**UNITED STATES OF AMERICA**
**BEFORE THE**
**FEDERAL ENERGY REGULATORY COMMISSION**

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| **Preventing Undue Discrimination and Preference in Transmission Service** | **Docket No. RM05-17-000**<br>**RM05-25-000** |

**REQUEST FOR CLARIFICATION AND ALTERNATIVE REQUEST FOR REHEARING OF THE NEW YORK INDEPENDENT SYSTEM OPERATOR, INC.**

Pursuant to Rules 212 and 713 of the Commission's Rules of Practice and Procedure[1] and Section 313(a) of the Federal Power Act ("FPA") the New York Independent System Operator, Inc. ("NYISO"), respectfully requests clarification, or, in the alternative, rehearing, of three aspects of the Commission's final rule in the above-captioned proceeding ("Order No. 890").[2]

The NYISO supports Order No. 890's objectives and its overall approach. In particular, the NYISO appreciates the Commission's recognition that Independent System Operators and Regional Transmission Organizations ("ISOs/RTOs") that administer markets based on locational marginal pricing ("LMP") are differently situated than vertically integrated transmission providers. The Commission was correct not to require ISOs/RTOs to "rejustify" existing provisions that are not affected in any substantive manner by the *pro forma* tariff revisions adopted in Order No. 890.[3] It was also appropriate to recognize that many of those revisions will not be relevant to

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1 18 C.F.R. § 385.212 and .713 (2006).

2 *Preventing Undue Discrimination and Preference in Transmission Service*, Order No. 890, FERC Stats. & Regs., Regulations Preambles ¶ 31,131 (2007), 72 Fed. Reg. 12266 (March 15, 2007) ("Order No. 890").

3 Order No. 890 at P 157.

ISOs/RTOs and that nothing in the final rule is "meant to upset the market designs" used by them.[4]

Nevertheless, there are several issues that the Commission should either clarify or address on rehearing. Specifically, the Commission's ruling prohibiting ISOs/RTOs from passing penalty costs associated with persistently missed transmission study deadlines on to their customers is inconsistent with precedent and based on a faulty premise.

The Commission should either clarify two aspects of that ruling or modify it on rehearing. The Commission should also clarify that it intends for the North American Electric Reliability Corporation ("NERC") and North American Energy Standards Board ("NAESB") to accommodate the needs of ISOs/RTOs when they develop standards related to Available Transfer Capability ("ATC") calculations and the posting of curtailment information. If this was not Order No. 890's intent, the Commission should modify the rule on rehearing to establish such a requirement.

## I. COMMUNICATIONS

Communications regarding this proceeding should be addressed to:

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* - Persons designated to receive service.

[4] *Id.* at P 158.

## II. SPECIFICATION OF ERRORS

In accordance with Rules 713(c)(1) and (2), the NYISO specifies the following errors in Order No. 890.

1. The Commission erred when it ruled generically that not-for-profit ISOs/RTOs would be prohibited from recovering operational penalty costs. The Commission made no effort to explain this departure from precedent and offered no valid rationale for the new policy.

2. The Commission erred when it held that not-for-profit ISOs/RTOs could pay operational penalties without passing the costs on to their customers. As is demonstrated below, the NYISO does not have revenues other than those: (i) that come from the charges it assesses to its customers; or (ii) that are used to offset customer charges.

3. The Commission erred to the extent that it did not direct NERC and NAESB to develop standards for ATC and curtailment information posting that make reasonable accommodations for ISOs/RTOs that administer LMP markets.

## III. REQUESTS FOR CLARIFICATION AND/OR REHEARING

### A. Order No. 890's Ruling that Not-For-Profit ISOs/RTOs May Never Recover Penalty Costs from their Customers Is Arbitrary, Capricious, and Inconsistent with Precedent

Order No. 890 subjected ISOs/RTOs to the same operational penalties that apply to other transmission providers for persistent lateness in completing transmission studies.[5] The Commission also ruled that it would prohibit not-for-profit transmission

[5] *See* Order No. 890 at P 1353.

providers, including ISOs/RTOs, from recovering the costs of such penalties from their customers. The Commission stated that: (i) it believed that all entities administering the tariff "should operate under the same rules, reporting obligations, and performance metrics;" and (ii) non-profit transmission providers have "other sources of money to pay penalties beyond the revenue they collect for sales of transmission service."[6] The Commission did note that it would "consider factors such as an entity's financial ability to absorb a penalty in determining whether to impose penalties in the first instance."[7]

In stark contrast to the instant ruling, in Order No. 672,[8] which addressed penalties for violations of reliability standards, the Commission neither generically allowed nor disallowed pass throughs of ISO/RTO penalty costs to customers. Instead, the Commission stated that it would consider the issue on a case-by-case basis. It also invited ISOs/RTOs to make Section 205 filings to propose penalty cost recovery mechanisms.[9]

Order No. 890's prohibition on not-for-profit ISOs/RTOs' recovering their penalty costs through rates in an unexplained departure from Order No. 672's case-by-case approach. The Commission identified no difference between reliability and operational penalties that would justify having different cost recoverability policies. In fact, Order No. 890 also expressly invoked Order No. 672 when it ruled that ISOs/RTOs

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6 *Id.* at P 1357.

7 *Id.*

8 *Rules Concerning Certification of the Electric Reliability Organization; and Procedures for the Establishment, Approval, and Enforcement of Electric Reliability Standards*, Order No. 672, FERC Stats. & Regs., Regulations Preambles ¶ 31,204, 114 FERC ¶ 61,104 (2006) ("Order No. 672").

9 Order No. 672 at P 635.

would be potentially subject to civil penalties but gave no indication that it was proposing to vary from Order No. 672's penalty cost recovery framework.[10]

Moreover, Order No. 890's premise that ISOs/RTOs have other sources of revenue that they could use to absorb penalty costs is flatly incorrect, at least in the NYISO's case.[11] It is technically correct that the NYISO has revenues other than those from selling transmission service insofar as it collects revenues for non-transmission services, *e.g.*, for market administration. On the other hand, the NYISO recovers these costs from the same customers, and through the same mechanism, *i.e.*, Rate Schedule 1 of its tariffs,[12] as its transmission costs. Similarly, it is technically correct that the NYISO earns some revenues from sources other than Rate Schedule 1. For example, the NYISO charges fees for conducting interconnection studies and performing other services, *e.g.*, customer training programs. It also earns interest on money that it holds for its own account. The NYISO's practice, however, is to use all such revenues to reduce Rate Schedule 1 charges. Simply put, the NYISO has no "excess funds" that could be used to pay such penalties.

Attachment I to this request for rehearing is a copy of the NYISO's audited financial statements for 2004 and 2005, the most recent years currently available. These

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10 Order No. 890 at P 1732. P 1732 is silent regarding the recoverability of civil penalty costs. To the extent that the Commission intended, notwithstanding its silence, to depart from Order No. 672's case-by-case approach with respect to civil penalties as well, the NYISO seeks rehearing on that issue as well.

11 The NYISO assumes, but has not confirmed, that other not-for-profit ISOs/RTOs will be similarly situated.

12 Both the NYISO's Open Access Transmission Tariff and Market Administration and Control Area Services Tariff include a Rate Schedule 1 that allows the NYISO to recover its costs.

statements illustrate that the vast majority of the NYISO's revenues come from Rate Schedule 1. The remaining revenue, *i.e.*, that from interest, lease,[13] and fee income, was all used to reduce the NYISO's charges to its customers.

Attachment II is an affidavit by the NYISO's Chief Financial Officer, Mr. Charles N. Garber. Mr. Garber confirms that the NYISO's practice is to use all of its revenues from sources other Rate Schedule 1 to reduce Rate Schedule 1 charges. Mr. Garber also affirms that the NYISO had no source of revenue other than those listed in Attachment I for 2006 and does not anticipate having any other source of revenue in 2007 or beyond.

Order No. 890 apparently intended to prevent not-for-profit ISOs/RTOs from passing penalty costs on to customers through rates for either transmission or non-transmission services. Likewise, the NYISO does not read Order No. 890 as allowing revenues that would ordinarily offset customer charges to be used to pay penalty costs. The NYISO assumes that the Commission would view this as an "indirect" pass through of penalty costs. If any of these interpretations are wrong, the NYISO respectfully asks that the Commission grant clarification and explain how not-for-profit ISOs/RTOs will be permitted to recover penalty costs consistent with Order No. 890.

Assuming, however, that Order No. 890 was intended to prohibit all direct and indirect pass-throughs of penalty costs, the NYISO respectfully requests rehearing. Order No. 890 inexplicably departs from Order No. 672's approach to penalty cost recovery. It is based on a false premise that not-for-profit ISOs/RTOs could somehow absorb penalty costs without charging their customers. Finally, its assertion that all

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[13] The NYISO briefly earned lease revenue during a period when it owned, but did not yet fully occupy, its new headquarters. All such revenue was used to offset Rate Schedule 1 charges. The NYISO no longer has any lease revenue.

transmission providers should be subject to the same cost recovery rule ignores the reality that a prohibition on recovery is a much harsher rule for not-for-profit ISOs/RTOs than it is for transmission providers that do have other means of paying penalties.

Indeed, the severity of Order No. 890's prohibition on cost recovery is inconsistent with the Commission's *Enforcement Policy Statement*.[14] Under that policy, penalties are supposed to be set at levels that account for the effect "on the financial viability of the company that committed the wrongdoing" and that reasonably reflect the seriousness of an offense.[15] Although Order No. 890 indicated that the Commission would consider financial impacts on ISOs/RTOs when deciding whether to assess penalties, it errs when it assumed that not-for-profit ISOs/RTOs can somehow absorb penalty costs. Accordingly, this determination in Order 890 exposes not-for-profit ISOs/RTOs to penalties that would be inconsistent with the *Enforcement Policy Statement*.

The NYISO recognizes that the question of the recoverability of operational penalty costs may not appear to be a major concern given the relatively small sizes of the penalties involved ($500 per study, per day). Nevertheless, it is a very important issue to the NYISO. If Order No. 890 is not modified then any operational penalty assessed against the NYISO would threaten is solvency. The NYISO is a not-for-profit 501(c)(3) corporation that accounts for every dollar of its operations to its customers and has not a single dollar of revenues, whether from transmission or non-transmission sources, that it is not obliged to credit to its customers. The NYISO appreciates that the Commission

[14] *Enforcement of Statutes, Orders, Rules, and Regulations*, 113 FERC ¶ 61,068 (2005) ("*Enforcement Policy Statement*").

[15] *Enforcement Policy Statement* at P 20.

was unwilling to generically authorize ISOs/RTOs to recover penalty costs in Order No. 672. The NYISO, however, is only asking that the Commission adhere to Order No. 672 and provide for case-by-case determinations regarding the recoverability of operational penalty costs in this proceeding.

In short, Order No. 890's conclusion that not-for-profit ISOs/RTOs may never recover operational penalty costs through their rates is inconsistent with precedent, and arbitrary, and capricious. The Commission should reverse this determination on rehearing, and adopt a rule that would allow not-for-profit ISOs/RTOs to argue, on a case-by-case basis, for an opportunity to recover penalty costs or why sanctions other than financial penalties should be imposed.

### B. The Commission Should Clarify that NERC and NAESB Must Develop ATC Standards and Curtailment Information Posting Rules that Accommodate ISOs/RTOs

Order No. 890 did not exempt ISOs/RTOs from its new ATC standards or curtailment information posting requirements. As is many other areas, however, Order No. 890 is clear that ISOs/RTOs may use their compliance filings to explain why they should not be required to comply with aspects of those requirements that are not relevant under LMP market designs.[16]

The NYISO anticipates that its compliance filing will demonstrate that ATC calculations will continue to be of limited significance within its control area because customers in LMP regions do not make physical transmission service reservations or take service on a "first come, first served, basis." That said, the NYISO calculates ATC at its external interfaces. It also uses ATC to determine the availability of non-firm

16 *See, e.g.*, Order No. 890 at P 229.

transmission service, *i.e.*, service for customers that do not wish to be exposed to congestion charges, which is available in New York but which no customer has taken.

Similarly, the NYISO will explain in its compliance filing that it does not regularly "curtail" firm transmission service in the sense contemplated by Sections 13.6, 14.7, or 33 of the *pro forma* transmission tariff. Instead, it continuously re-dispatches it system to avoid curtailments. The NYISO has never had to invoke NERC's Transmission Loading Relief ("TLR"), although its tariff does support the use of TLRs as a last resort. On the other hand, the NYISO "cuts" scheduled financial transactions at external interfaces for economic reasons, consistent with its tariffs and its market design.

The NYISO will therefore have an interest, and intends to participate, in the NERC and NAESB processes that will develop new ATC standards and curtailment information posting requirements. At the same time, the rules that NERC and NAESB will create will have different consequences for ISOs/RTOs than they will for traditional transmission providers that use physical reservations. Rules related to the *pro forma* ATC and curtailment requirements will be central features of traditional systems' market structures. By contrast, in ISO/RTO regions they will be comparatively peripheral. Consequently, stakeholders from traditional systems will have a much greater interest in the development of those rules and are likely, as a practical matter, to have more influence over their final form.

Thus, the NYISO is concerned that the NERC and NAESB processes will produce rules that primarily reflect the needs of traditional systems and that do not accommodate ISOs/RTOs that are based upon locational marginal pricing of transmission. The onus would then be on ISOs/RTOs to justify variations and waivers to the Commission, as they have had to with respect to NAESB's OASIS standards.

The NYISO does not believe that Order No. 890 intended for NERC and NAESB to develop "standards" that suit traditional systems but not the ISOs/RTOs that cover more than half of the load in the United States. The Commission could avoid this outcome by clarifying that it expects NERC and NAESB to produce standards that fulfill Order No. 890's objectives, *e.g.*, transparency and inter-regional consistency, and that are sufficiently flexible to work for ISO/RTO regions. The NYISO does not question the impartiality or good faith of NERC, NAESB, or its stakeholders and believes that a reminder is all that will be needed to prevent the imposition of unreasonable compliance burdens on ISOs/RTOs.

If, however, Order No. 890 was not intended to require NERC and NAESB to accommodate the needs of ISOs/RTOs, the NYISO respectfully requests rehearing. Although Order No. 890's requirements are primarily aimed at traditional systems and "bilateral" markets, its rules are also applicable to ISO/RTO regions. It would be arbitrary and capricious for the Commission to initiate stakeholder processes to create standards under Order No. 890 without requiring that the resulting standards be workable for all regions that will be subject to them.[17] Such a result would be inconsistent with the Commission's stated intent of Order 890 not to upset approved ISO/RTO market designs.

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[17] *New York Independent System Operator, Inc.*, 117 FERC ¶ 61,197 (2006). *See also* Letter Order, Docket No. ER07-369-000 (Jan. 29, 2007) (accepting the NYISO's compliance filing).

## IV. CONCLUSION

WHEREFORE, for the foregoing reasons, the New York Independent System Operator, Inc. ("NYISO") respectfully asks that the Commission grant its requests for clarification, or in the alternative, grant rehearing, and rule that: (i) ISOs/RTOs will not be generically prohibited from passing operating penalty costs on to customers but may be allowed to do so on a case by case basis; and (ii) NERC and NAESB must accommodate the needs and interests of ISO/RTOs that administer LMP markets when developing ATC standards and curtailment information posting standards.

Respectfully submitted,

Ted J. Murphy

Ted J. Murphy
Counsel for the New York Independent System Operator, Inc.

March 19, 2007

ATTACHMENT I

**INDEPENDENT AUDITORS' REPORT**

*To the Board of Directors of*
*New York Independent System Operator, Inc.*

We have audited the accompanying statements of financial position of New York Independent System Operator, Inc. ("NYISO") as of December 31, 2005 and 2004, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of NYISO's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of NYISO as of December 31, 2005 and 2004, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

New York, New York
March 31, 2006

## STATEMENTS OF FINANCIAL POSITION
AS OF DECEMBER 31, 2005 AND 2004

| | 2005 | 2004 |
|---|---|---|
| **ASSETS** | | |
| **CURRENT ASSETS:** | | |
| Cash and cash equivalents | $ 58,180,363 | $ [illegible] |
| Restricted cash | 252,878,234 | 193,275,340 |
| Accounts receivable, net (Note 2) | 12,454,894 | 15,139,434 |
| Prepaid expenses | 4,971,429 | 5,640,639 |
| Regulatory assets - current portion (Note 3) | - | 672,865 |
| Other current assets | 361,402 | 217,173 |
| **Total current assets** | **328,846,322** | **245,566,933** |
| **NONCURRENT ASSETS:** | | |
| Regulatory assets (Note 3) | 12,240,143 | 17,007,859 |
| Property and equipment, net (Note 4) | 76,137,208 | 83,974,918 |
| Other noncurrent assets (Note 1) | 15,325,329 | 3,074,645 |
| **Total noncurrent assets** | **103,702,680** | **104,057,422** |
| **TOTAL** | **$ 432,549,002** | **$ 349,624,355** |
| **LIABILITIES** | | |
| **CURRENT LIABILITIES:** | | |
| Accounts payable and accrued expenses | $ 15,535,507 | $ 14,992,304 |
| Market participant prepayments | 86,975,384 | 19,079,241 |
| Market participant security deposits | 101,190,024 | 172,842,650 |
| Long-term debt - current portion (Note 6) | 26,780,525 | 22,250,000 |
| Working capital reserve (Note 10) | 49,700,136 | 46,508,875 |
| Deferred revenue (Note 11) | 5,084,117 | 1,708,203 |
| Regulatory liabilities - current portion (Note 12) | 17,514,159 | 2,057,582 |
| Other current liabilities | 595,834 | 545,709 |
| **Total current liabilities** | **363,375,686** | **280,383,564** |
| **NONCURRENT LIABILITIES:** | | |
| Accrued pension liability (Note 9) | 2,166,365 | 530,675 |
| Accrued postretirement liability (Note 8) | 3,475,271 | 2,724,583 |
| Regulatory liabilities (Note 12) | 1,279,459 | 7,557,803 |
| Other noncurrent liabilities (Note 8) | 1,545,550 | 1,469,307 |
| Long-term debt (Note 6) | 60,754,671 | 56,958,423 |
| **Total noncurrent liabilities** | **69,173,316** | **69,240,791** |
| **COMMITMENTS AND CONTINGENCIES (Note 13)** | | |
| **TOTAL** | **$ 432,549,002** | **$ 349,624,355** |

*See notes to financial statements.*

## STATEMENTS OF ACTIVITIES
### FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

| | 2005 | 2004 |
|---|---|---|
| **REVENUES:** | | |
| Rate Schedule 1 tariff charge | $ 144,882,248 | $ 135,620,291 |
| Interest income | 2,121,390 | 254,473 |
| Lease income (Note 9) | 1,215,882 | - |
| Fees and services | 951,341 | 786,831 |
| **Total revenues** | 149,170,861 | 136,661,595 |
| **OPERATING EXPENSES:** | | |
| Compensation and related benefits (Note 8) | 45,693,068 | 37,735,650 |
| Depreciation and amortization | 35,856,529 | 24,373,869 |
| Professional fees and consultants | 26,327,352 | 20,999,485 |
| Rent, equipment leases and other facility costs | 17,476,454 | 15,680,042 |
| Federal Energy Regulatory Commission fees | 8,893,682 | 5,311,674 |
| Telecommunications | 4,642,278 | 4,525,675 |
| Administrative and other expenses | 2,981,482 | 4,477,103 |
| Training, travel and meeting expenses | 2,459,472 | 2,035,422 |
| Northeast Power Coordinating Council fees | 1,689,802 | 1,506,734 |
| Amortization of regulatory transition asset | - | 10,968,469 |
| **Total operating expenses** | 146,020,119 | 134,236,093 |
| **INTEREST EXPENSE—Net** | $ 3,150,742 | $ 2,425,502 |
| **NET RESULTS OF ACTIVITIES** | $ - | $ - |

See notes to financial statements.

## STATEMENTS OF CASH FLOWS
### YEARS ENDED DECEMBER 31, 2005 AND 2004

| | 2005 | 2004 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | | |
| Net results of activities | $ | $ |
| Adjustments to reconcile net results of activities to net cash provided by operating activities: | | |
| Depreciation and amortization | 35,856,530 | 24,375,869 |
| Amortization of regulatory transition asset | - | 10,968,489 |
| Loss on disposal of fixed asset | 45,017 | 47,874 |
| Change in operating assets and liabilities: | | |
| Decrease (increase) in accounts receivable and prepaid expenses | 3,344,779 | (545,257) |
| Decrease (increase) in regulatory assets | 5,440,582 | (17,680,725) |
| (Increase) in other assets | (17,394,913) | (606,103) |
| (Decrease) increase in accounts payable and accrued expenses | (692,821) | 2,851,337 |
| Increase in market participant prepayments | 67,897,143 | 3,115,711 |
| (Decrease) in market participant security deposits | (21,652,627) | (14,510,430) |
| Increase (decrease) in working capital reserve | 2,791,261 | (1,877,028) |
| Increase (decrease) in deferred revenue and other liabilities | 15,018,804 | (11,806,463) |
| **Net cash provided by (used in) operating activities** | 75,654,655 | (5,734,918) |
| **CASH FLOWS FROM INVESTING ACTIVITIES:** | | |
| (Increase) decrease in restricted cash | (29,602,894) | 10,753,311 |
| Acquisition of property and equipment (including capitalized interest) | (26,828,713) | (43,475,553) |
| **Net cash used in investing activities** | (56,431,607) | (32,722,242) |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** | | |
| Proceeds from mortgage | 14,708,750 | |
| Proceeds from 2004 - 2006 budget facility loan | 18,000,000 | 42,000,000 |
| Repayment of term credit loan | - | (12,656,961) |
| Repayment of mortgage | (2,131,887) | - |
| Repayment of 2004 - 2006 budget facility loan | (10,500,000) | - |
| Repayment of 2003 budget facility loan | (11,750,000) | (9,791,667) |
| Repayment of equipment term notes | - | (5,833,333) |
| **Net cash provided by financing activities** | 8,326,863 | 13,718,039 |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 27,549,911 | (24,739,121) |
| CASH AND CASH EQUIVALENTS—Beginning of year | 30,630,452 | 55,369,573 |
| CASH AND CASH EQUIVALENTS—End of year | $ 58,180,363 | $ 30,630,452 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION—Cash paid during the year for interest | $ 3,534,937 | $ 1,914,949 |
| NONCASH INVESTING ACTIVITIES: | | |
| Property and equipment additions which were accrued but not paid | $ 2,024,733 | $ 788,709 |
| Property and equipment additions previously accrued which were paid | $ 788,709 | $ 5,459,300 |

See notes to financial statements.

## NOTES TO FINANCIAL STATEMENTS
## YEARS ENDED DECEMBER 31, 2005 AND 2004

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

***Business Description*** — The New York Independent System Operator, Inc. ("NYISO") was formed in April 1997 and commenced operations on December 1, 1999. NYISO is incorporated in the State of New York as a not-for-profit organization. NYISO assumed the responsibilities of its predecessor, the New York Power Pool ("NYPP"), which had coordinated the reliability of New York State's electric power grid for more than 30 years. Formed as a result of Federal Energy Regulatory Commission ("FERC") policies, NYISO monitors a network of more than 10,775 miles of high-voltage transmission lines and serves approximately 300 market participants.

NYISO's principal objectives are to ensure the reliable, safe and efficient operation of the New York State transmission system and to administer an open, competitive and nondiscriminatory wholesale market for electricity in New York State. NYISO facilitates fair and open competition in the wholesale power market and creates an electricity commodity market in which power is purchased and sold on the basis of competitive bidding. NYISO utilizes a bid process for electricity and transmission usage, which enables New York State's utilities and other market participants to offer electricity at competitive prices, rather than regulated rates. Billing invoices are issued to each market participant by NYISO each month to settle transactions occurring in the previous month.

NYISO is governed by an independent board of directors, as well as a committee structure consisting of market participant representatives. In addition to FERC oversight, NYISO is also subject to regulation in certain aspects by the New York State Department of Public Service.

***Basis of Accounting*** — The accompanying financial statements have been prepared on an accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America.

***Regulation*** — NYISO's financial statements are prepared in accordance with generally accepted accounting principles for rate-regulated entities. Statement of Financial Accounting Standards ("SFAS") No. 71, *Accounting for the Effects of Certain Types of Regulation*, requires an entity that is rate regulated on a cost-of-service basis, to recognize regulatory assets and liabilities for amounts, which would otherwise be included in earnings, when authorized to do so.

***Revenue Recognition*** — Monthly settlements of market participants' energy transactions are not reflected in NYISO's Statements of Activities since they do not represent revenues or expenses of NYISO as NYISO merely acts as an intermediary in the settlement process. In this role, NYISO receives and disburses funds to/from market participants in the month following the month transactions occurred. See Note 14 for an unaudited summary of transactional volumes occurring in 2005 and 2004.

NYISO's two FERC-approved tariffs, the Open Access Transmission Tariff ("OATT") and the Market Administration and Control Area Services Tariff ("Services Tariff"), allow recovery of NYISO's capital requirements and operating expenses through a surcharge assessed to market participants. The revenue from this surcharge, Rate Schedule 1, is earned when energy is scheduled and dispatched. Market participants are then billed for such charges in the subsequent month.

NYISO's Rate Schedule 1 includes a timing mechanism that effectively meets the requirements of an alternative revenue program set forth in Financial Accounting Standards Board's Emerging Issues Task Force Issue No. 92-7, *Accounting by Rate Regulated Utilities for the Effects of Certain Alternative Revenue Programs*. Accordingly, revenue is recognized for net financing obligations and capital costs incurred during the reporting period based on the revenue requirement formula in the tariffs. NYISO has recorded an Other Noncurrent Asset of $11,397,988 in the accompanying 2005 Statement of Financial Position in connection with this rate-making recovery mechanism.

***Cash and Cash Equivalents*** — NYISO considers short-term marketable securities with original maturities of three months or less to be cash equivalents. The cash equivalents at December 31, 2005 and 2004 were held in money market accounts invested primarily in short term United States government obligations. NYISO's cash and cash equivalents consist primarily of funds accumulated for the working capital reserve, amounts due to market participants for overcollections on the voltage market, amounts for funding employee benefit plans, and for general operating purposes.

***Restricted Cash*** — Restricted cash consists primarily of market participant security deposits held in escrow accounts, amounts prepaid by market participants in advance of settlements billing dates, and amounts retained by NYISO pursuant to setoff agreements.

***Other Assets*** — Other assets consist primarily of timing differences on certain rate making recoveries, the intangible asset related to NYISO's pension plan, the fair value of securities held by the Trust Share Option Agreement, the fair value of interest rate cap and swap agreements, and other deferred charges.

***Property and Equipment*** — Property and equipment are recorded at cost. NYISO capitalizes property and equipment additions in excess of $5,000 with a useful life greater than one year. Depreciation is computed on the straight-line method over the assets' estimated useful lives of three to five years, except for building and building improvements, which are depreciated on a straight-line basis over twenty years. When assets are retired or otherwise disposed of, the cost and related depreciation are removed, and any resulting gain or loss is reflected in expense for the period. Repairs and maintenance costs are charged to expense when incurred.

In accordance with Statement of Position 98-1, *Accounting for Costs of Computer Software Developed or Obtained for Internal Use*, labor, overhead, interest, consulting and related costs incurred to acquire and develop computer software for internal use are capitalized and amortized using the straight-line method over three years. Costs incurred prior to the determination of feasibility of developed software and following the in-service date of developed software are expensed.

Long-lived assets are recorded at cost, and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be recoverable. Management is not aware of any events or changes in circumstances that would necessitate a review of any long-lived assets as of the years ended December 31, 2005 and 2004.

***Working Capital Reserve*** — In order to maintain the liquidity and stability of NYISO's markets, NYISO has accumulated a working capital fund through amounts charged to market participants under Rate Schedule 1. Any additional working capital needs would be billed to market participants in future Rate Schedule 1 charges. Market participants are entitled to interest on their principal contributions to the working capital reserve. Each market participant is allocated interest based on the respective ratio share of each market participant's principal contributions to the total working capital fund. Accumulated interest on the working capital fund is distributed annually to market participants.

***Market Participant Prepayments*** — Amounts received from certain market participants who do not provide an alternate form of financial assurance and must prepay their obligations to NYISO in advance of settlements billing dates, and amounts retained by NYISO pursuant to setoff agreements with bankrupt market participants are recorded as market participant prepayments.

***Deferred Revenue*** — Advance payments from developers for interconnection studies, security deposits and advance rental billings from a tenant leasing office space from NYISO are reflected as deferred revenue.

Fees for participation in NYISO's governance process are billed to market participants in advance of the year for which they apply and are amortized over the related governance period. All such unamortized amounts are included in deferred revenue.

***Income Taxes*** — NYISO is not subject to income taxes because it is operating as a corporation described in Section 501(c)(3) of the Internal Revenue Code, exempt under Section 501(a) of the Internal Revenue Code. NYISO is also exempt from paying New York State income tax or sales tax.

***Fair Value of Financial Instruments*** — The carrying amounts of current assets and liabilities and long term debt approximate their fair values. See additional details in Note 7.

***Concentration of Credit Risk*** — Financial instruments that subject NYISO to credit risk consist primarily of accounts receivable billings and Rate Schedule 1 revenue due from market participants. As provided in the OATT and Services Tariff, NYISO reviews the creditworthiness of market participants, who are required to either maintain certain financial statement criteria and/or approved credit ratings, to post specified financial security in an amount sufficient to cover their outstanding liability to NYISO, or to prepay their obligations in advance of settlement billing dates.

NYISO's tariffs establish specific periods for the adjustment of settlement invoices as originally billed and for challenges to amounts billed for a particular service month. Subsequent invoices issued during the settlement adjustment period "true up" amounts previously billed. After all true-up invoices are issued during the settlement adjustment period, market participants may challenge the amounts billed for a particular service month. If NYISO agrees with the provisions of the challenge, a final invoice is issued for that service month. As a result, NYISO is exposed to credit risk until all settlement, adjustment and final invoices for each service month are finalized and liquidated. However, Rate Schedule 1 of the OATT allows NYISO to recover bad debt losses from remaining market participants in future billings.

For original invoices issued prior to October 2002, settlement invoices may be adjusted up to two years after the date of original issuance, and these invoices may be challenged for an additional one year after the issuance of all settlement adjustment invoices. Effective with the October 2002 settlement invoice, these periods were shortened to one year for adjustments and four months for invoice challenges.

***Use of Estimates*** — Accounting principles generally accepted in the United States of America require management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

***Reclassifications*** — Certain reclassifications of prior period data have been made to conform with the current year presentation. NYISO accrued in accounts payable and accrued expenses amounts related to capital purchases incurred but not yet paid. In prior periods, amounts accrued but not yet paid were classified in the Statement of Cash Flows as cash flows from investing activities and the corresponding change in the related accounts payable as cash flows from operating activities. In 2005, NYISO revised its accounting policy to exclude accrued capital purchases from cash flows from investing and operating activities. Accrued capital purchases were $2,024,713 and $788,709 at December 31, 2005 and 2004, respectively. NYISO revised its 2004 Statement of Cash Flows to conform to this change. As a result, cash flows provided by operating activities and cash flows used in investing activities increased by $4,670,591. NYISO has also reclassified certain amounts previously reported as restricted cash to cash in the accompanying Statement of Financial Position at December 31, 2004, and the Statement of Cash Flows for the period then ended. This reclassification did not have an impact on total current assets.

***Derivative Financial Instruments*** — NYISO records derivative financial instruments in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS No. 133"). SFAS No. 133 requires that all derivative financial instruments be recognized as either assets or liabilities, measured at fair value. The accounting for changes in fair value of derivatives (i.e. gains and losses) depends on the intended use of the derivative and the corresponding designation. The fair values of NYISO's derivative instruments are quoted by external sources. The changes in the fair value of these derivatives qualify as cash flow hedges and are recorded as interest expense. Due to NYISO's regulated rates, the offset to the changes in fair value of these derivatives is recorded as other assets. See additional details in Note 7.

## 2. ACCOUNTS RECEIVABLE

NYISO's accounts receivable at December 31, 2005 and 2004 consisted of the following:

[illegible]

[illegible]

Rate Schedule 1 of the OATT allows NYISO to recover bad debt losses from market participants and provides guidance on the provisions of such recoveries. NYISO's reserve for doubtful accounts at December 31, 2005 and 2004 results primarily from past due settlement invoices related to two subsidiaries of Enron Corporation. The bad debt losses were recovered from market participants in accordance with the OATT and any amounts recovered from the Enron bankruptcy proceedings are refundable to these market participants. During 2005, NYISO recovered $2,759,606 from claims entered in the Enron bankruptcy process. This recovery amount will be refunded to market participants in 2006 and is reflected as a current Regulatory Liability on the 2005 Statement of Financial Position. Additional recoveries, which cannot yet be quantified, are expected and will also be refunded to market participants. As of December 31, 2005 and 2004, NYISO recorded unbilled receivables of $356,997 and $42,800, respectively, to reflect amounts yet to be recovered from remaining market participants in connection with other bad debt losses.

NYISO recovers its operating expenses via Rate Schedule 1 in the month following the month of service. Therefore, the unbilled operating expenses for December are billed and recovered in January of the subsequent year.

Unbilled replenishments of working capital reserve relate to amounts recoverable from market participants via future Rate Schedule 1 charges to recover amounts temporarily utilized by NYISO out of the working capital reserve.

## 3. REGULATORY TRANSITION ASSET AND REGULATORY ASSETS

NYISO's regulatory transition asset represents costs incurred and paid by the member companies of the NYPP to prepare NYISO for initial operations. In accordance with NYISO's tariffs, such costs were recovered from market participants through Rate Schedule 1 over a five-year period ended December 31, 2004 and were amortized over such same period.

At December 31, 2004, the regulatory transition asset was comprised of:

[illegible]

At December 31, 2005 and 2004, regulatory assets were comprised of:

[illegible]

During 2004, NYISO entered into a settlement agreement with its market participants to resolve a billing issue in NYISO's Transmission Congestion Contracts market. As of December 31, 2005 and 2004, respectively, NYISO's working capital fund has been temporarily depleted by $12,240,143 and $17,037,859, respectively, as a result of this settlement. NYISO is replenishing this temporary draw on the working capital reserve via a FERC-approved surcharge assessed to certain future transmission congestion contracts. The timing of the replenishments via this surcharge is dependent upon the amount and timing of activity in the transmission congestion contracts market. Remaining future replenishments are reflected as regulatory assets due from market participants.

In order to maintain acceptable transmission voltages on the New York State transmission system, certain market participants within the New York Control Area produce or absorb voltage support service (reactive power). Payments to market participants supplying voltage support service and recoveries from other market participants are assessed via Rate Schedule 2 of the OATT and Services Tariff. Differences between the timing of recoveries and payments for voltage support service that result in undercollections are reflected as regulatory assets. At December 31, 2005 and 2004, respectively, NYISO recognized a regulatory liability of $3,679,480 (see Note 12) and a regulatory asset of $672,866 related to such timing differences.

**4. PROPERTY AND EQUIPMENT**

Property and equipment includes interest of $82,735 and $292,451 capitalized during 2005 and 2004, respectively. As of December 31, property and equipment consisted of the following:

[illegible]

**5. SHORT-TERM DEBT**

At December 31, 2004, NYISO had a $50 million Revolving Credit Facility that was due to expire on October 26, 2005. On July 21, 2005, NYISO replaced the existing Revolving Credit Facility with a new $50 million Revolving Credit Facility that expires on July 21, 2010. The proceeds from this facility are to be used for working capital purposes. Interest on borrowings under this agreement is based on NYISO's option of varying rates of interest tied to either the prime rate or the London Interbank Offer Rate ("LIBOR"). At December 31, 2005 and 2004, respectively, there were no amounts outstanding on the Revolving Credit Facility.

**6. LONG-TERM DEBT**

On September 8, 2000, NYISO borrowed $48.5 million under a Term Credit Loan to reimburse NYPP member companies for their investment in the transition of the NYPP to the NYISO, and for the purchase of certain NYPP assets. Principal and interest payments were due monthly until December 2004, when the Term Credit Loan was fully repaid. Under this facility, interest was variable based on the 30-day LIBOR plus 125 basis points. However, in January 2001, NYISO entered into an interest rate swap agreement on the Term Credit Loan, which fixed the interest rate on this loan at 6.92%.

On November 1, 2001, NYISO entered into a $6.5 million line of credit facility to be utilized for the purchase of information technology equipment. This facility was subsequently increased to $10.5 million on November 8, 2002. By December 31, 2002, the entire $10.5 million of the line of credit facility was drawn and converted into Equipment Term Notes with principal and interest payable over three years. Computer hardware and software with a book value of $10.5 million were pledged as collateral for the Equipment Term Notes. In December 2004, the Equipment Term Notes were fully repaid, with $2.4 million representing voluntary prepayments against the debt. All collateral liens for computer hardware and software associated with the Equipment Term Notes were removed in January 2005. Interest on borrowings under this facility was based on NYISO's option of varying rates of interest tied to either LIBOR plus 125 basis points or the prime rate.

On February 13, 2003, NYISO entered into a $59.3 million unsecured line of credit facility ("2003 Budget Facility"), the proceeds of which could be drawn until February 29, 2004 to fund the 2003 development of significant information technology projects. By December 31, 2003, $47.0 million was borrowed on the 2003 Budget Facility, with principal and interest payments payable over four years, beginning in March 2004. Interest on borrowings under this facility was based on NYISO's option of varying rates of interest tied to either LIBOR plus 137.5 basis points or the prime rate. On April 8, 2005, this loan was refinanced to lower the LIBOR interest rate spread from 137.5 basis points to 65.0 basis points. NYISO has also entered into an interest rate cap agreement on this debt, effective January 2, 2004, which capped the maximum interest rate at 5.375% (4.65% after April 8, 2005 refinancing). At December 31, 2005, the interest rates on these borrowings were at the 4.65% cap level whereas at December 31, 2004 interest rates ranged from 3.38% to 3.66%. See additional information in Note 7.

On March 17, 2004, NYISO entered into an unsecured $100.0 million line of credit facility ("2004 - 2006 Budget Facility"), the proceeds of which may be drawn until December 2006 to fund the development of significant information technology projects during 2004 through 2006. NYISO has the option to convert borrowings under this 2004 - 2006 Budget Facility up to three times to term loans, with principal repayments made over four years. Interest on borrowings under this facility is due monthly and was based on NYISO's option of varying rates of interest tied to either LIBOR plus 60 basis points (for borrowings during the draw period not yet converted to term loans) or 100 basis points (for borrowings converted to term loans) or the prime rate. On April 8, 2005, this facility was refinanced to lower the LIBOR interest rate spread to 52.5 basis points (for borrowings during the draw period) and 80 basis points (for borrowings converted to term loans). NYISO entered into interest rate cap agreements on $82.0 million of this debt, which caps the maximum interest rate at 4.60% for borrowings during the draw periods not yet converted to term loans (4.525% after April 8, 2005 refinancing) and 5.00% for borrowings converted to term loans (4.80% after April 8, 2005 refinancing). See additional information in Note 7.

At December 31, 2004, $42.0 million was drawn on the 2004—2006 Budget Facility, which was converted to a term loan in February 2005 with principal and interest payments payable over four years beginning in March 2005. At December 31, 2005, the interest rate on these borrowings was at the cap level of 4.80% whereas at December 31, 2004, the interest rate was 3.62%. During 2005, an additional $18.0 million was drawn on the 2004—2006 Budget Facility, which will be converted to a term loan in February 2006 with principal and interest payments payable over four years. At December 31, 2005, the interest rate on these borrowings was 4.525%.

On July 8, 2005, NYISO entered into two financing agreements to purchase and renovate a 140,000 square foot office building. The first agreement is a $14.7 million mortgage to finance the building purchase ("Mortgage"), and the second agreement represents a $10.0 million line of credit for renovations during an 18 month period, beginning in July 2005 ("Renovations Loan"). The Mortgage has principal and interest payments payable over 20 years, beginning September 2005. Principal and interest payments on borrowings made during the Renovations Loan draw period are payable over 20 years, beginning in January 2007. Both agreements are secured by liens on the building and subsequent capitalized renovations. Interest on borrowings under both facilities is due monthly and is based on NYISO's option of varying rates of interest tied to either LIBOR plus 100 basis points or the prime rate. On February 15, 2005, NYISO entered into an interest rate swap agreement on the Mortgage, which fixes the interest rate on this loan at 5.79%. On February 15, 2005, NYISO also entered into an interest rate swap agreement on the Renovations Loan, which fixes the interest rate on these borrowings at 5.96%, beginning on January 1, 2007. As of December 31, 2005, $14.7 million was borrowed on the Mortgage, and there were no draws on the Renovations Loan.

At December 31, 2005, the following amounts were outstanding on NYISO's Long Term Debt:

At December 31, 2005, scheduled maturities of NYISO's Long-Term Debt were as follows:

## 7. DERIVATIVES AND HEDGING ACTIVITIES

In December 2003, NYISO entered into an interest rate cap agreement with a commercial bank to cap interest payments at 5.375% (4.65% after refinancing on April 8, 2005) on its 2003 Budget Facility. The notional amount of the debt on the date of the cap agreement was $47,000,000. Under the cap agreement, NYISO pays a variable interest rate tied to LIBOR on the outstanding principal amount of the 2003 Budget Facility from January 2004 through February 2008; however, this variable interest rate cannot exceed 5.375% (4.65% after refinancing). As of December 31, 2005 and 2004, the fair value of the interest rate cap was $196,073 and $92,215, respectively and is recorded in Other Current and Non-current Assets. For the year ended December 31, 2005 and 2004, NYISO recorded interest income of $191,531 and interest expense of $234,516, respectively, related to this derivative instrument. Such amounts are reflected in Interest Expense, net.

In March 2004, NYISO entered into interest rate cap agreements with a commercial bank to cap interest payments at 4.60% for draws and 5.00% for term loans (4.53% and 4.80% after refinancing on April 8, 2005) on its 2004 - 2006 Budget Facility. The notional amount of the debt on the date of the cap agreements was $82,000,000. Under the cap agreements, NYISO pays a variable interest rate tied to LIBOR on the draws and term loans of the 2004 - 2006 Budget Facility from March 2005 through December 2010; however, this variable interest rate cannot exceed 4.525% for draws or 4.80% for term loans. As of December 31, 2005 and 2004, the fair value of the interest rate cap was $1,361,635 and $678,191, respectively, and is recorded in Other Current and Noncurrent Assets. For the year ended December 31, 2005 and 2004, NYISO recorded interest income of $412,944 and interest expense of $421,809, respectively, related to this derivative instrument. Such amounts are reflected in Interest Expense, net.

In February 2005, NYISO entered into two interest rate swap agreements with a commercial bank to fix interest rate payments on the financing of a new office building purchase. The notional amount of debt on the swap agreement for the Mortgage was $14,708,750, and NYISO will pay a fixed interest rate of 5.79% on the outstanding principal amount of this financing on payments from August 2005 through August 2025. The notional amount of debt on the swap agreement for the Renovations Loan was $10,000,000, and NYISO will pay a fixed interest rate of 5.96% on payments from January 2007 through January 2027. As of December 31, 2005, the fair value of these interest rate swap agreements was $96,395 for the Mortgage and ($49,249) for the Renovations Loan, recorded in Other Noncurrent Assets and Other Noncurrent Liabilities, respectively. For the year ended December 31, 2005, NYISO recorded interest income of $47,146 related to these two swap agreements. This amount is reflected in Interest Expense, net.

NYISO is exposed to credit loss in the event of nonperformance by the commercial banks under the interest rate cap and swap agreements. However, NYISO does not anticipate nonperformance by the commercial banks.

## 8. EMPLOYEE BENEFIT PLANS

***Pension and Postretirement Plans*** — NYISO has a defined benefit qualified pension plan covering substantially all employees. Plan benefits are based on employee compensation levels and years of service, including service for certain employees previously employed by an NYPP member company. Employees become vested in pension benefits after five years of credited service. NYISO expects to contribute $2.0 million to the qualified pension plan in 2006.

NYISO also has an unfunded nonqualified excess benefit plan to provide employees with the full level of benefits as stated in the qualified plan without reductions due to various limitations imposed by the provisions of federal income tax laws and regulations. In 2005, this plan was amended such that the timing of payments would be made annually once a five-year vesting period is satisfied. Accordingly, this plan was curtailed in 2005 under SFAS 87, *Employers' Accounting for Pensions*. At December 31, 2005, NYISO has recognized a liability of $66,976, of which $57,875 represents the current portion of this liability.

NYISO sponsors a defined benefit postretirement plan to provide medical and life insurance benefits for eligible retirees and their dependents. Substantially all employees who retire from NYISO become eligible for those benefits provided they have been credited with at least five years of NYISO service. The benefits are contributory based upon years of service, with NYISO paying up to 50% of costs for retired employees and up to 25% for their dependents (subject to specified dollar limits). Medical coverage becomes secondary upon Medicare eligibility and life insurance coverage is reduced upon reaching age 65.

In May 2004, the FASB issued FSP 106-2, which supercedes FSP 106-1, to provide guidance on the accounting for plans under SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and disclosures for the federal subsidy under SFAS 132R. The provisions of FSP 106-2 are effective for fiscal periods beginning after June 15, 2004. During 2005, NYISO determined that benefits provided by NYISO's postretirement plan are not actuarially equivalent to Medicare Part D and therefore, there is no impact on NYISO's accumulated postretirement benefit obligation and net periodic postretirement cost for the year ended December 31, 2005.

The schedules that follow show the benefit obligations, the plan assets, and the funded status as of December 31, 2005 and 2004, and the change in benefit obligations and the components of net periodic cost for NYISO's qualified pension and postretirement plans for the years ended December 31, 2005 and 2004.

[illegible]

Amounts recognized in the Statements of Financial Position consist of:

[illegible]

NYISO uses a December 31 measurement date for its pension and postretirement benefit plans. NYISO's accumulated benefit obligation for the defined benefit pension plans is $15,135,211 and $11,666,176 at December 31, 2005 and 2004, respectively.

The following table shows the assumptions used to calculate the pension and postretirement benefit obligations and net periodic costs as of December 31, 2005 and 2004.

[illegible]

NYISO's expected rate of return on plan assets reflects anticipated returns on the qualified pension plan's current and future assets. To determine this rate, NYISO considers historical returns for equity and debt securities as well as current capital market conditions and projected future conditions. Given the current low interest rate environment, NYISO selected an assumed rate of 8.00%, which is lower than the rate otherwise determined solely on historical returns.

The targeted allocation and actual investment mix of the pension plan's assets are as follows:

[illegible]

Pursuant to resolutions adopted by NYISO's Board of Directors, NYISO's Retirement Board has been granted the authority to control and manage the operation and administration of NYISO's qualified pension plan, including responsibility for the investment of plan assets and the ability to appoint investment managers. The Retirement Board currently consists of NYISO's Chief Financial Officer, Vice President of Human Resources, General Counsel and Controller. The Retirement Board provides reports to the Finance Committee of the Board of Directors on at least an annual basis.

The long-term investment objective for NYISO's qualified pension plan assets is to maximize the total return on plan assets while limiting risk, reflected in volatility of returns, to prudent levels. To that end, NYISO's Retirement Board has appointed and regularly meets with an investment advisor to review asset performance, compliance with target asset allocation guidelines, and appropriate levels of asset diversification. NYISO's investment advisor operates under written guidelines provided by NYISO, which cover such areas as investment objectives, performance measurement, permissible investments, investment restrictions, and communication and reporting requirements.

The assumed health care cost trend rates for the postretirement plan are 9% for 2005 decreasing to 4.5% in 2010 and 10% for 2004, decreasing to 4.5% in 2010. A one percentage point change in the assumed health care cost trend rate would change the 2005 postretirement benefit obligation as follows:

[redacted]

The following benefit payments, which reflect expected future service, are expected to be paid:

[redacted]

***401(k) Plan*** — NYISO has a 401(k) Retirement and Savings Plan open to all non-temporary employees. This plan provides for employee contributions up to specified limits. NYISO matches 100% of the first 3% of employee contributions, and 50% of the next 2% of employee contributions. Employees are immediately vested in NYISO's matching contributions, which were $1,234,783 and $1,104,230 for 2005 and 2004, respectively.

***Long Term Incentive Plan*** — NYISO's Long Term Incentive Plan provides certain members of senior management with deferred compensation benefits. Benefits are based upon the achievement of three-year performance goals established by the Board of Directors, with participants becoming fully vested in these deferred amounts after the completion of the third year. For the first three performance cycles (2000-2002, 2001-2004 and 2002-2005), annual distributions were payable in the year following completion of the cycle. In 2005, there was a one-year performance cycle, payable in 2006. After 2005, distributions will be payable after the completion of each three-year cycle. Accrued Long Term Incentive Plan benefits included in Other Noncurrent Liabilities at December 31, 2005 and 2004, respectively, were $856,606 and $818,980. The short-term portion of such liability, included in Other Current Liabilities, at December 31, 2005 and 2004 was $118,725 and $545,709, respectively.

***Trust Share Option Agreement*** — NYISO has entered into a nonqualified share option agreement with a key officer whereby NYISO has granted to such officer the right to acquire debt and equity securities held by NYISO in a trust for an amount equal to 75% of the fair value of such securities. The options are immediately vested and are subject to certain restrictions of transferability. At December 31, 2005 and 2004, respectively, the fair market value of securities held by the Trust was $840,726 and $807,936. Options outstanding at December 31, 2005 expire from November 16, 2009 through February 19, 2012. NYISO records compensation expense for 75% of the fair value of the options granted at the date of grant. A corresponding liability is established until such time as the options are exercised. No options have been exercised as of December 31, 2005.

***Severance Pay Plan*** — In 2005, NYISO implemented changes to its organizational structure to more closely align with its corporate objectives and market participant expectations. As a result of these realignments, eleven employee positions were eliminated. These former employees were eligible to receive certain termination benefits under a Severance Pay Plan adopted by NYISO in 2005. Total severance costs resulting from these activities were $1,425,031, and are reflected in the Compensation and Related Benefits line item on the 2005 Statement of Activities. Of this total, $1,029,497 was paid to terminated employees during 2005, and the remaining $395,534 at December 31, 2005 is expected to be paid during 2006. As such, this balance is included with Other Current Liabilities on the 2005 Statement of Financial Position.

## 9. LEASE COMMITMENTS

***Operating Leases*** — NYISO has obligations under three operating lease agreements primarily for rental of office space. One lease agreement for property in Albany, NY, expires in January 2006. Another lease agreement for property in Altamont, NY, expires in February 2006, and is expected to be extended on a month-to-month basis thereafter. The third lease agreement for property in Albany, NY expires in April 2008, but is cancelable after April 2006.

Rent expense related to these leases in 2005 and 2004 was as follows:

[redacted]

The future minimum lease payments under these operating leases at December 31, 2005 are as follows:

[redacted]

On July 8, 2005, NYISO purchased an office building to relocate NYISO's alternate control center and to consolidate employees currently located in leased facilities. On this date, NYISO also executed an agreement to lease certain office space within the building to the previous owner of this building for a period of one year. The lessee may terminate the lease after ten months or may extend for two months. Rent paid includes $89,540 per month plus reimbursements for a percentage of operating, maintenance, real estate taxes and insurance costs. A security deposit of $281,521 was received at closing to be applied to the last two months' rent and expenses. In December 2005, the tenant gave notice to terminate the lease after ten months. On January 16, 2006, NYISO amended the lease terms to reduce the square footage rented and reduce rent and expense reimbursements by 98%. The minimum lease income recorded in 2005 was $517,056 plus additional rent income of $698,826. The future minimum lease income will be $341,526 in 2006, with the lease terminating in May 2006.

In connection with the purchase, management entered into a Payment in Lieu of Taxes ("PILOT") Agreement with the Rensselaer County Industrial Development Agency ("RCIDA") to achieve certain benefits. Per the terms of this agreement, NYISO will be required to make annual payments of approximately $175,000 for the first ten years. However, the agreement is cancelable at the discretion of NYISO.

### 10. WORKING CAPITAL RESERVE

At December 31, 2005 and 2004, the working capital reserve consisted of:

[illegible]

### 11. DEFERRED REVENUE

Deferred revenue at December 31, 2005 and 2004 consisted of the following:

[illegible]

### 12. REGULATORY LIABILITIES

At December 31, 2005 and 2004, respectively, NYISO recorded the following amounts as regulatory liabilities:

[illegible]

NYISO recovers its operating expenses through a surcharge assessed to market participants via Rate Schedule 1 of the OATT and Services Tariff. To the extent that transactional volumes billed under Rate Schedule 1 exceed the amount expected when the Rate Schedule 1 surcharge is established, NYISO reflects a regulatory liability for the overcollection amounts. Additionally, to the extent that NYISO's spending does not exceed the annual Rate Schedule 1 revenue requirement, a regulatory liability is also established for the underspending amounts. The regulatory liabilities resulting from Rate Schedule 1 load overcollections and underspending at December 31, 2005 and 2004, respectively, will be applied toward long-term debt in 2006.

In order to maintain acceptable transmission voltages on the New York State transmission system, certain market participants within the New York Control Area produce or absorb voltage support service (reactive power). Payments to market participants supplying voltage support service and recoveries from other market participants are assessed via Rate Schedule 2 of the OATT and Services Tariff. Differences between the timing of recoveries and payments for voltage support service that result in overcollections are reflected as regulatory liabilities. At December 31, 2005 and 2004, respectively, NYISO recognized a regulatory liability of $3,679,480 and a regulatory asset of $677,865 (see Note 3) related to such timing differences.

During 2005, NYISO recovered $2,759,606 from claims entered in the Enron bankruptcy proceedings to recover amounts previously charged to market participants for bad debt losses on two Enron subsidiaries. This recovery amount will be refunded to market participants in 2006.

Certain amounts recovered under NYISO's ratemaking mechanisms are based on estimates. The difference between actual results and estimates that result in overcollections are reflected as regulatory liabilities due to market participants. Additionally, under NYISO's ratemaking structure, principal payments on long-term debt are recovered to fund the cost of acquiring certain property and equipment. Differences resulting between the timing of recoveries of such principal payments and the depreciation expense associated with such property and equipment also result in overcollections reflected as regulatory liabilities. At December 31, 2005 and 2004, respectively, NYISO has recognized an Other Noncurrent Asset of $11,397,988 (see Note 1) and a Regulatory Liability of $4,766,585 related to such timing differences.

### 13. COMMITMENTS AND CONTINGENCIES

NYISO is routinely involved in regulatory actions. In the opinion of management, none of these matters will have a material adverse effect on the financial position, result of operations or liquidity of NYISO.

The most significant legal proceeding affecting NYISO is a civil suit, filed by New York State Electric and Gas, seeking recovery of $6.6 million in compensatory damages and unspecified punitive damages, associated with alleged excessive payments for reserves of electricity during the period January to March 2000. This case has been stayed pending the outcome of related proceedings at the FERC and the D.C. Circuit Court of Appeals. While it is not possible to predict the outcome of this matter with certainty, in the opinion of NYISO management, this proceeding will not have a material adverse effect on the financial position, results of operations or liquidity of NYISO.

### 14. MARKET ACTIVITY (UNAUDITED)

The following amounts represent the transactional volume of energy and energy-related products in NYISO's markets during the years ended December 31, 2005 and 2004 (in $ billions). The increase in energy transactions from 2004 to 2005 is driven primarily by price rather than volume considerations.

[illegible]

# ATTACHMENT II

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

| | |
|---|---|
| **Preventing Undue Discrimination and Preference in Transmission Service** | **Docket No. RM05-17-000<br>RM05-25-000** |

## AFFIDAVIT OF CHARLES N. GARBER

STATE OF NEW YORK )
) ss
COUNTY OF ALBANY )

CHARLES N. GARBER, being duly sworn, deposes and says:

1. I am Vice President and Chief Financial Officer of the New York Independent System Operator, Inc. (the "NYISO"), a not-for-profit 501(c)(3) corporation organized under the laws of the State of New York. I have held this position since January, 2005. Prior to joining the NYISO, I was Vice President and Treasurer of NUI Corp.

2. The purpose of this affidavit is to confirm the factual accuracy of Section III.A of the NYISO's *Request for Clarification and Alternative Request for Rehearing* in the above-captioned proceeding.

3. Section III.A correctly explains that the NYISO is a not-for-profit entity that recovers all of its costs from its customers through "pass through" charges under Rate Schedule 1 of its tariffs. Although the NYISO obtains some revenues, *e.g.*, from

fees it charges for performing interconnection studies and from the interest it earns on other money, it uses all of these revenues to reduce charges under Rate Schedule 1.

4. Section III.A correctly states that the NYISO accounts for all of its revenues to its customers, that the NYISO could only pay penalties by directly charging its customers or by using revenues that would otherwise be used to reduce customer charges, and that the NYISO has no other revenues from which it could pay penalties.

5. Attachment I correctly depicts the NYISO's revenues, and the sources from which they were derived in 2004 and 2005. The NYISO did not have any revenues from sources other than those listed in Attachment I during 2006. I do not anticipate that the NYISO will have revenue from sources other than those listed in Attachment I during 2007, or in future years.

6. Thus, I hereby attest that all of the factual statements in Section III.A.1 of the NYISO's *Request for Clarification and Alternative Request for Rehearing* are accurate and true.

7. This concludes my affidavit.

## ATTESTATION

I am the witness identified in the foregoing affidavit. I have read the affidavit and am familiar with its contents. The facts set forth therein are true to the best of my knowledge, information, and belief.

Charles N. Garber
CHARLES N. GARBER

SUBSCRIBED AND SWORN to before me this 19th day of March, 2007.

Notary Public

SHAHID SAULAT
Notary Public - New Jersey
ID No. 23[illegible]3
My Commission Expires November 4, [illegible]