February 27, 2002

VIA AIRBORNE EXPRESS
Richard J. Grossi
Chairman
New York Independent Operator
3890 Carman Road
Schenectady, NY 12303

c/o William J. Museler
President and Chief Executive Officer
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303

Re: Reply to Appeals of Con Edison and LIPA of the NYISO Management Committee's Approval of Niagara Mohawk Power Corporation's Congestion Reduction Proposal

Dear Chairman Grossi:

Pursuant to the "Procedural Rules for Appeals to the ISO Board," Niagara Mohawk Power Corporation, a National Grid Company, respectfully submits three copies of its Response to the appeals of the Consolidated Edison Company of New York, Inc. and the Long Island Power Authority of the Management Committee's decision at its February 7, 2002 meeting to approve Niagara Mohawk's Congestion Reduction Proposal.

A copy of this appeal has been electronically transmitted to Ms. Kristen Kranz for service on the members of the Management Committee. Thank you.

Sincerely,

Jerry J. Ancona
Manager of Power Scheduling and Billing
Niagara Mohawk Power Corporation

cc: Ms. Kristen Kranz

Niagara Mohawk Power Corporation, a National Grid Company, ("Niagara Mohawk") submits this Response to the appeals of the Consolidated Edison Company of New York, Inc. ("Con Edison") and the Long Island Power Authority ("LIPA") of Niagara Mohawk's Congestion Reduction Proposal ("CRP") pursuant to section 4.01 of the NYISO's Procedural Rules for Appeals to the ISO Board of the Management Committee's decision.

INTRODUCTION AND BACKGROUND

On January 23, 2002, the Management Committee approved by an affirmative vote of 73.85 percent the CRP sponsored by Niagara Mohawk. CRP is intended to rectify a problem identified under the NYISO's current rules, that TOs receive the same congestion revenues regardless of whether their facilities are operating or not. As a result, the NYISO's present congestion management system has had the unintended consequence of significantly reducing – and in some instances even eliminating -- the incentives Transmission Owners ("TOs") would otherwise have to avoid unnecessary outages of their transmission facilities and to minimize the duration and severity of any transmission outages they cannot avoid.

By directly assigning "Counter Flow TCCs" to TOs to offset their TCC revenues in the event of any "Significant Transmission Facility Outages,"[1] CRP will restore the incentives to control transmission outages that would be provided by a properly functioning marketplace. Because the TOs are the entities responsible for ensuring the availability of transmission facilities in New York State, and because congestion costs are a major factor contributing to high

[1] A "Significant Transmission Facility Outage" is defined as an outage that has an impact on Congestion Rent Shortfall during a six month TCC Auction period of $250,000 or more.

wholesale electricity prices in New York State, common sense and basic economics both require that such incentives be restored.

Con Edison and LIPA object to this reasonable and necessary reform on a variety of grounds. LIPA claims: (1) that CRP violates the "business solution" that formed the basis of the New York TOs' undertaking to jointly develop the NYISO; (2) that CRP violates section 3.04 of the NYISO/TO Agreement by impermissibly affecting the value of certain grandfathered TCCs, which LIPA claims are a "transitional arrangement" protected by that provision; (3) that CRP discriminates against transmission owners with underground and underwater cables; and (4) that CRP inappropriately "penalizes" TOs for maintaining their systems in conformance with "Good Utility Practice." Con Edison claims that the CRP is discriminatory, unfair, in violation of the NYISO/TO Agreement, and will have a "chilling effect" on the construction of new transmission facilities. All of these claims are without merit for the reasons noted below.

The intent of the Management Committee approved CRP proposal has always been: (1) to benefit the overall market by providing stronger incentives for TOs to reduce congestion caused by transmission outages; (2) to focus outage congestion cost responsibility more closely on the TO capable of affecting the outage; and (3) to improve the fairness and efficiency of TCC full funding cost allocations. This, in turn, should help reduce congestion allowing increased flow on constrained interfaces, thereby: (1) increasing market efficiency and decreasing overall production costs; (2) expanding trading opportunities with a wider more competitive market; (3) reducing the opportunity for the abuse of market power; and (4) improving overall reliability.

ARGUMENT

I. THE CRP DOES NOT UNREASONABLY MODIFY THE ALLOCATION OF CONGESTION SURPLUSES AND CONGESTION SHORTFALLS ESTABLISHED IN THE BUSINESS SOLUTION

LIPA and Con Edison both claim that the CRP should be rejected because it unfairly modifies the allocation of congestion surpluses and congestion shortfalls established in the "Business Solution" which formed the basis of the New York TO's decision to develop and propose the establishment of the NYISO. According to both LIPA and Con Edison, the Business Solution provided for an allocation of congestion surpluses and congestion shortfalls on the basis of megaWatt-miles of transmission facilities owned by each TO and TCC Auction residual revenue, regardless of the source of any particular source of congestion shortfalls or surpluses. Niagara Mohawk agrees that the Business Solution provided for the allocation of congestion shortfalls and surpluses on a megaWatt-mile and TCC Auction residual revenue basis. That fact is, however, totally irrelevant to the fundamental question of whether TOs should receive the same congestion revenues regardless of whether their facilities are in service or not, which is the result which LIPA and Con Edison seek to achieve in their appeals. Niagara Mohawk submits that elimination of this "free ride" has nothing to with the allocation of any legitimate congestion shortfalls or surpluses that may exist after this "free ride" has been corrected. Niagara Mohawk further submits that to the extent that any such legitimate congestion surpluses do exist, one thing that the NYISO should be certain to avoid is any allocation of those surpluses that would deprive TOs of normal profit incentives to avoid unnecessary transmission outages and to minimize the total costs of outages that cannot be avoided.

Moreover, the current sharing mechanism does not recognize TO revenue obtained from grandfathered arrangements and other TCCs not offered in the TCC Auction. Thus, TOs that receive a large portion of their TCC revenue from TCC Auction residual revenue bear a disproportionately high share of congestion rent shortfall costs caused by outages, regardless of which TOs incurred the outages.

LIPA's superficially appealing claim that there should be "symmetry" between allocations of congestion surpluses and shortfalls ignores the fact that these costs do not arise in the symmetrical fashion that LIPA suggests. Shortfalls and surpluses are not likely to be caused by the same facilities, and do not necessarily have the same probability of occurring. Congestion rent shortfalls occur when transmission outages take place on transmission facilities with heavily subscribed (or even over-subscribed) TCCs. This high level of subscription, in turn, is more likely to occur across facilities that have high anticipated levels on congestion. Congestion rent surpluses, on the other hand, occur when congestion occurs on transmission facilities with relatively lightly subscribed TCCs. This is more likely to occur on facilities with low anticipated levels of congestion. While surpluses could theoretically be generated by a fully subscribed facility, this would be highly unlikely, and the magnitude of those surpluses would be relatively low.

Although surpluses were significant after the initial TCC auction, surpluses have decreased as the market has matured. Thus, Market Participants became more sophisticated in predicting likely areas of congestion, and purchased TCCs accordingly. In this respect, surpluses are likely to remain low and/or decrease further. The CRP approved by the Management Committee approved proposal (Objective 4) specifies that a more accurate congestion rent shortfall/surplus cost allocation from miscellaneous causes be developed. Miscellaneous causes are those not easily attributed to a specific TO, and consequently these would generally apply to all surpluses. Niagara Mohawk strongly supports this endeavor.

Notwithstanding the foregoing concerns, however, transmission facilities into Long Island are fully subscribed, and consequently are inherently incapable of generating any transmission surpluses. Whenever those fully-subscribed facilities are taken out of service, they necessarily generate far greater congestion shortfalls under the NYISO's current rules than other, less heavily subscribed facilities. Thus, LIPA's "symmetry" claims are inherently flawed and must be rejected.

II. CRP DOES NOT INTERFERE WITH GRANDFATHERED TCCs

LIPA and Con Edison also claim that CRP interferes with their grandathered TCCs for service over LIPA's Y49 and Y50 submarine cables, in violation of section 3.04(c) of the NYISO/TO Agreement. What this contention ignores is the simple fact that LIPA's and Con Edison's grandfathered arrangements relating to the use of those facilities did not purport to hold either LIPA or Con Edison harmless in the event of an outage of either or both of those facilities. Instead, prior to the formation of the NYISO, LIPA and Con Edison received the benefits of those transmission facilities only when they were operational. As a result of the substantial differences in market prices between Long Island and the rest of New York State, LIPA in particular had powerful economic incentives to maximize the availability of these transmission facilities.

These incentives were inadvertently eliminated by the NYISO's congestion management system, and CRP proposes only to restore LIPA and Con Edison to the situation in which they found themselves prior to the formation of the NYISO. This result cannot be regarded as depriving LIPA or Con Edison of any of their "grandfathered" rights under their pre-existing transmission arrangements. Simply stated, LIPA and Con Edison cannot be allowed to use the grandfathering provisions of the NYISO OATT and the NYISO/TO Agreement to achieve any greater protection from the costs of outages of these transmission facilities than they had under the arrangements in effect immediately prior to NYISO startup.

III. CRP DOES NOT UNDULY DISCRIMINATE AGAINST OWNERS OF UNDERGROUND OR SUBMARINE CABLES

LIPA and Con Edison both claim that CRP discriminates against them as owners of underground or submarine cables, and in favor of upstate transmission owners, most of whose transmission facilities are overhead. Niagara Mohawk agrees with LIPA and Con Edison that the economics of underground and submarine cables are different from those of overhead facilities. However, Niagara Mohawk believes that efficient planning and construction of transmission systems will only occur if all TOs are required to bear the full costs of the transmission facilities they choose to install. Only in such circumstances can prudent utility planners appropriately take the differing costs and benefits of these varying types of facilities into account in determining which types of facilities to install in an particular location.

LIPA's and Con Edison's suggestion that this result is somehow unduly discriminatory is simply absurd. All facilities, whether they are over-head, underground or underwater are treated identically under the CRP if they incur a forced outage. Similarly all are treated the same if they incur a planned outage. There is no more reason to require utilities with overhead lines to subsidize utilities with underground or submarine cables than there is to require generators fueled by low cost coal to subsidize the fuel costs of generators fueled by more expensive resources such as oil and gas. Such cost shifting is both inconsistent with the competitive markets the NYISO was created to foster and in direct conflict with the numerous provisions of the NYISO OATT and the NYISO/TO Agreement designed to prevent cost shifting among TOs.

LIPA's and Con Edison's further suggestion that the large differences in LBMPs between their markets and the rest of New York State will expose them to inordinate financial risks that will "chill" investment in new transmission capacity ignores the simple fact that they are already receiving congestion payments reflecting that differential under the NYISO's current congestion management system. CRP will simply offset those congestion revenues by the creation of a "Counter Flow TCC', which could reduce the congestion revenues received by LIPA and/or Con Edison to an expected value of zero.[2] Thus, far from subjecting LIPA and Con Edison to an inordinate burden, the CRP will instead prevent LIPA and Con Edison from receiving an inordinate and unearned windfall during those periods when their transmission facilities linking these markets are not operating.

IV. CRP DOES NOT DISCOURAGE GOOD UTILITY PRACTICE

LIPA also claims in its appeal that CRP "creates a perverse disincentive" for good utility practice by penalizing a TO for taking a facility out of service even if it does so in accordance with good utility practice. Once again, LIPA fails to understand that the CRP is not designed to "punish" TOs for taking transmission facilities out of service, but rather to ensure that TOs bear the full economic costs of their actions in this regard. Only in this way can all market participants be certain that each TO will carefully weigh the costs and the benefits of its actions and seek to minimize total outage costs to the system.

In contrast, perpetuation of the NYISO's current congestion management system, where outage costs are spread among all TOs according to formulas that result in little or none of those costs falling on LIPA and Con Edison clearly does provide LIPA and Con Edison with a perverse incentive to forego expenditures required to keep their transmission facilities in service.

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[2] Where TCCs are auctioned off, the auction price may be above or below the actual value of any Counter Flow TCC, depending on the shifting balance between supply and demand for transmission services and for congestion

The result of this perverse incentive is clear for all to see in the poor availability of LIPA's Y-49 cable since the NYISO's current congestion management system was placed into effect.

V. CON EDISON's CLAIM THAT CRP DOES NOT ADDRESS THE CAUSE OF CONGESTION SHORTFALLS IS IRRELEVANT

Finally, Con Edison objects that CRP "fails to address the cause of congestion shortfalls." The short response to this objection is that CRP was not intended to address congestion shortfalls. Instead, as previously noted, that proposal is intended to internalize to each TO the costs of any significant outage on its transmission system, in order to provide all TOs with economic incentives to minimize the costs associated with such outages. While internalizing these costs may have some beneficial impacts on congestion shortfalls, Con Edison's suggestion that the viability of CRP should be assessed on this basis is specious.

Moreover, the NYISO staff is presently working on a proposal to address the congestion shortfall issues identified by Con Edison in a more comprehensive manner. Niagara Mohawk supports these efforts, as long as they are not used as a pretext to perpetuate the provisions of the NYISO's current congestion management system that interfere with market incentives for all TOs to minimize the costs associated with outages of their transmission facilities.

CONCLUSION

WHEREFORE, for the above stated reasons, Niagara Mohawk Power Corporation respectfully requests that the NYISO Board reject the appeals of the Management Committee's approval of Niagara Mohawk's Revised Congestion Reduction Proposal submitted by the Consolidated Edison Company of New York, Inc. and by the Long Island Power Authority, and that the Board instead join with the Management Committee to approve the filing of that

(..continued)
hedges over time.

proposal with the Federal Energy Regulatory Commission under section 205 of the Federal Power Act, 16 U.S.C. § 824d.

Respectfully submitted,

Jerry J. Ancona
Manager of Power Scheduling and Billing
Niagara Mohawk Power Corporation
300 Erie Boulevard West
Syracuse, NY 13202-4250
Phone: (315) 460-2152
Fax: (315) 460-2494