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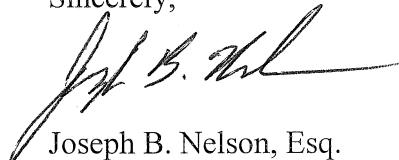
C/o Mr. William J. Museler
President and Chief Executive Officer
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303

**Re: Notice of Appeal by the Long Island Power Authority and LIPA
of the Management Committee's Actions on a Working Capital and
Remaining Losses Allocation Methodology**

Dear Chairman Grossi:

Pursuant to the Procedural Rules for Appeals to the NYISO Board, the Long Island Power Authority and LIPA hereby submit three copies of a Notice of Appeal of the Management Committee's February 20, 2003 actions on a working capital and remaining losses allocation methodology. A copy of this Notice of Appeal has been electronically transmitted to NYISO Staff for purposes of service.

Sincerely,



Joseph B. Nelson, Esq.

Attachments

**Notice of Appeal by the Long Island Power Authority and LIPA
of the Management Committee's Actions on a Working Capital and
Remaining Losses Allocation Methodology**

Decision Appealed: February 20, 2003 Management Committee action on Motions #3 and #3a regarding the working capital and remaining losses allocation methodologies.

Summary and Background: During its meeting of February 20, 2003, the Management Committee acted on two motions (Motion #3 and #3a) relating to changes in the methodology for allocating any remaining loss or funding of working capital collections. The Long Island Power Authority and its operating subsidiary LIPA (collectively "LIPA") hereby appeal the Management Committee's approval of the allocation methodology proposed in Motion #3. The approved allocation methodology contains a significant bias against transactions in the LBMP market which could induce a change in market participant behavior toward scheduling bilaterals as opposed to LBMP market transactions in order to reduce exposure to potential remaining loss allocations.

LIPA urges the NYISO Board to retain the existing allocation methodology for remaining losses and working capital allocation. In the event that the NYISO Board believes a change is necessary, LIPA supports the alternative allocation methodology set forth in Motion #3a as proposed at the Management Committee meeting. The Motion #3a allocation methodology was developed with significant market participant and NYISO Staff input at the Scheduling and Pricing Working Group and approved by the Business Issues Committee on February 11, 2003. Further, NYISO staff has acknowledged that this allocation methodology does not contain a bias toward either bilateral or LBMP transactions.

Appeal

I. Introduction

LIPA is appealing the Management Committee's actions on both Motion #3 and Motion #3a. As an initial matter, LIPA urges the NYISO Board's rejection of Motion #3 in light of the fact that the existing allocation methodology (using a load ratio share charged on a megawatt hour ("MWH) basis) remains an equitable allocation methodology that does not create the potential for bias or other problems that are inherent in the Motion #3 methodology. In the event that the NYISO determines that a change in the existing methodology is necessary, however, LIPA appeals the Management Committee's rejection of Motion #3a. LIPA's alternative methodology provides necessary improvements to remove the inherent bias towards bilateral transactions and to recognize a continuing distinction between remaining loss risks and the need for working capital funds which should be reflected in the allocation methodologies.

II. The Current Allocation Methodology for Remaining Losses and Working Capital Should be Retained

At present, the allocation of remaining losses and working capital funding is performed on a load ratio share charged on a MWH basis. While parties have criticized the general use of a load ratio share allocation with respect to other matters under the NYISO OATT on the grounds that generators are not covered under such allocations, each application of a load ratio share must be viewed independently and weighed against the alternatives that exist. In this instance, the application of the existing methodology does not create any inherent market biases and allocates costs to the ultimate beneficiaries of the market stability created through both the remaining loss treatment and

working capital funding. In contrast, as described in more detail below, the methodology adopted under Motion #3 will create a market bias towards bilateral transactions and moves incremental working capital funding away from the similar allocation treatment afforded to Schedule 1 costs. In the end, the benefits of moving to the development of a new allocation methodology are outweighed by the costs of adopting a flawed proposal.

III. The Proposed Remaining Losses and Working Capital Allocation Methodology Conflicts with Fundamental NYISO Market Design Principles

The Management Committee's approval of Motion #3 supports the modification of allocation methodologies for remaining losses and working capital allocations that would 1) allocate working capital requirements prospectively on a pro rata share based on a customer's dollar volume participation in the NYISO markets and 2) allocate remaining losses (those losses existing after an individual customer's credit requirement has been fully utilized to cover the loss) to customers based on their pro rata share of transactions in the NYISO markets on a dollar volume basis.

The remaining losses allocation formula is not meant as a form of security against individual market participants experiencing a loss in the NYISO markets (such credit risk is covered by the other terms of the Financial Assurance Requirements). Rather, the remaining losses allocation formula allocates the amount of loss to the NYISO after the defaulting party's individual credit requirements are exhausted. The allocation of such remaining losses must be accomplished in a fair and nondiscriminatory manner that does not impose any undue impacts on the reliability or economics of the NYISO markets.

The Motion #3 allocation methodology does not meet this standard of avoiding undue reliability impacts or economic impacts on the NYISO markets. Rather, this

allocation methodology provides a clear incentive to market participants to alter their behavior in the marketplace for the sole purpose of avoiding the allocation of a particular remaining loss. In fact, NYISO Staff concur with LIPA and other market participants that the Motion #3 allocation methodology will create an incentive for market participants to favor bilateral transactions in order to avoid allocation of remaining losses.

Under the Motion #3 methodology, market participants offering a generating resource into the LBMP market and purchasing energy to serve load in the market would have both the sale of energy into the market and the purchase of energy from that market included in the allocation on a dollar volume basis. In contrast, a load and a generator scheduling a bilateral transaction would only have the cost of ancillary services, losses and congestion included in the allocation for that transaction with the overall dollar volume of the energy transaction excluded. Accordingly, the Motion #3 methodology could force entities such as LIPA to shift its generation from bidding into the LBMP market to scheduling bilateral transactions to minimize the risk exposure posed by this methodology. By design, such scheduling is likely to cause generators to be block-scheduled in a manner that reduces market efficiency. More importantly, combustion turbines that can provide 10-minute and 30-minute reserves may be block-scheduled to provide energy through bilateral transactions instead of providing reserves.

Since inception, great care has been given in the design of the NYISO markets to avoid structural bias toward either the bidding of load and resources directly into the NYISO's LBMP market or participation by means of a bilateral transaction. The methodology adopted under Motion #3, however, completely ignores this design principle and instead imposes a real and significant penalty on a market participant that

chooses to bid its load and resources directly into the LBMP market rather than scheduling a bilateral transaction. There is no reason to now implement a credit policy that effectively negates this principle of balance within the market design. It is especially troubling since there are many other allocation methodologies available that would not impose such a significant disincentive to participation in the LBMP market.

IV. The Proposed Methodology for Remaining Losses is Unnecessarily Discriminatory Toward Market Participants that Both Serve Loads and Have Significant Resources

The Motion #3 methodology also is discriminatory since it does not recognize the offsetting credit risk that exists for market participants that are both buyers and sellers into the NYISO markets. LIPA has long-term bilateral contracts for sufficient resources to meet its energy needs and currently bids the vast majority of both its resources and load into the LBMP market. Such selling to and purchasing from the NYISO market has a real and measurable netting effect on the credit risk of the NYISO. The remaining loss allocation methodology, however, adds purchases and sales together in its allocation and ignores the offsetting of risk. In doing so, the Motion #3 allocation methodology unfairly penalizes market participant that have significant generating resources as well as load that are bid into the NYISO's Day-Ahead Market—even though the participant's activity in the NYISO market has a measurable netting effect on the NYISO's credit risk.

V. The Motion #3 Methodology Also Discriminates Against Market Participants that Serve Load and Control Resources in Higher Cost Constrained Regions

Under Motion #3, the working capital and remaining losses methodology would change from a cost allocation on a MWH basis to a dollar revenue basis. This allocation methodology shift, however, increases the allocation of costs to market participants in higher priced constrained regions. As described in Section IV above, the Motion # 3

allocation methodology will not recognize offsetting risks by netting of purchases and sales but rather will add purchases and sales together. This approach further penalizes customers that transact business in higher power cost regions, regardless of whether the defaulting party transacts business in that region or a lower cost region. The overall effect of the shift to a dollar revenue basis coupled with no netting of purchases and sales, is that the methodology becomes unnecessarily punitive to market participants that both serve load and control significant resources in these higher priced regions.

The interaction of these effects in the Motion #3 methodology assigns costs to a market participant well beyond that market participant's justifiable share of risk. During development of the credit policy, NYISO staff performed calculations of LIPA's share during the month of May 2002. These calculations indicated that LIPA would assume 16% of any loss allocated under Motion #3 using May 2002 transactions. LIPA's net credit risk in May 2002 was less than half a million dollars on a total market volume basis of over 700 million dollars.¹ Under the Motion #3 methodology, LIPA would assume 16% of the loss risk for transactions that provided a net risk to the NYISO of less than two tenths of a percent! The magnitude of this effect is likely even greater since the NYISO evaluated a month (May 2002) in which Long Island prices tend to be closer to statewide averages. LIPA's own calculations indicate that its share of losses could be 25 to 35 percent during the summer months when there are greater upstate/downstate price differentials. Any entity assuming the loss risk of the magnitude mentioned above will have to consider the benefits of moving to a bilateral bidding structure that has the potential to reduce the loss risk by an order of magnitude or more.

¹ NYISO did not calculate a net volume. However it is reasonable to assume that a net volume calculation would probably result in net transactions volume of \$350 to \$500 million or more.

VI. Motion #3a Achieves the Modification of Credit Loss and Working Capital Allocation Methodologies in a Non-Discriminatory Manner

Over the course of several months, LIPA and other market participants have worked with NYISO Staff to develop an alternative allocation methodology for credit loss and working capital that would not favor bilateral transactions over LBMP transactions. On February 11, 2003, the BIC approved (with modification) a LIPA-proposed allocation methodology attached to this appeal as Attachment A which would fairly and efficiently allocate the risk of remaining losses. In supporting the BIC's adoption of LIPA's proposal, the NYISO market design staff concurred that the proposal would not contain a bias in favor of bilateral over LBMP transactions. The LIPA proposal, as modified and approved by the BIC was presented to the Management Committee as Motion #3a.²

There are 2 primary components to LIPA's Motion #3a allocation methodology— (1) the allocation of the cost of working capital and (2) the allocation of the remaining loss. First, working capital allocations are changed from the dollar volume approach used in Motion #3 to the same formula as Rate Schedule 1 charges for NYISO fixed budget expenditures (i.e. 85/15%). During the consideration of the allocation methodologies for remaining loss and working capital, a number of parties noted that remaining losses and working capital costs have different purposes in the NYISO markets and that the allocation of such costs should not be blindly married. In particular, it was noted that working capital is a customer deposit meant to provide cash flow to the

² As a matter of clarification, LIPA's proposal of Motion #3a was not intended as support for the modification of the existing credit loss and working capital allocation. As noted in Section II, LIPA believes that benefits of modifying the existing load ratio share allocation methodology are outweighed by the flaws in the present approach adopted under Motion # 3. However, in the event that the NYISO Board determines that a modification to the allocation methodology is required, LIPA's Motion #3a addresses the most critical failings of the methodology approved under Motion #3 by eliminating the inherent bias towards bilateral transactions and providing for separate treatment of the working capital allocation.

NYISO to meet its financial obligations whereas remaining losses are an after-the fact allocation of costs associated with participant defaults. As a result of these discussions, the NYISO staff in its straw proposal to the Scheduling and Pricing Working Group changed its proposal to have separate treatment of working capital costs as opposed to remaining loss allocations. Consequently, Motion #3a adopts the same adjustment.

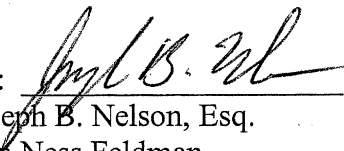
The remaining losses allocation contained in Motion #3a is based on an energy-weighted approach. Remaining losses would be allocated 50% to energy injections and 50% to energy withdrawals. The energy withdrawal allocation would be based on a zonal price adjusted MWH basis for each customer's energy withdrawals over the total for the NYISO market. The energy injection portion of the methodology would not be price adjusted and would be allocated based on a customer's energy injections over the total energy injections for the NYISO market. Since both injections and withdrawals are assessed based on an energy volume basis, both bilaterals and transactions that participate in the NYISO market would be treated equally. This approach was developed in conjunction with discussions between both generators and loads and was based on a general agreement that the energy-weighted approach was a superior methodology to the allocation proposed under Motion #3.

VI. Recommendation

LIPA respectfully requests that the NYISO Board of Directors reject the NYISO Management Committee's adoption of Motion #3 and retain the existing allocation methodology for remaining losses and working capital funding. In the alternative, LIPA respectfully requests that the NYISO Board of Directors direct the adoption of Motion #3a as the basis for the allocation of remaining losses and working capital funding.

Dated: March 6, 2003

Respectfully Submitted,

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ATTACHMENT A

Working Capital and Credit Loss Allocations (Motion 3a)

Working Capital

Since working capital is a customer deposit used as a cash flow management tool by the NYISO, working capital assessments would be allocated on prospective calls made by the NYISO to augment the level of the working capital fund according to the formulas used for recovering NYISO fixed budget costs as allocated under Rate Schedule 1 (i.e. 85/15%).

Remaining Credit Loss Allocation

The remaining credit loss allocation would be allocated in total to loads and generators based on a fixed allocation of 50% to total energy withdrawals and 50% to total energy injections. Individual customers would be allocated their portion of these costs based on the following allocation methodologies:

Energy Withdrawal Allocation

50% of the remaining credit loss would be allocated to total energy withdrawals based on the following formula:

$$\% \text{ paid by customer} = \text{CAW}/\text{NYAW}$$

Where:

CAW = Price adjusted Withdrawals = The sum of the Customers Actual Energy Withdrawals for all Transactions to supply Load n the NYCA and hourly energy schedules for all Wheel Through and Exports in MWHs times the average DAM zonal LBMP of the applicable withdrawal zone(s) or proxy bus(es) during the month of loss.

NYAW = Price adjusted statewide Actual Withdrawals = The total of the NYISOs Actual Energy Withdrawals and hourly Energy schedules for all Wheel Throughs and Exports in MWHs times the average DAM zonal LBMP of the applicable withdrawal zone(s) or proxy bus(es) during the month of loss.

Energy Injection Allocation

50% of the remaining credit loss would be allocated to total energy injections based on the following formula:

$$\% \text{ paid by customer} = \text{CI}/\text{NYI}$$

Where:

CI = The sum of the Customers Actual Energy Injections for all Transactions to supply load n the NYCA and hourly energy schedules for all Imports in MWHs during the month of loss.

NYI = The total of the NYISOs Actual Energy Injections for all Transactions to supply load n the NYCA and hourly energy schedules for all Imports in MWHs during the month of loss.