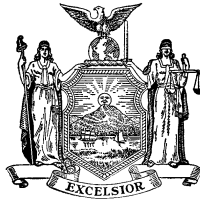


STATE OF NEW YORK DEPARTMENT OF PUBLIC SERVICE
THREE EMPIRE STATE PLAZA, ALBANY, NY 12223-1350
www.dps.ny.gov

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December 20, 2012

Leigh Bullock
New York Independent System Operator, Inc. (NYISO)
10 Krey Boulevard, Rensselaer, NY 12144
Sent via E-Mail: lbullock@nyiso.com

Re: FTI's Evaluation of the New York Capacity Market

Dear Ms. Bullock:

The Staff of the New York State Department of Public Service (DPS Staff) hereby provides its comments on FTI's Evaluation of the New York Installed Capacity (ICAP) Market. DPS Staff would first like to thank FTI Consulting for providing a very comprehensive and thoughtful analysis. We agree with the report's principal conclusion that there is no compelling case for introducing a NYISO-run forward capacity market, because such a project would be immensely complex and would likely create more problems than it solves.

Regarding the New York City "buyer-side" mitigation rules, we appreciate the report's support for an exemption for merchant entrants who are not buyers and have no market power. It is logical that these entrants should not be subject to "buyer-side" mitigation. DPS Staff recommends further improvements to the buyer-side mitigation rules by establishing a blanket exemption for resources

below a certain size threshold, as those resources would similarly not have an opportunity to benefit from suppressed prices. In addition, DPS Staff recommends that generating units that have contracts with entities, such as municipalities, which are not large enough to benefit from depressed prices by contracting for "uneconomic" capacity, should also be exempt from mitigation measures.

DPS Staff agrees in principal with the report's recommendation to place greater reliance on the energy and ancillary services markets, which provide much more granular price signals than can be provided by ICAP markets. This can best be achieved by pursuing real-time dispatchable load. To the extent the NYISO can rely on dispatching load to efficiently "shave the peaks," rather than calling on specialized peaking generators, the NYISO could ultimately achieve greater reliability with less reliance on capacity markets. However, we would caution against over-reliance on extreme price spikes. Relying on such price spikes would be inappropriate for several reasons, including: 1) they typically reflect extreme, short-term events that may threaten reliability; 2) they are unreliable because, in these extreme events, the dispatch models are at times inaccurate and yield inappropriate prices; and, 3) they are unpredictable and thus ineffective in encouraging new entry. By contrast, an increased reliance on real-time dispatchable load would provide more effective scarcity pricing, with more hours at moderately high levels (e.g., \$500/MWh), than the occasional extreme peak.

DPS Staff disagrees with the implication in the report that there is no downside to unnecessarily creating new capacity zones based on the rationale that a new zone would not "bind" if it is not needed. It is essential to recognize that every time a piece of the Rest-of-State (ROS)

market is broken off (which is arguably a competitive, well-functioning capacity market), it makes the ROS market less competitive and increases the chances of a non-competitive outcome in the new "smaller" zone. Additionally, with the NYISO proposal to have the highly-contested buyer-side mitigation rules apply to **all** new zones, the risk of an economic project being mitigated would increase. Thus, DPS Staff requests that the NYISO acknowledge and account for the substantial risks associated with creating new zones.

As a general observation, DPS Staff notes that the capacity market is becoming increasingly complex and litigious. The installed capacity reserve requirement existed long before the NYISO commenced operations in 1999. While the original intent of the capacity market was simply to ensure sufficient resources are available statewide to meet peak load in a reliable manner, market participants appear to have lost sight of that fact, and are instead looking to the market as a catch-all to address various perceived competitive market imperfections that the capacity market is ill-suited to address. Besides staving off retirements, market participants are trying to use ICAP to address local reliability needs, shortage pricing (See discussion below on steeper demand curves), and improve the planning processes. As a result, the capacity market is in danger of becoming a liability to New York's competitive markets. DPS Staff recommends that the NYISO and market participants refocus their efforts on the capacity markets original purpose, and develop alternative ways to address the other perceived market issues.

Regarding the report's detailed recommendations, DPS provides the following comments:

> P. iii: The top paragraph refers to "the role of the capacity market to make up the residual 'missing money.'" The reference to "missing money" could be

misinterpreted as ensuring that every generator is guaranteed an "adequate return." In fact, healthy markets depend on the possibility of both entry and exit; thus, the electricity market rules must allow for efficient retirements, so long as they do not threaten reliability. The role of the capacity market should be limited to ensuring sufficient resources to meet peak loads reliably, not to retaining every incumbent resource regardless of market conditions.

> P. v: DPS Staff has significant concerns with increasing the steepness of the demand curves. While in theory the value of capacity should reflect the value of lost load, in practice such a direct translation may result in nearly vertical demand curves, similar to the NYISO's original market design. Unfortunately, such steep demand curves failed to provide predictable price signals to the market, and thus proved ineffective in ensuring sufficient resources to meet peak loads reliably. Additionally, steeper demand curves increase the ability to exercise market power, as a small amount of MWs can have a large impact on prices. In contrast, the current demand curves have maintained sufficient capacity resources, while providing signals for retirements when appropriate.

> P. vi: DPS Staff continues to maintain that the New York City (NYC) "buyer-side" mitigation measure (i.e., bid floors on new entrants) is both inappropriate and unnecessary. It is inappropriate because it mitigates sellers, not buyers. A "buyer-side" mitigation measure would put a floor on the buyers' (Load-Serving Entities (LSEs)) bids, not on new entrants' bids. In fact, there already is an effective floor on the buyers' bids, which is provided by the ICAP spot market demand curve. The demand curve prevents LSEs from withholding demand in the spot

market, and therefore prevents them from exercising buyer-side market power, just as the bid cap on NYC suppliers prevents them from exercising seller-side market power. We recognize that these measures are not perfect, because market power could also be exercised through physical entry and exit. However, it should be recognized that new entry in NYC, even if "uneconomic," generally does not threaten reliability. While new entry may temporarily depress NYC ICAP market prices, this will only encourage the retirement of some existing NYC generation, and cause ICAP prices to return to prior levels. As a result, any attempt by LSEs to permanently "crash" the NYC ICAP market price will be unsuccessful. Therefore, the bid floor on new entrants ("buyer-side" mitigation) and its attendant controversies are unnecessary as well. We would add, however, that if the NYC demand curve were to be made steeper, this would tend to exaggerate the price impacts of entry and exit, and could prove disruptive to the NYC market and require additional mitigation rules.

> P. xi: The report observes that the New York Public Service Commission's retail access design may be deterring LSEs from engaging in forward contracting for capacity. The report suggests that if forward contracting were deemed desirable it could be achieved through changes in the retail access design, instead of via a NYISO forward capacity market. We agree with the general thrust of this recommendation that alternative approaches could be preferable to a NYISO-based forward capacity market. We note that when the New York Transmission Owners divested most of their generation, certain contractual restrictions were included to address local reliability and market power issues. Similarly, when local reliability issues have required the deferment of proposed retirements, those

issues have been addressed via contracts negotiated between the local transmission owner and the supplier. DPS Staff suggests that similar contract-based approaches may provide a more effective means of addressing local reliability and market power issues than a NYISO-based forward capacity market. Contracts with Transmission Owners could also be tailored to supplement the NYISO and Transmission Owner planning processes. Such contracts would be designed not to replace the ICAP markets, but to address other specific issues which cannot yet be resolved by the energy, ancillary services, or capacity markets.