

Mark S. Lynch
President & CEO

August 1, 2006

Hon. Paul D. Tonko
Chairman, Committee on Energy
The Assembly
State of New York
Room 713, Legislative Office Building
New York, NY 12248

Dear Assemblyman Tonko:

This is in response to your July 27, 2006 letter. While your letter was addressed to Joseph T. Kelliher, Chairman of the Federal Energy Regulatory Commission (FERC), and William Flynn, Chairman of the New York State Public Service Commission (PSC), as well as to me, I can only respond on behalf of the New York Independent System Operator (NYISO) and myself. We take very seriously all of the issues raised in your letter, and we believe we have acted promptly, decisively and appropriately in response to them. As in the past, we stand ready to cooperate with your office in addressing electric power issues affecting New York State.

As you know, the NYISO is a not-for-profit corporation and is not a governmental entity. It is pervasively regulated by FERC, pursuant to the Federal Power Act, and its authority and responsibility is defined in its FERC approved tariffs and organic contracts. Its directors, officers and staff are totally independent of any market participant or sector of market participants. It is committed to administering the State's capacity and energy markets fairly, efficiently and consistently with its tariffs.

Under New York's market design, the purchase and sale of sufficient installed capacity (ICAP) is essential to maintain system reliability, to comply with electrical criteria established by the North American Electric Reliability Council (and, in the future, Electric Reliability Organization criteria), to create incentives for new investment in generation facilities, and to maintain the availability of existing power plants.

Your concerns stem from recent pricing outcomes in the New York City ICAP auctions for the summer of 2006, in which the prices paid for capacity were not reduced as might have been expected as a result of the recent addition of electric generating capacity in the City. This apparent anomaly came to the NYISO's attention shortly after the first auction and the NYISO acted immediately, consistent with its authority, to investigate it, consult with internal and external legal and economic experts (including the NYISO's Market Monitoring Unit and its Independent Market Advisor), and then

bring this matter to the attention of its regulator. All of this was done thoroughly and later discussed in public meetings with appropriate committees of the NYISO's market participants, with the results of the investigation posted prominently on the NYISO's website. Since these actions were fully transparent and well known to market participants, as well as to both Federal and State regulators, I am at a loss to understand the reference in your letter to "behind closed doors influences."

On June 7, the NYISO reported the situation to the Office of Enforcement at FERC, which is the appropriate Division of FERC to act on any abusive exercise of market power that might have taken place. The conclusion of my letter to FERC was "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..." I am also at a loss, therefore, to understand how this report to the only duly constituted agency with authority over the issue represents the NYISO "washing its hands" of the situation.

At the time that the Con Ed power plants were sold to private investors, and well before the NYISO even existed, a series of measures were adopted for the purpose of mitigating the exercise of market power in capacity markets by the prospective new owners of the plants. The principal characteristic of those mitigation measures was a price cap regime. That regime was proposed by Con Ed, approved by the PSC and FERC and was held out to prospective purchasers, who invested substantial sums, presumably in reliance on that regime. The mitigation regime was incorporated into the NYISO tariffs when the NYISO came into existence. The results of the auction that gave rise to the concerns expressed in your letter were expressly contemplated in the FERC order.

After conducting its inquiry into the ICAP auction, the NYISO reached several conclusions: First, the in-city ICAP mitigation measures worked as intended to limit the exercise of market power by capping clearing prices at levels previously determined to be just and reasonable by the FERC and PSC. Second, no individual market participant violated the existing ICAP tariff provisions. Third, the existing mitigation measures, including the level of the price caps, were an integral part of the divestiture of in-city generation which occurred before the commencement of New York's wholesale electricity markets and which had been approved at both State and Federal levels. It is abundantly clear that these asset transactions and the market rules affecting future ownership were part of a balance struck among the buyers, seller, and regulators well before the NYISO's existence. It is equally clear, in our view, that the NYISO has neither the authority nor the responsibility to act unilaterally to disrupt these well-settled expectations. Moreover, such disruption could have had significant adverse effects on the New York markets.

Far from tolerating market power abuse, NYISO market power mitigation measures have been a model for other ISO's and RTO's and have been implemented in a manner that has avoided many of the adverse outcomes seen in other electricity markets.

Where necessary, the NYISO has in the past and will continue to vigorously litigate improper market behavior in appropriate forums. The NYISO also has adopted market rules to address gaming and manipulation where no rule explicitly prohibiting such behavior previously existed.

There are several avenues to effect change that remain open with respect to the ICAP markets. As noted above, the FERC has exclusive jurisdiction to regulate wholesale electricity markets, and the FERC's Office of Enforcement may initiate action based upon the disclosures set forth in the NYISO's June 7, 2006 letter. We are prepared to cooperate fully with federal regulators should they ask for the NYISO's assistance. Further, any party with standing may seek relief directly from FERC under the Federal Power Act if they believe a market outcome was unjust and unreasonable. As noted above, in light of FERC's prior determinations, the NYISO has found no factual or legal basis to reach such a conclusion, nor are we aware that any party has sought such relief before FERC. Finally, ICAP market rule changes may be developed through the NYISO's governance processes.

Over the past several weeks, there have been a number of meetings of market participants to consider changes to the current ICAP tariff provisions. The NYISO has facilitated open discussions on this issue and the PSC staff and other stakeholders have actively participated. NYISO's management will continue to facilitate this process and, should a tariff change be presented to the NYISO's Board of Directors, the Board will, of course, give it full consideration. The NYISO governance process on this issue remains in progress and it is thus impossible to predict how the issue will ultimately be addressed.

I hope this letter clarifies the NYISO's actions and views. I would like to take this opportunity to thank you for your interest, and I would welcome the opportunity to discuss these matters further with you.

Sincerely,

Mark S. Lynch

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President & CEO

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cc: W. Flynn
J. Kelliher