NYISO Board of Directors Decision
On
Working Capital and Bad Debt Losses Allocation Appeal

INTRODUCTION AND BACKGROUND

On December 16, 2002, the Management Committee narrowly rejected, by a vote of 57.09%, a package of proposed tariff revisions including: (i) revised creditworthiness requirements and (ii) a revised methodology for allocating bad debt losses and working capital contributions among market participants. The proposed tariff revisions would allocate responsibility for bad debt losses and working capital contributions to both loads and suppliers based on each customer's gross volume of transactions in the NYISO-administered markets, as measured in dollars.[1] At its December 17, 2002 meeting, the Board of Directors instructed the NYISO to revisit the proposed bad debt loss and working capital provisions to consider criticisms the Long Island Power Authority ("LIPA") had raised. The Board also directed the NYISO management to file revisions to the NYISO tariffs with the Federal Energy Regulatory Commission ("FERC") under section 206 of the Federal Power Act ("FPA") to incorporate the creditworthiness requirements that had been presented to the Management Committee.

On February 20, 2003, the Management Committee reconsidered the entire package of proposed tariff revisions initially presented to it on December 16, 2002 and approved the revisions by a vote of 60.36%. At the same meeting, LIPA made a motion to amend the proposed package to incorporate alternate methodologies for allocating bad debt losses and working capital contributions. LIPA's motion failed with a vote of 30.00%.

On February 21, 2003, the NYISO filed revisions to its tariffs with FERC to incorporate the creditworthiness portions of the package that had been first rejected, then accepted by the Management Committee. As explained in the NYISO's filing, the Board filed those tariff revisions unilaterally pursuant to FPA section 206 because, although the Management Committee had approved the *entire package* of revisions that included the creditworthiness provisions, it had not approved the creditworthiness provisions standing alone. Similarly, while the Board of Directors had considered and directed the NYISO to file the creditworthiness provisions, it had not approved the bad debt loss and working capital provisions of the package. The NYISO stated in its filing that it would later present the bad debt loss and working capital provisions approved by the Management Committee to its Board of Directors and, if approved, would file additional revisions to its tariffs and request that the entire package of proposed revisions be treated as a consensus filing made pursuant to FPA section 205.

SUMMARY OF ARGUMENTS

APPELLANT'S POSITION:

LIPA appeals from the Management Committee's February 20, 2003, actions regarding the methodology for the allocation of bad debt losses and working capital contributions. LIPA argues that the NYISO should retain the existing allocation methodology which assigns responsibility for these costs entirely to loads on the basis of MWhs of energy purchases rather than adopting a "flawed proposal" that would allocate these costs to all customers on the basis of the dollar volume of each customer's participation in the NYISO-administered markets. If the NYISO determines that the current allocation methodology should be changed, LIPA appeals the Management Committee's rejection of LIPA's proposed alternative methodology.

LIPA argues that the dollar volume allocation methodology approved by the Management Committee would create a bias against participating in the LBMP markets and could force customers to retreat to bilateral transactions to reduce their exposure to potential bad debt loss allocations. Under the dollar volume allocation methodology, a customer buying or selling in the LBMP markets would have the price of its energy purchases attributed to it when determining its allocation of bad debt losses and working capital contributions. In contrast, a customer engaging in bilateral transactions, where the price of energy is not known to the NYISO, would only have the cost of ancillary services, losses, and congestion attributed to it. According to LIPA, the bias against LBMP market participation created by the dollar volume methodology "reduces market efficiency" and "impose[s] a real and significant penalty on a market participant that chooses to bid its load and resources into the LBMP market rather than schedule bilaterals." LIPA asserts that the dollar volume allocation methodology, therefore, conflicts with a fundamental NYISO market design principle that seeks 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."

LIPA argues further that the dollar volume allocation methodology discriminates against a customer that both serves load and has significant supply resourcesbecause it does not recognize the customer's offsetting credit risk. LIPA states that it bids a substantial amount of both load and supply into the LBMP markets and that this has a "real and measurable netting effect on the credit risk of the NYISO." Because the dollar volume allocation methodology adds purchases and sales together without any netting or offsetting, LIPA argues that this methodology "unfairly penalizes" customers that both serve both load and supply generation.

Finally, LIPA argues that the dollar volume allocation methodology discriminates against customers located in higher-cost regions because the price of energy in those areas would result in a greater allocation of costs per MWh of energy bought or sold than in lower costs areas.

LIPA's alternate proposal, which it urges the NYISO to adopt in the event that it determines a change to the current allocation methodology is necessary, would apply a different formula for allocating bad debt losses and working capital contributions. LIPA proposes splitting the allocation of bad debt losses evenly among loads and suppliers according to MWhs of withdrawal or injection. LIPA further proposes that working capital contributions be allocated according to the same split currently applied to the NYISO's budgeted operating costs (i.e. 85% to loads and 15% to suppliers). LIPA argues that its alternative is preferable for the allocation of bad debt losses because it would treat bilateral and LBMP transactions equally.

MOTIONS IN OPPOSITION:

Joint Movants: Multiple Intervenors, the City of Jamestown Board of Public Utilities, and the New York Consumer Protection Board (collectively "Joint Movants") oppose LIPA's appeal.

Joint Movants urge the Board of Directors to reject LIPA's alternate allocation methodology for bad debt losses and working capital contributions on the grounds that the Management Committee correctly considered and rejected LIPA's proposal. The approved dollar volume allocation methodology, according to Joint Movants, "correctly aligns the volume of a party's transactions with the NYISO with its credit risk and with the bad debt loss exposure as compared to other market participants." Joint Movants point out that LIPA's request that it be permitted to net its purchases and sales was carefully considered by the Credit Policy Working Group and rejected because, in effect, other customers would be subsidizing LIPA.

Joint Movants also challenge LIPA's argument that the dollar volume allocation methodology favors bilateral transactions. According to Joint Movants, "LIPA has it backwards" because parties in bilateral transactions already bear the costs of credit risk. Moreover, the Joint Movants state that "[f]or a party to threaten to pull out of the LBMP market because it claims to fear bad debt losses, ignores the advantages it receives by participating in the pooled market."

Joint Movants state that "no serious proposal to [assess bad debt losses only to loads] has been discussed at any working group or committee level since work on the new credit policy began over two years ago." Joint Movants also challenge LIPA's claim that loads are the sole beneficiaries of the NYISO's coverage of bad debt losses and working capital contributions stating that, "a good argument could be made" in favor of allocating 100% of the costs of bad debt and working capital contributions to the generators because "these mechanisms function as insurance that generators will be paid by the NYISO."

Finally, the Joint Movants request that the Board of Directors direct the NYISO Staff to amend the pending section 206 filing which covers only the credit requirements portion of the financial assurance policy and convert it into a section 205 filing comprised of the three-part package of revisions addressing creditworthiness, bad debt losses, and working capital. To this end, the Joint Movants emphasize that at the February 20, 2003, Management Committee meeting, after more than two years of discussions and work by the market participants, a three-part comprehensive financial assurance policy was approved with over 60% affirmative vote.

Con Ed: Consolidated Edison Company of New York ("Con Ed") also filed a motion in opposition to LIPA's appeal.

Con Ed argues, like the Joint Movants, that the continuation of the current rules regarding the allocation of bad debt losses would not be fair to loads. Con Ed asserts that "a good argument could be made" that working capital contributions and bad debt loss allocations "should go 100 percent to generators since these mechanisms function as insurance that generators and other suppliers will be paid by the NYISO."

Con Ed states that the section 206 creditworthiness filing, pending before FERC, should be converted into an FPA section 205 filing of the entire package of financial assurance measures approved by the Management Committee on February 20, 2003. Con Ed urges the Board to reject LIPA's appeal because the Management Committee approved the comprehensive financial assurance policy in its entirety with over 60% in favor.

Discussion

The Board has carefully reviewed all of the papers submitted in this matter and, for the reasons set forth below, declines to reverse the Management Committee's approval of a new method for allocating bad debt losses and working capital.

The Board spent much time considering LIPA's assertion that the dollar volume method would cause market participants to shift to the bilateral markets in order to avoid absorbing bad debt losses. We find LIPA's concerns that the dollar volume method would create a "bias" against the LBMP markets largely theoretical. Underlying LIPA's arguments are two assumptions that we find unpersuasive. First, LIPA seems to believe that the fear of absorbing a large bad debt loss would, by itself, be enough to cause market participants to flee the LBMP markets and engage instead in bilateral transactions. While the risk of absorbing part of a bad debt loss may play some role in how parties structure their transactions as between the LBMP and bilateral markets, it is only one of a number of factors that parties must consider. We note that the bilateral markets are not without significant risks (e.g., the risk of counter parties' default). By itself, the risk of absorbing some portion of a bad debt loss in the LBMP markets does not appear sufficient to create the "bias" toward bilateral markets that LIPA theorizes.

Second, LIPA appears to presume that market participants could somehow forecast when the LBMP markets would be forced to absorb bad debt losses and, in advance of those losses, restructure their transactions to participate in the bilateral markets. Despite the many well-publicized financial difficulties many market participants are experiencing, the NYISO markets have experienced few defaults. Moreover, even when a market participant appears financially healthy, a sudden bankruptcy may occur. Based upon recent history, therefore, we are skeptical that any market participant could accurately predict such losses and would, in response to that prediction, move into the bilateral markets as LIPA suggests.

Nevertheless, we will monitor the markets to determine whether the phenomenon LIPA predicts actually happens and, if adverse market or reliability consequences ensue, we will act quickly to address these issues.

We have considered the dollar volume method as an alternative to the existing bad debt and working capital allocation mechanism and do not find it unreasonable or discriminatory. In particular, we believe that it appropriately allocates some portion of bad debt loss and working capital costs to suppliers – a result that is consistent with this Board's view that *all* market participants should bear some portion of the NYISO's costs whether budgeted or otherwise.

We find it telling that no other market participant joined in LIPA's assertions that the dollar volume method would create a "bias" against the LBMP market; that it would "discriminate" against participants located in higher cost areas of the state; or that it is flawed because it fails to "net" sales against purchases for determining bad debt loss and working capital allocations.

Therefore, after two years of discussion, and Management Committee approval, we decline to reverse or modify the Management Committee's decision to adopt the entire package of financial assurance amendments, including the bad debt loss and working capital provisions at issue herein. We instruct NYISO Staff to file the working capital and bad debt loss amendments with the FERC a soon as practicable and to request that the Commission convert the pending FPA section 206 filing into a section 205 filing.

The appeal is denied.

June 17, 2003

[1] Under the existing provisions, these charges are allocated entirely to loads on the basis of each customer's load-ratio share, as measured in MWhs.