nationalgrid

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June 25, 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

REPLY 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 Reply 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**

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

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

Numerous parties submitted comments in response to the list of questions propounded in the Order. The comments showed significant splits of opinion on certain issues: for example, the advisability of using long-term capacity contracts as a resource adequacy tool.[2] On some

[1] Case 06-M-1017, *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*, 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] *See* Initial Comments of the NRG Companies at 10 ("All LSEs in New York, not just the major regulated electric utilities, should be required to engage in a portfolio approach to procure a mix of resources, including long-term contracts, from competitive suppliers in order to ensure resource adequacy."); Comments by City of New York at 5 ("Utilities should be encouraged or, if necessary, effectively required to enter into economically beneficial long-term contracts for new market resources."); Initial Comments of the National Energy Marketers Association at 3 ("long term contracting represents a huge step backward toward the vertically integrated energy monopoly model."); Responses of the New York Independent System Operator, Inc. at 7 ("Long term contracts to facilitate new investment should be used only if the investment is otherwise economic").

issues, however, harmony prevailed: for example, even those parties who did support a requirement for utilities to enter into long-term capacity contracts were virtually unanimous in stating that the utilities must be assured recovery of costs resulting from such contracts.

On the surface, there also appears to be virtual unanimity in support of the desirability of retaining most or all aspects of New York's competitive electricity markets. Many parties praised competition, and none asked the Commission to reject or reconsider it, or took issue with the Commission's statements in recent cases regarding "the promising level of success [with competitive markets] that has been achieved in New York without most of the serious difficulties others have encountered."[3] At the same time, however, some parties proposed solutions to the Commission's concerns that National Grid believes could substantially impair or even dismantle competitive markets in the state. No party explicitly presented the Commission with a stark choice – "choose Option A and continue to develop competitive markets, or choose Option B and begin to dismantle them" – but National Grid believes that just such a choice is implicit in some of the comments. A decision by the Commission to abandon competition would be a momentous one; it would be unfortunate indeed for the Commission to arrive at such a result inadvertently, or without a full appreciation of the implications of some decision which, while neutral on its face, could result in serious damage to competitive electricity markets in New York.

National Grid is a strong proponent of competitive markets, and urges the Commission to adopt a resource adequacy mechanism for New York that interferes as little as possible with them. Indeed, given the close relationship between the subject matter of the Commission's Phase II inquiry in this proceeding and the issues in Case Number 07-M-0458, Review of Retail

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[3] 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.

Access Policies, where the Commission is seeking to remove barriers to access to competitive energy suppliers for New York retail customers, National Grid presumes that compatibility with competitive markets is among the Commission's bedrock requirements for any new resource adequacy regime. However, regardless of how the Commission decides to proceed, it must avoid superficial or overly optimistic analyses that may gloss over serious implications of certain courses of action.

The Commission Must Recognize the Fundamental Implications of Proposals for Integrated Resource Planning and Long-Term Contracting on Competition and the Commission's Pro-Competitive Policies

As National Grid discussed in its initial comments, long-standing Commission policies have as their objective the creation of robust competitive retail electricity markets in New York,[4] and the Commission and New York market participants have expended much effort in this direction. As a result of these policies and these efforts, New York has seen impressive gains and expansions of electric commerce, both in retail and wholesale markets. Many parties – including independent load serving entities ("ESCOs"), electricity customers, merchant generation developers, and the state's public utilities – have fundamentally changed their modes of activity as a result of the changes wrought by the Commission's policies, creating substantial reliance interests in the continued expansion of competition in New York's electric markets. State utilities that restructured their operations and divested billions of dollars of generating assets, merchant generators that built plants in New York, ESCOs who entered the retail markets,

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

customers who signed up with the ESCOs, transmission owners have transferred operational authority to the New York Independent System Operator ("NYISO"), and many other parties all have a stake in the developing competitive market regime, and would have to bear significant costs and disruption of fundamentally adjusting their activities if these markets were undermined, whether intentionally or otherwise. Commenters that support a new requirement for integrated resource planning and/or long-term contracting by distribution utilities and energy service companies appear to assume that new requirements can coexist comfortably with the Commission's pro-competition policies. As National Grid and others showed in their initial comments, this assumption is at best unsupported and at worst profoundly mistaken. Implementation of new requirements for integrated resource planning and/or long-term contracting will have serious consequences that the proponents of these requirements do not address and which the Commission will have to consider carefully.

Furthermore, the Commission adopted its pro-competitive market policies in the first place for a very good reason: to harness the efficiencies of the competitive marketplace in the interest of better service and lower prices for consumers. Dismantling competitive markets would constitute a surrender of the gains already made in this direction and a renunciation of all such gains for the future. Such a course would also be fundamentally incompatible with the Commission's ongoing inquiry into the efficacy of utilities' retail access programs in Case Number 07-M-0458: if retail competition is to be abandoned, no purpose is served by assessing the relative merits of programs to promote it. Proponents of new regulatory constructs for integrated resource planning and long-term contracting fail to appreciate that attempts to overlay these new regimes on portions of the market, without adequate consideration for their full consequences runs a substantial risk of undermining the effective operation of the markets overall. Any move in this direction warrants very careful consideration of its potential implications. The effects of such a regulatory about-face on the stability of the State's business environment – and, almost as important, *perceptions* of the stability of the State's business environment – cannot be predicted, but it seems likely that they would be quite negative.

The likely fallout from a Commission reversal of, or retreat from, its competition policies, would be momentous, with far-reaching consequences. Obviously, a decision to undertake such a reversal or retreat should not be taken lightly, or undertaken without a searching investigation, first, of the need for such a step, and second, of its likely consequences.

Yet the comments of some parties to this proceeding appear to be inviting the Commission to consider heading down such a path, though for the most part they do not acknowledge that fact, let alone analyze its implications. Under some interpretations, several of the resource adequacy proposals made in this proceeding – even some that seem innocuous on their face – could seriously undermine New York's competitive electricity markets. In what follows, National Grid primarily responds to the Initial Comment submitted by the New York Department of Public Service Staff ("Staff Comments"), simply because, while these proposals leave many details unresolved, they still represent the most completely articulated alternative to a competitive market-friendly resource adequacy mechanism (such as New England's Forward Capacity Market or "FCM") that has been presented by any party. While Staff's broad brush proposal is short on details, and while this lack of full elaboration handicaps us somewhat in our analysis of the implications of this proposal on competition, there can be little doubt that what Staff recommends could have the unintended consequence of undercutting the operation of competitive electricity markets in New York.

Staff's Proposals

Staff urges the Commission to institute what it calls the Dynamic Energy Planning Process ("DEPP") in conjunction with long-term capacity contracts to address New York's resource adequacy needs. As Staff describes DEPP, it would

> serve as the vehicle for selecting resource enhancement alternatives that are economically viable, cost effective to ratepayers and consistent with the efficient operation of the electric grid. The process would ensure that public policy goals such as protecting the environment, reducing carbon emissions to combat global warming, and promoting energy efficiency are met. The diversity of fuel sources for generation can be assured and new generation technologies can be accommodated and developed.[5]

DEPP would have two tracks: a long-term state-wide planning process on a three-year cycle with a 15 to 20-yr planning horizon, and a yearly track with a five-year horizon performed by each utility to fill in the details and implement its part of the long-term plan. Staff would ensure that utilities received proper guidance and information with respect to their planning; would monitor implementation of the various planning efforts; and would make such reports to the Commission as were necessary to facilitate the planning process. The product of this process would be a draft plan submitted by Staff to the Commission for review and approval. In Staff's view, long-term contracts are a desirable tool to implement plans developed through the DEPP process, and the Commission should remove barriers to their use.[6]

While Staff indicates that it believes its proposed DEPP would be consistent with NYISO's Comprehensive Reliability Planning process and other NYISO mechanisms,[7] Staff does not discuss or analyze whether it would also be consistent with competitive markets. Indeed, it is not clear what role would be left for the competitive markets under the regime proposed by Staff. Resource planning and resource selection would be overseen by regulators,

5 Staff Comments at 4-5.
6 *Id.* at 5-8.
7 *Id.* at 7-8.

implemented by public utilities, and paid for through the utilities' regulated rates. Staff believes there is a "planning gap," because the State "no longer performs the State Energy Plan process that in the past identified benchmarks, and proposals for meeting those benchmarks."[8] But there is a gap only if the Commission shares Staff's implicit assumption that a regulatory planning regime will better identify and reward efficient and cost-effective energy solutions than competitive markets. This assumption is directly contrary to the foundation of the Commission's pro-competitive policies. Staff's proposal appears to implicitly contemplate a return to the heavily regulated electric industry that New York abandoned a decade ago as inefficient and out of step with technological developments.

While Staff's proposal represents a laudable attempt to respond to the Commission's concerns about how environmental impacts and other policy considerations could be reflected in resource acquisition decisions, it is instructive to consider the issues the Commission would have to face if it attempted to adopt Staff's proposal. For example, while Staff and other parties correctly point out that a long-term contracting requirement for utilities would not work without guaranteed full cost recovery, such an arrangement would mean that merchant generators in the market, as well as those considering entry, would have to compete against large, established utility companies whose risks and credit were underwritten by the state. Such an arrangement has the potential to provide utilities with such an advantage that merchants would no longer be able to compete. Only after their departure, when the inefficiencies of the old, heavily-regulated system resurfaced, would prices begin to rise, likely eventually far above where they would have been had competitive markets been permitted to work. Clearly, such a course of action would also make it very difficult to regain the trust of the business community if New York ever again wished to try to induce entry of merchant generators into its markets. Similarly, while Staff

[8] *Id.* at 5.

correctly recognizes the importance of recovering costs incurred to procure resources under DEPP from the specific customer groups benefiting from these resources, it fails to consider how this could be accomplished when customers are free to procure electricity from ESCOs, rather than the utilities that would be procuring resources under DEPP. Likewise, Staff gives no consideration to the prospect that the DEPP process could lead to requirements for utilities to acquire unneeded or overly expensive resources, leading to a new generation of costs to be borne by customers who do not seek out competitive alternatives.

It should be clearly recognized that the kind of regime we understand Staff to be proposing would place the Commission, and not the market, squarely in charge of setting generation prices, as it was under the traditionally regulated regime in place before restructuring. The kind of pervasive planning role this regime gives to Staff and the Commission – including determinations as to the kinds of resources that are "efficient" – would likely involve the Commission in setting prices for most of the generation market directly through utility rate cases. It might be thought that such a result could be avoided as long as the Commission and Staff set only the types of resources that are required and then mandate the utilities to contract with merchant generators to supply them. As we explained in our initial comments, however, far from eliminating regulatory price-setting, such a regime merely pushes it back a step, into the shadows. "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."[9] Among other things, under these circumstances the pricing of the long-term

[9] Peter Cramton and Steven Stoft, "A Capacity Market that Makes Sense," *Electricity Journal*, August/September 2005, at 3.

contracts tends to equilibrate at the level of the penalty payments.[10] 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.[11] Neither does the use of long-term contracts avoid other difficult questions: Should the penalties (and hence the price) be higher or lower in different parts of the state? Should the utilities be permitted to construct their own generating plants to supply the needed reserves if this is the lowest-cost option? What is the function of ESCOs if the generation market is once again occupied by large regulated utility companies that do not compete on commodity prices? Once regulators begin setting prices in this way, competitive markets are essentially dead.

Substitution of regulated commodity service rates for prices set by competitive markets is disadvantageous for customers in a number of ways. One of the most important of these is the fact that such a substitution would take the risks inherent in volatile fuel and energy prices away from competitive suppliers – where the Commission's market restructuring initiative sought to put them – and squarely onto customers, who would once again become the guarantors of the costs expended to generate electricity, instead of consumers able to take advantage of the effectiveness of the free market in rewarding efficient business decisions and penalizing inefficient ones.

It should not be imagined that such a process of re-regulation, once undertaken, could be either reliably contained or limited to one portion or sector of the market. For example, covering a large portion of the state's capacity needs through state-mandated and regulated long-term

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10 *Id.*

11 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.

contracts squeezes competitive suppliers out of the capacity markets by depriving them of potential customers, whose "business" is already locked up over many years at regulated prices by these mandated contracts. Another example: forcing merchant generators to adjust their prices to meet "competition" from utilities with regulated rates and guaranteed returns in one part of the market (e.g., capacity) could deprive them of the margin they need to survive financially in the capital-intensive, long-term investment environment of electric generation. A merchant generator that goes out of business because of pressure on capacity prices will no longer be in the business of selling competitive energy either. Re-regulation of part of the market may thus experience "mission creep" as competitive suppliers are driven from the field, rendering more and more regulated service necessary.

Such re-regulation could also place New York on a collision course with FERC, whose ISO/RTO regime – in which New York's markets are already heavily involved – contemplates a marketplace of competitive generation suppliers. Staff appears to realize this, but its only solution is to "urge" FERC "to defer from intruding upon State prerogatives to advance reliability and public policies through the use of long-term contracts."[12] While National Grid heartily supports this sentiment, it is also aware that it can be difficult to put into practice, as seen in the recent jurisdictional controversy over station service rates.[13]

Another major issue that the Commission would have to confront if it decided to adopt Staff's DEPP regime would be the impact of such an action on other Commission proceedings currently in progress, and the question of how these other proceedings in turn might affect the prospects for success of the DEPP regime. For example, the Commission's stated purpose in Case Number 07-M-0458, Review of Retail Access Policies, is to remove barriers to access to

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12 *Id.* at 23.

13 *See Niagara Mohawk Power Corp. v. FERC*, 452 F.3d 822 (D.C. Cir. 2006), *cert. denied*, 127 S. Ct. 2129 (2007).

competitive energy suppliers for New York retail customers.[14] However, fostering competition in that proceeding while undermining it in this one would send conflicting messages to the markets, sow confusion, waste resources, and make little sense from a policy perspective. Similarly, Case Number 03-E-0641, the Commission's Mandatory Hourly Pricing initiative, is premised on the need for load response to make competitive electricity markets more efficient.[15] It would make little sense, however, for customers to bear the expense and disruption of installing and operating sophisticated new metering systems if prices are simply going to be set, directly or indirectly, by the regulatory authorities. Likewise, Case Number 07-M-0548, the Commission's Energy Efficiency Portfolio Standards proceeding, seeks to reduce New York's energy consumption over the next eight years.[16] Competitive markets are famous for keeping consumption of goods to efficient levels; central planning is equally famous for its lack of ability to achieve this goal.

Even Staff concedes that the resource adequacy picture in New York has significant positive aspects. Staff appears to agree that the main problems with New York's current resource adequacy regime revolve around two issues: (a) sluggish response to capacity market signals in New York City, and (2) the observation that markets, left to themselves, may place too little value on unpriced state policies such as fuel diversity and renewable resources. Staff also

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[14] *Proceeding on Motion of the Commission to Review Policies and Practices Intended to Foster the Development of Competitive Retail Energy Markets*, Order on Review of Retail Access Policies and Notice Soliciting Comments at 5-6 (issued April 24, 2007) ("The 2004 Retail Access Policy Statement directed utilities to file plans that incorporated programs and practices that would encourage retail market development by reducing or removing barriers to entry for ESCOs to provide competitive retail services.").

[15] Case 03-E-0641, *Proceeding on Motion of the Commission Regarding Expedited Implementation of Mandatory Hourly Pricing for Commodity Service*, Order Denying Petitions for Rehearing and Clarification in Part and Adopting Mandatory Hourly Pricing Requirements at 1-2 (issued April 24, 2006).

[16] Case 07-M-0458, *Proceeding on Motion of the Commission Regarding an Energy Efficiency Portfolio Standard,* Order Instituting Proceeding at 6 (issued May 16, 2007)("The objective of the proceeding is to balance cost impacts, resource diversity, and environmental effects, by decreasing the State's energy use through increased conservation and efficiency.")

recognizes that the existing capacity markets have worked well to assure adequate generation capacity in upstate New York, and have done so within the context of the existing competitive markets, and with minimal central planning by regulators.[17] This suggests that mechanisms compatible with competitive markets can be effective in inducing entry of adequate capacity given the right conditions and market design; at the very least, this effective upstate resource adequacy regime is something worth preserving. It would seem counterproductive for the Commission to abandon this successful upstate capacity market, and reverse its long-standing support for competition competitive markets into the bargain, in order to address these narrow, albeit important, resource adequacy concerns.

17 Staff Comments at 25-26.

Conclusion

The Commission should not reverse its well-established commitment to competitive markets without a searching examination of alternatives; at the very least, the Commission should ensure that any decision it does make regarding the future of New York's electricity markets is supported by a full analysis of likely outcomes.

The Commission initially introduced competition into the New York markets in order to solve a host of ills arising from the traditionally regulated regime that preceded them. It would be unfortunate if the Commission were to throw away the progress already made and the promise of future progress in exchange for a regime that has already been tried and found wanting. It would be even more unfortunate if the Commission were to cause such result inadvertently, by failing to undertake a searching investigation of the likely implications of a superficially appealing resource adequacy mechanism. National Grid urges the Commission to undertake such a searching investigation, and pledges to assist in this endeavor in whatever way it can.

Respectfully submitted,

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