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June 5, 2007

Honorable Jaclyn A. Brilling
Secretary
New York State Public Service Commission
Three Empire State Plaza
Albany, NY 12223-1350

Re: Case 06-M-1017 – Proceeding on Motion of the Commission as to Policies, Practices and Procedures for Utility Commodity Supply Service to Residential and Small Commercial and Industrial Customers – Phase II

INITIAL COMMENTS OF NIAGARA MOHAWK POWER CORPORATION

Dear Secretary Brilling:

Niagara Mohawk Power Corporation, d/b/a National Grid, hereby submits for filing an original and ten copies of its Initial Comments in the above referenced proceeding. Copies of this filing are being served electronically and via U.S. Mail to the active parties in this proceeding.

Kindly acknowledge receipt of this filing by date-stamping as received the enclosed duplicate copy of this letter and returning it to our courier. Please contact the undersigned if you require any further information in connection with this filing.

Respectfully submitted,

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STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

Proceeding on Motion of the Commission as to the Policies, Practices and Procedures for Utility Commodity Supply Service to Residential and Small Commercial and Industrial Customers	)))))	**Case No. 06-M-1017**

COMMENTS OF
NIAGARA MOHAWK POWER CORPORATION D/B/A NATIONAL GRID
ON PHASE II ISSUES

On April 19, 2007, the Commission issued its "Order Requiring Development of Utility-Specific Guidelines for Electric Commodity Supply Portfolios and Instituting a Phase II to Address Longer-Term Issues" ("Order") in the captioned proceeding.[1] As requested in the Order, Niagara Mohawk Power Corporation d/b/a National Grid ("National Grid") respectfully submits its initial comments on the Phase II issues identified in the Order.

BACKGROUND

In the Order, the Commission discussed and decided a number of substantive issues regarding utility hedging to protect retail electric customers from excessive price volatility, and ordered the New York electric utilities to "collaborate with other parties on the development of guidelines consisting of hedging measurement standards and volatility limitation goals, either in rate cases or in proceedings dedicated to that purpose."[2]

The Order also provided further clarification of the scope of the proceeding, including institution of a Phase II to undertake "an examination . . . of the use of long term contracts and

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1 *Proceeding on Motion of the Commission as to the Policies, Practices and Procedures for Utility Commodity Supply Service to Residential and Small Commercial and Industrial Customers*, Case 06-M-1017, "Order Requiring Development of Utility-Specific Guidelines for Electric Commodity Supply Portfolios and Instituting a Phase II to Address Longer-Term Issues" (issued April 19, 2007) (hereinafter cited as "Order").

2 Order at 26.

other means to facilitate the entry of new resources that would further the public policy goals of the State regarding electric infrastructure."[3] Noting that New York's current resource adequacy mechanisms have "not led to much merchant driven supply" in New York City, and expressing the opinion that the capacity market operated by the New York Independent System Operator ("NYISO") addresses reliability but is less successful at addressing other public policy issues, the Commission concluded:

> there may be a growing need for a rational and comprehensive decision-making approach to guide the future of New York's electricity infrastructure...We conclude that integrated planning for public policy purposes needs to be further considered in an expedited manner.[4]

Accordingly, the Commission solicited comments on a list of eleven questions regarding the best mechanism or mechanisms for accomplishing the state's policy goals with respect to resource adequacy. In its discussion, the Commission indicated that one such mechanism it intends to investigate is long-term capacity contracts:

> it appears that the use of long term contracts could facilitate entry of new supply.... Moreover, new capacity might not be built in the absence of long term agreements between a new entrant and one or more load serving entities (LSEs). Thus, a more detailed inquiry is needed regarding long term contracts.[5]

National Grid appreciates the opportunity to provide its responses to the Commission's questions, and discussion of the considerations underlying them. National Grid urges the Commission to continue to work collaboratively with all parties and stakeholders to develop a robust resource adequacy mechanism for New York that interferes as little as possible with the competitive electricity markets. Any such mechanism also should be compatible with energy products currently offered in New York, and with New York's retail access regime. This mechanism should provide clear guidance to market participants, but at the same time be flexible

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3 *Id.* at 35-36.
4 *Id.* at 33.
5 *Id.* at 34.

enough to accommodate changing market conditions and new public policy initiatives. Last but not least, the Commission's ruling in this proceeding should support – or at least not obstruct – the construction of adequate transmission capacity in the state. As National Grid discusses in detail below, a requirement for utilities to enter into long-term capacity contracts with suppliers meets few, if any, of these criteria. However, several other approaches – some of which are similar to programs the Commission has already put in place – can meet these criteria.

COMMENTS

I. The Commission Should Ensure That Any Resource Adequacy Mechanism It Selects Promotes Rather Than Hinders the Development of Competitive Markets, and Supports Rather Than Obstructs Other Important State Policies.

While Phase II of the Order expands the scope of the current proceeding to a broad review of resource adequacy issues, this review should not take place in a vacuum. Rather, Phase II should be seen against a backdrop of long-established policies that the Commission and many of the parties to this proceeding have labored for more than a decade to implement, and upon which they have relied in structuring their business plans and operations. Beginning in the mid-1990s with the Competitive Opportunities proceedings and continuing to the present day, the Commission and these parties have worked to design, implement, and refine competitive retail electricity markets in New York. In 2004, the Commission issued its Retail Market Policy Statement, in which it listed the successes and benefits that competition has brought to the state, "reaffirm[ed its] commitment to fostering competition whenever possible through steady progress in retail access program design and incentive ratemaking," and lauded "the promising level of success that has been achieved in New York without most of the serious difficulties others have encountered."[6] The Commission since has reaffirmed its commitment to competitive

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[6] Case 00-M-0504, Statement of Policy on Further Steps Toward Competition in Retail Energy Markets (issued August 25, 2004), 235 P.U.R.4th 225, 2004 WL 1924991 at 21.

markets many times,[7] most recently two months ago in its Review of Competitive Retail Energy Markets, in which it stated: "We have long supported the development of viable and sustainable competitive markets, which promote economic efficiency and thereby yield consumer benefits. . . . In response . . . retail energy markets have developed and grown. . . . [T]he retail energy marketplace is established in New York and is continuing to expand."[8] The Commission also has continued to refine New York's retail market design to support competition.[9]

The Order is entirely consistent with this long-standing Commission policy to bring the benefits of competition to New York consumers. As the Order notes:

> [T]his Commission has consistently found that the development of competitive markets, where feasible, will assist in assuring the provision of safe and adequate utility services at just and reasonable costs. We have consistently endorsed competition where it is more effective than regulation, but also realize that markets alone may not automatically satisfy a broad range of public policy needs and goals.[10]

It should be recognized that the Commission has already begun to address the market conditions responsible for the competitive markets' "not automatically satisfy[ing] . . . public policy needs and goals" with respect to resource adequacy. As economists specializing in capacity markets have pointed out, the "market failure" that can prevent competitive markets from creating economically efficient levels of capacity is "the absence of a robust demand side."[11] Having recognized earlier than most regulators the price instability such conditions can cause, the

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7 *See e.g.* Case 00-M-0504, Statement of Policy on Rate Design Issues (issued February 14, 2005); Case 06-G-1386, Re New York State Electric & Gas Corporation, (issued December 22, 2006), slip op. 2006 WL 3797954, at 2.

8 Case 07-M-0458, Proceeding on Motion of the Commission to Review Policies and Practices Intended to Foster the Development of Competitive Retail Energy Markets (issued April 24, 2007), slip op. at 4-5.

9 Case 06-M-0647 et al., Order Adopting ESCO Price Reporting Requirements and Enforcement Mechanisms (issued November 8, 2006).

10 Order, at 29-30 (citations omitted).

11 Peter Cramton and Steven Stoft, "A Capacity Market that Makes Sense," *Electricity Journal*, 18, 43-54, August/September 2005, at 2.

Commission began a program several years ago for unleashing robust demand side responsiveness in New York, and has already made substantial progress. For example, the Commission has already ordered mandatory hourly "real-time" pricing for large industrial and commercial retail customers in New York.[12] In addition to its benefits to markets generally, real-time pricing offers greater protection to customers by putting in their hands the ability to decide when electricity prices are too high, and to react by reducing consumption during those periods.

Given this background, and in view of the Commission's continuing strong support for competitive markets, its ongoing eradication of barriers to the proper operation of these markets, and the impressive expansion of electric commerce in New York that has resulted from competition, National Grid does not see the Order as an invitation to begin dismantling New York's competitive markets or to wall off a portion of these markets to be forever protected from competition. Rather, National Grid views the Order as a mandate to create a mechanism for ensuring ample electricity supply in New York that is either competition-based, or that at least has the smallest possible negative effect on the competitive markets. Any mechanism adopted to ensure resource adequacy also should not be unduly difficult to transform to a fully competitive model. Significantly, Commission precedents addressing issues similar to the instant proceeding, *i.e.*, those regarding New York's Renewable Portfolio Standard ("RPS"), have stressed the importance of these same two objectives, "competitive neutrality"[13] and eventual transition to a fully competitive mechanism.[14]

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12 Case 03-E-0641, Re Mandatory Hourly Pricing for Commodity Service (issued April 24, 2006), 248 P.U.R.4th 496, 2006 WL 1083297 at 1.

13 *See* Case 03-E-0188, Re Retail Renewable Portfolio Standard (issued Sept. 24, 2004), 235 P.U.R.4th 414, 2004 WL 2667219, at 23 ("2004 RPS Order").

14 *Id.* at 7 ("this Commission desires that, ultimately, competitive markets will sustain renewable resource development, and we expect that as part of the 2009 Review NYSERDA will submit a proposed plan for transitioning this effort to a more market-based approach over time.").

Building on these two complementary objectives – least impact on the emerging competitive markets and ease of transition to a competitive model – a number of corollary principles naturally emerge that should guide the Commission's decision-making in the area of resource adequacy.

II. The Commission Should Follow Certain Principles To Guide Its Choice Of a Resource Adequacy Mechanism.

A. The Commission Should Impose Out of Market Solutions Only If It Determines That No Market-Based Solutions Exist.

The Commission should begin its deliberations in this proceeding by searching for solutions within the competitive markets themselves to address its resource adequacy and public policy concerns. Competitive market mechanisms that advance resource adequacy and public policies would obviously be the least disruptive to competitive markets. Only if the Commission concludes after a full investigation that no competitive market solutions to its concerns exist should the Commission turn to evaluating solutions that are not market-based.[15]

The Commission should keep several considerations in mind when considering whether to impose out-of-market solutions to resource adequacy concerns. First, the fact that New York's competitive markets do not appear to be encouraging the construction of generating capacity in New York City or addressing other public policy goals today does not mean that they *cannot* do so. The recent history of the New York markets – and electricity markets throughout the country – is rife with examples of competitive market design adjustments that produced just

15 *See* Order at 29-30 ("We have consistently endorsed competition where it is more effective than regulation..."); *see also* Case 00-M-0504, Statement of Policy on Further Steps Toward Competition in Retail Energy Markets (issued August 25, 2004), 235 P.U.R.4th 225, 2004 WL 1924991 at 17 (The Commission stated "robust competition, where feasible, should be our long-range vision. In the best of all worlds, all retail functions (except delivery) now provided by utilities would be competitive.").

the desired effect without undercutting competition.[16] In the same way, there may be adjustments to the current competitive regime that can resolve the Commission's resource adequacy concerns without resorting to out-of-market mechanisms. It may be observed, for example, that many regions of the country maintain adequate capacity margins without recourse to long-term contracting requirements or similar regimes, and that large amounts of electric generation investment have occurred recently in Great Britain under a purely competitive market structure.[17]

Second, the Commission already has begun the process of resolving the market design "flaw" responsible for the resource adequacy concerns it seeks to address, by giving large electric customers the power to react to price in the electricity markets as they do in almost every other area. It would be ironic indeed if a market-disruptive regime were imposed just at the time when customers and the markets began to reap the salutary results of the Commission's real-time metering and pricing initiative. This initiative, once it comes to fruition, should greatly ameliorate the factors underlying the resource adequacy issues the Commission has identified.[18] The benefits of this initiative should not be snatched away from customers after they and the utilities have undergone the expense and disruption associated with the changeover to competitive markets.

Finally, the Commission should recognize that, despite its superficial resemblance to a market-based solution, a requirement for utilities to enter long-term contracts with capacity

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16 *See e.g., Niagara Mohawk Power Corp, v. New York State Reliability Council, et al.,* 116 FERC ¶ 61,084 (2006) (where a Resource Adequacy Issues joint task force was developed).

17 *See e.g.*, Oxera, 2006. Energy Market Competition in the EU and G7: preliminary 2005 rankings, October 2006 at 44 ("The UK currently has the most competitive market in the EU."), Report on Behalf of the UK Department of Trade and Industry, London, available at: http://www.dti.gov.uk/files/file35324.pdf.

18 *See e.g., NRG Power Marketing, Inc. v. New York Indep. Sys. Operator, Inc.*, 91 FERC ¶ 61,346, at 62,166 (2000) ("A robust, competitive market needs correct, real-time price signals in order to function properly").

suppliers is actually just the opposite. Such contracts by their very nature supersede the business judgments of market participants, and lock in pricing structures in the absence of knowledge of how electricity market prices will behave in the future. Where such contracts are mandated by a regulatory authority, they may expose the participants to risks that they likely otherwise would have declined to accept. This kind of preemption of private business judgments in the realm of mandatory contracts – which has the additional effect of transferring much price risk from capacity suppliers to utility customers – could not be more at odds with competitive markets, and often has had disastrous results in the past. For example, the New York utilities that entered long-term contracts with non-utility generators in the 1980s under the requirements of the Public Utilities Regulatory Policies Act of 1978 ("PURPA")[19] were able to extricate themselves only slowly and at great expense when the market price for energy dropped far below the projections upon which these contracts' prices were based.[20] Similarly, California is still in the painful process of disentangling itself from the long-term contracts the state signed in the wake of the Western Energy Crisis.[21] Of course, the ultimate victims of such mistakes in governmental policy are consumers, who ultimately bear the higher energy costs resulting from such requirements.

Not only is the use of long-term contracts to obtain adequate generation capacity fraught with danger for consumers and the state economy, but the use of such contracts does not avoid the need for a central administrative authority to effectively set prices and quantities in place of

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19 Public Utility Regulatory Policies Act of 1978, Pub. L. No. 95-617, 92 Stat. 317 (codified as amended in scattered sections of titles 15, 16, 42 & 43 of the United States Code).

20 Case No. 06-M-0002, In re Orange and Rockland Utilities, Inc., 2006 WL 2852356 (issued October 6, 2006) (order authorizing the deferral of up to $1,195,747 incurred for the termination of a NUG contract); Case No. 05-E-1222, In re New York State Elec. & Gas Corp., 2006 WL 2560636 (issued August 23, 2006) ("In the case of NYSEG, the estimate for 2007 is that the expiration of above-market costs of contracts with non-utility generators (NUGs) will result in an overall rate decrease of $81 million.").

21 *Id.* at 2.

the market. "Long-term contracting requires specification of the mandatory energy option contracts, the penalty for a failure to hold sufficient options and the penalty for failure to perform when called. Notice that at least in shortage situations, the penalty for nonperformance needs to be set administratively at a level above the spot energy price to provide sufficient incentive for investment."[22] Among other things, under these circumstances the pricing of the long-term contracts tends to equilibrate at the level of the penalty payments.[23] Thus, in setting penalty payments, the regulator is in effect setting the price that utilities and their customers pay for long-term capacity contracts. Set too low, this price will not induce entry of new capacity; set too high, it will overcharge customers for capacity.[24] Neither does the use of long-term contracts avoid the locational question: should the penalties (and hence the price) be higher or lower in different parts of the state? This is another question that the central authorities will have to determine under a long-term contracting regime, with no help from the competitive markets.

In terms of an uncomplicated transition to a fully competitive market, long-term contracts present further difficulties. Mandatory long-term contracts from which utilities cannot extricate themselves obviously will delay the transition to a competitive market until they expire – in the long term. In the meantime, such a regime "locks up" large portions of the wholesale market, doing great harm to their liquidity. The inevitable result is that the portion of the capacity market not covered by mandatory contracts will progressively shrink due to the resultant small field of uncommitted customers to whom competitive suppliers might offer capacity products.

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22 "A Capacity Market That Makes Sense," at 3.

23 *Id.*

24 Peter Cramton and Steven Stoft, "The Convergence of Market Designs for Adequate Generating Capacity with Special Attention to the CAISO's Resource Adequacy Problem, A White Paper for the Electricity Oversight Board," April 2006 at 21-22 available at: www.ksg.harvard.edu/hepg/Papers/Cramton_Stoft_0406.pdf.

For all of these reasons, while it may be tempting to think of a long-term contracting requirement as a "market-based" solution to resource adequacy and related public policy concerns, in fact such a regime fails to qualify as such on all counts: it substitutes central regulation for participants' business judgments, and solves none of the problems for which overtly administrative capacity markets often are justly criticized.[25]

B. Any Out Of Market Regulatory Mechanism Imposed Should Be As Narrowly Focused As Possible And Compatible With Competitive Markets And Other Existing Market Mechanisms.

Going outside normal market mechanisms to create incentives for entry can easily distort market prices, often in self-defeating ways. Such out-of-market solutions inevitably sacrifice some level of economic efficiency, because even the best designed administrative mechanisms are unlikely to be as effective as competitive markets in winnowing out inefficient investments and minimizing consumer costs. In addition, market power mitigation measures that may have to be implemented to prevent generators from taking unfair advantage of an out-of-market resource adequacy mechanism can suppress market prices to such an extent that new entry is actually discouraged rather than encouraged.[26] Obviously, any resource adequacy mechanism the Commission adopts must be tailored carefully to hold to a minimum such distortions of competitive market price signals, and to avoid undercutting the viability of merchant generators or to creating disincentives for construction of sufficient transmission in needed locations.

However, the Commission's task in this case is a good deal more complicated even than this. As the Commission is well aware, a number of other programs are already in place that directly affect the amount and kind of generation capacity in New York. For example, the NYISO operates its locational installed capacity ("LICAP") markets, which use administratively-

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25 *Id.* at 2; "A Capacity Market That Makes Sense," at 3.

26 *See e.g., PJM Interconnection, LLC*, 112 FERC ¶ 61,031 (2005).

determined "demand curves" to set capacity prices depending on the amount of capacity already in the market.[27] The New York Power Authority ("NYPA") and the Long Island Power Authority ("LIPA") from time to time undertake programs of construction of new power plants and transmission facilities in response to their respective load and capacity situations.[28] Also, the Renewable Portfolio Standard ("RPS") program, administered by the New York State Energy Research and Development Authority ("NYSERDA"), provides subsidies specifically to support the entry of renewable energy resources into the New York markets.[29]

Were the Commission to decide to mandate a resource adequacy mechanism in addition to the capacity programs already in place in New York State, the Commission would need to consider how this new mechanism would interact with these existing capacity programs, as well as with the organized wholesale electric markets in New York State. The dangers of having too little reserve capacity, or of having new capacity arrive on the scene too late to address shortages, are easily recognized, if not always easily addressed. On the other hand, a mechanism or combination of mechanisms that produces too much capacity too early or capacity of the wrong kind (*e.g.,* baseload vs. quick-start units) or that is too expensive may have its own serious problems. A very recent example is the ill-fated New England LICAP market, which likely would have required New England electricity consumers to pay billions of dollars to existing generators without encouraging the addition of adequate new capacity or, at best,

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27 *New York Indep. Sys. Operator, Inc.*, 103 FERC ¶ 61,201 at P 14 (2003).

28 For example, in December 2005, NYPA put into commercial operation one of the cleanest, most-efficient power plants in New York City's history in Astoria, Queens, http://www.nypa.gov/ccp/default.htm. The Caithness Long Island Energy Center is expected to be completed and begin generating electricity for LIPA's customers by the summer of 2009, (http://www.lipower.org/company/powering/caithness.html).

29 *See* 2004 RPS Order at 2 ("the Commission finds that financial incentives will be required to support the development of renewable resources").

overcompensating any new capacity additions.[30] Any resource adequacy mechanism should also be carefully tailored to avoid problems with premature retirement of existing capacity suppliers, increased cost associated with maintaining excess capacity, timing, and other effects.

C. Any Non-Market Mechanism Must Reflect Projected Retail Access Load Shifts.

One aspect of New York's competitive electricity markets that National Grid believes is especially beneficial to customers, and for that reason should be preserved, is retail access. At the same time, maintaining consistency with retail access will pose a challenge to any overly rigid out-of-market capacity mechanism. State retail access programs permit electricity customers to quickly and easily switch electricity suppliers with minimal notice. As a consequence, the magnitude of the load a utility will serve may change substantially over the years a long-term capacity commitment, such as a long-term contract, would extend. As an example of this, a report issued by the New York State Department of Public Service ("DPS report") details migration of load to and from New York utilities for the period March 2006 to March 2007.[31] The DPS report shows that during this period, Consolidated Edison Company of New York, Inc.'s ("ConEd") load migration increased by 19.0%; National Grid's load migration increased by 8.8%; New York State Electric and Gas Corporation's ("NYSEG") load migration increased by 10.7%; Orange and Rockland Utilities, Inc.'s ("O&R") load migration decreased by 10.9%; and Rochester Gas and Electric Corporation's ("RG&E") load migration decreased by 0.9%.[32] Aggregation of load shifts of such magnitudes over even a single year could result in very large changes in load responsibility for utilities. Thus, if utilities were required to enter long-term contracts or other commitments based on estimates of their future loads that turn out to

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30 *See Devon Power LLC*, 115 FERC ¶ 61,340 (2006).

31 The March 2007 Electric Retail Access Migration Reports are available at: http://www.dps.state.ny.us/Electric_RA_Migration.htm

32 *See* http://www.dps.state.ny.us/Electric_RA_Migration.htm.

be incorrect, they could be saddled with excess capacity whose costs they would have to pass through by raising rates to their customers. Furthermore, utilities that find themselves with such a long-term capacity "overhang" would have a disincentive to vigorously pursue programs such as those promoting energy efficiency and distributed generation, potentially frustrating important state policies, as the Commission has recognized in its RPS proceeding.[33]

Such a mismatch between load and obligations would be exacerbated by the existence of non-utility LSEs ("ESCOs") in New York's retail electric markets. A long-term contracting requirement that applied to utilities but not ESCOs would permit the customers of the latter to "free ride" on those of the former, who would bear the cost burden of supporting capacity adequacy in New York without assistance from the ESCO customers, even though the ESCO customers would benefit equally from the improved reliability. Such an inequitable distribution of benefits and burdens would be unfair, and would further distort competitive market prices.

While National Grid does not believe that a long-term contracting requirement is either needed or desirable to address the Commission's concerns, if the Commission does decide to adopt such a requirement (or any similarly rigid long-term mechanism), certain ameliorative measures must accompany it. Any long-term contracting requirement adopted by the Commission should include some means to accommodate the fact of rapidly shifting retail loads in the New York markets. In fact, the Commission has already thought through these issues in its Renewable Portfolio Standards proceeding, which is the program currently mandated by the Commission that is most analogous to a resource adequacy mechanism of the kind suggested in the Order. RPS subsidizes renewable energy generation facilities with funds raised through LSE customer billings. However, such billings "follow the load" by attaching a volumetric surcharge to each individual customer's electric consumption, rather than by assigning costs or capacity

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33 2004 RPS Order at 2.

obligations to the LSEs.[34] A similar mechanism will be indispensable in the event that any new capacity mechanism the Commission adopts requires utilities to enter into long-term capacity contracts or similarly rigid long-term arrangements.

D. Utilities Should Not Be Required To Take On Obligations That Are Inconsistent With The Commitments Their Customers Make To Them.

As discussed in the previous subsection, requiring New York utilities to make long term capacity commitments when their loads may change substantially over time would create serious problems and distorted incentives in the marketplace. In addition to this, requiring New York utilities to enter into long-term contracts to provide financial support to new generators is inconsistent with the role such utilities play under retail access. Under New York's retail access program, utilities are not solely or even primarily responsible for supplying retail customers with commodity service; indeed, Commission policy favors transferring responsibility for such commodity service from the utilities to ESCOs. Consequently, relying on these utilities to enter into long-term contracts for capacity in order to support the reliability of this commodity service creates a fundamental mismatch of commitments.

This inconsistency with other state policies and with customer commitments makes mandatory long-term capacity contracting requirements applied to New York utilities a counterproductive approach. However, should the Commission adopt this approach, it should recognize that, in the absence of some ameliorative mechanism, this is tantamount to requiring each utility's remaining customers to pay for long-term capacity obtained on behalf of customers who have switched to a different supplier. Utilities would be entitled to rate recovery for the costs they prudently incur under long-term capacity contracts entered into pursuant to such a

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[34] 2004 RPS Order at 11 ("Revenue necessary to support this program will be raised through a non-bypassable volumetric wires charge on the delivery customers of each of the State's investor-owned utilities.").

requirement.[35] Failing to allow recovery of such costs could raise serious legal and constitutional concerns.[36] Indeed, unless the Commission makes clear at the outset its intention to permit recovery of the costs of capacity contracts that utilities enter into to fulfill an obligation the Commission imposes on them, the resulting market uncertainty will be reflected in higher capacity costs that customers must bear, as investors and generation counterparties increase the risk premiums they demand in their relations with the utilities.[37]

Should the Commission decide to require utilities to enter into long-term capacity contracts it will have to address the rate mechanism through which the costs of those contracts would be recovered. Limiting recovery to the utilities' commodity customer rates would be unfair, as well as poor public policy. It would require those customers to subsidize customers who obtain commodity service from ESCOs, which to would seriously distort competitive

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35 *See Abrams v. Public Svc. Dept.*, 483 N.Y.S.2d 785, 787 (3d Dept. 1984), where the court stated:

> In our view, the guiding concept applicable to the facts of this case was stated by Justice Brandeis in his concurring opinion in *Southwestern Bell Tel. Co. v. Public Serv. Comm.*, 262 U.S. 276, 290, 43 S.Ct. 544, 547, 67 L.Ed.2d 981, when he stated that "[t]he thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise". It follows that the test of whether expenditures may be deemed used and useful is not whether the expenditures have resulted in a facility electric service to the public, but whether the expenditures were prudently undertaken toward that end.

See also, e.g., Long Island Lighting Co. v. Publ. Serv. Comm'n, 134 App. Div.2d 135, 143, 523 N.Y.S.2d 615, 620 (3d Dep't 1987); *Re Consolidated Edison Company of New York, Inc.*, Case 02-E-1656, slip op. at 5 (Jan. 24, 2003); *Consolidated Edison Co. of New York, Inc. - Indian Point No. 2 Outage*, Opinion No. 79-1, slip op at 6 (Jan. 16, 1979).

36 The Fifth Amendment prevents federal and state governments from "taking" property without just compensation. *See also* Charles E. Bayless, Stranded Cost Recovery: A Practical Argument for Utilities, Pub. Util. Fort., June 1, 1997, at 40; Leigh H. Martin, Note, Deregulatory Takings: Stranded Investments and the Regulatory Compact in a Deregulated Electric Utility Industry, 31 Ga. L. Rev. 1183 (1997)("The Court articulated [a] framework in *Penn Central Transportation Co. v. New York City*, in which it identified three principal factors to consider when evaluating claims of regulatory taking: the economic impact of the regulation on the property owner, the extent to which the regulation diminished the investment-backed expectations, and the character of the governmental action involved.)(internal citation omitted).

37 *See El Paso Electric Co., et al.*, 71 FERC ¶ 63,001 at 65,008 (1995)("an increase in regulatory risk would increase financial costs"); *Florida Power & Light Co.,* 70 FERC ¶ 61158 (1995)("Eliminating the uncertainty of future refunds should, all things being equal, reduce the utility's risk and hence its cost of capital over time.").

markets, and would violate the Commission's well-established policy of allocating costs to customers who benefit from them.[38] As mentioned in the previous subsection, the Commission has already addressed these issues in its Renewable Portfolio Standards proceeding. In that proceeding, the Commission decided to circumvent all such difficulties proactively by preventing any loss of revenues to utilities as a result from retail migration.[39] The policy considerations in the instant proceeding are identical to those in the RPS proceeding.

E. Any Capacity Mechanism Must Encourage Construction of a Robust Transmission Infrastructure, Which Is Critical To Addressing the Commission's Public Policy Objectives.

Much attention has been paid recently to the issue of transmission infrastructure adequacy in the United States.[40] While transmission infrastructure adequacy and generation capacity adequacy may appear superficially to be two separate issues, they are intimately related, as the Commission is well aware. A robust transmission infrastructure serves resource adequacy by bringing together loads and resources that are remote from one another, thus giving customers access to capacity in order to reduce energy costs, improve reliability and capture environmental benefits. Thus, any resource adequacy mechanism that fails to expand transmission capacity along with generation capacity is incomplete and inefficient. Furthermore, any resource

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[38] *See* Case 05-G-1209, Re New York State Electric & Gas Corporation, 2005 WL 3004436 (NYPSC) (issued November 9, 2005)("To properly price utility services, each class of customers should pay for the costs it imposes. Otherwise, customers might be compelled to improperly subsidize service to others, a result that is not only fundamentally unfair but also sends inaccurate price signals.").

[39] *Re Competitive Retail Energy Markets*, NYPSC, Apr. 24, 2007, p. 3.

[40] *Promoting Transmission Investment Through Pricing Reform*, Order No. 679, 116 FERC ¶ 61,057 at P 10 (2006)("investment in transmission facilities in real dollar terms declined significantly between 1975 and 1998... data for the most recent year available, 2003, shows investment levels still below the 1975 level in real dollars. This decline in transmission investment in real dollars has occurred while the electric load using the nation's grid more than doubled.") (internal citations omitted); S. Rep. No. 109-78, at 8 (2005)(stating that "Billions of dollars need to be invested in the national transmission grid to ensure reliability and to allow markets to function."); *see also* Chairman Joseph Kelliher's Statement on Regulations for Filing Applications for Permits to Site Transmission Facilities, Docket No. RM06-12-000, (November 16, 2006)(stating "Last year, Congress concluded that the status quo was failing to develop the strong transmission grid that our country needs.").

adequacy mechanism that discourages expansion of transmission capacity along with generation capacity is counter-productive.

An effective, well-established method for allowing transmission infrastructure to keep pace with generation capacity is the imposition of a capacity deliverability requirement. A deliverability requirement reflects the fact that a resource that is not deliverable to an LSE cannot contribute to the reliability of service to that LSE's customers, and thus should not be considered a capacity resource available to that LSE. For example, a utility operating in a load pocket may be required to enter into a capacity contract with a remote generator, but if there is no available transmission capacity into the load pocket to deliver the energy under realistic conditions, this contract will be worthless. In order to count a contract such as this as contributing to reliability or public policy goals, the capacity must be accessible to customers, not merely hypothetically, but under real-world circumstances likely to be present at the times when the customers are likely to need it.

The capacity concerns relating to New York City, which the Commission cites as a principal reason for the Phase II inquiry in this proceeding, have less to do with a state-wide shortage of capacity – which does not exist[41] – than with the difficulties associated with bringing capacity that is abundantly available upstate into New York City. These transmission constraints into the city create the need for special local reliability requirements (e.g., "minimum oil burn" and LICAP), the dispatch of inefficient and less environmentally friendly units, market power mitigation rules, and an overall increase in electric costs. Indeed, the fact that shortages or potential shortages are a locational phenomena cause by insufficient transmission rather than shortfalls in the state's stock of generation may mean that reduced entry of new generation at this

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[41] *See* NYISO, Power Trends 2007 at 5-6 (2007), available at http://www.nyiso.com/public/newsroom/current_issues/index.jsp.

time is a rational economic response to overall state supply and demand conditions. In any case, artificially stimulating new entry by shifting risk from generators to customers through long-term contracts in the absence of adequate transmission is detrimental to customers and does little to address the locational nature of the state's resource adequacy problems. A resource adequacy mechanism that ignores the need for adequate transmission capacity as well as adequate generation capacity may lead to a scenario where import constrained areas within the state do not benefit from mechanisms adopted to create additional capacity resources. An abundance of capacity upstate and a shortage downstate indicate that a statewide solution of the capacity problem is needed, and that this solution must include significant transmission system upgrades as a crucial ingredient.

As the Commission is well aware, the New York stakeholders have been discussing a deliverability requirement for several years on independent grounds. Such a deliverability requirement is not a novel idea, but has been used successfully for many years in PJM, and is in the process of being adopted in California.[42] Furthermore, Commission precedents closely analogous to this proceeding, those regarding the RPS program, require what is essentially a deliverability requirement, at least for out-of-state generation. RPS too is a mechanism for procuring adequate generation capacity, the single difference being that RPS seeks to induce the entry specifically of renewable resource capacity. Recognizing that a requirement of actual delivery will "help ensure that New York State ratepayers enjoy the benefits from the costs they will incur to support the RPS program and its objectives," the Commission ordered that such a requirement be imposed on out-of-state generation seeking to qualify for RPS subsidies.[43] In the case of capacity under the Commission's contemplated resource adequacy program, transmission

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42 *See e.g.*, *Cal. Indep. Sys. Operator Corp.*, 116 FERC ¶ 61,274 (2006).

43 2004 RPS Order at 44.

infrastructure constraints within New York make an *intra*state deliverability requirement just as important as an interstate requirement.

Adequate generation infrastructure and adequate transmission infrastructure are both necessary to support reliable electric service and other New York public policy goals. National Grid therefore believes that any resource adequacy mechanism the Commission adopts must include provisions encouraging construction of transmission infrastructure to allow New York to make a transition to a deliverability requirement as part of its resource adequacy proposal.

F. The Costs of Any Resource Adequacy Mechanism The Commission Adopts Should Be Funded Under the Principle That Beneficiaries Pay For Costs Expended To Benefit Them.

National Grid recommends that the Commission fund any resource adequacy mechanism it adopts on the basis of the "beneficiaries pay" cost allocation principle it has established in past cases.[44] Under this approach, costs are recovered locally (for example, in the rates of a particular utility) when the benefits for which they pay are local, and statewide (through the rates of all customers) when they benefit the state as a whole. However, such cost allocation should be based upon pre-established cost categories. A case-by-case approach to cost allocation determinations can lead to delay and disruption in the process of assigning costs, which can translate into delay and disruption in constructing needed facilities. Costs associated with a resource adequacy program should be recovered through a volumetric surcharge on the delivery rates of whichever groups of customers benefit from the particular investment, as established by pre-determined classes of investments. Contracts or commitments entered into to meet statewide policy goals should have their costs recovered through the delivery rates of all customers in the State. Contracts or other commitments designed to meet needs in a particular region of the State

[44] *See* Case 05-G-1209, Re New York State Electric & Gas Corporation, 2005 WL 3004436 (NYPSC) (issued November 9, 2005).

should be recovered through the rates of customers that benefit in that region. Such a matching of costs and benefits is the only fair and economically efficient way to provide public goods.

III. Evaluation of Resource Adequacy Options Under the Principles Discussed Above

Given the discussion in the previous section, it is now possible to evaluate straightforwardly the different options that the Commission has for structuring a resource adequacy regime.[45] Indeed, National Grid believes that the constraints imposed by existing policies and programs limit the viable contenders to a narrow range.

A. A Capacity Procurement Mechanism Similar to New England's Forward Capacity Market Is Likely New York's Best Option.

Almost exactly one year ago, FERC approved a settlement agreement establishing New England's Forward Capacity Market ("FCM").[46] Administered by ISO New England ("ISO-NE"), FCM is a hybrid mechanism that seeks to harness competitive market forces to efficiently achieve capacity targets set by regulators. In FCM's first step, ISO-NE uses price separation data to determine whether to implement the market regionally or in separate zones within its control area. (To simplify the discussion, this summary addresses the case where FCM is implemented regionally; in the locational case, separate auctions are held for each separate zone.) Next, ISO-NE estimates (using a stakeholder-approved methodology) the total regional capacity requirement that will exist in New England three years in the future, and assigns to each LSE a fraction of this total requirement equal to that LSE's respective fraction of regional load. Annual Forward Capacity Auctions ("FCAs") are then held, at which generators sell and LSEs purchase capacity for the current three-year-ahead period (i.e., capacity for 2014 will be auctioned in 2011, etc). The FCAs are "descending clock" auctions, in which bidding begins at

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45 The discussion of alternatives in this section responds to Question 11 posed in the Order.

46 *Devon Power LLC*, 115 FERC ¶ 61,340 (2006).

an ISO-NE-determined level equal to twice the estimated cost of entry of new generation, and is continued in subsequent iterations until all of the required capacity is purchased. Changing conditions – such as load shifts – between the time of an FCA and its corresponding three-year-forward capacity period are accommodated by holding seasonal and monthly "reconfiguration auctions" that allow LSEs and generators to buy and sell capacity to make up shortfalls or unload excess capacity. The reconfiguration auctions are held on the same regional or locational basis as the original FCA. Deductions in the prices a generator receives in the capacity auctions are made for imputed profits earned by the generator in the energy market during the actual capacity year and for failures to be available to provide energy when the market experiences shortage conditions. Bid restrictions are enforced to discourage attempts to exercise market power.[47]

FCM has many obvious advantages.[48] The foremost of these is that planned capacity that receives capacity payments has the obligation to build when and where it is needed. Furthermore, while a central administrator establishes the total level of capacity the region needs, the cost of supplying this capacity is set by the market, competitive bidding providing the impetus for disciplining prices. Thus, the mechanism is generally compatible with competitive markets, ensures that the markets actually provide the needed resources, and minimizes distortion of price signals for other electricity products, such as energy and ancillary services.[49] A transition to full competition should take place naturally under this regime as well, as energy markets mature and capacity as a separate product progressively loses its value, this development being automatically

47 *See Devon Power*, at P 15 et seq. During a transition period beginning in 2006 and ending in 2010, capacity prices will not be set by the auction mechanism but by a schedule agreed as part of the settlement. *Id.* at P 30 et seq.

48 For a full discussion of these from an economist's point of view, see "The Convergence of Market Designs for Adequate Generating Capacity," *supra.*

49 The energy market profit and performance deductions from the prices generators receive in the auctions are intended to further emulate the competitive market, in which capacity would not be priced separately from energy, no price caps would exist, and consumers would be reacting to real-time prices. *See* "The Convergence of Market Designs for Adequate Generating Capacity" at 17-19.

reflected by FCM's energy profits deduction. A New York FCM could be implemented either state-wide or locationally, depending on the state's needs. FCM also features a mechanism to accommodate the load shifts associated with retail access in the configuration auctions that allow LSEs to rebalance their capacity vs. load portfolios on a monthly basis. Finally, use of FCM would ameliorate market "seams" between New York and New England, which could result in price distortions and manipulative generation bidding behavior between the two regions.

FCM is not a panacea. Importantly, if implemented locationally, FCM raises issues relating to transmission adequacy. That is, locational FCM uses capacity prices to boost construction of new generating facilities without necessarily ensuring that transmission capacity is also optimal. For this reason, any FCM or FCM-like capacity mechanism that is adopted by the Commission must be accompanied by a robust transmission planning mechanism to ensure that New York consumers enjoy the benefits of economically efficient solutions to the state's capacity needs.

B. Use Of a Mechanism Like the Commission's RPS Program May Also Be A Viable Alternative

As discussed above, National Grid favors a mechanism that, like FCM, relies on competition to the maximum extent possible in today's markets. However, should the Commission decide instead to use a long-term contracting mechanism to achieve its goals, National Grid believes that a mechanism like the Commission's RPS program is the best alternative – and perhaps the only viable alternative. As we have mentioned above, RPS is the mechanism currently mandated by the Commission that is most analogous to a long-term contract-based resource adequacy mechanism. RPS is a mechanism for procuring adequate generation capacity by entering into long-term contracts with suppliers, the single difference being that RPS seeks to induce the entry specifically of renewable resource capacity. In developing RPS, the Commission confronted many of the same issues it confronts in this proceeding, though on a smaller scale. RPS relies on a central state agency – the New York State Energy Research and Development Agency ("NYSERDA") – to facilitate the entry into New York of qualifying renewable resource-based generation.[50] NYSERDA's mandate is to offer subsidies, backed up by long-term contracts, to qualifying generation facilities that commit to sell their energy in New York. These generators then bid into the NYISO market like any other resource.[51] The funds used to subsidize these qualifying resources are obtained through a small per-kWh surcharge on the bills of retail customers, excluding certain categories of low-income and other special customers.[52]

Within the universe of resource adequacy programs based on long-term contracts, this is a simple and elegant solution. Though not free from problems, the RPS mechanism has several signal advantages. It offers capacity resources the inducement of long-term contracts, but does so in a way that avoids the potential negative impacts of long-term contracts on Retail Access and other aspects of the markets: the long-term contracts are made between generation developers and a state agency, and funded by a volumetric surcharge on individual customer electric bill, allowing the capacity costs to stay precisely allocated to their beneficiaries regardless of the magnitude and direction of load shifts among LSEs. As the Commission found:

> Because of our adoption of a central procurement model, it is not necessary to create an alternative compliance mechanism to ensure individual load serving entities' compliance with RPS targets. . . .The central procurement approach provides for all regulated electric utility delivery customers. . . to fund the RPS program while also relieving ESCOs from any obligation to procure renewable resources, thus eliminating a potential deterrent for ESCOs to enter the New York market.[53]

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50 *Id.* at 19 ("The RPS procurement structure will be administered by NYSERDA.").

51 *Id.* at 23, 26.

52 *Id.* at 44.

53 2004 RPS Order at 10-11.

Just as importantly, the RPS mechanism, if structured properly, can coexist with competitive markets at both the wholesale and retail levels, and reduce the price distortions introduced into the markets by long-term contracts. As the Commission noted, "[w]ith NYSERDA as administrator, the funds will be administered in a competitively neutral manner."[54] The RPS subsidies are designed to augment the income the targeted investors can realize from competitive markets – these subsidized capacity resources are then bid into the NYISO markets in exactly the same way as other resources. While certain kinds of resources are given a comparative competitive advantage in this way, this is precisely the intent of the program. The Commission may wish to retain this aspect of RPS in its overall resource adequacy program, at least to the extent of favoring the kinds of generation resources that contribute to its specific public policy goals.

Another advantage of the RPS mechanism is that it permits all of the subsidy dollars raised from customers to be funneled directly to *new* generation developers. Under the RPS mechanism, subsidies can be fine-tuned to replace only the "missing money" caused by price caps in the energy market, but not to give new entrants undue advantages over existing resources. An RPS mechanism maximizes the effectiveness of customer dollars in other ways as well. For example, the fact that they are contracting with a New York State agency should allow generation developers to minimize the risk premiums they might otherwise demand from investor-owned utilities in this ever-changing marketplace.

The Commission has listed a host of other RPS advantages as well:

> The Commission views central procurement as preferable to the individual procurement models used elsewhere . . . Central procurement will expedite the start of the program and provide more immediate feedback and control of the initial procurements. These early procurements should provide valuable market information about the extent of supply-side competition as this market develops. .

[54] *Id.* at 51.

> . . [A]dministrative costs should be reduced because the central procurement model provides economies of scale and entails a competitive selection process with which NYSERDA is already acquainted. . . . [E]ven though the RPS standard applies to retail sales, collection of RPS program costs as a non-bypassable wires charge is easier to apply administratively.[55]

Furthermore, the gradual withdrawal of "competitively neutral" subsidies in a transition to a fully competitive capacity market should not be disruptive. (In fact, the Commission has directed NYSERDA to report to it on how a transition from RPS to a fully competitive renewable portfolio mechanism can be accomplished in the future.[56]) All of these advantages should also accrue to a broader-scale capacity procurement mechanism for New York, if it is structured along the lines of the established RPS program.

However, while an RPS-like model has advantages, it is far from perfect. For one thing, it is effectively an administratively-established out-of-market subsidy. As with any out-of-market solution, some level of economic efficiency is likely to be sacrificed. Even the most carefully-constructed administrative program is unlikely to be as effective as competitive markets in rewarding efficient competitors and winnowing out inefficient competitors when they decide upon whom to bestow the state subsidies, and determining the minimum effective amount of subsidy that must be provided in order for the mechanism to work.[57] Furthermore, the regulator must carefully calibrate the subsidies so that they are large enough to ensure an effective incentive for entry, but not so large as to undercut market prices for unsubsidized generators on the other.

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[55] *Id.* at 10, 51, 65-66.

[56] *Id.* at 18.

[57] *Preventing Undue Discrimination and Preference in Transmission Service*, 118 FERC ¶ 61,119 at P 811 (2007)("competition...combined with enforcement proceedings, audits, and other regulatory controls, will assure just and reasonable rates."); *Policy for Selective Discounting By Natural Gas Pipelines*, 111 FERC ¶ 61,309 at P 46 (2005)("the Commission has moved from a regulatory model to a model based on greater competition").

Furthermore, like the FCM mechanism discussed above, an RPS-type mechanism will not necessarily ensure that optimal or even adequate levels of transmission infrastructure are created to support the new generation or address load pocket problems. For this reason, it is especially important that any RPS-like capacity mechanism that is adopted by the Commission be accompanied by a deliverability requirement and include a robust transmission planning mechanism.

C. Requirement for Utilities To Enter Into Long-Term Contracts With Generators.

Under this option, the NY State Reliability Council ("NYSRC") or the Commission would presumably set the total capacity requirement for New York, or, if applied locationally, would set the total capacity requirement for each capacity zone. Utilities would be assigned a fraction of this total capacity requirement corresponding to their fraction of load in the relevant area. Utilities would then be required to enter into long-term contracts directly with generators for this amount of load.

This kind of long-term contracts approach enjoyed a brief heyday among economists, but many problems were soon disclosed. For one thing, it was discovered that requiring long-term contracts did not eliminate the need for heavy-handed market regulation, but merely pushed it back a step. Economists concluded that "long-term contracting requires specification of the mandatory energy option contracts, the penalty for a failure to hold sufficient options, and the penalty for failure to perform when called."[58] At the same time, the approach did not even necessarily provide the impetus for entry of new generation that it was intended to produce:

> In practice, investors face considerable exposure both to spot market prices and to long-run contract prices based on predictions of future spot market prices. The result, at present, is an investment market with a high risk premium, especially compared with regulated markets. This is simply a dead-weight loss . . .[59]

58 "A Capacity Market That Makes Sense," at 3.

59 *Id.* at 7.

As a result, experts in generation capacity markets have concluded that the "long-term energy contracts . . . approach fails to replace the missing money at the root of the adequacy problem."[60]

In addition to its weaknesses from a purely economic viewpoint, the long-term energy contracts approach has several other public policy drawbacks that we believe make it unsuitable for use in New York. First, as now recognized by states such as California that have required delivery utilities to enter into long-term contracts, such an approach is incompatible with retail access. Retail access in California has therefore been suspended for those customers for whom the delivery utilities are responsible for contracting.[61] Mandatory long-term contracting also severely limits flexibility to make a smooth transition to a competitive capacity market when conditions are right, as no such transition may be made until the contracts lapse. Cramton and Stoft conclude that long-term contracts' effect on investment is negligible until these contracts reach 15 or 20 years in duration.[62] Clearly having to wait over a decade to implement a competitive capacity market after the supporting infrastructure and market design are in place is tantamount to leaving the market under heavy-handed regulation indefinitely.

Regulatory cost recovery with mandatory long-term contracts introduces distortions and perverse incentives into the markets in other ways as well. Retail load shifts resulting from customers switching suppliers mean that benefits and burdens are mismatched, with customers who remain with the original supplier subsidizing those who leave by paying for long-term capacity that was procured to support them. Investors perceive such markets as risky because of the potential for stranded costs, and so demand higher rates of return, driving up the utilities

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60 "The Convergence of Market Designs for Adequate Generating Capacity," at 1.

61 D.01-09-060, issued by the California Public Utilities Commission, articulated the urgent reasons for suspending direct access, and the need for quickly achieving finality on the extent of outstanding direct access contracts. 2001 Cal. PUC LEXIS 846.

62 "The Convergence of Market Designs for Adequate Generating Capacity," at 2.

borrowing costs and their customers' bills. Utilities facing a capacity supply "overhang" because of departing load may have a disincentive to vigorously apply conservation programs in its service areas, and disincentives to vigorously promote retail customer choice.[63]

Furthermore, it is not clear how a long-term contracting requirement could be fairly implemented without the cooperation of the NYSRC, NYISO and FERC; the alternative would be to saddle New York consumers with the "double whammy" of paying both NYISO's LICAP charges and the costs of the utilities' long-term contracts. Finally, the potential for discouraging the construction of adequate transmission capacity to load pocket problems is particularly severe under the long-term contracting approach; this is because utilities and their customers that are already under long-term obligations to procure expensive generation capacity will likely be unwilling to also pay for transmission upgrades.

IV. Responses to Questions

As part of its Phase II inquiry, the Commission posed eleven questions for the parties to discuss. National Grid provides its answers to these questions below.

<u>Question 1</u>:

Should there be a statewide integrated resource planning process to examine long-term electricity resource needs? To what extend to in what manner would a statewide integrated resource planning process build on or parallel existing reliability planning processes? What time frame should be examined in such a process and what issues should be considered? What is the role of the utilities and other interested parties in the process? How should the process differ from any previous integrated resource planning processes? What processes should be adopted, if any, to ensure that resource portfolios at the utility and statewide level, satisfy overall planning objectives and public policy considerations? How should immediate concerns and long range considerations be addressed?

<u>Response</u>:

National Grid believes that a regulated integrated resource planning ("IRP") process would move the State back towards a process that was used when vertically integrated utilities

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63 *See generally*, "A Capacity Market that Makes Sense."

were heavily regulated. It should be recalled that the State abandoned this very process in favor of markets, which the State believed would provide better results at lower costs to customers.[64] A return to IRP would mean abandonment of competitive markets and likely an eventual return to full regulation. National Grid does not believe that such extreme measures are warranted or desirable, and that relatively modest adjustments to the current market regime are likely to accomplish the desired results better and more cheaply.

The current NYISO planning process attempts to elicit market responses to system capacity needs. This has not resulted in sufficient long-term capacity commitments because the market failures caused by the lack of robust demand response to prices has required energy price caps and other measures which weaken price signals to generators, and because the incentives with which NYISO has sought to replace these market price signals have turned out to be weak or ineffective. While these incentives (in the form of its LICAP market) have produced sufficient capacity upstate, they have produced too little in New York City and Long Island. Thus, the really crucial issue is not the appropriateness of the planning process, but how market incentives can be adjusted or supplemented to support public policy and long-term reliability. While some improvements to NYISO's planning process can undoubtedly be made, the main path to a better capacity adequacy situation in New York runs through improvement of incentives for generator entry coupled with a firm obligation to build capacity where and when it is needed.

Rather than initiate its own competing or parallel planning process, the State should consider what is missing from the present NYISO planning process in order to avoid mutual interference among processes and loss of focus through too many processes pursuing the same

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64 Case 03-E-0640, Re Investigate Potential Electric Delivery Rate Disincentive (issued May 2, 2003), 2003 WL 2010975 (N.Y.P.S.C.)

goals. Overlapping processes could cause confusion, divert attention, and send conflicting signals, for example if capacity studies produced by the two separate planning processes recommended concentrating on different regions or using different fuel sources or technologies. The NYISO's Comprehensive Reliability Planning Process (Reliability Needs Assessment) is fairly detailed and does a good job identifying what is needed and when to maintain system reliability. Any additional planning process should not reinvent the wheel but should attempt to supply the missing elements of the NYISO process in a way tailored to meet the State's public policy goals in the areas of transmission, demand response, renewables, and fuel diversity with a minimum of disruption or confusion.

Energy-related capital projects involve large, long term commitments of money, time, and expertise, which investors are loath to undertake in a market with an uncertain regulatory future. For this reason, a planning process that has any chance of attracting significant merchant investment must look out 10 to 20 years. Resource adequacy and diversity should be two issues considered when developing such a plan. Other State policies related to clean air, clean water, and so on should be coordinated with energy planning so that they do not work at cross purposes. For example, an environmental policy that penalized a fuel type encouraged by the energy planning process could only cause confusion, inefficiency, and unnecessary perceptions of market risk.

Any statewide resource planning process that supplements NYISO's process should obviously involve all relevant stakeholders. However, in order to avoid delays in the process, the Commission should clearly define and articulate the level of input it will seek and accept from such stakeholders. Also, the particular strengths and abilities of various stakeholder sectors should be exploited to the full. Many parties in addition to the utilities have a part to play in the implementation of state energy policy, merchant generation, renewable energy sources, and demand response programs being just a few examples. A statewide energy plan should be flexible enough to leave room for innovative solutions offered by any party or stakeholder that can assist with its implementation, and should offer a mechanism for comparing disparate solutions to problems both for their economic efficiency and for their ability to meet other state policy goals. Indeed, the dynamics of an open, competitive electricity market demand that resource planning should not rely exclusively on one party or segment of the market to implement the plan.

While the capacity issues with which the Commission is concerned are important and should be addressed with all deliberate speed, the Commission has had the foresight to undertake its Phase II consideration of these issues significantly in advance of the time when any kind of actual capacity shortage or similar emergency is likely to arise in New York. The Commission's immediate concerns (*i.e.* price volatility) are being addressed in Phase I of this proceeding, and we believe that the hedging strategies being utilized by utilities in the state are adequate to deal with these, at least in the medium term. Also, New York as a whole is for the time being still in an excess supply situation, which gives the Commission and the parties some flexibility to proceed cautiously and with due deliberation rather than to rush to effect an ill-conceived mechanism whose potential drawbacks have not been fully explored.

<u>Question 2</u>:

Should major regulated electric utilities be required or encouraged to enter into long-term contracts, with existing generators, proposed generators, and other entities, that facilitate the construction of new generation, the development of additional energy efficiency, the development of additional renewable generation resource, the re-powering of existing generation, or the relief of transmission congestion? Should such contracts be entered into for the purposes of improving fuel diversity, mitigating market power, or furthering environmental policies?

<u>Response</u>:

As we have discussed in the previous sections of this submission, the disadvantages of long-term contracts far outweigh their advantages, as has been the experience of a number of states, including New York with its PURPA contracts and California with its forward energy contracts. For these reasons, regulated electric utilities should not be required or encouraged to enter into any type of long-term capacity contracts. In addition, such an approach would be both unfair and inefficient, in that it would rely on a single segment of the market to address the needs of the entire market.[65] If such a long-term contracting requirement *were* adopted, mechanisms would have to be put in place to ensure full recovery of all prudently incurred costs under such contracts to the utilities even if market conditions change in such a way as to make the contracts commercially unviable.

Indeed, the Commission has thought through these issues and resolved them in a robust manner in its RPS process, as discussed above. As we suggested, there are a whole host of reasons why this model or one like it would be a necessary correlate to a long-term capacity contracting regime. Among other reasons, this approach is not vulnerable to the criticism that has been levied by some suppliers against long-term contracting by utilities, namely, that it can constitute abuse of demand side market power if it has the purpose or effect of reducing market prices. Regardless of the merit or lack of merit in this criticism, lower market clearing prices do signal suppliers that entry is not required because it is not rewarded.

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[65] Cost causation principles dictate that those who cause costs to be incurred and benefit from them should be the ones who bear those costs. The Federal Power Act provides that a utility may not charge rates that "make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage." 16 U.S.C. § 824d(b); *see also Electricity Consumers Resource Council v. FERC*, 747 F.2d 1511 (D.C. Cir. 1984) (remanding a marginal rate scheme that resulted in cross-subsidization of certain customers by other customers). Similarly, under section 205(a) of the Federal Power Act, a utility may charge only rates that are "just and reasonable." 16 U.S.C. § 824d(a); *See also* Case 05-G-1209, Re New York State Electric & Gas Corporation, 2005 WL 3004436 (NYPSC) (issued November 9, 2005)("To properly price utility services, each class of customers should pay for the costs it imposes. Otherwise, customers might be compelled to improperly subsidize service to others, a result that is not only fundamentally unfair but also sends inaccurate price signals.").

Question 3:

Should Load Serving Entities other than utilities, including the New York Power Authority and the Long Island Power Authority, be required or encouraged to enter into long-term contracts as described above? What role, if any, might entities other than Load Serving Entities play in such resource procurement?

Response:

While National Grid believes that an FCM-type mechanism is the most optimal method for addressing the Commission's goals, if the Commission determines that a solution involving long-term capacity contracts is desirable, entities such as NYSERDA, NYPA, and LIPA, which were created expressly to implement state policies, are the logical parties to take on that role. These entities have already been given direct responsibility as well as authority to implement and support a number of capacity-related state public policy goals.[66] Given their experience and authority in this area, it would seem an efficient use of resources to assign one or more of them the responsibility to meet statewide capacity adequacy policies by entering into long-term contracts or other commitments with generators, if the Commission decides to take a long-term contracting approach. In addition to the many advantages of this "RPS-type" approach discussed in previous sections of this submission, having a centralized entity coordinate and implement a statewide policy (with financing supported by a volumetric charge on all delivery customers) seems to National Grid to be both the fairest and the most workable approach, should the Commission require long-term contracts.

Question 4:

Should resource procurement, as described in Question 1, be coordinated on a statewide basis? What regulatory oversight, if any, would be appropriate?

Response:

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66 *See* 2004 RPS Order at 48.

One major benefit of a mechanism administered by NYSERDA and overseen by Department of Public Service Staff is the reassurance that such "official" state involvement will give an added level of reassurance to generation developer counterparties whose expectations that their long-term contracts or other commitments will be honored is key to the effectiveness of any such program.

Question 5:

What barriers, if any, exist that discourage long-term contracts for development of new electricity resources? What barriers exist, if any, for the development of new electricity resources? Should incentives beyond what exist today be created to encourage entry into long-term contracts generally, or to foster the development of any particular type of resource? How could those incentives be structured consistent with the goal of acquiring the most cost effective resources?

Response:

One barrier to long-term contracting is the state's retail access regime. Customer choice – the freedom to switch suppliers at will, whether in the long-term or short-term – means that, all else being equal, utilities cannot prudently enter into more than a certain level of long-term capacity commitments, corresponding to the minimum level of load they believe they are certain to retain over the long-term. This does not mean that retail access should be abandoned. On the contrary, National Grid supports retail access and competitive markets. Instead, any solution implemented by the Commission to resolve capacity concerns must recognize the potential mismatch between long-term capacity commitments and retail choice, and take it into account. National Grid believes that FCM or a mechanism similar to the Commission's RPS program could be implemented without hindering retail access

New York's current NYISO-operated capacity markets, in which upstate requirements are set too high and downstate locational requirements are set too low, discourages generators from entering the New York City market. Other barriers also exist that may discourage generation developers from building new capacity in New York, irrespective of whether long-term commitments are offered to them. These include: 1) siting rules, procedures, and practices that may be inefficient, delay-prone, or which do not permit investors to form an accurate estimate of when their assets might begin generating revenues; 2) overly aggressive changes in market rules, including changes in regulatory policy, which can turn a good investment into a bad one unpredictably and irrespective of the competitive climate; 3) unless handled correctly, preferential treatment for certain classes of resources (*e.g.* RPS resources) that may persuade other suppliers that they cannot compete on a level playing field; and 4) reliability or market rules that mask true market signals (for example, locational ICAP requirements that are too low in load pockets and too high outside them).

The Commission's RPS program already provides signals to promote the development of renewable resources. If the Commission determines that more renewable resources are consistent with state policy, then the RPS program can and should be expanded. However, the State should avoid creating multiple programs trying to meet overlapping goals; multiple programs run by multiple agencies would be even worse. Such a proliferation of programs would only lead to confusion, lack of focus, excessive administrative burdens, and potentially conflicting or incompatible goals. It is also worthwhile keeping in mind that each additional subsidy or incentive given to generators means an additional surcharge to be borne by customers. At some point, the margin of additional benefit gained from such subsidies may become too expensive to justify the added cost. However, as we have mentioned elsewhere, if such additional capacity incentives are to be offered, we believe that the best way to offer them is through a process that is least disruptive to New York's competitive markets.

<u>Question 6</u>:

Should constraints be imposed that would under certain circumstances, restrict the resource types eligible for long-term contracts, limit the length of contract terms or establish the content of other contract conditions? What steps should be taken to limit any anti-competitive impacts long-term contracts might create?

Response:

While state policies must of course govern such decisions, the Commission has consistently made it clear that a very important state policy is the reasonableness of charges levied on New York electric customers.[67] Any limitations on capacity resource types eligible for long term contracts or other, similar special commitments will serve to increase the overall cost to customers of maintaining adequate capacity. If a facility in a general solicitation for capacity supply can meet the traditional restrictions imposed by the State (*e.g.* emissions, siting, permitting, etc.) then it should be able to compete on level footing with every other facility, or, if the resource adequacy mechanism is to be applied locationally, in the location in which it will deliver its product. Thus, a general solicitation should be open to all suppliers. Whenever the State tailors a special program to promote certain specific policies like renewable, demand response, clean coal, etc, it sacrifices to a certain extent the cost benefits of broader competition, because of the economic truism that the smaller the supply pool, the higher the pricing premium demanded.

Market mechanisms that allow only new or proposed facilities to participate in a solicitation or an incentive pricing regime is disfavored generally by economists as unworkable

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67 Statement of Policy on Further Steps Toward Competition in Retail Energy Markets at 14 ("our task is to continue doing what we can to promote the development of competition in the pipeline capacity markets and doing what we must to provide customers with just and reasonable rates and safe and adequate service"); Statement of Policy on Rate Design at 8 ("To the extent reasonable and practical, competitive service rates should be designed to permit the equitable recovery of utility costs from each customer in accordance with the manner the costs were incurred so as to ameliorate the effects of over-recovering from higher use customers in a class or under-recovering from customers with a below-class-average usage.").

and because such mechanisms create more problems than they solve. Such mechanisms put existing facilities at a disadvantage, and often lower their market value. It should be recognized that resource adequacy can be threatened by premature retirement of existing facilities as well as by a failure of new units to enter the market. Furthermore, to the extent that the utilities or other entities (like LIPA or NYPA) entering into long-term contracts with these new (but not old) facilities are guaranteed cost recovery under state law and regulation, this raises potential market power and anti-competitive issues that are very difficult to resolve. Some of these problems can be avoided if new facilities are provided a limited subsidy (as in the RPS program) but then are required to compete on equal footing with other market participants for all their other revenues. In this case, the subsidy is less disruptive to the competitive market in the sense that the market activity of the subsidized resources (*i.e.*, bidding capacity, energy, ancillary services, or other products) will be somewhat comparable to and subject to the same market discipline as that of other facilities. This kind of approach reduces, though it cannot eliminate, market distortions resulting from regulatory intervention in the markets.[68]

Question 7:

Should restrictions or guidelines be imposed on the resource procurement practices employed in selecting the resources that would be acquired under the long-term contracts?

Response:

An open process allowing all qualified facilities, including existing facilities, to compete is probably the only viable alternative if a market approach is selected. Even though such an approach dilutes resources that might otherwise be concentrated on inducing new capacity to

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[68] *See e.g.*, Lloyd Spencer, *Energy Market Participants: The Risks of Being Jack-of-all-Trades*, 141 No. 11 FORTNIGHT 28 ("Regulatory intervention can create market distortions."); Joseph P. Tomain, The Dominant Model of United States Energy Policy, 61 U. Colo. L. Rev. 355 ("The decision [Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954)] spurred regulatory efforts that caused significant market distortions.").

enter the market power, price distortions, and perverse incentives associated with a tiered pricing system would likely outweigh any benefits such a system might have. An RPS-type direct subsidy may allow the Commission more flexibility to target state moneys only to new entrants, but faces the disadvantages of an out-of-market mechanism.

One important restriction that the Commission should enforce under any mechanism in which it may be relevant is a prohibition against intentional overbuilding for the purpose of driving down prices for existing units. Efforts to crowd out existing units by promoting the construction of excessive new facilities would be uneconomic and would impact future capacity investments once new facility bidders begin to wonder how long it will be before attempts are made to undercut prices in order to crowd out their (now "existing") units.

Question 8:

How should long-term contract costs be recovered from customers, and should different recovery mechanisms be developed based on the type of resource that is acquired under the contract, the length of the contract, or other factors?

Response:

A consistent cost recovery process should be used for all long term contracts. Using different methods for different resource types or contract lengths will add unnecessary complications to billing and other systems with no obvious benefit. Any long-term contract costs associated with a resource adequacy program should be recovered through a volumetric surcharge on the delivery rates of all customers that benefit from the facilities in question, based on a cost allocation mechanism that implements pre-established investment categories, as we have said above. Contracts or commitments entered into to benefit customers statewide and meet statewide policy goals should have their costs recovered through the rates of all customers in the State. Contracts or other commitments designed to meet needs in a particular region of the State should be recovered through the rates of customers that benefit in that region. Such a matching of costs and benefits is the only fair and economically efficient way of providing public goods.

Question 9:

What procedures should be followed in reviewing a long-term contract and in establishing its qualification for cost recovery? Under what circumstances, if any, should recovery of contract costs be pre-approved?

Response:

As discussed above, any mechanism that assumes utilities will absorb the prudent costs of long-term contracts into which the state requires them to enter would be unlawful, unworkable, and unfair. Whatever process is used to effect State policy, all prudent costs expended under it by the utilities must obviously be allowed full cost recovery or the entire process will be undermined. Any potential for the creation of new stranded costs would increase perceived risks, causing generator counterparties to raise their prices and utility investors and lenders to raise the returns they demand. Stranded costs leave a mess that must be cleaned up sooner or later by regulators or the courts, as both California and New York have learned through bitter experience.

Any process established to govern utilities' entry into long-term contracts or other commitments with generators (bidding process, evaluation, form of agreement, etc.) must be pre-approved. Any costs associated with contracts that are entered into as a result of this process (assuming they are implemented prudently) must be fully recovered.

Question 10:

Can long-term contracts (energy and/or capacity) be harmonized with existing NYISO rules for energy and capacity markets, and with potential NYISO forward capacity markets? If so, how can they best be harmonized? What changes to NYISO market rules, if any, would be necessary or appropriate for the purpose of accommodating long-term contracts? Should NYISO market rules recognize or ameliorate the impact, if any of long-term contracting on the NYISO capacity prices paid existing generators, or, if amelioration is appropriate, should it be accomplished through non-NYISO mechanisms?

Response:

As we discussed in previous sections of these Comments, reform of the NYISO rules to provide for a capacity procurement option similar to New England's FCM is likely New York's best option for ensuring adequate resource adequacy. However, if the Commission were to decide that long-term contracts should be mandated, the option that could best be harmonized with existing NYISO rules would be to authorize a state agency or entity to sign long-term contracts with generators that provide a partial subsidy, analogous to the RPS process. Since the rest of the generation facility's revenue would be based on income generated in the NYISO markets (or perhaps arrangements entered into as part of Phase I of this Proceeding), the generators' responses to market signals should not be too far out of line with those of unsubsidized generators that bid into the various markets to maximize revenues.

Question 11:

Are there any other creative solutions that might be considered to address the issues identified herein?

Response:

National Grid has discussed a number of alternatives in Section II and III of these comments. Please refer to the discussions there.

Respectfully submitted,

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