A Partnership Including
Professional Corporations
28 State Street
Boston, MA 02109-1775
617-535-4000
Facsimile 617-535-3800
www.mwe.com

Boston
Chicago
London
Los Angeles
Miami
Moscow
New York
Orange County
Silicon Valley
Vilnius
Washington, D.C.

MCDERMOTT, WILL & EMERY

March 7, 2003

BY ELECTRONIC MAIL, FACISIMILE AND FEDERAL EXPRESS

Richard J. Grossi
Chairman
c/o William J. Museler
President and Chief Executive Officer
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303

Re: Motion in Support of the Appeals of the Management Committee's Decision to Approve the Demand Curve Proposal

Dear Chairman Grossi:

Morgan Stanley Capital Group Inc. hereby submits three copies of its Motion in Support of the Appeals of the Management Committee's Decision to Approve the Demand Curve Proposal.

A copy of the Motion in Support has been transmitted electronically to Kristen Kranz, with the request that, upon receipt, she serve it upon each member of the Management Committee.

Sincerely,

Aaron J. Bullwinkel

Aaron J. Bullwinkel

Attorney for Morgan Stanley Capital Group Inc.

AJB:lm

Enclosures

cc: Kristen Kranz (via electronic mail)

MOTION IN SUPPORT OF THE APPEALS OF THE MANAGEMENT COMMITTEE'S DECISION TO APPROVE MOTION #2, THE DEMAND CURVE PROPOSAL

I. PRELIMINARY STATEMENT

Morgan Stanley Capital Group Inc. hereby supports the appeals of the NYISO Management Committee's February 13, 2003 decision to approve Motion #2, the Demand Curve Proposal. MSCG requests that the Board of Directors of NYISO reject the Demand Curve Proposal due significant concerns regarding the negative effects of the implementation of the Demand Curve Proposal, as well as procedural concerns regarding certain voting irregularities that undercut the validity of the decision of the Management Committee. As the arguments with respect to procedural concerns of the voting irregularities have been adequately discussed in the Notices of Appeal filed in this matter, MSCG will not address this issue in its Motion.

II. ARGUMENT

The implementation of the Demand Curve Proposal represents a significant modification to the existing bid-based NYCA Installed Capacity market. With the imposition of the proposed Demand Curve Proposal, NYISO will effectively impose an administratively determined price floor in the NYCA ICAP market. MSCG contends that such an action by NYISO demands a thorough and comprehensive investigation of the expected costs and benefits. The Management Committee was not presented with such an analysis and, as such, numerous concerns with the proposal have not been satisfied.

A. A similar measure to the Demand Curve Proposal implemented in the United Kingdom in 1990 was not successful.

Throughout the current debate over the Demand Curve Proposal, no information concerning the imposition of a similar system in the United Kingdom has been presented or considered. Specifically, in the England and Wales Power Pool as instituted in 1990, there was a capacity component similar to that proposed for New York. This component was calculated by each half-hour and added to each half-hourly pool energy price. It consisted of a constant value known as the Value of Lost Load (VOLL) which was set by regulatory fiat that was then multiplied by a model-based, computed Loss of Load Probability (LOLP). The model estimated LOLP based on prevailing reserves. This is clearly analogous to the New York proposal whereby a model allocates a set ICAP cost to the hourly price based on prevailing reserves. MSCG was an active participant in the England and Wales Power Pool. In its experience, few participants were prepared to trade this capacity component, yet it was a very volatile component of the total price experienced by suppliers and consumers. As a result, participants were unable to effectively hedge their exposures. This was a serious issue and contributed to a perception of pool failure and the eventual complete restructuring of 1999. Certainly, the unsuccessful experience on the similar system should be examined and investigated prior to imposing the Demand Curve Proposal in the NYCA.

B. NYISO has failed to demonstrate that the implementation of the Demand Curve Proposal will promote desired generation.

Proponents of the implementation of the Demand Curve Proposal argue that it will increase reliability in the NYCA system. It is argued that ensuring a certain level of ICAP prices for generators will motivate the creation or continuation of generation in the NYCA.

Thus, reliability will be enhanced. However, in advocating for the Demand Curve Proposal, the proponents have failed to demonstrate that higher prices in the ICAP market are necessary to promote and retain generation.[1] While higher prices will result in greater ICAP revenues for generators, the link between this increase in revenues and the promotion of generation (new and existing) in the NYCA has not been demonstrated.

The proposed measure will be extremely imprecise, and thus, inefficient and costly method of encouraging additional generation needed to increase reliability in NYCA. As noted above, the main argument for the Proposed Demand Curve is to increase reliability by increasing the amount of the generation at the time it is needed. Even the strongest proponents of the measure would not deny that the only time that extra capacity is needed in NYCA is at the time of the highest peak loads. At all other times, the need for additional generation has not been demonstrated. Therefore, the logical measure would be to encourage the addition of peak generation in the areas of concern. However, as the proposal calls for an indiscriminant subsidy to all generation types independent of their ability to address the reliability needs, it is not an effective method of achieving its goals.

The proposal also fails to adequately address the locational aspect of reliability. The proposal to have three ICAP zones is again too imprecise and inefficient to encourage generation at locations that most adequately address reliability needs. In addition to promoting higher costs to obtain an adequate increase in generation, this measure will result in significant ratepayer cross-subsidies from areas with sufficient generation to the areas with generation deficiency. The size of the overinvestment stemming from the

[1] In fact, NYISO fails to consider that generators do not rely solely on revenues from ICAP markets, but also from other sources, such as energy and ancillary service markets.

imprecise nature of the measure and the social and economic aspects of arising cross-subsidies were not studied and presented to the board.

C. The Demand Curve Proposal is contrary to the promotion of market efficiency and has not been demonstrated to be an improvement over the current system.

The implementation of the Demand Curve Proposal is an impediment to the operation of a freely competitive Energy market.[2] Instead of promoting market principles in the NYCA Energy market, the NYISO will impose an administratively determined demand curve to regulate market activity. As noted by the City of New York and Consumer Power Advocates in its appeal, the imposition of the Demand Curve Proposal is antithetical to the underlying goal of the creation of the NYISO, namely "to encourage the influence of *competitive forces* in the wholesale electricity market, while providing consumer with a manageable transition to a new market form." [Emphasis added.][3] Instead of promoting the desired competitive forces in the market, NYISO would exercise regulatory control over an essential component of the market, the demand curve. This action would represent a step-back toward regulated markets in the NYISO.

Moreover, the proponents of the Demand Curve Proposal have failed to demonstrate that its imposition would be an improvement over the current market based system. In fact, any claim that the imposition of the Demand Curve Proposal would more efficiently promote generation than peak energy pricing has not been substantiated. In light of recent modifications to the energy markets in order to improve the accuracy of energy market pricing in the NYCA, the proponents of the Demand Curve Proposal should

---

[2] Included in the mission statement of NYISO's 2002 Business Plan is the goal of "the development and rapid evolution of efficient and non-discriminatory competitive power markets."
[3] *Notice of Appeal by the City of New York and Consumer Power Advocates of the Management Committee's Decision with Respect to the Demand Curve Proposal* (February 27, 2003).

demonstrate that it is necessary to implement the proposal to achieve the stated reliability goal. Again, such an analysis has not been provided and considered by the Management Committee.

D. The Demand Curve Proposal will result in increased cost to ratepayers.

In addition to failing to attract and retain desired generation, the Demand Curve Proposal will impose significant costs upon NYCA ratepayers. As noted above, the Demand Curve Proposal is nothing more than an administratively imposed subsidy to generators. Unfortunately, the ratepayers will ultimately bear the burden of this subsidy. While the materials presented to the Management Committee significantly vary as to the exact amount that the imposition of this proposal will cost ratepayers, the ratepayers will certainly experience an increased burden as a result of this action. Prior to implementing a significant modification to the NYCA ICAP market, NYISO should undertake a comprehensive cost analysis to fully understand the ramifications on the ratepayers of this action. In addition, prior to imposing significant costs upon ratepayers, NYISO should be confident that the benefits from the system modification merit such costs. As NYISO has not been provided with a sufficient cost-benefit analysis with regard to this proposal, the Board should reject the imposition of the Demand Curve Proposal its completion and review.

III. CONCLUSION

As noted above, the imposition of the Demand Curve Proposal represents a significant modification of the NYCA ICAP market and is contrary to the promotion of free and competitive markets. The implementation of a substantially similar measure in the UK power market was unsuccessful. The costs of such a proposal should be fully investigated and the benefits of such a proposal should be clearly demonstrated prior to its imposition. Importantly, MSCG has identified significant costs associated with this proposal, but has failed to identify the corresponding benefits. Accordingly, the Board of Directors of NYISO should reject the implementation of the Demand Curve Proposal approved by the Management Committee on February 13, 2003.

For these reasons, Morgan Stanley Capital Group Inc. respectfully requests that the Board of Directors reject the Demand Curve Proposal approved by the Management Committee on February 13, 2003.

Dated: March 7, 2003

Respectfully submitted,

Aaron J. Bullwinkel

Doron F. Erickson
Aaron J. Bullwinkel
McDermott, Will & Emery
28 State Street
Boston, MA 02109
(617) 535-4000
Attorneys for Morgan Stanley Capital Group Inc.