

MARCH 18, 2003

**NYISO BOARD OF DIRECTORS DECISION
ON
APPEALS OF THE MANAGEMENT COMMITTEE VOTE
ON THE PROPOSED INSTALLED CAPACITY DEMAND CURVE**

Eleven parties (collectively, the “Appellants”)¹ appeal from the Management Committee’s (“MC’s”) February 13, 2003 vote to implement the Installed Capacity demand curve. Seven parties (collectively, the “Appellees”)² have filed Motions in Opposition to those appeals.

Initially, Appellants challenge a procedural ruling by the MC Chair that prohibited four new Members of the MC from voting at the February 13 meeting. Appellants also challenge the substantive merits of the demand curve, arguing that the MC’s decision should be overturned because (i) the demand curve proposal is inconsistent with a competitive bid-based market; (ii) there is no proof that the demand curve will result in new generation in New York State; (iii) the demand curve has not been adequately justified in relation to its cost; (iv) the demand curve is inconsistent with the Standard Market Design (“SMD”) proposed by FERC and the ICAP markets of neighboring control areas; and (v) the NYISO’s Market Monitoring Unit has not indicated that it can detect market manipulation under the demand curve. A consolidated appeal filed by the City of New York and CPA suggests, in the alternative, that the demand curve be effective for only one year while alternatives are considered by the Resource Adequacy Model (“RAM”) Group. The Appellees challenge each of the arguments raised by the Appellants.

For the reasons set forth below, we deny the appeals, direct the NYISO to file the proposed demand curve with FERC under Section 205 of the Federal Power Act, and recommend that the By-Laws and Governance Subcommittee of the MC develop an amendment to the Committee By-Laws explicitly addressing the issue of processing new members and defining when they are qualified to vote at NYISO meetings.

Analysis and Decision

After careful review of the documents submitted by the parties, we decline to overturn the decision of the Management Committee to approve the demand curve. The demand curve is one

¹ The Appellants are: New York State Electric & Gas Corporation (“NYSEG”), Rochester Gas & Electric Corporation (“RG&E”), Strategic Energy, L.L.C., the City of New York, Consumer Power Advocates (“CPA”), Multiple Intervenors, Strategic Power Management, Inc., Agway Energy Services, Inc., ECONenergy Energy Company, Inc., Mirabito Gas & Electric, Inc., and Select Energy, Inc. Consolidated Edison Company of New York, Inc. and Morgan Stanley Capital Group Inc. filed Motions in Support of the appeals.

² The Appellees are: New York State Consumer Protection Board, Independent Power Producers of New York, Inc., Keyspan-Ravenswood, L.L.C., New York State Public Service Commission (“PSC”), AES NY, L.L.C., Mirant Corporation, and Sithe Energy Marketing, L.P.

measure intended to cope partially with the current economic environment in which financing of new facilities has essentially dried up and investors do not see a reasonably reliable stream of revenues to justify investment in New York generating facilities. The Management Committee believes that the current markets can be improved in this respect.

New York is already approaching a serious deficiency in capacity.³ While New York is not alone in this situation, and is working in the “RAM” group with surrounding control areas toward uniform solutions, the rate of capacity additions in New York has not been satisfactory, and both the Board and the Management Committee believe that an expedited adjustment to the ICAP market is appropriate. We believe that the demand curve is a step in the direction of sending more appropriate signals to potential investors. Meanwhile, New York will continue to work with adjoining control areas towards a regional approach.

Procedural Challenges. Several Appellants contend that the February 13, 2003 special MC meeting should not have been scheduled until at least ten days after the BIC February 11 meeting, to allow for the ten-day period for filing appeals from BIC actions. They also challenge the Chair’s procedural ruling that effectively prohibited four new Members from voting at the February 13 meeting.

We cannot find that the MC Chair acted improperly or outside his discretion under Section 4.02 of the MC By-Laws. There are no provisions in the ISO Agreement or the MC By-Laws that circumscribe the proximity of an MC meeting to a BIC meeting. The timing of the MC meeting is within the discretion of the MC Chair. Although the meeting took place prior to the expiration of the ten-day period for filing appeals, Members were not deprived due process. They were free to make the same arguments at the special MC meeting to the same people, for or against the proposal, that would have been made if the discussion were addressed as an appeal to the MC.

Just prior to the special MC meeting, the ISO experienced a flurry of new members seeking to join and vote on the demand curve.⁴ The Chairman of the MC ruled that these eleventh hour members should not be allowed to vote, since they joined the ISO after the demand curve issue was placed on the MC agenda. We need not decide the correctness of his finding, since, as provided below, we find that a contrary finding would not have changed the outcome of the vote.

Under Section 2.02 of the MC by-laws, the new members, none of whom were natural persons, were required to designate their representatives seven days in advance, and two of them failed to

³ The reliability impact of a capacity shortage is of special concern in New York. We are not willing to allow reliability to be jeopardized, particularly in New York City, where blackouts have potentially catastrophic consequences.

⁴ Four new participants joined the NYISO after the special MC meeting was scheduled: Agway Energy Services, Inc., ECONergy Energy Company, Inc., Mirabito Gas & Electric, Inc. and Fortistar/Lockport Energy Associates, L.P. While Appellants correctly point out that Agway and Fortistar/Lockport were permitted to vote at the February 11 BIC meeting, that is not dispositive because no Member challenged their voting at the BIC.

do so.⁵ If the votes of the two new members who designated their representatives in a timely manner had been counted, the demand curve measure would still have passed. Moreover, no Appellant availed itself of the administrative challenge to the Chair's ruling available at the meeting under Section 4.03 of the MC By-Laws; had they done so, a vote on the procedural ruling would have been taken at the MC meeting, and would have decided this issue. We thus cannot find any impropriety in the MC's authorization of the demand curve filing. We are also instructing our staff and counsel to assist market participants in preparing such amendments to the MC by-laws as are necessary to avoid confusion in the future.

Substantive Challenges. The demand curve proposal, initially introduced by the PSC at the May 21, 2002 ICAP Working Group ("ICAPWG") meeting, is the result of nearly a year of discussion and negotiation. A group of Market Participants refined a demand curve proposal rejected on December 13, 2002 by the BIC; the revised proposal passed at the February 11 BIC meeting, and at the special MC meeting on February 13. The Independent Market Advisor, Dr. David Patton, participated in discussions at various points in the process and presented an analysis of costs at the BIC and MC meetings where the proposed demand curve was considered.

We believe that the demand curve proposal has been sufficiently analyzed and is justified as a measure to preserve system reliability and foster market efficiency. The purposes of the demand curve are (1) to enhance system and resource reliability by valuing the ICAP available above the New York State Reliability Council ("NYSRC") requirements and (2) to promote greater stability in the ICAP market, resulting in a more effective economic signal for new investment.⁶ While Dr. Patton has estimated that in the first year, the proposed demand curve may result in increased capacity revenues to generators, those estimates necessarily overestimate the true costs to consumers because they do not recognize the short and intermediate-term capacity contracts that would protect customers from price increases in the short-run. Moreover, if additional capacity comes into existence it will increase competition and exert downward price pressure in the energy markets.⁷

Dr. Patton has explained that these short-term costs are transitional and will be eliminated over time as the market moves toward a long-run equilibrium. Once this equilibrium level is achieved with the demand curve, it is Dr. Patton's view that consumers are likely to realize significant savings relative to the long-run equilibrium capacity level under the current capacity market

⁵ Section 2.02, MC By-laws: "A member of the Management Committee may designate any person to represent the member...by seven days advance written notice...." "A member that is not a natural person *must* be represented by a representative...." Emphasis added.

⁶ The current process creates what amounts to a vertical demand curve, resulting in a value for capacity that is either very great or almost nothing. Both the new and the old processes are subject to being termed "administratively determined," since the ICAP market is created by the tariff. Our independent market advisor believes that the new demand curve will send more appropriate signals to potential investors than the older system it will replace.

⁷ The Board also considered studies done by other economists on both sides of the issue.

system. Both the PSC and the State Consumer Protection Board support the approval of the demand curve.

Appellants raised concerns about the potential for market manipulation under the demand curve. The NYISO Staff monitors all qualified resources. Any qualified resource that does not bid is subject to review by Market Monitoring and instances of potential withholding will be reviewed. In addition, Dr. Patton advises that the proposed demand curve will discourage withholding because under the proposed demand curve an ICAP Supplier or a Market Participant with excess supply would not be able to drive the price to a deficiency level by withholding, as is theoretically possible now with the vertical demand curve. Therefore, we refuse to grant the appeals on this basis.

NYSEG and RG&E argue, without citing to any supporting authority, that the “NYISO does not have the statutory or contractual authority to order LSEs to buy more capacity than the level needed to satisfy the NYSRC’s reserve requirement.” The provisions of the ISO Agreement and the NYISO/New York State Reliability Council Agreement address the NYISO’s responsibilities with respect to Installed Capacity, at most suggesting that the NYISO’s implementation of Installed Capacity requirements must be consistent with the NYSRC’s establishment of a minimum statewide obligation. Those provisions do not limit the NYISO’s discretion.

Appellants also contend that the new demand curve will result in unacceptable increases in the cost of electricity that will be reflected in retail markets. While our chief concern is the efficient functioning of the wholesale markets we are charged to administer, we note that our market advisor has reviewed the rate impact of the changes, and we do not find it excessive. What is most important is that it will send better price signals to investors without imposing a severe burden on consumers.

We also reject Appellants’ contention that the demand curve proposal is not consistent with FERC’s SMD or discussions held by the RAM Group. The NYISO, together with PJM and ISO-NE, established the RAM Group (formerly known as the Joint Capacity Adequacy Group) in late 2001 to harmonize the resource adequacy market rules in the Northeast. In joint comments, dated January 10, 2003, the three ISOs indicated they will work through the RAM Group during the coming year to develop the key market design elements for the central resource market -- “including . . . the possible use of a demand curve for price determination.” After a thorough review under their respective stakeholder procedures, the ISOs plan to seek approval in 2004 for implementation of a new resource adequacy procurement mechanism in their respective regions. The first forward auction under that new mechanism would likely be for the capability year beginning in either 2006 or 2007 -- as long as four years from now. If the RAM process determines to implement a demand curve, the fact that the NYISO may have chosen to implement a demand curve previously will simplify the transition to the new process for New York market participants. If the RAM process should adopt another auction mechanism, there will be ample time for the NYISO to transition to that mechanism.

The appeals are denied.