

nationalgrid

VIA OVERNIGHT UNITED PARCEL SERVICE COURIER

October 23, 2006

Karen Antion
Chair of the NYISO Board of Directors
c/o Mr. Mark S. Lynch
President and CEO
New York Independent System Operator, Inc.
10 Krey Boulevard
Rensselaer, New York 12144

RE: Motion in Support of and Comments on the New York State Department of Public Service (“DPS”) and Consolidated Edison of New York Inc. (“ConEd”) Joint Proposal for In-City Capacity Mitigation.

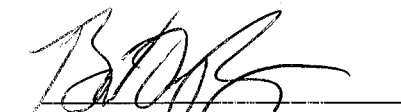
Dear Ms. Antion:

Pursuant to the Procedural Rules of Appeals to the NYISO Board, Niagara Mohawk Power Corporation d/b/a National Grid (“National Grid”) hereby submits its comments regarding capacity market mitigation proposals presented to the September 29, 2006 NYISO Management Committee (“MC”). At the September 29th MC meeting, National Grid supported the joint Department of DPS-ConEd proposal (Motion #4) which is intended to further mitigate the impact of potential market power from certain New York City capacity suppliers. While National Grid supports efficient wholesale electric markets that are free from the influences of market power, National Grid is concerned that capacity prices resulting from the DPS-ConEd proposal may, by themselves, result in several unintended consequences.

A copy of these comments has been electronically mailed to NYISO staff for posting on the NYISO website.

If you have any questions, please contact me at (315) 428-5136.

Respectfully submitted,



Bart D. Franey
Principal Analyst

Niagara Mohawk Power Corporation d/b/a National Grid

cc: Roxane Maywalt
Colin Owyang

COMMENTS OF NATIONAL GRID

SUMMARY AND BACKGROUND

At its September 29, 2006 meeting, the MC adopted the DPS-ConEd proposed mitigation measures for certain In-City (New York City) generators.¹ Pursuant to the Procedural Rules of Appeals to the NYISO Board, National Grid hereby files these comments and a motion in support of the Board's review and approval of the MC's decision to further mitigate capacity bids of certain Locational Installed Capacity ("LICAP") suppliers in New York City.

Competitive markets depend upon prices to signal the need for generating capacity.² National Grid fully supports competitive markets and recognizes the benefits that properly designed markets have in encouraging efficient infrastructure investment decisions. A rational market design will allow the natural laws of supply and demand to signal through prices the need for additional supply when resources become scarce and the lack of need for additional supply in areas of surplus. Similarly, and of particular relevance to this appeal, a properly designed locational market like New York's LICAP market should send more specific, localized price signals to reflect zonal surpluses and shortages to which suppliers and customers respond to bring the market back to a desired point of supply-demand equilibrium.

In the absence of proper market design, markets fail. They fail in a variety of ways and for a variety of reasons. Of particular relevance to this appeal, a market design which permits the exercise of market power, by either buyers or sellers, can cause the market to fail. Such behavior masks actual supply and demand conditions, inaccurately indicating through artificially

¹ See September 29th 2006 MC Final Motions, available from the NYISO Website at the following link: http://www.nyiso.com/public/webdocs/committees/mc/meeting_materials/2006-09-29/final_motions_092906_mc.pdf

² New York's capacity markets are meant to provide generators with an additional source of revenue to make up for the income denied to them in the mitigated energy market.

distorted prices either a false shortage or false surplus condition. If left unchecked, market power will needlessly increase the costs borne by customers and may ultimately lead to inefficient investment decisions. However, proper market design should sufficiently mitigate market power concerns to permit a market's continued functioning without the need for out-of-market actions.

Nevertheless, the current New York LICAP market design allows for the potentially improper exercise of market power.³ National Grid has outlined elsewhere⁴ why the Board needs to ensure that the New York City LICAP market provide proper and transparent price signals to indicate where, when, and what level of capacity is needed.⁵ National Grid also has

³ *Consolidated Edison Co. of New York, Inc.*, "Order Accepting Market Power Mitigation Measures, as Modified, for Filing," 84 FERC ¶ 61,287 (1998) ("1998 Order").

⁴ See Notice of Appeal of the Management Committee Decision to Reject the Proposed Revision of the 2006-2007 Locational and Statewide Installed Capacity Requirements, dated March 7, 2006, available from the NYISO Website at the following link:
http://www.nyiso.com/public/webdocs/committees/appeals/feb_9_2006/national_grid_nyiso_board_appeal_3_7_06.pdf

⁵ The NYISO's recent Comprehensive Reliability Plan Process ("CRPP") indicates where capacity is needed. See "The Comprehensive Reliability Plan 2005: A Long-term Reliability Assessment of New York's Power System," dated August 22, 2006, at page 39, Available from the NYISO Website at the following link:
http://www.nyiso.com/public/webdocs/services/planning/reliability_assessments/2004_planning_trans_report/crp_final08222006.pdf ("[Given the] deferred retirement of the Poletti unit and current load forecast, the Market Proposals are not required to maintain LOLE criteria for the first Five Year Base Case [2005-2010]. If completed, however, these [Zone New York City and Long Island] projects would maintain LOLE criteria through 2014. Because of planning uncertainties and the clearly identified needs in the second five years [2011 – 2015], the NYISO believes that these projects should maintain their current in schedules for permitting, constructions and coming into service.

Although these developers have significant financial resources available to them, the proponents of market-based generation solutions also stated that their viability may depend upon entry into long-term contracts for the sale of their output.")

proposed an appropriate solution for the current market problems.⁶ National Grid continues to believe that resolution of these concerns constitutes the single best method of establishing a functional locational capacity market in general, consistent with FERC's intention.

The DPS-ConEd proposal and subsequent appeals to the Board demonstrates the increased importance and urgency of resolving the fundamental problems outlined elsewhere. Currently, market circumstances have created an expectation that capacity prices ought to be lower than their market - and demand - based indicators, conversely out-of-market solutions are occurring in order to keep supply and demand in balance. These problems are emblematic of the symptoms of the underlying ailment of an improper market design. The Board should correct the current market design to produce a properly function market. If the Board does not require such corrections, then it should at least be mindful of the significant risks to reliability and market functionality, associated with combining the DPS-ConEd proposed with existing capacity market requirements.

Combining the DPS-ConEd mitigation proposal with current LICAP policies would, contrary to customer needs, adversely affect reliability in a time of increasing demand.⁷

⁶See generally *Niagara Mohawk Power Corporation, a National Grid Company v. New York State Reliability Council, L.L.C. and New York Independent System Operator, Inc.*, "Complaint of Niagara Mohawk Power Corporation, a National Grid Company, Requesting Fast Track Processing," filed October 6, 2005, in Docket EL06-1-000. The Free Flowing Equivalent IRM will maintain current NYCA reliability levels – with no sacrifice to current region-wide LOLE levels – and properly address the effect of transmission constraints with the corresponding LICAP Requirements. As such, the Free Flowing Equivalent will produce prices more in line with zonal reliability needs

Incorporating the DPS-ConEd proposal into the existing market design will exert significant downward pressure on New York City LICAP prices. Those deflated prices will signal falsely that an abundant surplus of capacity exists in a location that the CRPP indicates LICAP resources are needed to avoid potential capacity shortages. That paradoxical situation –low capacity prices in an area of high capacity demand – very likely will create additional administrative or continued use out-of-market solutions, further hampering the robust development of a competitive capacity market and potentially competitive energy markets generally. National Grid thus is concerned that the combined impact of the DPS-ConEd proposal and current LICAP policies ultimately may pose a significant reliability challenge for the NYISO and its ability to administer competitive markets.

In general, National Grid is concerned that the DPS-ConEd proposal - by itself - will result in several unintended consequences such as:

1. The collapse of market signals that will chill future investments in capacity resources;
- and

⁷ See “The Comprehensive Reliability Plan 2005: A Long-term Reliability Assessment of New York’s Power System,” dated August 22, 2006, Finding Number Two – Plan Risk Factors, Item 5, at page 9, available from the NYISO Website at the following link: http://www.nyiso.com/public/webdocs/services/planning/reliability_assessments/2004_planning_trans_report/crp_final08222006.pdf (“Increased load growth or retirement of additional generating units beyond those already included in the plan for either economic and/or environmental factors, as well as continued degradation of the voltage performance of the New York System, would adversely affect reliability.”). See also Letter to the NYSRC Executive Committee from NYSRC Reliability Compliance Monitoring Subcommittee, dated November 9, 2005, Subject: New York Control Area Resource Adequacy Assessment for the 2005-2008 Period, available from the New York State Reliability Council Website at the following link: <http://www.nysrc.org/pdf/MeetingMaterial/ECMeetingMaterial/ECAGenda81/NYCAResourceAdequacyAssessment2005-08.pdf> (“It is crucial that planned [generating] projects be completed on schedule. Otherwise, the possibility of insufficient capacity in NYCA, NYC, and Long Island in 2008 could lead to load shedding in excess of the NYSRC 0.1 days per year loss-of load expectation criterion, together with an excessive number of voltage reductions and other emergency procedures.”).

2. The collapse of market signals that may require the need for out-of-market solutions such as regulated contracts between generators and transmission owners in order to prevent the premature retirement of existing resources and to maintain reliability.

Consequently, National Grid respectfully requests that the Board ensure that the issues raised by National Grid in its appeal to the Board⁸ get resolved prior to the implementation of the DPS-ConEd proposed market mitigation measures. Resolving the issues in National Grid's Installed Reserve Margin ("IRM") complaint prior to implementing the DPS-ConEd proposal will ensure that the market mitigation measures do not adversely interfere with the laws of supply and demand.

ARGUMENT

The current debate over New York City LICAP prices is rooted in the expectation that capacity prices should be consistent with a market that has surplus supply⁹ (i.e., LICAP levels in excess of the minimum LICAP requirement).¹⁰ If surplus supply does exist, then New York City

⁸ See "Notice of Appeal of the Management Committee Decision to Reject the Proposed Revision of the 2006-2007 Locational and Statewide Installed Capacity Requirements," dated March 7, 2006, available from the NYISO Website at the following link: http://www.nyiso.com/public/webdocs/committees/appeals/feb_9_2006/national_grid_nyiso_board_appeal_3_7_06.pdf

⁹ See "In-city Capacity Market Performance: NYSDPS: 6/12/2006," ICAPWG Meeting Materials, available from the NYISO Website at the following link: http://www.nyiso.com/public/webdocs/committees/bic_icapwg/meeting_materials/2006-06-12/in_city_capacity_market_performance_nydps.pdf ("Based on NYISO posted data, it appears that about 800 MW of NYC capacity went unsold in the spot auctions for May and June 2006. This implies higher prices in both the NYC and statewide capacity markets, compared to an auction where all available NYC supplies had cleared. If all available NYC capacity had been sold, the NYC UCAP price would have dropped by about \$7.26/kW-month (from \$12.71 to \$5.45).").

¹⁰ Per the "Revised Locational Installed Capacity Requirements Study Covering the New York Control Area For the 2006 – 2007 Capability Year; Operating Committee March 28, 2006,"

LICAP prices should be significantly below current levels. However, past and recent out-of-market actions taken, particularly in New York City, are inconsistent with this assumption of surplus supply for New York City. For example, the retirement of the existing Polletti unit was deferred from 2008 until 2009 due to a lack of locational capacity in New York City.¹¹ Thus, if a capacity shortage does or is predicted to exist, then localized prices should reflect that zonal situation.

The DPS-ConEd market mitigation proposal is intended to simulate expected market outcomes under competitive conditions. The immediate consequence of adopting the DPS-ConEd mitigation rules is that it will put significant downward pressure on New York City LICAP prices. Any significant reduction in New York City LICAP prices will discourage investments in demand response, generation and transmission capacity, and encourage existing New York City resource to retire. These consequences are all rational outcomes, assuming New York City's capacity levels are in excess of minimum reliability requirements.¹² By contrast, they are all irrational outcomes if New York City's capacity levels do not exceed those required to satisfy reliability requirements.

the New York City LICAP market is actually long by 11%; or roughly 1,060 MW of surplus capacity, available from the NYISO Website at the following link:
http://www.nyiso.com/public/webdocs/services/planning/resource_adequacy/2006_lcr_report.pdf

¹¹ See Letter dated May 8, 2006 to Timothy Carey, President and Chief Operating Officer New York Power Authority, from Michael Calimano, Vice President Operations and Reliability New York Independent System Operator, available from the NYISO Website at the following link: http://www.nyiso.com/public/webdocs/committees/bic_espwg/meeting_materials/2006-05-15/Letter_to_Tim_Carey_NYPA.pdf

¹² Similarly, when the market is overbuilt, the combined energy and capacity prices should result in revenues less than what a generator would require to operate economically and existing inefficient units can be expected to retire.

While National Grid supports the DPS-ConEd proposal and those parties' intention to mitigate the potential for supply-side market power abuse, National Grid agrees with IPPNY that combining the DPS-ConEd mitigation proposal with current LICAP policies will "send diametrically opposite signals to the marketplace concerning the need for and timing of capacity resources in the NYISO compared to the findings in the NYISO's [] Comprehensive Reliability Planning Process ("CRPP")."¹³ The disconnect between minimum capacity levels needed in New York City and market signals resulting from an assumed surplus in supply was identified as problematic by National Grid with the 2005-2006 installed capacity requirements.¹⁴ In addition, if capacity prematurely retires or planned capacity does not get built, these events will present significant reliability challenges for the NYISO.¹⁵ In the event that the market fails to provide

¹³ See "IPPNY's Notice of Appeal of Management Committee's September 29, 2006 approval of Motion #4 recommending adoption of proposed in-City installed capacity market monitoring and mitigation measures," at page 1, item 4.

¹⁴ See *Niagara Mohawk Power Corporation, a National Grid Company v. New York State Reliability Council, L.L.C. and New York Independent System Operator, Inc.*, "Complaint of Niagara Mohawk Power Corporation, a National Grid Company, Requesting Fast Track Processing," filed October 6, 2005, in Docket EL06-1-000, at page 7 (" [T]he stated intent of a *locational* capacity mechanism is to signal through prices a need for capacity in a particular location. Because NYSRC allows intra-regional constraints to increase the region-wide requirement, NYSRC's current IRM practice creates an upstate-to-downstate subsidy, thereby lowering LICAP prices in the transmission-constrained zones. Consequently, the LICAP prices in transmission-constrained New York City and Long Island are lower than their current and projected capacity needs would otherwise suggest, while the prices in upstate New York are higher than needed, thus diminishing the signal the LICAP market is purportedly designed to provide.")

adequate resources to maintain reliability, the NYISO will be under considerable pressure to increase its reliance on a de facto resource adequacy policy that requires the Responsible Transmission Owner to solve a reliability need¹⁶ or rely on other forms of out-of-market solutions.¹⁷

¹⁵ See “The Comprehensive Reliability Plan 2005: A Long-term Reliability Assessment of New York’s Power System,” August 22, 2006, Finding Number Two – Plan Risk Factors, Item 5, page 9, available from the NYISO Website at the following link: http://www.nyiso.com/public/webdocs/services/planning/reliability_assessments/2004_planning_trans_report/crp_final08222006.pdf (“Increased load growth or retirement of additional generating units beyond those already included in the plan for either economic and/or environmental factors, as well as continued degradation of the voltage performance of the New York System, would adversely affect reliability.”) See also Letter to the NYSRC Executive Committee from NYSRC Reliability Compliance Monitoring Subcommittee, date, November 9, 2005, regarding New York Control Area Resource Adequacy Assessment for the 2005-2008 Period, Available from the NYSRC Website at the following link: <http://www.nysrc.org/pdf/MeetingMaterial/ECMeetingMaterial/ECAGenda81/NYCAResourceAdequacyAssessment2005-08.pdf> (“It is crucial that planned [generating] projects be completed on schedule. Otherwise, the possibility of insufficient capacity in NYCA, NYC, and Long Island in 2008 could lead to load shedding in excess of the NYSRC 0.1 days per year loss-of load expectation criterion, together with an excessive number of voltage reductions and other emergency procedures.”).

¹⁶ See New York Independent System Operator, Inc., FERC Electric Tariff, Original Volume No. 1, Open Access Transmission Tariff,” Attachment Y, Sheet 948, available from the NYISO Website http://www.nyiso.com/public/webdocs/documents/tariffs/oatt/att_y.pdf (“Responsible TO: The Transmission Owner or Transmission Owners designated by the NYISO, pursuant to the NYISO Planning Process, to prepare a proposal for a regulated solution to a Reliability Need or to proceed with a regulated solution to a Reliability Need. The Responsible TO will normally be the Transmission Owner in whose Transmission District the NYISO identifies a Reliability Need.”).

¹⁷ See “New York State Department of Public Service Report on the State of Competitive Energy Markets Progress To Date and Future Opportunities,” dated March 2, 2006, at page 24, available from the NYDPS Website at the following link: <http://www.dps.state.ny.us/StaffReportCompetition.pdf> (“The generation market in the Eastern United States, and therefore in upstate New York, is currently in a surplus capacity state. As such, while a few merchant plants have been completed since the introduction of the Demand Curve, upstate prices from the Demand Curve are low and are properly signaling a lack of demand. In the tight New York City capacity market, the financial incentives provided by the Demand Curve have been supplemented by requests for proposals by Transmission Owners for long-term contracts.”).

In order to overcome the adverse and undesirable consequences of a further reduction in New York City LICAP prices and abandoning the benefits of competitive markets (e.g., voluntary participation in bilateral contracts), the Board needs to ensure that the New York City LICAP market provides proper and transparent price signals to indicate where, when, and what level of capacity is needed.¹⁸ That market design correction in itself will do more to mitigate potential market power than any targeted measure intended to address the root cause of this and other capacity market design problems. Therefore, the Board should at a minimum act to mitigate market power by approving the DPS-ConEd proposal, but the implementation of the DPS-ConEd proposal should follow a correction to the underlying market design as proposed by National Grid's IRM Complaint.

CONCLUSION

The problem of signaling for additional capacity resources when supply becomes scarce and mitigating the impact of market power in markets that are tight, and thus prone to such behavior, are not easily solved. The impact that market mitigation measures have on supply conditions requires a balanced design that does not interfere with the fundamental laws of supply

¹⁸ See "The Comprehensive Reliability Plan 2005: A Long-term Reliability Assessment of New York's Power System," dated August 22, 2006, at page 39, available from the NYISO Website at the following link:

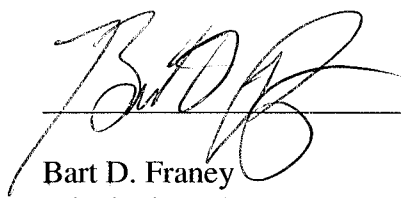
http://www.nyiso.com/public/webdocs/services/planning/reliability_assessments/2004_planning_trans_report/crp_final08222006.pdf ("[Given the] deferred retirement of the Poletti unit and current load forecast, the Market Proposals are not required to maintain LOLE criteria for the first Five Year Base Case [2005-2010]. If completed, however, these [Zone New York City and Long Island] projects would maintain LOLE criteria through 2014. Because of planning uncertainties and the clearly identified needs in the second five years [2011 – 2015], the NYISO believes that these projects should maintain their current in schedules for permitting, constructions and coming into service.

Although these developers have significant financial resources available to them, the proponents of market-based generation solutions also stated that their viability may depend upon entry into long-term contracts for the sale of their output.”).

and demand by indicating a false shortage or false surplus condition. Solving the current paradox in the New York City capacity market can be resolved with a market design that prudently mitigates the effect of market power such as proposed by DPS-ConEd, combined with a capacity market design that provides transparent price signals to indicate where, when, and what levels of capacity are needed to maintain reliability.

Therefore, National Grid respectfully requests the Board to support the DPS-ConEd proposal as a way of minimizing the potential for supply-side market power abuse. In addition, National Grid respectfully requests the Board to ensure that the issues raised by National Grid in its appeal to the Board get resolved prior to the implementation of the DPS-ConEd proposed market mitigation measures. Resolving the issues in National Grid's IRM complaint prior to implementing the DPS-ConEd proposal will ensure that the market mitigation measures do not ultimately interfere with the laws of supply and demand.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'B. Franey', is written over a horizontal line.

Bart D. Franey
Principal Analyst
Niagara Mohawk Power Corporation d/b/a National Grid