NEW YORK INDEPENDENT SYSTEM OPERATOR
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August 16, 2005

Honorable Magalie R. Salas
Secretary
Federal Energy Regulatory Commission
888 First Street, NE
Washington, DC 20426

New York Independent System Operator, Inc.'s
Report in Docket No. ER05-941-001 Regarding the
Use of the 97th Percentile for Virtual Transactions Credit Requirements

Dear Ms. Salas:

On May 5, 2005, the New York Independent System Operator, Inc. ("NYISO") filed, in part, to revise its Open Access Transmission Tariff ("OATT") and its Market Administration and Control Area Services Tariff ("Services Tariff") to reduce the amount of collateral required to participate in its Virtual Transactions market.[1] The NYISO proposed to reduce the basis for calculating collateral to four days from the seven days then required. On May 26, 2005, EPIC Merchant Energy LP ("EPIC") filed a Motion to Intervene and Protest ("EPIC Protest") arguing that four days of collateral was still excessive and that the use of the 97th percentile was unreasonable.[2] On June 10, 2005, the NYISO filed a Motion for Leave to Answer and Answer to EPIC's Protest ("NYISO Answer") discussing the workings of the Virtual Transactions market and the resulting need for four days of collateral.[3] On June 22, 2005, EPIC filed a Motion to Strike and Reply to NYISO's Answer wherein EPIC again contended, in part, that the 97th percentile reference price is unreasonable and results in an excessive collateral requirement.[4]

On July 1, 2005, the Commission issued an Order directing the NYISO to use two days in the formula for calculating the Virtual Transactions collateral requirement.[5] In addition, the July

[1] *NYISO Tariff Revisions to Allow an Additional Form of Collateral and Reduce the Collateral Required in the Virtual Transactions Market*; Docket No. ER05-941-000 (May 5, 2005) ("May 5th Filing"). Capitalized terms that are not otherwise defined herein shall have the meaning set forth in Article 1 of the NYISO's OATT and Article 2 of the Services Tariff as applicable.

[2] *Motion to Intervene and Protest of EPIC Merchant Energy LP*; Docket No. ER05-941-000 (May 26, 2005).

[3] *Motion for Leave to Answer and Answer of the New York Independent System Operator, Inc. to the "Protest" of EPIC Merchant Energy, LP;* Docket No. ER-05-941-000 (June 10, 2005).

[4] *Motion to Strike and Reply of EPIC Merchant Energy LP;* Docket No. ER05-941-000 (June 22, 2005).

[5] *New York Independent System Operator, Inc.*, 112 FERC ¶ 61,004 (2005) at P. 17 ("July 1 Order").

1 Order directed the NYISO to submit a compliance filing discussing the appropriateness of using a reference price based on a 97th percentile in calculating collateral requirements for the Virtual Transactions market. The Commission's July 1 Order did not address NYISO's Answer or EPIC's Motion to Strike and Reply to NYISO's Answer. The NYISO respectfully submits this filing in compliance with the Commission's July 1 Order.

I. Background

When the NYISO initially filed to implement the Virtual Transactions market, it expressed concerns, shared by many of its Market Participants, about potential financial volatility in the new market and the added risk to Market Participants as a whole. In response to those concerns, Market Participants approved an approach that used the 97th percentile to establish credit requirements for the Virtual Transactions market.[6] In doing so, Market Participants expressed their risk tolerance for losses that could potentially be socialized among Market Participants. The NYISO stated in its original filing that, "[T]he NYISO may propose further modifications to its permanent credit policies regarding Virtual Transactions after it gains more experience with this new market feature."[7] The NYISO's May 5th Filing, approved unanimously by stakeholders, did exactly that – it revised the collateral requirement by reducing it based on experience to date with the Virtual Transactions market. Market Participants, who ultimately will bear any bad debts suffered as a result of under-collateralization, did not act to modify the use of the 97th percentile at that time.

EPIC expressed concern that the 97th percentile is artificially high and results in the NYISO requiring excessive amounts of collateral. EPIC also suggested the 50th percentile is more appropriate. In the July 1 Order, the Commission directed the NYISO to submit a compliance filing "justifying the assumed market clearing price of 97 percent of the highest actual price experienced in the market for Virtual Transactions."[8] The NYISO analyzed data, as discussed below, based upon 12 months of actual bidding and clearing prices in the Virtual Transactions market to determine the amount of financial exposure that would have resulted if the Virtual Transactions collateral requirements were based upon the 50th percentile and two days.

II. NYISO's Analysis

The NYISO analyzed <u>actual</u> daily bids and clearing prices for the Virtual Transactions market over the period of January 1, 2004 through December 31, 2004 ("Study Period"). The

[6] The credit provisions of the NYISO's OATT and Services Tariff provide a formula which determines the amount of collateral required in order to participate in the Virtual Transactions market. The collateral required is equal to the product of : (i) the Mega-Watt-hours ("MWh") the customer has applied to be authorized to bid per day; (ii) a multiplier of a certain number of days (historically this was seven, but is currently two); and (iii) the highest differential between the Day-Ahead and Real-Time Energy prices in the New York Control Area at the 97th percentile over the previous ninety days.

[7] *New York Independent System Operator, Inc.'s Filing of Tariff Revisions to Implement Virtual Bidding*, Docket No. ER01-3009-000 (September 4, 2001); Filing Letter, footnote 5.

[8] July 1 Order, P. 17.

Study Period represents the most recent full year of data available, to capture the different price volatilities that exist during the summer, winter, and shoulder periods. The objective was to identify the number of occurrences where a Market Participant had a single-day loss that would have exhausted all of the Market Participant's collateral posted in the Virtual Transactions market if the required collateral amounts had been determined using the 50th percentile and two days.[9] Additionally, the analysis calculated the total dollar amount in excess of that collateral (*e.g.* obligations for which the NYISO would not have had collateral under the 50th percentile and two day analysis) that could have resulted in a bad debt. The analysis assumed that the Market Participant did not make payment for any amounts in excess of the Market Participant's collateral. Given the fact that a Market Participant has two days worth of virtual bids "in the pipeline" at any given point in time, the analysis then took whatever the results were of those two days and netted it against the one-day loss that exhausted all the collateral.

The following example helps illustrate the NYISO's analysis. Assume a Market Participant was required to provide $100,000 of collateral under the 50th percentile and two days formula. Further assume that on Monday the Market Participant entered a Day-Ahead bid to supply 10,000 MWh of electricity at $60 per MWh on Tuesday. Assume the Real-Time Market price cleared at $72 per MWh on Tuesday. The MP would have sustained a loss of $120,000 (*i.e.*, 10,000 MW times $12 per MWh price differential) which completely exhausted the $100,000 of posted collateral. The analysis would have flagged this situation as one "occurrence." In order to determine the total dollar amount at risk in excess of the Market Participant's posted collateral, the analysis would then look at the results of the two remaining days of bids "in the pipeline" and net that against the loss in the first day. To complete the example, assume that same MP had a loss of $180,000 on Wednesday and a gain of $50,000 on Thursday. The analysis would calculate the "risk amount over collateral" as $150,000 ($120,000 initial loss - $100,000 posted collateral - $180,000 Wednesday loss + $50,000 Thursday gain).

Using the criteria described above over the Study Period, the analysis flagged 36 occurrences where a one-day loss exhausted all of a Market Participant's collateral. Those 36 occurrences combined resulted in approximately $1.1 million of financial risk to Market Participants in excess of collateral posted. In other words, if the NYISO were only holding collateral based upon the 50th percentile and two days over the Study Period, the market would have been subject to a potential bad debt loss of over $1.1 million.[10] Running the same analysis using the 97th percentile and two days to determine the collateral amounts resulted in no such occurrences, and consequently, no financial risk in excess of collateral posted.

The NYISO's May 5th Filing, which proposed a reduction from seven to four days of collateral while leaving the 97th percentile untouched, passed by a unanimous vote of Market

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[9] Under this scenario, all bidding and clearing prices are actual; however, the NYISO substituted the collateral amounts that using the 50th percentile and two days would produce, as opposed to the 97th percentile and seven days that actually existed at the time. Additionally, the approach was liberal from a Market Participant's point of view that must post collateral because it did not identify days of consecutive losses that resulted in all of the collateral being exhausted.

[10] Before the NYISO would actually experience the full bad debt loss in this amount, all of the Market Participants would have had to: (i) failed to cure the exposure by posting more collateral and (ii) defeated any collection attempts by the NYISO for delinquent amounts.

Participants. If Market Participants were uncomfortable with using the 97th percentile, they could have changed it, but did not. Since that time, only one Market Participant has filed with the Commission to express dissatisfaction with the approach taken. While a reduction to the 50% percentile arguably may benefit a few, it would create a significant risk to the market as a whole.

EPIC's Protest attempts to minimize the unanimous stakeholder vote approving the May 5th Filing by stating that, "[t]he Commission has recognized the inherent limitations of the stakeholder process."[11] EPIC's Protest also quotes the Commission's order in a PJM docket that while the stakeholder process is given deference, "[i]t is incumbent for the ISOs and RTOs to include in their filings support for their proposals, including a full justification for their proposed credit or collateral provisions…"[12] The instant filing clearly demonstrates that the use of a credit requirement based on the 50th percentile and two days would have left Market Participants exposed to over $1.1 million of potential losses for 2004. The result of NYISO's analysis speaks for itself. While a single Market Participant may find the exposure created by the 50th percentile acceptable, it does not appear that the over 200 other market Participants agree. Moreover, without minimizing EPIC's concern, the NYISO does not view retention of the 97th percentile as an unreasonable barrier to entry.

Based on the July 1 Order, the NYISO is currently working through the stakeholder process of analyzing the feasibility of moving to a one-day Virtual Transactions collateral window with a report due to the Commission by December 28, 2005. The NYISO held meetings of the Credit Policy Task Force on July 15 and August 12, 2005 to discuss with Market Participants matters identified in the July 1 Order as well as additional ideas for potential improvements to the Virtual Transactions collateral requirement. In addition to the efforts discussed above, the NYISO proposes to study the full year of 2005 data, which contains very volatile summer weather patterns, and to include the results of that study in the December 28, 2005 report along with any other improvement ideas the stakeholder process yields.

III. Conclusion

WHEREFORE, for the foregoing reasons, the New York Independent System Operator, Inc. respectfully requests that the Commission accept this compliance filing and not order any changes in the Virtual Transactions credit requirements at this time.

Respectfully submitted,

/s/ Andrew S. Antinori
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Andrew S. Antinori, Senior Attorney
New York Independent System Operator, Inc.
290 Washington Avenue Extension

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[11] EPIC's Protest at page 11.

[12] *Id.*, referring to PJM Interconnections, LLC, 104 FERC ¶61,309 at P. 19 (2003).

Albany, New York 12203

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

New York Independent System Operator, Inc.) Docket No. ER05-941-001

NOTICE OF FILING
(August __, 2005)

Take notice that on August 16, 2005, the New York Independent System Operator, Inc. ("NYISO") submitted a filing in compliance with the Commission's July 1, 2005 order in the above-captioned proceeding. That compliance filing addressed the NYISO's use of the 97th percentile in calculating collateral requirements for its Virtual Transactions market. The NYISO states that it has served the official service list compiled by the Secretary in this proceeding. In addition, the NYISO has electronically served a copy of this filing on the official representative of each of its customers, on each participant in its stakeholder committees, on the New York State Public Service Commission, and on the electric utility regulatory agencies of New Jersey and Pennsylvania.

Any person desiring to intervene or to protest this filing must file in accordance with Rules 211 and 214 of the Commission's Rules of Practice and Procedure (18 CFR 385.211 and 385.214). Protests will be considered by the Commission in determining the appropriate action to be taken, but will not serve to make protestants parties to the proceeding. Any person wishing to become a party must file a notice of intervention or motion to intervene, as appropriate. Such notices, motions, or protests must be filed on or before the comment date. Anyone filing a motion to intervene or protest must serve a copy of that document on the Applicant. On or before the comment date, it is not necessary to serve motions to intervene or protests on persons other than the Applicant.

The Commission encourages electronic submission of protests and interventions in lieu of paper using the "eFiling" link at http://www.ferc.gov. Persons unable to file electronically should submit an original and 14 copies of the protest or intervention to the Federal Energy Regulatory Commission, 888 First Street, N.E., Washington, D.C. 20426.

This filing is accessible on-line at http://www.ferc.gov, using the "eLibrary" link and is available for review in the Commission's Public Reference Room in Washington, D.C. There is an "eSubscription" link on the web site that enables subscribers to receive email notification when a document is added to a subscribed docket(s). For assistance with any FERC Online service, please email FERCOnlineSupport@ferc.gov, or call (866) 208-3676 (toll free). For TTY, call (202) 502-8659.

Comment Date: 5:00 pm Eastern Time on _____________

Magalie R. Salas
Secretary

CERTIFICATE OF SERVICE

I hereby certify that I have on this day served the foregoing document on the official service list compiled by the Secretary in this proceeding. I have also electronically served this document on the official representative of each of its customers, on each participant in its stakeholder committees, on the New York State Public Service Commission, and on the electric utility regulatory agencies of New Jersey and Pennsylvania.

Dated at Albany, New York this 16th day of August, 2005.

/s/ Andrew S. Antinori
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