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President & CEO

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Susan Court, Esq.
Director, Office of Enforcement
Federal Energy Regulatory Commission
888 First Street, NE
Washington, DC 20426

Dear Ms. Court:

The purpose of this letter is to inform you of an issue that has been brought to our attention regarding the Installed Capacity (ICAP) markets in New York City. The issue arises from arrangements approved as part of the restructuring and generation divestiture that took place prior to establishment of the NYISO under the supervision of the Federal Energy Regulatory Commission (Commission) and the New York Public Service Commission (NYPSC). At that time, the Commission approved a price cap for ICAP sold by certain generating units divested by Consolidated Edison Company of New York, Inc. (ConEd). Concerns have been expressed to the NYISO about the fact that, notwithstanding the recent addition of new capacity, the market for ICAP in New York City continues to clear at the cap price.

Since the beginning of 2006, New York City has seen the development of approximately 1,000 MW of new generating capacity. The additional capacity has increased the amount of capacity available inside the City for offering into the summer capability period ICAP auctions in order for LSEs to comply with the New York City locational ICAP requirement. Despite the additional capacity, spot market auction prices have not decreased.

This outcome is predictable because generating capacity within New York City does not provide a great enough surplus, leaving several suppliers in the position of being "pivotal" and thus able to maximize profits by bidding enough capacity at the price cap to maintain ICAP prices at that level. The auction bidding patterns and results reflect that strategy. Prices for ICAP in the most recent spot auctions did not fall below the level of the price caps, as might have been expected in a less concentrated market.

Prior to electricity restructuring in New York, the power plants in New York City were owned by ConEd, then a vertically integrated electric utility company. In connection with the restructuring of the electric industry in New York that led to the formation of the NYISO, ConEd

divested some three-quarters of its generation, in a process that was overseen by the NYPSC.¹ Because of the size and number of packages into which the divested generation was grouped, the post-divestiture market for capacity was expected to continue to have a significant level of concentration. It was clear that until additional capacity was built creating a sufficient surplus and diversity, unrestrained competition would not be feasible in the New York City capacity market. It was also clear that prospective purchasers of ConEd plants needed to be able to estimate a stream of revenues from those plants in order for them to formulate offers to purchase the facilities. Likewise, ConEd sought to maximize the proceeds from the divestiture. The higher proceeds served also to minimize any stranded costs from the restructuring.² ConEd thus submitted proposed mitigation measures to the Commission for approval prior to the divestiture, in order to achieve both of these objectives. Those mitigation measures included a price cap for capacity. In its 1998 Order approving the price cap, the Commission stated: "ConEd seeks such approval in advance of the divestiture so that potential purchasers of the generating units can evaluate the impact of these mitigation measures on their potential revenue streams before placing bids."³

The price cap for capacity was set in 1998 at \$105 per KW-year for ICAP and, except for translation to the more recently adopted standard of Unforced Capacity (UCAP), has remained in effect at that level. In 2002, as directed by the Commission⁴ the capacity price cap provisions were moved from the ConEd tariff to the NYISO Market Administration and Control Area Services Tariff ("Services Tariff").⁵

¹ *Consolidated Edison Company of New York, Inc.*, 188 PUR4TH 149 (1998). As this Commission stated in its order approving ConEd mitigation measures: "ConEd's development of market power mitigation measures reflects an obligation imposed by a settlement in the New York Commission's restructuring proceeding. In that proceeding, market analyses indicated that in-city generators could exercise localized generation market power. On July 21, 1998, the New York Commission issued an order approving ConEd's proposed divestiture, finding the market power mitigation proposal acceptable. In its order, the New York Commission concluded that ConEd's proposal strikes an appropriate balance by minimally inhibiting market development while ensuring that consumers are protected from high prices." *Consolidated Edison Company of New York, Inc.*, 84 FERC ¶61,287 (1998).

² As the Commission stated in its 1998 Order, "while a reduction in the price cap should result in lower capacity prices to ratepayers in the short-run, it may also depress the proceeds from the auction which, in turn, can result in higher prices in the long-run (in the form of higher stranded costs)."

³ *Consolidated Edison Company of New York, Inc.*, 84 FERC ¶61,287 (1998).

⁴ *New York Independent System Operator, Inc.*, 99 FERC ¶61,246 (2002).

⁵ Services Tariff, Attachment H §4.5(b).

With the recent addition of generating capacity in New York City, it is reasonable to ask whether it was contemplated that prices could stay at the level of the price cap despite the addition of new capacity. The answer appears to be that such a result was explicitly contemplated. In footnote 17 to its 1998 order, the Commission said:

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

Against this background, the NYISO has been requested to look into whether or not its tariffs or the Commission's regulations have been violated. Our conclusion is that neither the tariff nor the Commission's regulations have been violated. We must conclude that the bidding and auction results have been consistent with the market conditions contemplated by the NYPSC and the Commission, and with the price cap approved by the Commission. The situation which now prevails was foreseen by the Commission and all parties at the time of the divestiture, and was the basis upon which potential purchasers would formulate their offers for the divested power plants. Those offers resulted in the prices paid for the generating units.

The NYISO is thus not in a position to second guess this arrangement, which was made with the blessing of appropriate agencies of State and Federal government before the NYISO even came into existence. Moreover, the arrangement involves questions of third-party reliance on the approved capacity mitigation measures. Since the mitigation measures are being applied as apparently intended, the NYISO has concluded that it does not have authority to take further action with respect to bidding in the New York City capacity markets.

Nevertheless, in light of the questions that have been raised about the apparent anomaly of an increase of supply over demand without a resulting drop in prices, the NYISO believes it appropriate to bring the current situation in the New York City capacity market to the attention of the Commission for such consideration and action as it may deem appropriate in the exercise of its continuing jurisdiction over the New York City capacity markets and the participants in those markets. The NYISO stands ready to provide such further information or other assistance as the Commission may request.

Sincerely yours,

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