generation.

29. KeySpan asserts that NYISO's proposed supply-side mitigation rule is unjust and unreasonable, as demonstrated by a comparison of clearing prices under the existing mitigation rule, i.e., the offer caps, and NYISO's proposal. KeySpan argues that these clearing prices fall well short of both the net cost of new entry (CONE)[24] and the levels that NYISO assumes would be revenue adequate under its proposed reset Demand Curve.[25] Specifically, KeySpan claims that the total annualized clearing prices or revenues in 2007 under NYISO's proposed mitigation rule would allow suppliers to receive barely 20 percent of existing CONE,[26] and that for the 12-month 2008-09 capability period, NYISO's mitigation rule will yield annual clearing prices that are less than 40 percent of net CONE included in the NYISO Demand Curve Filing. Further, KeySpan notes that parties offer no analysis that would suggest in the years beyond 2008-2009, the outcomes will be any different.

30. KeySpan argues that NYISO's assumption that a competitive offer price can only be based on short-run marginal costs is inappropriate, and that capacity is more analogous to transmission service that is not charged at its short-run marginal costs, but at its average costs. KeySpan further argues that the perfect competition model is not appropriate for the in-City capacity market, because the government sets price caps and determines the principal parameters affecting demand (e.g., installed capacity requirements, net CONE and the slope of the curve), and because load is motivated and able to exercise monopsony-like power to add uneconomic capacity to suppress prices. KeySpan also argues that NYISO's position that the proposed demand curve, coupled

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[23] In its proposal, NYISO demonstrates that if the proposed supplier mitigation rules had been in place for the Summer 2007 ICAP spot auction, the in-City reference level applied to pivotal suppliers would have been $5.60/kW-month.

[24] The cost of new entry, or CONE, is the cost of adding a LMS 100 peaking unit to the in-City market. *New York Independent System Operator Inc.,* 122 FERC ¶ 61,064 (2008) at 23. The net cost of new entry, or net CONE, is CONE less energy and ancillary services revenues (seasonally adjusted).

[25] KeySpan Reply Comments at 7.

[26] *Id.*

with the proposed mitigation, will be revenue adequate is simply an assumption, not a fact or even a conclusion based on reasoned analysis. KeySpan argues that the demand curve will be compensatory to suppliers only if clearing prices over time average out to the net CONE price; KeySpan argues that this will not be the case in the in-City market, especially if no net buyer mitigation is adopted.

31. KeySpan argues that NYISO's supplier mitigation proposal must also be modified to require that all the capacity of a unit be purchased if any capacity of that unit is purchased, or at least to require payment of all the costs of such capacity (as defined above), even if only part of the capacity is purchased. KeySpan claims this is necessary because these costs are not divisible where a unit's capacity is procured piecemeal. KeySpan claims these costs are incurred in order to have a unit available to provide capacity from all or a part of it; therefore, if only a part of a unit's indivisible capacity is procured, the costs associated with the whole indivisible unit should be compensable under a going forward costs test.

Commission Determination

32. We find NYISO's proposal is a just and reasonable methodology for mitigating supplier market power, while maintaining revenue adequacy for suppliers, including the DGOs.

33. We find that NYISO's proposal will produce market clearing prices that cover suppliers' net going forward costs. NYISO's proposal shows that its proposal would have resulted in a calculated reference level of $5.60-kW/month for the Summer 2007 ICAP in-City spot auction.[27] NYISO's proposal also includes an analysis of existing suppliers' gross[28] and net going forward costs that shows that almost all suppliers in NYC – steam, combined cycle, and gas-fired combustion turbine units – will have negative net going forward costs, and only oil-fired combustion turbine units will have positive net going forward costs ($0.60/kW-month).[29] NYISO's independent experts' analysis suggests that the expected market clearing price under NYISO's proposal will be sufficient to allow existing suppliers to recover their going forward costs of providing capacity.

34. We conclude, based on these facts, that the combination of proposed offer caps and a mitigation reference level based on a price determined by the intersection of the demand curve and the level of supply equal to all qualified UCAP eliminates the ability

[27] Patton Affidavit at 58.

[28] Ungate Affidavit at 14.

[29] Patton Affidavit at 50.

of a capacity seller to exercise market power and assures that capacity prices will be determined by the administratively set demand curve and the determination of available capacity. That is because no mitigated supplier will be able to influence the market price, since each mitigated supplier's offer cap will be set to ensure that its capacity will be taken in the auction, except in the event that its specific net going forward costs exceed the reference level, a fact that seems unlikely given the provided testimony regarding reference levels and offer caps. Sellers not subject to mitigation could submit offers above the reference level, but individually these sellers, who are not pivotal, have a low likelihood of affecting market-clearing prices and profiting by such action.

35. KeySpan's assertion that NYISO's proposal is unjust and unreasonable because it will produce expected market clearing prices below net CONE has no merit. While a capacity market may produce market clearing prices equal to or in excess of net CONE in certain market conditions, the NYC capacity market is currently enjoying a surplus of capacity.[30] This surplus should translate into market clearing prices that are below net CONE, and therefore we would expect that any just and reasonable proposal would produce market clearing prices that are below net CONE, as NYISO's proposal does. Market-clearing prices under the proposed mitigation will likely fall significantly below new entry costs in the short-run, but this is to be expected given the significant excess supply that currently exists.

36. Regarding KeySpan's argument that a competitive offer price should be based on average costs, not marginal costs, the Commission disagrees. The Commission has consistently found that it is just and reasonable to base competitive offer prices on marginal costs,[31] and nothing in NYISO's proposal, the in-City market, or the comments of the interveners, including KeySpan, show any evidence or support that using marginal cost-based offers is an unjust and unreasonable standard.

37. The Commission also finds no merit in KeySpan's assertion that perfect competition is not the appropriate model for the in-City market.[32] First, the Commission notes that suppliers are not limited to market clearing prices equal to the reference level.

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[30] Potomac Economics, Ltd., *NYISO State of the Market Report* (2006).

[31] *Commonwealth Edison Company*, 113 FERC ¶ 61,278, *citing to New York Independent System Operator, Inc.*, *order on reh'g*, 110 FERC ¶ 61,244 (2005), *PJM Interconnection, LLC,* 117 FERC ¶ 61,331 (2006).

[32] We also find that the imposition of a bid cap on KeySpan's in-City generation by New York State in the New York State Proceeding (*see supra*, n.10) to have no impact on our determination here. While New York State's action removes KeySpan's ability to affect in-City capacity prices, Astoria and NRG retain the ability to artificially raise prices that must be addressed.

The reference level, which is based on an assumption of all qualified UCAP selling into the market as price takers, is simply an offer cap, not a price cap. If the market clears at a price higher than the reference level, all suppliers are paid that price. While it is true that the demand portion of the in-City market is administratively determined, it must be noted that the ICAP Demand Curves are slightly adjusted in favor of reliability, thereby ensuring that the amount of capacity purchased is adequately higher to accommodate reliability needs under the Demand Curve than if demand was determined strictly in a market setting. We also disagree with KeySpan's assessment of LSEs' ability to exercise market power under NYISO's proposal, and we address that argument below in section D.

38. Regarding KeySpan's request to alter NYISO's proposal to require that all capacity of a unit be purchased (or that a unit be paid for all of its capacity) if any capacity of that unit clears in the market, the Commission disagrees. The Commission sees no justifiable reason to guarantee payments to a supplier for all of its capacity if all of its capacity does not clear the market. KeySpan merely describes the risk that all suppliers face, i.e., that in certain market conditions, all of their capacity may not be purchased. KeySpan's request would result in discriminatory treatment of the DGOs vis-à-vis other market participants by guaranteeing the DGOs sales of all of their capacity, regardless of whether it clears, but not providing the same guarantee for other suppliers. KeySpan and other in-City capacity suppliers should be subject to this market risk, not insulated from it.

ii. <u>Removal of Price Cap and Physical Withholding</u>

39. NYPSC states that NYISO does not address the ability of DGOs to exercise market power by physically withholding ICAP from the market through strategies like retiring, mothballing, or de-rating DGOs (e.g., by reducing maintenance).

40. NYPSC also rejects NYISO's contention that all market participants should receive the market-clearing price. NYPSC claims that 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 measures will eliminate the exercise of market power.[33] NYPSC claims 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.

41. Astoria, KeySpan, Dynegy and Coral Power, Entergy/Mirant, and IPPNY support the elimination of the revenue cap. Dynegy and Coral Power and Entergy/Mirant argue

[33] NYPSC Protest at 19, *citing Southwest Power Pool, Inc.,* 114 FERC ¶ 61,289, at P 203 (2006) (SPP Order).

that such a cap would amount to discrimination among generators and are concerned about the signals conveyed to the marketplace if the revenue cap remains. Entergy/Mirant argues that revenue caps are an inefficient net buyer mitigation tool that undercuts the ability of the capacity market to fairly compensate existing resources. Astoria, Entergy/Mirant, and IPPNY state that the cap is no longer necessary since NYISO's proposal will prevent pivotal suppliers from affecting the market-clearing price.[34] Astoria argues that pivotal suppliers cannot exploit the New York state regulatory process relating to retirement and mothballing in order to physically withhold capacity from the market.[35] Astoria also states that retaining the revenue cap as "insurance" against physical withholding – as some parties request – is duplicative of existing market rules and would unnecessarily interfere with the proper functioning of the in-City ICAP market. Astoria disagrees with the argument that the removal of this revenue cap will cause pivotal suppliers to be reluctant to add new capacity, asserting that this argument is unsupported and ignores the success of competing suppliers in entering the in-City ICAP market and the incentives that exist to add economic capacity.

42. KeySpan states that the revenue cap by itself is unduly discriminatory under current market conditions in which the level of the cap is below net CONE and should be removed. KeySpan argues that the existing revenue caps are outdated cost-based rates. KeySpan also notes that revenue caps do not directly prevent physical withholding, and market monitors should be able to easily monitor physical withholding from the capacity market. KeySpan states that whereas physical withholding from the energy market could be valuable for relatively short periods, physical withholding of capacity from a monthly product should be much harder to hide from market monitors. KeySpan states that NYISO must review the retirement of units or placing them on inactive status, and that unit availability and status is audited by NYISO. KeySpan claims that its proposed transition proposal, including a two-year transitional fixed capacity price would also prevent or minimize incentives to physically withhold, and after expiration of the transition period, flattening the slope would also reduce incentives for physical withholding.

43. ConEd, the City of New York, Consumer Power Advocates, and NY Consumer Board oppose NYISO's plan to eliminate the revenue cap on capacity sales by DGOs. NY Consumer Board asserts that NYISO has not fully analyzed the effect its proposal would have on how suppliers operate their plants if the revenue cap is lifted. The City of

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[34] Additionally, Entergy/Mirant state that the Commission, NYISO and NYPSC all have rules against physical withholding and market monitoring and enforcement mechanisms to ensure that it does not occur.

[35] Astoria notes, *inter alia*, the long lead times for notice and the rigorous analysis of the reliability impacts of removing a unit from service which would prevent such a strategy.

New York and NY Consumer Board further assert that economic withholding of capacity can exist even under an offer cap regime, but that a revenue cap eliminates the incentive to engage in this activity. NYPSC claims that it is critical that the Commission retain the $105 revenue caps on DGOs in order to avoid creating any additional incentives for physical withholding and to ensure DGOs are not over-compensated. ConEd claims that the price cap, which does not deal with whether a generator is being adequately compensated, but rather, with providing an extra level of protection to consumers should a DGO exercise market power through physical withholding,[36] should be retained. ConEd claims that the existing price cap of $105 was based on the units initially available for sale, and that the cost of the units actually sold was $89/kW-year, without consideration of energy and ancillary services revenue offsets. NYPSC argues that elimination of the revenue caps could have a tremendous impact on "auction outcomes" and consumer payments: NYPSC estimates that consumers could potentially pay over $500 million per year in additional costs. NYPSC asserts that the DGOs' market power cannot be limited simply by mitigating auction offers, as proposed by the NYISO, because the DGOs are very large suppliers in a very constrained market where few sites are readily available to new entrants, providing the DGOs with incentive to physically withhold capacity.

44. NRG notes that the parties that oppose the removal of the existing price caps express concern that generators would mothball or retire units and drive the prices received for their remaining units above the existing price caps, and that such arguments implicitly recognize if NYISO's proposal is adopted, the rational economic decision would be to retire or mothball the units because the resulting price signals will not be sufficient to retain existing generation. NRG states that rather than fix those price signals through a comprehensive solution, these commenters would require DGOs to stay in the market (foreclose the rational economic decision) and allow recovery of just their going forward costs.

45. In its reply comments, NYISO argues that the revenue cap is not needed as a measure against physical withholding since physical withholding is addressed by the spot market must-offer requirement for any capacity not sold bilaterally or in the strip or monthly auctions. NYISO claims that retaining the revenue cap would only reduce the incentives to stay in the market, and thus tend to bring about the very market exit that is of concern to the commenters supporting retention of the revenue cap. NYISO asserts that it did not intend the lifting of the ban on the ability of mitigated suppliers to enter into bilateral contracts to provide a means to engage in withholding by exporting. NYISO states that any such potential would need to be addressed in the tariff revisions to

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[36] ConEd states that physical withholding can occur when a DGO decides to re-power a unit, or otherwise retire an existing unit.

comply with the Commission's order in this docket and may warrant further consideration in the NYISO stakeholder process.

46. NRG asserts that although prices above the existing price cap are unlikely to occur under NYISO's proposal, a generator must be able to realize the benefit of scarcity pricing under any revised regulatory paradigm, especially if such scarcity occurs in response to the rational economic decision to retire or mothball the unit as a result of NYISO's proposal. NRG further argues that the approach backed by the comments of the net buyers in this proceeding is fundamentally flawed in that it is an attempt to keep older, environmentally-unfriendly units trapped into producing in New York, when it is economically rational for these units to retire and make room for newer, more efficient units.

47. Astoria takes issue with NYPSC claim that pivotal suppliers could also engage in physical withholding by decreasing the availability rating for a DGO's unit over time. Astoria states that not only is this physical withholding strategy unlikely to succeed, but it is also not beneficial enough to create sufficient incentive for DGOs to engage in such behavior.

48. IPPNY states that, in addition, to address NY Consumer Board and NYPSC's argument that DGOs should not receive the same revenues as new facilities because of the stricter environmental standards currently in place, older DGOs must incur additional allowance costs, thus mirroring a new plant's costs to comply with certain environmental standards.

Commission Determination

49. We find NYISO's proposal to remove the revenue cap on the DGOs to be an appropriate action in the broader context of NYISO's proposal. As we state above, NYISO's proposal removes the ability of mitigated suppliers to affect the market clearing price. Because mitigated suppliers will not have the ability to affect market prices in the spot auction by submitting artificially high offers, those suppliers should receive the market clearing price like any other supplier. As the Commission has found previously, it is appropriate to allow all suppliers to be paid the market clearing price when the suppliers' market power has been adequately mitigated.[37] There is no reason to deny mitigated suppliers the market clearing price when the ability of those suppliers to affect the market price has been eliminated. Thus, we find NYISO's removal of the revenue cap for the DGOs to be appropriate.

50. While the Commission finds that NYISO's proposal should eliminate any possibility of economic withholding by mitigated suppliers, we recognize the possibility

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[37] SPP Order, 114 FERC ¶ 61,289 at P 203.

that suppliers may attempt to physically withhold in order to affect market prices. NYISO has appropriately included a must offer requirement for mitigated units in its proposal. Under NYISO's proposal, all capacity of mitigated units that is not sold bilaterally or in the strip or monthly auctions must be offered into the spot auction. However, we recognize that there may be ways for both mitigated and unmitigated sellers to attempt to exercise market power when they can no longer economically withhold capacity – by various physical withholding strategies. Physical withholding would affect the determination of supply; under NYISO's proposal, reductions in the amount of supply would raise the reference level.

51. As pointed out by numerous commenters, there are ways a supplier could physically withhold its capacity in order to affect the size of the NYISO's calculation of all available UCAP and the subsequent mitigation reference level. These practices include retiring, mothballing, or de-rating their units.[38] At the same time, however, retiring, mothballing, or de-rating a unit may be appropriate economic decisions under particular circumstances. We therefore cannot prescribe a per se rule to address physical withholding. However, we note that NYISO has committed to addressing certain concerns regarding withholding in tariff revisions to comply with this order.[39] We will require NYISO to address concerns with other potential mechanisms for physical withholding, including premature retirement, mothballing, and de-rating, in that compliance filing. We will also direct NYISO's market monitor to monitor for physical withholding and promptly report any instances of withholding to the Office of Enforcement.

iii. Regulatory Compact

52. NRG argues that NYISO's proposal disrupts the regulatory compact made and approved in the 1998 Divestiture Order and that NYISO has not justified changing the regulatory compact. NRG states that the market monitor recognizes that the price that the DGOs paid for the in-City units were likely substantially higher than they would have been if stricter market power mitigation measures had been required. NRG asserts that replacing the $105/kW-year offer and revenue cap with an offer cap that is 55 percent lower than summer 2007 levels raises equity concerns. NRG further argues that any change to the regulatory compact must result in a balanced and efficient capacity market. Entergy/Mirant contends that if the Commission were to retain revenue caps at the same time it was strengthening supplier mitigation, the original deal entered into at the time of divestiture would be materially altered. In its comments, FPL Energy claims that the

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[38] For example, NYPSC demonstrates that a generator with a supply of 2000 MW can profit from de-rating just 100 MW of capacity. NYPSC Initial Comments (Affidavit of Thomas S. Paynter at 6).

[39] NYISO Reply Comments at 11.

instant proposal transforms the "deal" that the DGOs relied upon when they purchased ConEd's generation units.

53. NRG states that the NYISO attempts to justify changing the regulatory compact by noting that there was an increase in capacity in the in-City market in 2006 but no corresponding drop in prices in the May 2006 ICAP Spot Market Auction; however, NYISO ignores that the Commission explicitly recognized that prices would remain at the cap until supply increased. Furthermore, NRG claims that the Summer 2006 prices were not unjust and unreasonable because they reflect the cap, which was set below ConEd's 1996 costs. NRG argues that a just and reasonable price under the demand curve would be prices up to net CONE, but prices in the Summer 2006 were substantially below net CONE, and the $105kW-year cap is well below the recent net CONE in the in-City market.

54. NRG does not assert that the Commission cannot revise the in-City market mitigation to create efficient markets; rather, NRG contends that simply lowering capacity revenues by more than 60 percent on annualized basis, without creating a balanced and efficient market with both net buyer and seller market power mitigation, is arbitrary and capricious.

55. Parties such as Multiple Intervenors argue that NYISO's proposal does not violate a regulatory compact for DGOs or that no proof of the existence of such a compact has been offered. According to Multiple Intervenors, claims that the regulatory compact exists to immunize the DGOs from modifications of existing market monitoring and mitigation measures are not supported by the facts or the law. Multiple Intervenors argues that the Commission's 1998 Divestiture Order made clear that any modifications to the approved measures may be proposed and adopted in the future and that bidders for ConEd's generation facilities were placed on clear notice that the market power mitigation measures approved by the Commission in 1998 would be subject to possible modifications in the future. The City of New York concurs with Multiple Intervenors' position, stating that the 1998 Price Caps Order is no longer apposite to defend certain parties' contentions that economic withholding is justified under a regulatory compact theory.

56. ConEd claims that FPL Energy's theory of a deal that supports the generators' claims to maintain artificially high revenues is simply not true, and points out that FPL Energy offers no supporting evidence to back up its claim that a deal exists. Similarly, ConEd argues that FPL Energy and NRG's argument that the imposition of seller mitigation breaks a regulatory compact is wrong, and ConEd points out that FPL Energy and NRG offer no proof of the existence of such a compact.

Commission Determination

57. The Commission finds that the 1998 Divestiture Order did not prevent NYISO from proposing, or the Commission from accepting, just and reasonable changes to the in-City market and mitigation rules. While the 1998 Divestiture Order was intended to provide a clear statement of the mitigation measures that would apply after divestiture, it did not provide the DGOs with a guarantee that they would be able to receive payments equal to the highest DGO bid cap in perpetuity. Rather, the Commission explicitly stated that parties could propose changes to the DGO offer cap, as well as to the mitigation rules for the in-City market – requiring only that any changes to the mitigation rules be filed with the Commission.[40]

58. Therefore, given the explicit recognition in our 1998 Divestiture Order that parties could propose changes to the DGO offer cap, the Commission believes that NYISO's proposed revision to its supplier mitigation proposal, and our acceptance of them, are not precluded by any "regulatory compact."

iv. Removal of the Ban on Bilateral Contracts

59. Astoria and KeySpan agree with NYISO's proposal to eliminate restrictions on DGOs entering into bilateral capacity contracts because allowing DGOs to enter into these types of contracts will enable them to make long-term investment decisions regarding these assets. The City of New York, on the other hand, asserts that the bilateral contract prohibition must be retained in the light of recent seller market conduct.

Commission Determination

60. We find the NYISO's proposal to allow the DGOs to sell capacity via bilateral contracts to be just and reasonable. As NYISO points out, the ban in the original mitigation measures on sales of DGO capacity in bilateral contracts was a measure to prohibit DGOs from evading the revenue cap.[41] With the removal of the revenue cap for mitigated suppliers, it is no longer necessary to prevent DGOs from selling capacity bilaterally.

v. Pivotal Supplier Test and Application Threshold

61. Several parties, such as Astoria, assert that application of the pivotal supplier test should be based only on control of generation, without a test based on ownership. Astoria claims that NYISO's definition of "pivotal supplier" is inconsistent with Commission precedent, which states that "[o]ur guiding principle is that an entity

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[40] 1998 Divestiture Order, 84 FERC ¶ 61,287 at 62,358.

[41] NYISO filing letter at 28.

controls the facilities when it controls the decision-making over sales of electric energy including discretion as to how and when power generated by the facilities will be sold."[42]

62. ConEd asserts that the mitigation measures for suppliers should apply to a broader category of suppliers. ConEd argues, and Multiple Intervenors agrees, that the thresholds for application of seller mitigation to pivotal suppliers should be lowered to 200 MW and that mitigation measures should apply to non-pivotal suppliers with more than 500 MW and to suppliers holding swap agreements that encourage economic withholding.

63. In its reply comments, NYISO contends that the two-part pivotal supplier test is the only practical means of providing the necessary protections for the market against attempts to evade a "pivotal supplier" designation and that the 500 MW threshold is sufficient to capture all of the large net suppliers in the in-City market. NYISO also recognizes that there is a reasonable range of assumptions for the 500 MW threshold.

Commission Determination

64. The Commission will accept NYISO's proposal to subject only pivotal suppliers of greater than 500 MW to mitigation, but will reject NYISO's two-part pivotal supplier test. Instead, we will require NYISO to file a pivotal supplier test based solely on control of resources, as explained below.

65. First, with regard to the pivotal supplier test based on ownership or control, the Commission finds that it is appropriate for NYISO to determine pivotal suppliers based on control of capacity resources. As NYISO posits, and no protesters disagree, a supplier that accumulates control over enough capacity resources can have a significant impact on auction prices.

66. With regards to protesters' arguments against a pivotal supplier test based on ownership, we agree. In Order No. 697, we stated:

> [I]f a seller has control over certain capacity such that the seller can affect the ability of the capacity to reach the relevant market, then that capacity should be attributed to the seller when performing the generation market power screens. The capacity associated with contracts that confer operational control of a given facility to an entity other than the owner must be assigned to the entity exercising control over that facility, rather than to the entity that is the legal owner of the facility.[43]

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[42] Order No. 697 at P 176.

[43] *Id.* at P 157.

We further stated that "[o]ur guiding principle is that an entity controls the facilities when it controls the decision-making over sales of electric energy including discretion as to how and when power generated by the facilities will be sold."[44] We also noted that "the determination of control is appropriately based on a review of the totality of circumstances on a fact-specific basis."[45]

67. In its reply comments, NYISO points out that it has no "determinative indicator" that a pivotal supplier has indeed transferred all control of its pivotal capacity.[46] However, as we stated in Order No. 697:

> With regard to the suggestion that we adopt a rebuttal presumption that the owner of the facilities controls the facility, our historical approach has been that the owner of a facility is presumed to have control of the facility unless such control has been transferred to another party by virtue of a contractual agreement.[47]

Therefore, NYISO may presume that the owner of a capacity resource retains control over that resource for the purposes of applying the pivotal supplier test until the owner is able to make a demonstration that it has effectively conveyed control of the capacity resource to a non-affiliated third party.

68. We also find NYISO's proposal to apply mitigation to suppliers that are both pivotal and control at least 500 MW to be just and reasonable. The Commission agrees with NYISO's empirical assertion that non-pivotal suppliers greater than 500 MW and any other supplier smaller than 500 MW cannot profit from economic withholding given the mitigation and in-City market construct we are accepting here.[48] ConEd provides no empirical showing that non-pivotal suppliers with greater than 500 MW of capacity or

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[44] *Id.* at P 176.

[45] *Id.*

[46] NYISO Reply Comments at 12.

[47] Order No. 697 at P 183.

[48] As an example using the 2007 Summer ICAP in-City Demand Curve and a reference level of $5.60/kW-month, a 500 MW unit that economically withheld 50 percentof its capacity in order to raise the market clearing price would suffer net revenue losses. The supplier would have enjoyed greater capacity revenues offering 100 percent of its capacity competitively and receiving a lower market clearing price than if only 50 percent of its capacity cleared, albeit at a higher market clearing price. See example in P 70 – 71, *supra*.

suppliers with less than 500 MW could profit from economic withholding. ConEd's assertion that financial instruments can increase a supplier's incentive to economically withhold has not been shown to warrant rejection in this case of NYISO's proposals. As NYISO points out in its reply comments, ConEd's proposed revision to lower the threshold to all suppliers with at least 200 MW of capacity has no practical impact on the market, as there currently are no suppliers offering capacity between 200MW and 500MW.

69. To illustrate that non-pivotal suppliers greater than 500 MW and any other supplier smaller than 500 MW cannot profit from economic withholding given the mitigation and in-City market construct we are accepting, consider a non-pivotal, 500 MW supplier. For this example, assume NYISO's proposed supplier mitigation is applied under the conditions of the Summer 2007 ICAP in-City Demand Curve, including a reference level of $5.60/kW-month. If this supplier offered its capacity competitively, all 500 MW would clear and would be paid a capacity clearing price of $5.60 on each kW of capacity, for total revenue equal to $2.8 million.

70. Now suppose, instead, that the unmitigated supplier chose to offer only half of its capacity competitively and economically withhold the other half by offering the other half at a price high enough to ensure that it would not clear in the market. Based on the slope of the 2007 Summer ICAP in-City Demand Curve, the expected clearing price would be approximately $7.88/kW-month. The supplier's revenues, therefore, would reflect 250 MW sold at a price of $7.88/kW-month, or $1.97 million. Compared with offering its capacity competitively, therefore, the supplier will lose approximately $830,000 in capacity revenue by economically withholding half of its capacity.[49] No rational supplier would undertake this strategy, i.e., economically withhold, because it is unprofitable. As such, we find NYISO's proposal to only mitigate pivotal suppliers that control at least 500 MW of capacity to be reasonable in preventing suppliers from exercising economic withholding in the in-City capacity market.

vi. Going Forward Costs

71. Several parties request a revision of NYISO's proposed definition of "going forward costs." NYISO defines going forward costs as the costs that could be avoided if a unit is "mothballed" rather than being kept in service and used to provide capacity. Astoria argues that NYISO's calculation fails to recognize the opportunity costs associated with exports and with choosing to maintain a unit in operation. Dynegy and Coral Power contend that property taxes should be recoverable because a generation owner unable to pay its facility's property taxes will not continue operating for long. IPPNY states that costs related to pollution abatement equipment should be recoverable.

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[49] The $830,000 is the difference between capacity revenue of $2.8 million in the competitive offer scenario and $1.97 million in the economic withholding scenario.

NRG states that capital expenditures related to re-powering existing sites or developing new sites should be included in the definition of going forward costs.

72. KeySpan asserts that NYISO is wrong in assuming that going forward costs are the same whether a unit is selling capacity or it is selling only energy and ancillary services. KeySpan argues that the going forward costs of a capacity resource must include the cost of providing a day-ahead energy call option since providing capacity subjects a generator to penalties during outages. KeySpan states that the sale of ICAP gives the NYISO call rights on a unit's energy for a period of time (at least one month) on a day-ahead basis. KeySpan claims that NYISO is simply assuming these risks and costs are zero.

73. KeySpan states that generators must be able to recover all unavoidable costs outside of retiring the unit to continue economic operations, including: (1) property taxes; (2) site leasing, and land ownership costs; (3) capital investments in existing facilities; (4) capital investment or debt costs; (5) capital expenditures; and (6) lost opportunity costs.

74. KeySpan also claims that NYISO is mistaken in assuming that the capacity market would enable recovery of going forward costs at the same rate ($/kW) for a unit that sells all of its capacity as for a unit that sells only 1 MW of capacity. KeySpan notes that a bidder expecting to be a marginal unit in the capacity market needs to cover all of its capacity costs whether it sells 1 MW or all of its 100 MW. KeySpan asserts that selling 1 MW at a rate determined under a rate design computed assuming all 100 MW are sold provides only 1/100 of the necessary revenues. KeySpan explains that a marginal unit in the capacity market needs to be able to include all its costs in the first MW because, if a single MW is sold, none of the costs associated with the other 99 MWs can be avoided and the resource is revenue deficient.

75. In its reply comments, NYISO generally argues that the definition of going forward costs should not be expanded.

<u>Commission Determination</u>

76. The Commission will accept NYISO's definition of going forward costs with one revision. The key issue is in identifying the relevant costs of remaining in operation, i.e., the relevant costs that can be avoided if the unit shuts down. We agree with NYISO that, in most cases, it would be rational to mothball a plant and retain the option to bring it back into service rather than permanently retire it.

77. The Commission also agrees with NYISO that many of the comments on this issue assume that including additional costs in the definition of going forward costs would automatically result in their recovery. This assumption ignores the possibility that a unit (with its higher priced offer) may not clear in the auction.

78. The Commission finds that opportunity costs related to exports to neighboring markets – including PJM and ISO-NE – are appropriate for inclusion in NYISO's upcoming filing (as directed above)[50] in which it has committed to address issues related to physical withholding, including exports from in-City suppliers. Opportunity costs related to firm energy and capacity exports from in-City suppliers to external markets is inextricably linked to the issue of how to treat in-City suppliers that wish to export capacity. As such, we will defer action on the appropriateness of including opportunity costs related to exports until NYISO fully addresses all issues relating to physical withholding and exporting.

79. The costs of capital expenditures to re-power existing sites or develop new sites are inappropriate to include in the going forward costs of an existing unit. Such costs involve investment decisions in new plant based on expectations of future market prices, not decisions on whether to continue to operate existing plants. These costs have no relation to the decision whether or not to mothball existing generation already in operation, and thus are inappropriate to include in the definition of that generator's going forward costs.

80. Costs related to compliance with pollution control requirements, however, can be avoided by mothballing, and are therefore appropriate for inclusion in the calculation of going forward costs. NYISO must include costs related to pollution control equipment to meet environmental standards in its definition of going forward costs. Costs related to pollution control that have already been incurred are inappropriate for inclusion in the definition of going forward costs; such costs are sunk.

81. Costs such as property taxes, site leasing, and land ownership costs are only appropriate for a unit that wishes to retire as these costs are not avoided if a unit is merely mothballed. NYISO's proposal allows units that seek to retire the ability to raise its reference level to account for these types of costs.

82. The Commission disagrees with KeySpan's assertion that it should be allowed to include all of a unit's going forward costs in the price of the first MW of capacity. Under KeySpan's assertion, the first MW of a 200 MW unit would be offered at a much higher price than the other 199 MW. Thus, the 199 MW of capacity offered at the lower price would clear in the market, while the other higher priced 1 MW may not. This would be a nonsensical result. Further, KeySpan's proposal appears to be an attempt to insulate it from the market risk of selling its capacity, to which all suppliers selling in markets like the in-City capacity markets are and should be exposed. Insulating sellers from market risk is the antithesis of what markets do and what markets reward.

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[50] See Commission Determination in section C(ii) above.

83. We also disagree with KeySpan's assertion that going forward costs for providing capacity should be adjusted higher to account for the risk a capacity resource faces in becoming subject to availability penalties. The risk described by KeySpan related to providing capacity is already priced into the capacity payment received by capacity suppliers. The in-City Demand Curve features a reliability premium in which the amount of capacity procured by the market is higher than the minimum requirement. Capacity suppliers are paid extra to be available when called upon; this premium compensates capacity resources for their risk in providing capacity.

vii. Miscellaneous

84. Energy Curtailment Specialists assert that NYISO seeks to implement a market solution that fails to address the need for new capacity resources starting in 2011. Energy Curtailment Specialists argues that the NYISO Compliance Filing reduces the value of capacity in the in-City market and effectively signals to investors that the in-City market does not need investment in either new generating capacity or demand response resources.

85. Consumer Power Advocates states that reducing the offer caps would cause the capacity clearing prices to not reflect the free market, which would cause demand response resources, who are price takers, to disappear as capacity prices fall. In addition, it states that peak power plants, which rely far more on capacity prices than energy prices, would become less economically viable, while some base load power plants may not survive. Consumer Power Advocates asserts that the market failure could be addressed by entering the price and quantity of long-term capacity bilateral agreements into NYISO clearing auction calculators.

Commission Determination

86. The Commission finds the comments of both Energy Curtailment Specialists and Consumer Power Advocates unpersuasive. The in-City market presently enjoys a surplus of capacity, and under NYISO's proposal the market will send the appropriate price signal that new investment is not needed in the short run. NYISO's proposal – which mitigates suppliers and net buyers with market power – will also ensure that, in the long run, the changing price of capacity accurately reflects the changing value of capacity and will send the appropriate price signals to investors. As demand grows and units retire, the price for capacity should increase and send the appropriate price signals that additional investment is needed.

D. Prevention of Uneconomic Entry

87. In its October 4, 2007 filing, NYISO proposes a mitigation methodology to remedy potential uneconomic entry by net buyers who can benefit from artificially

depressed capacity prices.[51] The proposal would apply to all new entry deemed "uneconomic" in the form of an offer floor equal to 75 percent of net CONE, applicable to all new entrants for the first three years of operation. To prevent circumvention of this floor, new capacity deemed uneconomic and subject to the floor would not be able to directly participate in bilateral transactions, or in strip or monthly auctions.

88. Exemptions from net buyer mitigation are to be available if NYISO determines that a new entrant's costs are legitimately less than 75 percent of net CONE. NYISO proposes to apply the net buyer mitigation measures to all projects built subsequent to approval of these market rule revisions, thereby exempting the recently completed 1000 MW of capacity from the NYPA and ConEd units from mitigation. NYISO argues that since the rule is prospective and meant to deter future action, it makes no sense to apply this rule to any existing units.

i. <u>Comments</u>

89. ConEd claims that net buyers are not exercising market power, and therefore, there is no harm to address. Dynegy disagrees with ConEd's claims, stating that net buyer market power must be addressed, even if it has not been a problem in the past, because the potential for future problems exists.

90. NYPSC argues that the Commission should reject minimum offer requirements for new ICAP supplies because appropriate prices are determined under the ICAP Demand Curve. Astoria, on the contrary, argues that the Demand Curves and state regulation alone do not provide sufficient mitigation against the ability of load to use uneconomic entry to artificially suppress market clearing prices.

91. Several parties seek rejection of NYISO's net buyer mitigation proposal citing conflicts with state requirements and goals, and overly broad application of the measure. Protesters claim that NYISO's proposed net buyer mitigation measures either do not go far enough to protect the integrity of the market from uneconomic entry or do not provide a reasonable opportunity to recover the costs of investment by new entrants or DGOs. Several parties state that NYISO's proposal will keep prices consistently below net CONE and thus not attract or retain the necessary infrastructure. Dynegy expresses concern that generators may look to increase or maximize out-of-state sales because of NYISO's proposal.

[51] NYISO describes this as follows: "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."

92. NYPSC requests that the Commission reject the proposed minimum offer requirements for new ICAP supplies on the basis that they could interfere with New York's standards for resource adequacy and the ability to self-supply ICAP. NYPSC also states that NYISO's proposal is undesirable and undermines the public interest because 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 New York State's resource adequacy requirements or receiving ICAP payments when excess capacity causes clearing prices to fall below the minimum offer requirement. NYPSC states that, given the overlap in state and Federal jurisdictional responsibilities, NYPSC respectfully requests that the Commission recognize NYPSC's authority over resource adequacy standards, including enforcement of such standards. NYPSC claims that the changes it proposes would not adversely impact matters within the Commission's jurisdiction, such as establishing just and reasonable wholesale energy rates. Several parties raise the issue of whether NYPSC has jurisdiction over any aspect of NYISO's proposal and whether NYPSC's proposal to eliminate certain measures of NYISO's proposal would adversely impact matters within the Commission's jurisdiction.

93. Astoria and other generators argue that NYPA's Poletti I facility and the NYPA and ConEd units have exacerbated the existing capacity oversupply and should be subject to the proposed mitigation measures applicable to new uneconomic entrants. NYPA argues that recently built generation must be exempt from net buyer mitigation to avoid setting bad precedent and creating market uncertainty. NYPA further argues that its Poletti I facility should not be mitigated because the need for net buyer market power mitigation has not been demonstrated and it would in fact harm in-City customers.

94. Several parties disagree with NYISO's proposal to apply net buyer mitigation for only three years and contend that the offer floor should not be 75 percent of net CONE. Astoria Generation proposes extending the length of time that mitigation will apply to account for the possible entry of larger units than have entered to date. KeySpan claims that the exemption for special case resources (SCRs) is inappropriate while Multiple Intervenors argues that such an exemption is appropriate. Hudson Transmission requests that, should the Commission decline to reject these mitigation measures, the Commission should instruct NYISO to clarify and revise the uneconomic portion of its proposal so that this measure does not apply to new controllable transmission lines. Several parties propose alternatives to NYISO's net buyer mitigation measures.

95. ConsumerPowerline states that the market failure that exists in the in-City market is caused by ConEd's high-priced bilateral purchases, which ConsumerPowerline seeks to cure by having the price and quantity of long-term capacity bilaterals entered into NYISO clearing auction calculators.

ii. <u>NYISO Reply Comments</u>

96. In its reply comments, NYISO suggests two revisions to its net buyer mitigation measures, but overall seeks to maintain its proposal as originally filed. NYISO maintains that the 75 percent of net CONE threshold is appropriate and similar to the thresholds used in PJM and ISO-NE and is intended to provide a leeway of more than 400 MW to recognize the scale of economic new unit entry. NYISO asserts that it would use appropriate procedures and return to the Commission for authority to adjust the floor as the need arises. NYISO also claims the addition of resources for non-reliability reasons, including a desire for increased self-supply, would not be precluded by the NYISO proposal.

97. NYISO proposes to amend its net buyer mitigation measures in two ways. First, NYISO proposes to apply net buyer mitigation for the longer of 3 years or "a period determined by the size of the new investment divided by the annual growth rate in capacity demand."[52] NYISO states that "the duration of the mitigation could be" the longer of three years or "the estimated duration of uneconomic surplus calculated by dividing the new ICAP MW by the projected annual increases in ICAP requirements for New York City."[53] NYISO originally chose three years as the appropriate length of time for mitigation based on an average growth in demand in the in-City market of approximately 150 MW per year. Thus, by the end of the three years, in-City demand would grow enough to make any attempt at market price manipulation ineffective. The new higher demand would result in a market price that reflected the new need for entry and the uneconomic unit that was entered into the market three years previous would not be large enough to depress the price. However, if a unit larger than 400-500 MW enters, the floor would expire after three years and this unit would then still be able to depress prices in the market for some period of time. NYISO's amended proposal then would allow for the mitigation to be effective for longer if the new uneconomic unit is larger. For example, if a 750 MW unit enters the market, assuming a growth of 150 MW in demand per year, the mitigation would remain in place for five years.

98. Second, NYISO proposes to modify its ex ante test to prevent it from becoming a barrier to entry for larger units with lumpy investment streams. Under the amended ex ante test, a new unit would be exempt from mitigation if: (1) the post-entry market clearing price in the first year is higher than the offer floor (i.e., 75 percent of net CONE) or (2) the average post-entry market clearing prices in the first three years after entry is higher than the new unit's entry costs (i.e., the net CONE of the new unit).

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[52] NYISO Reply Comments at 18.

[53] *Id.* Patton Affidavit at P 20.

99. NYISO maintains that exemptions for the existing ConEd and NYPA units is appropriate since deterrence of their entry by definition is no longer possible and the Commission has generally required market power mitigation measures to be applied prospectively. NYISO states that the equity issue appears to relate more to supplier expressions of concern about the immediate revenue impacts on suppliers of lowering the cap on their offers from current levels. If that is the case, NYISO suggests that if the Commission decides to address this concern, it should do so directly by adopting a phase-in of the supplier mitigation measure rather than indirectly through the application of an offer floor to existing units. NYISO also maintains that exemption for SCRs from uneconomic entry provisions is appropriate. However, NYISO does not find that special exemption for controllable transmission is warranted. If merchant transmission can show that open-season allocation of transmission scheduling rights and other applicable procedures establish that the project would be economic, then it should qualify for an exemption from mitigation.

Commission Determination

100. We accept NYISO's proposal for net buyer mitigation, with modifications, in order to prevent uneconomic entry that would reduce prices in the NYC capacity market below just and reasonable levels.

101. Large net buyers may have both the incentive and the ability to depress prices through uneconomic entry. The in-City market is dominated by two large net buyers – ConEd and NYPA. A large net buyer could acquire new capacity that is not needed in the market and whose costs exceed the market price. Such an investment would be inefficient, the net buyer would lose money on the capacity, and no rational seller would knowingly make such an investment. But the investment could benefit the net buyer because the additional capacity could reduce the market price for capacity and lower the net buyer's total capacity bill. If the newly added capacity represents only a portion of the net buyer's total capacity needs, the reduction in the buyer's total capacity bill caused by the lower prices could more than offset the loss on the newly added capacity investment. As a result, a large net buyer could have an incentive to make such an inefficient investment. However, this would result in the LSE's captive ratepayers bearing the risk of uneconomic investment. The mitigation of net buyers' sales of capacity proposed by NYISO should help avoid this.

102. Generators state that the additional 1000 MW of capacity recently acquired by Con Ed and NYPA represents uneconomic entry that these two net buyers acquired with the intention of artificially reducing capacity prices in NYC. They argue that, if such uneconomic entry is allowed to continue while seller mitigation is increased, capacity prices in NYC will be permanently depressed well below net CONE and will cease to encourage independent investment. If uneconomic entry is allowed to happen, an LSE could invest in a new generating unit every two or three years and perpetually keep the market price depressed. This would lead to the negative effects described above.

103. Markets require appropriate price signals to alert investors when increased entry is needed. By allowing net buyers to artificially depress prices, these necessary price signals may never be seen. While a strategy of investing in uneconomic entry and offering it into the capacity market at a low or zero price may seem to be good for customers in the short-run, it can inhibit new entry, and thereby raise price and harm reliability, in the long-run. Under the FPA, the Commission must ensure that rates are just and reasonable. The courts have long held that establishing just and reasonable rates involves a balancing of consumer and investor interests. [54]

104. The Commission has accepted similar provisions to prevent uneconomic entry by net buyers in approving long-term capacity markets in both PJM[55] and ISO-New England.[56] While these capacity markets are both more forward looking than NYC's, typically procuring capacity three years in advance of the year in which it is called on, the logic is no different for the NYC market.

105. Furthermore, as described above, properly constructed capacity markets can also encourage reliable and efficient levels of investment only if market participants can expect prices that provide a reasonable opportunity to recover the costs of needed investment. In order to prevent uneconomic entry by net buyers and the adverse effects that can follow from such entry, net buyer mitigation is necessary.

106. Finally, the Commission notes that, while this mitigation applies to all new entry into the in-City market, this mitigation is aimed at preventing uneconomic entry by net buyers of capacity, the only market participants with an incentive to sell their capacity for less than its cost. New capacity offered by net sellers of capacity would not profit from this strategy, and so would not enter the ICAP market with uneconomic capacity; it will only enter the market when the market sends the price signal indicating that profit can be earned by entering the market. In this regard, NYISO must specify in its proposed tariff language that the mitigation of uneconomic entry applies only to net buyers bringing uneconomic capacity into the market.

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[54] See *Federal Power Commission et al. v. Hope Natural Gas Co.*, 320 U.S. 591; 64 S. Ct. 281; 88 L. Ed. 333; 1944 U.S. Lexis 1204.

[55] *PJM Interconnection, LLC,* 117 FERC ¶ 61,331, at P 103-04 (2006), *order on reh'g and clarification,* 119 FERC ¶ 61,318, *order on reh'g,* 121 FERC ¶ 61,173 (2007).

[56] *Devon Power, LLC,* 115 FERC ¶ 61,340, at P 109-15 (2006), *order on reh'g,* 117 FERC ¶ 61,133 (2006).

a. .75 Net CONE Bid Floor

107. The Commission accepts NYISO's proposal to set a net buyer offer floor equal to seventy-five percent of net CONE as a reasonable solution to forestall potential uneconomic entry. This offer floor will deter uneconomic entry by preventing such entry from depressing the market price significantly below the net CONE. While commenters raise an issue with the floor being set at seventy-five percent of net CONE rather than at a higher level, such as one hundred percent of net CONE, as Astoria suggests, the Commission agrees with NYISO that its proposed seventy-five percent level of mitigation serves two purposes. It deters uneconomic entry but is not so high as to deter economic entry. Further, the Commission has approved the use of similar offer floors at or near seventy-five percent of net CONE for ISO-New England and PJM.[57]

108. To ensure that the offer floor operates as intended and is established at an appropriate level, the Commission directs the NYISO market monitor to include, in each of its future annual state of the market reports, an analysis of the effectiveness of this price floor, with a recommendation whether or not it should be changed.

b. Conflict with State Requirements and Goals

109. Although the Commission "will defer to state and local entities' decisions when possible on resource adequacy matters, . . . resource adequacy can have a significant effect on wholesale rates and service."[58] In *Mississippi Industries v. FERC*,[59] the court stated, "[c]apacity costs are a large component of wholesale rates" and therefore the share of the capacity costs of the system carried by each affiliate will significantly affect the wholesale price it pays for energy.[60] While the allocation of capacity did not set sales prices, it directly affects costs and "consequently, wholesale rates"[61] and therefore "FERC's jurisdiction under such circumstances is unquestionable."[62]

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[57] *See* 115 FERC ¶ 61,340 at P 109-15 (2006); 117 FERC ¶ 61,331 P 103-04 (2006).

[58] *PJM Interconnection, LLC,* 119 FERC ¶ 61,318, at P 40 (2007).

[59] 808 F.2d 1525 (D.C. Cir. 1987), *vacated in part on other grounds*, 822 F.2d 1103 (D.C. Cir. 1987) (*Mississippi Industries*).

[60] *Id.* at 1541.

[61] *Id*.

[62] *Id.* (*citing Nantahala Power & Light Co.*, 426 U.S. 953 (1986)).

110. Because uneconomic entry could produce unjust and unreasonable capacity prices by artificially depressing those prices, and NYISO's proposal provides a reasonable means to deter uneconomic entry in the in-City market, we deny NYPSC's request that the Commission reject the proposed minimum bid requirements for new capacity suppliers. Contrary to NYPSC's claim, we find that granting its request would adversely impact matters within the Commission's jurisdiction – in particular, the establishment of just and reasonable wholesale electric energy rates.[63] Adoption of NYPSC's proposal would lead to artificially depressed capacity prices, thus both causing existing generators to be under-compensated and also directly and adversely impacting the Commission's ability to set just and reasonable rates for capacity sales in the in-City market. Most recently, in orders involving ISO New England, Inc. (ISO-NE),[64] the Commission stated that New England's similar "[Installed Capacity Requirement] is one of the principal determinants of the price of capacity and, hence, falls within the Commission's jurisdiction to review 'any rate, charge or classification' charged by a public utility for electric transmission or sales subject to agency jurisdiction, and 'any rule, regulation, practice, or contract affecting such rate, charge or classification. '"[65]

111. The NYISO's offer floor proposal is an integral part of NYISO's proposal, which the Commission is adopting, needed to "promote long-term reliability while neither over-compensating nor under-compensating generators."[66] The issue before us 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 order to remedy identified flaws in the ICAP market. As we have found previously, issues of resource adequacy are important to the Commission in meeting our statutory mandate under the FPA to ensure that the rates, terms and conditions of jurisdictional transmission

[63] E.g.s, ISO New England, Inc., 122 FERC ¶ 61,144; New York State Reliability Council, 122 FERC ¶ 61,153 (2008).

[64] *ISO New England, Inc.*, 118 FERC ¶ 61,157, *order denying reh'g*, 120 FERC ¶ 61,234 (*ISO-NE I*); *ISO New England, Inc.*, 119 FERC ¶ 61,161, reh'g denied, 121 FERC ¶ 61,125 (2007) (*ISO-NE II*); *accord ISO New England, Inc.*, 122 FERC ¶ 61,144 (2008).

[65] *See ISO-NE II,* 119 FERC ¶ 61,161 at P 23.

[66] March 6, 2007 Order, 118 FERC ¶ 61,182 at P 17.

and sales of electric energy are just, reasonable, and not unduly discriminatory, or preferential.[67]

112. Further, we find that our action in approving NYISO's minimum bid proposal does not adversely affect NYPSC's regulation of resource adequacy in NYC. This new pricing methodology does not prescribe whether or what types of generation facilities should be built, contrary to NYPSC's concerns.[68] Additionally, as we previously stated, NYISO's measures dealing with the prevention of uneconomic entry is aimed at net buyers of capacity. Thus, there is no interference with New York State's standards for resource adequacy, as this limitation would allow not only more traditional generation, but also renewable resources (for example, those under renewable portfolio standard requirements) and demand response resources.

c. Length of Net Buyer Mitigation

113. NYISO proposes to determine the length of mitigation (if longer than three years) by dividing "the size of the new investment…by the annual growth rate in capacity demand."[69] We presume that the annual growth rate would be measured in MWs per year.[70] Thus, NYISO proposes that the offer floor for any individual uneconomic investment be the longer of three years or a period of time equal to the size of the new investment divided by the annual growth in demand for capacity.

114. The Commission agrees with NYISO and various commenters that a longer period of mitigation may be necessary for larger units and that the length of time a unit should be mitigated by a price floor should vary depending on the size of the unit in question. We agree that the general method by which NYISO proposes to determine this length of time is appropriate, although we will require changes in some details below. In order to determine the exact method by which that other period of time is calculated, the Commission agrees with Astoria that the growth rate in demand should be calculated based on the average growth in demand for capacity in NYC over the previous three

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[67] *See ISO-NE II*, 119 FERC ¶ 61,161 at P 27–28; *California Independent System Operator, Inc,*, 116 FERC ¶ 61,274 at P 1112–14 (2006); *California Independent System Operator, Inc.*, 119 FERC ¶ 61,076 at P 521–64.

[68] E.g.s, ISO New England, Inc., 122 FERC ¶ 61,144; New York State Reliability Council, 122 FERC ¶ 61,153 (2008).

[69] NYISO Reply Comments at 18.

[70] Measuring the growth rate as a pure percentage would give nonsensical results. For example, if a new 500 MW generator were built, and the growth rate was ten percent per year, this unit would be mitigated for 5000 years (i.e., 500 divided by 0.1).

years (measured in MW). By using the average of three past years, there is no uncertainty over growth because it has already occurred, and by averaging, we recognize that growth can change from year to year and especially large or small changes in growth in any one year should not unduly affect the length of time a unit in mitigated. To avoid future confusion, this calculation must be reflected in revised tariff sheets the ISO submits.

115. The Commission also agrees with Astoria that previous years' uneconomic entry, as well as other excess capacity above the minimum capacity requirement, ought to be included in the calculation. While NYISO argues this would be penalizing a market entrant for something out of its control, we disagree. The issue is not that a new entrant has control over the past actions of others, but that it can take advantage of those actions. For example, suppose that 750 MW of surplus capacity exists in Year 1. If growth in demand was 150 MW/year on average, it would take five years for that growth to fully absorb the 750 MW of surplus capacity. However, if another 450 MW of uneconomic entry occurs in Year 2, the market in Year 2 would have 1050 MW of surplus capacity. (That is, the market would have absorbed 150 MW of last year's uneconomic capacity, leaving 600 MW plus the additional 450 MW of entry this year). The market will then need seven years to absorb all of this surplus capacity. Yet, under NYISO's proposal, mitigation will only be in place for four years (the four years remaining on Year 1's surplus capacity, which runs concurrently with the three years of mitigation on the new entry). For this reason, in order to remove the incentive to invest in uneconomic entry, the Commission concludes that previous surplus capacity must be included in any determination of the length of mitigation.

116. When calculating the length of mitigation, NYISO is directed to include all new uneconomic entry plus the portion of surplus capacity from previous investments that has not been absorbed by the market. Otherwise, uneconomic entry could perpetuate any existing surplus capacity indefinitely. In the example above, uneconomic entry in Year 2 would thus be subject to mitigation for seven years (450 MW of new entry plus 750 MW of old entry minus 150 MW times 1 year of old entry that has been absorbed by the market, all divided by 150 MW). This calculation methodology must be reflected in revised tariff sheets the ISO submits.

d. <u>Exemption Based on Estimated Future Prices</u>

117. To ensure the mitigation rules do not deter economic entry, the Commission agrees that units should be exempted when their decision to enter was based on price signals the market sent indicating that entry was needed. If NYISO predicts in some future year that market prices will be greater than the net CONE, then this indicates that building new capacity to begin operation in that year is economically rational. Such new capacity should not be penalized after-the-fact for a decision to build that was economically rational at the time the decision was made. If the actual capacity price in a year is below seventy-five percent of net CONE and differs from the forecast of higher

capacity prices for that year made at the time the decision to build the new capacity was made, the owner of the new capacity should not be penalized because it (and NYISO) did not correctly estimate that demand. Thus, in this circumstance, we believe that the owner of the new capacity should be allowed to offer below the price floor in order to be assured of being selected as a capacity resource and receiving whatever capacity price clears the market. To do otherwise would be a penalty that could deter economic entry. Thus, we accept NYISO's proposal to grant a waiver to such a unit if either of two cases prove to be true: if NYISO estimates that the post-entry price in the first year after entry will be greater than seventy-five percent of net CONE; or if the average of estimated post entry prices in the first three years after entry is greater than net CONE.

e. Exemption of ConEd and NYPA Units

118. The Commission also agrees that both the NYPA and ConEd units, which came online in 2006, should be exempted from net buyer mitigation. NYISO's proposal clearly applies to "new" uneconomic entrants, not existing capacity. To apply this new market rule to units that already exist in the market misses the point of this prospective rule, which is to affect future actions. Deterrence of their entry, by definition, is no longer possible. Thus, whether or not these units were purposefully brought on-line to depress prices (a determination neither NYISO nor the Commission has made), they are already in the market and for the market to send the correct price signal, they should offer their marginal cost, not an artificial price floor. NYISO recognizes this result:

> A competitive capacity offer price for most units is close to zero because the incremental costs of supplying capacity from an existing unit are typically very low. Hence, it is competitive for suppliers to offer capacity at offer prices close to zero and this conduct cannot be considered an exercise of monopsony market power, whoever is doing it.[71]

119. While the DGOs argue that because their units have been mitigated the ConEd and NYPA units should also be mitigated, considering the new seller mitigation being instituted here, the Commission disagrees. As previously discussed, the Commission's order approving the divestiture and market mitigation rules under which DGOs' units currently operate contained no guarantee that the generator offer caps would never change.[72] Further, while the Commission has a duty to ensure that market prices are just and reasonable, and therefore that they are neither too high nor too low, the prices that will result from the mitigation scheme adopted here have not been shown to be unreasonable; in fact, they will in most cases provide more than the going forward costs of existing generation. As we discussed previously, because mitigated suppliers are

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[71] NYISO Filing, Patton Affidavit at P 64-65.

[72] *See* 1998 Divestiture Order.

capped at the higher of their going forward costs or the reference level and going forward costs (i.e., the costs not recovered through sales of energy or ancillary services) for all existing generation is considerably less than the reference level prices, the market clearing prices will be sufficiently high to ensure that DGO suppliers are able to recover their going forward costs which would include any going forward investment costs not already recovered or recoverable through energy and ancillary service revenues.

f. Exemption of SCRs

120. The Commission agrees that mitigation of uneconomic investment should not apply to SCRs. Demand response is a valuable tool for the maintenance of reliability and fulfills this role in an environmentally benign way. Applying the offer floor for generators to SCRs could erect a barrier to entry into the markets by demand response. There is no basis to establish an offer floor for demand response resources based on the cost of new generation entry because there is not necessarily any connection between net CONE by generation and net CONE by demand response resources. Moreover, it is not clear, nor is it proposed here, how NYISO would determine the cost of SCR entry or if that entry was uneconomical.

g. Controllable Transmission

121. NYISO proposes to apply this mitigation to controllable transmission projects as well as traditional generating capacity. Protesters argue that this is a misapplication of the mitigation. But the Commission agrees with NYISO that, because both transmission and generating capacity are paid based on the same principle of making capacity available in-City, there should be no special exemption. Controllable transmission and generating capacity should be subject to the same mitigation.

E. Forward Capacity Market

122. Although not proposing a forward auction, NYISO suggests that its proposed mitigation measures could easily be adapted to work with a forward auction. For example, if a qualifying new offer clears in the forward auction at a price higher than 75 percent of net CONE, then no additional mitigation would apply going forward. If the qualifying new offer does not clear in the forward auction or clears at a price less than 75 percent of net CONE, then it would subject to the offer floor in the spot auction, as described above. As in the monthly spot auctions, the supplier should have the opportunity to justify a forward offer at a price less than 75 percent of net CONE. If the justification is accepted, then the supplier will be exempt from the offer floor in the spot auction if it clears at a price higher than the justified level in the forward auction. NYISO adds, though, that a forward auction is not necessary to implement these mitigation measures.

i. Comments and Reply Comments on Forward Capacity Market

123. Several parties urge the Commission to implement a forward capacity market design in the in-City market similar to that implemented by PJM and ISO-NE so that long term in-City market structures and not just short-term issues will be addressed. However, the parties differ in their approaches to implement a forward capacity market. Some parties argue that the Commission must direct NYISO to make a compliance filing within a specified timeframe, while others argue that the standard stakeholder process is more appropriate for creating a forward capacity construct.

124. LIPA, NY Consumer Board, Multiple Intervenors, and NY Transmission Owners oppose the suggestion that the Commission should require NYISO to make a "compliance" filing regarding the development of a forward capacity market. Multiple Intervenors, NYPSC, and NY Transmission Owners state that they agree with NYISO that the stakeholder process should be allowed to continue to develop a forward capacity market, unfettered by artificial timelines. Multiple Intervenors state that allowing the stakeholder process to continue at the NYISO would ensure that all parties affected by a forward capacity market have an opportunity to fully participate in its possible development. Multiple Intervenors assert that as PJM and ISO-NE gain experience with their forward capacity markets (ISO-NE's first auction is in February 2008), the NYISO will be able to benefit from their experience in determining whether a forward capacity market should be implemented, and, if so, how it should be designed. The NY Transmission Owners states that section 3.03 of the NYISO/TO Agreement requires NYISO to seek and obtain NYISO Management Committee and NYISO Board approval for tariff filings to be made under section 205 of the FPA and that, in the absence of that approval, NYISO is limited to filings under section 206 of the FPA. The NY Transmission Owners states that this aspect of NYISO's governance structure is critical to the proper functioning of NYISO and ensures that it will seek input from stakeholders prior to filing proposed changes to its tariff.

125. ConEd asserts that NYISO should be directed to make a FPA section 205 filing with the Commission to institute a forward market design for the in-City capacity market by June 1, 2008, or, if not, to provide a detailed status report of its stakeholder efforts at that time, with an estimate of the additional time required, and the steps necessary over that period to create a new market structure.

126. Other parties request various deadlines by which NYISO must file a compliance filing with its proposal for a forward capacity market mechanism. Entergy/Mirant adds that any forward market mechanism should apply to the entire NYISO market, not to individual zones on a piecemeal basis. IPPNY and Entergy/Mirant add that such a proposal should include a demand curve mechanism. NRG proffers that a well-designed forward capacity market should include the following characteristics: (1) capacity obligations should be procured 3-5 years in advance; (2) a descending-clock auction similar to that used in ISO New England's Forward Capacity Market (FCM); (3) new

projects should have the option to lock in multi-year commitments; (4) the market should feature reconfiguration auctions; and (5) the market should have qualification processes, mitigation measures, and a transition period similar to that in ISO New England's FCM.

127. In its reply comments, NYISO states that a potential forward market design is the subject of on-going stakeholder proceedings that should be allowed to proceed. Moreover, those stakeholder discussions involve all interested parties in New York, not just the intervenors in this proceeding, and may result in forward markets for the state as a whole and possibly for Long Island, which is beyond the limited examination of only the in-City Market in this proceeding. Comments on a party's preferred attributes of a forward market belong in those stakeholder discussions and not here.

ii. Commission Determination

128. The Commission will not order NYISO in this proceeding to put development of a forward capacity market on a priority track with any sort of specific timeline, as some parties propose. We find that NYISO can fully satisfy the objectives of this filing, described above, without a forward capacity market. To the extent NYISO and its stakeholders continue to consider a forward capacity market, it could potentially provide an alternative method to address long-term capacity needs in NYC and the entire NYISO region.

129. Moreover, we find that a discussion of the specifics of a forward capacity market does not belong in this proceeding. Current stakeholder discussions on this matter may ultimately result in a forward capacity market for the state as a whole, not just NYC. As such, interested and affected parties who may not be involved in this proceeding (which is NYC-specific) should continue to have the opportunity to participate in stakeholder discussions on this topic. We therefore agree with NYISO that matters related to the preferred attributes of a forward capacity market should be addressed in the on-going stakeholder process rather than in the instant proceeding.

F. Refunds

130. NYISO proposes to implement its mitigation measures prospectively, without refunds, since: (1) all interested parties have been aware of the $105/kW-year cap for DGOs which the Commission indicated would apply to DGOs so long as they remained pivotal; and (2) ordering refunds and changing market outcomes after bids and offers in the voluntary ICAP auctions have been made may lead to regulatory uncertainty and harm market credibility.

i. Comments and Reply Comments on Refunds

131. Several parties oppose refunds in this proceeding. NRG notes that the existing market design has resulted in market outcomes that were both expected and authorized

under NYISO's existing tariff, and that while the Commission established a refund effective date in this proceeding, market participants had little choice but to adapt their expectations based upon the existing market rules.

132. Astoria, KeySpan, and IPPNY argue that the requests for refunds must be denied because no market participant has violated the filed tariff. NRG and Keyspan claim that ordering refunds is inappropriate because they did not withhold capacity. Keyspan points out that the tariff does not require that all capacity clear in the market, that it be offered at a price at which it would be expected to clear, or at a "competitive price" based on marginal costs or going forward costs. Astoria contends that the instant proceeding does not involve a determination of whether there was a violation of the NYISO tariff by either the ISO or market participants, but instead, involves a section 206 proceeding designed to revise the bidding rules in the in-City ICAP Market. According to Astoria, since the Commission ordered an investigation pursuant to section 206 of the FPA, any refunds ordered must be in accordance with that section.

133. Astoria and IPPNY argue that the Commission has adopted a policy against resettling markets**,** which would require speculation as to how parties would have bid had they known at the start of each auction what the revised bid rules would have been. IPPNY states that NYPSC's and Con Edison's calculation of refunds wrongly assumes that all suppliers would offer ICAP at zero in the NYC ICAP market if the market were resettled. Similarly, Dynegy and Coral Power argue that retroactively changing the in-City rule would entail unwinding the six-month strip, monthly and spot market auctions that have occurred in both markets and recalculating each transaction, a procedure which would present much difficulty and would face criticism and challenges. In addition, Dynegy and Coral Power note that capacity suppliers have certain obligations, such as submitting energy and reserve bids in the day-ahead market and that, having satisfied these requirements, not receiving payments for these bids would be unfair.

134. NRG and Keyspan argue that there is no basis for refunds for periods after the refund effective date of May 12, 2007 because the rates involved have not been shown to be unjust and unreasonable, and in fact, should have been higher. NRG and Keyspan point out that the DGOs' caps are below the just and reasonable rate of net CONE. Further, Keyspan argues that no party that claims refunds are appropriate has demonstrated that a resettlement of the in-City capacity market would produce just and reasonable rates.

135. Dynegy and Coral Power and Entergy/Mirant state that in the event the Commission determines that refunds are appropriate, they ask that the refunds be limited to the in-City ICAP market. NRG also argues that refunds should not be ordered for the Rest of State region (ROS) since the ROS's rates are not and have not been the subject of any investigation subject to refund.

136. ConsumerPowerline argues that refunding ratepayers would threaten the reliability of NYC's electric supply and cause market uncertainty that could lead to planned base load power plants getting scrapped.

137. ConEd points out that ConsumerPowerline does not demonstrate how the imposition of refunds could cause demand response providers to not participate in the market in the future nor do they demonstrate how plants could be harmed.

138. Multiple parties also argue that refunds are appropriate because the Commission set a refund effective date of May 12, 2007, effectively placing all market participants on notice that the rates collected from that point forward may be revisited. ConEd claims that because consumers paid capacity prices that are twice the competitive rate, the public interest is affected, and corrective action is needed. ConEd claims that capacity prices in 2006 and 2007 were artificially inflated due to economic withholding of the DGOs. NY Transmission Owners state that no party has a reasonable expectation to retain the benefit of market manipulation. ConEd and NY Transmission Owners cite *California v. FERC*, 383 F.3d 1006, 1015 (9th Cir. 2004), in which, they claim, the court authorized the Commission's use of retroactive refunds in instances where market power abuses have occurred. NYPSC proposes that refunds should be issued for the difference between the actual market clearing price in the NYC capacity market, $12.72/kW-month, and the NYISO-determined capacity clearing price had the market cleared at the competitive level, or $5.60/kW-month. ConEd agrees, and claims that at least $110 million is owed by sellers to LSEs in refunds.

139. ConEd disagrees with NYISO's assertion that refunds are inappropriate because market participants "knew the rules." ConEd claims that market participants expected the price of capacity to be determined by the normal workings of supply and demand, and not by economic withholding strategies.

140. NY Consumer Board, Multiple Intervenors, and Consumer Power Advocates state that the prohibition against refunds will seriously damage consumer confidence in NYISO and would also have a deleterious effect on the perceptions of market participants of the market and regulatory credibility.

141. NY Transmission Owners state that it is not credible for NYISO to recommend against refunds without knowing the results of the Commission's Office of Enforcement (OE) and United States Department of Justice investigations.

142. The NY Consumer Board requests that the Commission order NYISO to recalculate the in-City and ROS capacity prices back to May 12, 2007 and provide refunds to New York State consumers as of the refund effective date. The City of New York states that the practical effect of the May 2007 refund effective date does not operate to make overcharges in 2006 and in the early part of 2007 subject to

disgorgement, but provides a mechanism by which partial economic justice can be achieved for consumers.

ii. Commission Determination

143. The Commission finds that, under the circumstances in this case, there is no basis for ordering refunds. Therefore, we will accept NYISO's Proposal to implement the revised market rules prospectively, without refunds.

144. The Commission has significant discretion under the FPA to determine whether to order refunds.[73] Under section 206 of the FPA, the Commission "may," but is not required to, order refunds of amounts in excess of those that would have been paid had the just and reasonable charge or rate been in effect and upon a finding that a rate or charge is unjust and unreasonable.[74] The establishment of a refund effective date is a requirement set out by section 206 of the FPA that is a predicate for refunds in the event the Commission ultimately determines a refund is warranted; it does not mandate that refunds be ordered. Contrary to the assertions of several parties in favor of refunds, "[t]he establishment of a refund effective date does not constitute a determination that refunds will be ordered or how such refund amounts and refund period will be determined."[75]

145. The Commission finds that as there has been no demonstration of a violation of NYISO's tariff or existing capacity market rules, refunds are not appropriate in this case. Bids of up to the $105/kW-year cap were not only permissible under the NYISO's Market Administration and Control Area Services Tariff (Services Tariff)[76] but consistent with the Commission's expectations when the Commission approved ConEd's divestiture plan. The Commission recognized in its 1998 Divestiture Order that:

> Given the circumstances present here, existing suppliers are likely to bid the price cap and set the market clearing price at that level even as new generation is added and supply increases. This is because, until the supply increases sufficiently to supplant substantial amounts of existing capacity, the existing suppliers will be assured that at least some of their capacity

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[73] *See Towns of Concord,* 955 F.2d 67, 75-76 (D.C. Cir. 1992); *Niagara Mohawk Power Corp. v. FPC,* 379 F.2d 153, 159 (D.C. Cir. 1967).

[74] 16 U.S.C. § 824e(b) (2000).

[75] *Ameren Services Co. v. Midwest Indep. Transmission Sys. Operator, Inc.* 121 FERC ¶ 61,205 at P 107 (2007).

[76] Section 4.5(b) of Attachment H of NYISO's Services Tariff.

> will be selected at any price and so they have an incentive to bid the price cap to maximize revenues on those sales.[77]

Although the DGOs have continuously offered at a price equal to their cap and the spot price of capacity has remained at the highest DGO's cap, neither the tariff nor the Commission's regulations were violated. Therefore, refunds should not be ordered.

146. While parties in favor of refunds argue that *California v. FERC* supports their position, we find that the case is not analogous to the circumstances of this case. ConEd argues that "'in the past, [the Commission] has ordered refunds in instances where utilities violated FPA § 205, either by violating the terms of an accepted rate, or by charging rates without first seeking approval under FPA § 205.'"[78] In *California v. FERC,* the court found that the Commission abused its discretion by improperly concluding that retroactive refunds were not legally available for regulatory violations, specifically, non-compliance with the Commission's reporting requirements, which were an integral part of the market-based rate tariff.[79] However, the bidding behavior in this case did not violate the filed rate. Since there was no tariff violation, retroactive refunds to address a filed rate violation would be improper.

147. On numerous occasions, the Commission has denied refunds out of concern over the creation of market uncertainty and the possible inequities that could arise from retroactively resettling the market.[80] We find that granting refunds here would create substantial uncertainty in the market and undermine confidence in them. Further, given the impossibility of predicting and restoring what might have happened in the market under an alternative set of circumstances, and as market participants can neither revisit economic decisions nor retroactively alter their conduct, refunds should not be granted in this instance. Ordering refunds would require the Commission to speculate as to the extent to which both mitigated and non-mitigated market resources would have participated in the market, and how they would have behaved. There is no basis to assume that the same amount of capacity that cleared in the market would have been available at prices in the $5.60/kW-month range. Units with high opportunity costs, for instance, might not have participated in the market had lower clearing prices existed in

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[77] 84 FERC ¶ 61,287, at 62,357 n.17.

[78] ConEd Initial Comments at 20 (quoting *California v. FERC,* 383 F.3d at 1015).

[79] *California v. FERC,* 383 F.3d at 1018.

[80] *New York Indep. System Operator,* 92 FERC ¶ 61,073 at 61,307 (2000); *Sithe New England Holdings, LLC v. FERC*, 308 F.3d 71 (1st Cir. 2002) (*Sithe*); *Midwest Independent Transmission System Operator, Inc*., 117 FERC ¶ 61,113 at P 95 (2006) (*MISO*), *order on reh'g,* 118 FERC ¶ 61,212, *order on reh'g,* 121 FERC ¶ 61,131 (2007).

the market. A decrease in participation by these entities, in response to the lower clearing prices, which parties supporting refunds allege would have resulted, would have caused an increase in the clearing price as supply was reduced. As "ICAP is not devised to compensate past investment but to spur sellers to make new investment and net buyers to meet their reserve capacity obligations,"[81] ordering refunds would not help achieve the goals of ICAP and would not redress the harm that is claimed by the parties favoring refunds. Rather, we find that changing the market rules prospectively, as in this case, will adequately address concerns over net buyer and seller market power.

148. Finally, we find no justification to award refunds state-wide, as requested by certain parties.[82] As we explained in our March 6, 2007 Order, this matter "involves price/market power mitigation for the NYC ICAP market (the in-City ICAP market)."[83] Further, as we stated in our July 6, 2007 Order:

> We expect the New York ISO and the other parties to formulate comprehensive solutions to the problems of the in-City ICAP market that will provide a level of compensation that will attract and retain needed generating capacity and thus promote long-term reliability, while not over compensating generators. With regard to the matter of coordination with broader New York state issues, we agree with the New York ISO that the New York ISO stakeholder process should continue concurrently with this proceeding.[84] Ordering refunds for the entire NYCA ICAP market would be beyond the scope of this proceeding.

Because the ROS market was neither the subject of this section 206 proceeding nor was there any notice that the ROS market would be subject to refund, ordering refunds for the ROS market would be beyond the scope of the proceeding.

149. Finally, in the July 6, 2007 Order, the Commission referred parties' allegations of market manipulation to OE for a separate investigation.[85] The results of that separate investigation have been placed in the record, in the form of an OE report. That

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[81] *Sithe,* 308 F.3d at 78.

[82] Multiple Intervenors Initial Comments at 9.

[83] 118 FERC ¶ 61,182 at P 2.

[84] 120 FERC ¶ 61,024, at P 13.

[85] *Id.* at P 17.

investigation found no manipulation, and as a result, we will exercise our discretion and take no further action on parties' allegations of market manipulation.[86]

G. Miscellaneous

i. Long Island

150. In its initial comments, LIPA states that, as a result of the fundamentally different structures of the Long Island and in-City markets, LIPA strongly urges the Commission to take note of the lack of any support for extending the results of this proceeding to Long Island. LIPA claims that any such precedent established or applied to Long Island or the statewide market would be unjustified and could result in significant unintended consequences. LIPA agrees with the fundamental premise of the changes NYISO proposes for the in-City market: the problems of the in-City market can be remedied by specific market rule changes for the in-City market without upsetting the fundamental market structures that currently exist statewide and on Long Island.

Commission Determination

151. We agree with LIPA that any application of the results of this proceeding to the Long Island market would be beyond the scope of this proceeding.

The Commission orders:

(A) NYISO's proposal, as modified in its Reply Comments, is hereby accepted subject to the modifications set forth in text above.

(B) NYISO is hereby directed to file tariff sheets containing revised market rules reflecting the above-accepted changes within 60 days of the date of this order.

By the Commission.

(S E A L)

Kimberly D. Bose,
Secretary.

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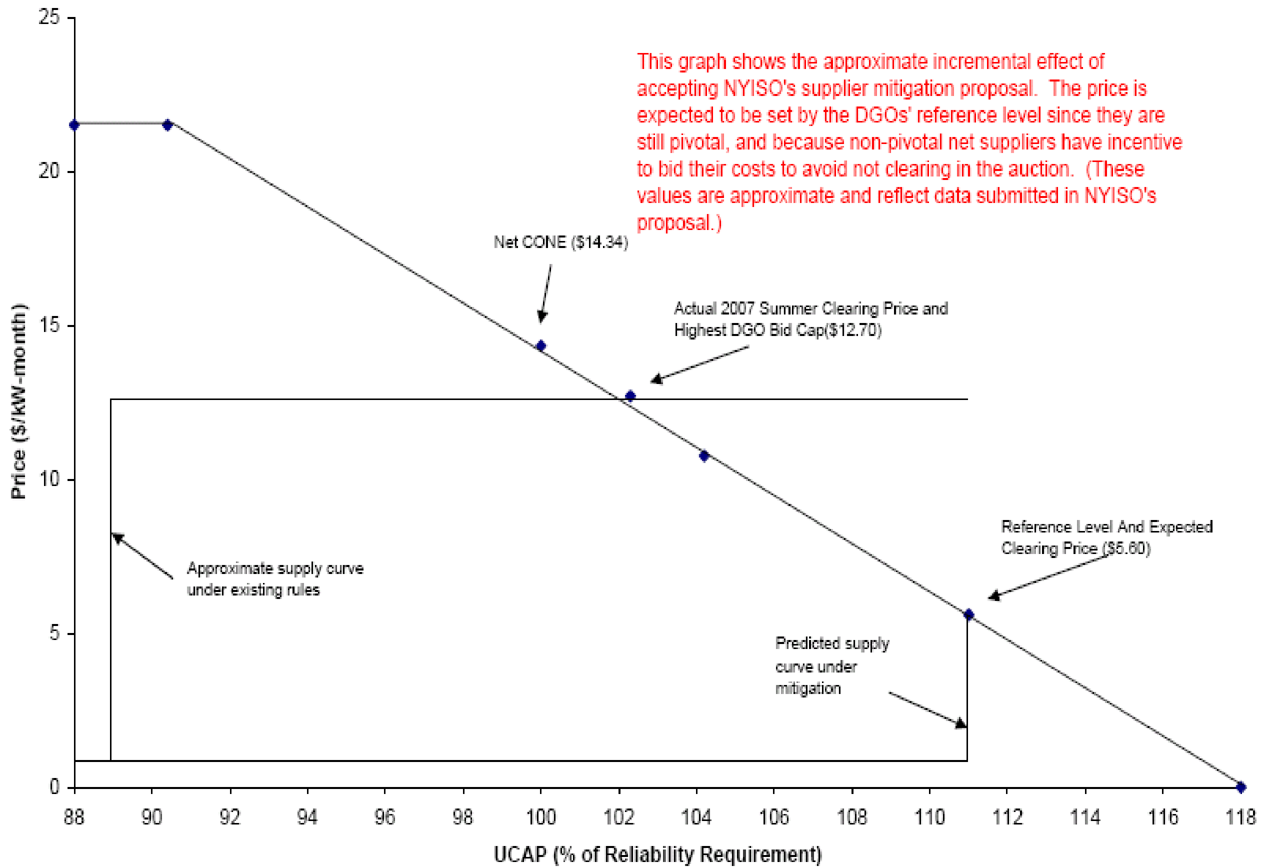
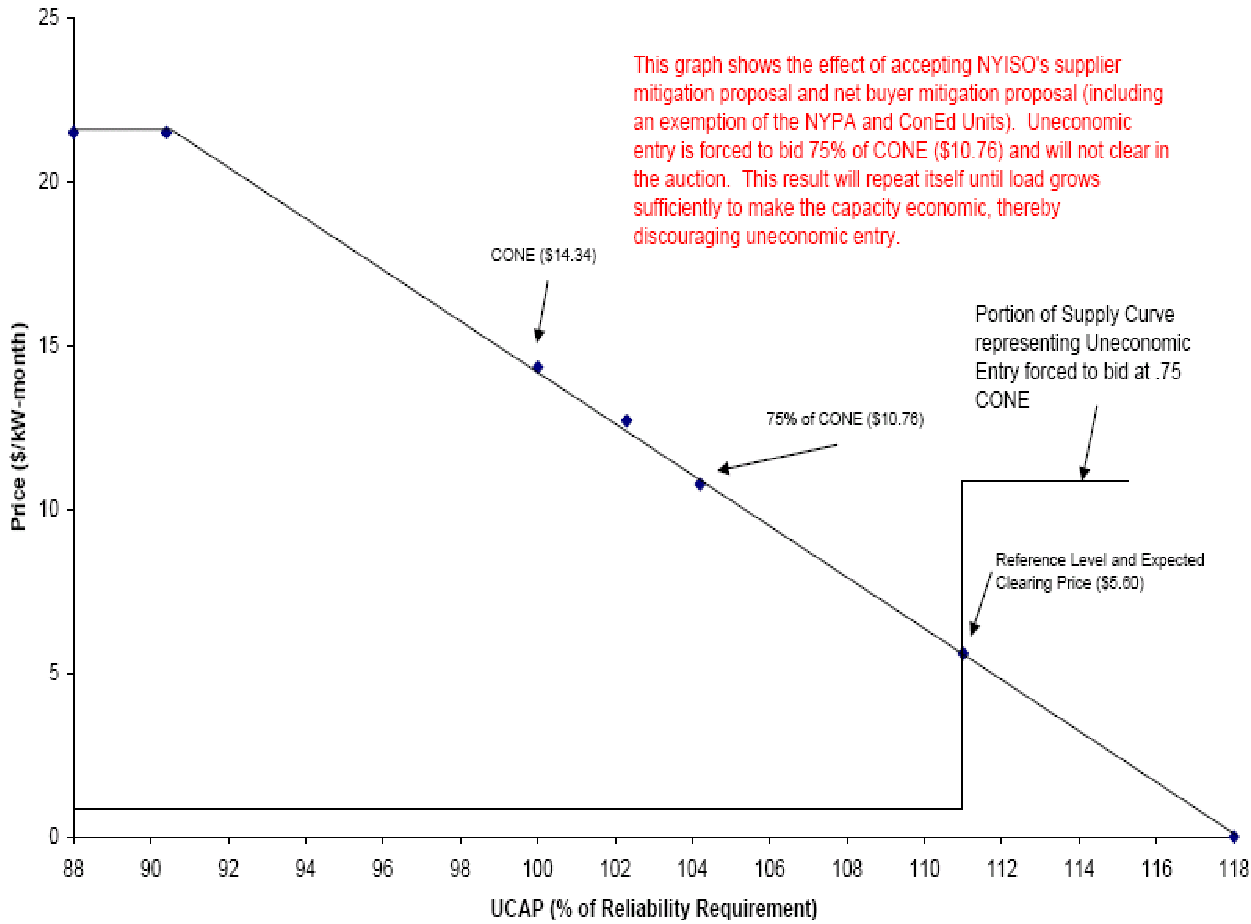
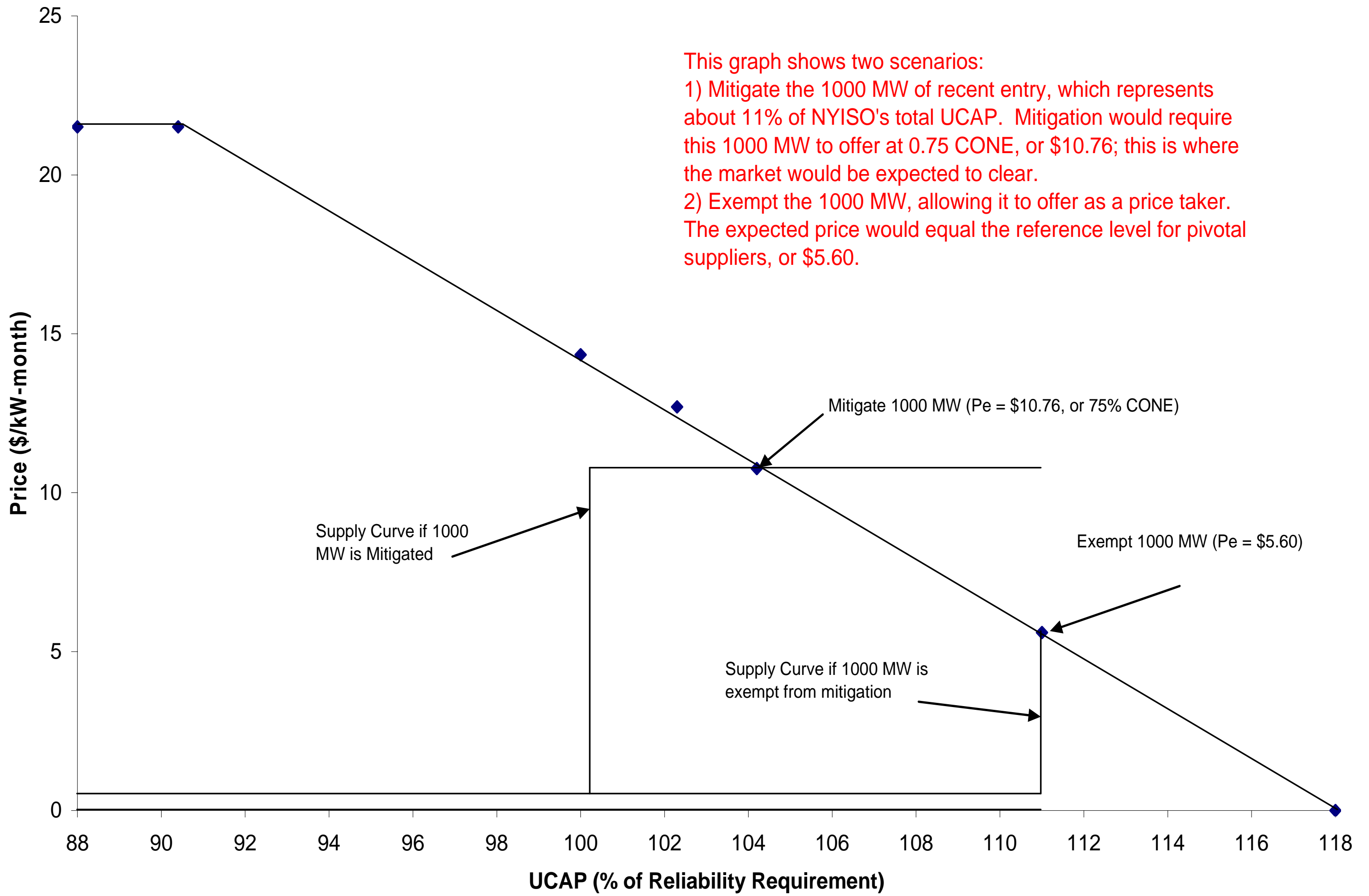
[86] *See, e.g., Heckler v. Chaney,* 470 U.S. 821 (1985); *Pacific Gas and Electric Co. v. FERC*, 464 F.3d 861 (9th Cir. 2006).

The following graphs are based on the actual in-City ICAP Demand Curve for the Summer 2007 capability period. The actual market clearing price in that auction was $12.70/kW-month. The calculated reference level ($5.60/kW-month) is the price calculated by NYISO independent market monitor, and Net CONE ($14.34/kW-month) is based on the data from the Demand Curve. These graphs are intended to be generally illustrative in explaining the effects of NYISO's proposed mitigation methodology as it would have applied to the in-City capacity market under Summer 2007 conditions. The Commission notes that these graphs do not reflect the recent New York State-imposed mitigation on KeySpan's generation (*see n. 10, supra*). These graphs also necessarily include estimates of certain market parameters, including, but not limited to, the in-City supply curve (which is based on supplier offers to which the Commission has no access), and the quantity, in percentage terms, of total capacity and capacity related to individual suppliers.




Effect of Net Buyer Mitigation Proposal on Future Uneconomic Entry
Appendix A-2
This graph shows the effect of accepting NYISO's supplier mitigation proposal and net buyer mitigation proposal (including an exemption of the NYPA and ConEd Units). Uneconomic entry is forced to bid 75% of CONE ($10.76) and will not clear in the auction. This result will repeat itself until load grows sufficiently to make the capacity economic, thereby discouraging uneconomic entry.
CONE ($14.34)
75% of CONE ($10.76)
Portion of Supply Curve representing Uneconomic Entry forced to bid at .75 CONE
Reference Level and Expected Clearing Price ($5.60)
Price ($/kW-month)
0
5
10
15
20
25
88
90
92
94
96
98
100
102
104
106
108
110
112
114
116
118
UCAP (% of Reliability Requirement)


Expected Price Effect of Mitigation v. Exemption for ConEd, NYPA Units
Appendix A-3
This graph shows two scenarios:
1) Mitigate the 1000 MW of recent entry, which represents about 11% of NYISO's total UCAP. Mitigation would require this 1000 MW to offer at 0.75 CONE, or $10.76; this is where the market would be expected to clear.
2) Exempt the 1000 MW, allowing it to offer as a price taker. The expected price would equal the reference level for pivotal suppliers, or $5.60.
Mitigate 1000 MW (Pe = $10.76, or 75% CONE)
Supply Curve if 1000 MW is Mitigated
Exempt 1000 MW (Pe = $5.60)
Supply Curve if 1000 MW is exempt from mitigation
Price ($/kW-month)
25
20
15
10
5
0
88
90
92
94
96
98
100
102
104
106
108
110
112
114
116
118
UCAP (% of Reliability Requirement)