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July 25, 2002

VIA OVERNIGHT MAIL AND FAX
Richard J. Grossi
Chairman
New York Independent System Operator
3890 Carman Road
Schenectady, NY 12303

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

Re: Notice of Appeal of the Management Committee's Decision

Dear Chairman Grossi:

Pursuant to the "Procedural Rules for Appeals to the ISO Board," Select Energy, Inc., on behalf of Select Energy New York, Inc. ("Select Energy"), respectfully submits three copies of an appeal of the Management Committee's decision at its July 11, 2002 meeting to deny Select Energy's motion to defer for a short period of time the implementation of modeling changes to the Day-Ahead Market that affects the calculation of locational marginal prices in New York City.

A copy of this appeal has been electronically transmitted to Kristen Kranz who has agreed to serve it on the members of the Management Committee.

Sincerely,

David B. Raskin
Attorney for Select Energy, Inc.
and Select Energy New York, Inc.

Appeal by Select Energy, Inc.
of Management Committee Decision

Select Energy, Inc., on behalf of Select Energy New York, Inc. ("Select Energy"), hereby appeals the decision of the Management Committee ("MC") to deny Select Energy's motion to defer for a short period of time implementation of modeling changes to the Day-Ahead Market ("DAM") that affect the calculation of LMPs inside New York City, in order to provide a reasonable opportunity for the ISO and market participants to review the effect of such modeling changes on TCCs sold to parties prior to the implementation of such modeling changes.[1]

I. Summary

Select Energy's motion was designed to provide an opportunity for the MC and the NYISO to adequately review the impacts of a NYISO operating decision affecting TCC values that was never approved by the MC and was implemented unilaterally by the ISO without consideration of the impacts on congestion and pre-existing TCCs. Select Energy was attempting to create a vehicle for this matter to be aired fully for the first time and to avoid potential litigation.

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[1] At the July 11, 2002 Management Committee meeting, Select Energy made the following Motion, which was rejected by the Management Committee:

"1. The model changes made to the DAM that were made effective June 19, 2002 should be removed until April 30, 2003.

2. Engage in a process to review alternatives regarding the current 5-year TCCs sold under mistaken assumptions, which will include a review of any implementation timeline for reinstating the DAM model changes. These reviews should be completed prior to April 30, 2003."

The ISO's modeling change for the DAM, while referenced in the NYISO's March 20, 2002 filing with FERC to implement new market power mitigation measures, was *not* required to implement those mitigation measures or any other FERC requirement and should have been considered independently. Moreover, the NYISO did not study the impacts of this change in advance, as it should have, and did not provide sufficient information to market participants to enable them to evaluate it before it was implemented. To the limited extent that the ISO provided relevant information, it was incomplete and in one significant instance inaccurate.

When the modeling changes at issue were implemented on June 19, 2002, this had an enormous impact on the value of In-City TCCs. The ISO never disclosed to Select Energy that this impact would occur. Select Energy presumes that the ISO did not anticipate these changes and was as surprised as Select Energy was that the new modeling so significantly changed the pattern of congestion inside New York City. As things now stand, Select Energy reasonably believed it was purchasing one TCC product and now has been left with a different product with a significantly different (and less favorable) value, because the ISO changed the rules of the game.

In considering this matter, the ISO Board should not be affected by the vote of the MC. This modeling change adversely affects a small number of MC members that own In-City TCCs, and therefore it should be no surprise that most of the MC was not interested in re-opening this matter. However, fundamental fairness requires that the interests of those market participants who were directly affected be addressed in circumstances where the ISO made a unilateral change to the market without considering its potential impact on parties that purchased TCCs in good faith.

II. Relevant History:

On several occasions beginning with the fall 2000 TCC auction, Select Energy[2] has acquired TCCs within Zone J, New York City ("In-City TCCs"). These purchases were made based on Select Energy's analysis of congestion from then available data, which Select Energy used to estimate the value of TCCs it was considering purchasing. Select Energy considers it a fundamental proposition that a market participant considering the purchase of TCCs be able to rely on data made available by the ISO regarding historical congestion patterns (which flow from ISO's contemporaneous modeling assumptions), in order to evaluate whether and how to participate in the TCC auctions and/or to buy TCCs bilaterally from others. Otherwise, the TCC market is little more than a crapshoot, and neither the ISO nor market participants will ever have reason to believe that this market will create efficient or fair outcomes.

Prior to June of this year, the ISO's congestion management software modeled New York City as one zone (Zone J) and within that zone modeled one 138kV load pocket. The ISO did not model LMPs for congestion beyond that represented by the single 138kV load pocket, and any required redispatch of individual generators within this load pocket did not show up as LMP price differences and therefore did not impact on the value of In-City TCCs. During this time

[2] References to Select Energy in this appeal include Niagara Mohawk Energy Marketing, Inc., which was acquired by Select Energy on December 1, 2001.

period, the NYISO did not have the contractual authority (or modeling capability in place) to accomplish LMP-based redispatch for the third level of New York City constraints known as the "sub-load pocket". For these seven sub-load pockets, congestion was managed using out-of-merit generation notifications by Con Edison, the local transmission owner.

This level of ISO operational authority, modeling and congestion management within New York City produced congestion values that did not include the effect of constraints within the seven sub-load pockets. In order to evaluate the potential value of TCCs at the time, a market participant such as Select Energy would have reviewed these historical congestion levels (which flow from the contemporaneous ISO modeling assumptions) and based its purchasing decisions on them.

During the second half of 2001, the NYISO began considering changes to the way the system is operated in New York City, in order to bring the level of ISO operational control in New York City into relative conformity with the level of control that the ISO has over the rest of the New York transmission grid. This included potential changes to the way in which congestion is managed in New York City. The ISO presented proposals to the Business Issues Committee ("BIC") to assume operational control over the remaining transmission facilities in New York City, and to model the third level sub-load pockets in New York City so that resulting congestion could be included in the LMP-based system redispatch.

Significantly, these changes in operations and system modeling would only affect the value of TCCs if the ISO chose to apply these new modeling assumptions to the calculation of congestion prices in the Day Ahead Market ("DAM"), where congestion is cleared. It was *not* necessary, however, for the ISO to make this change in the DAM modeling in order to effectuate its broadening of operating control over transmission within New York City as directed by FERC or to eliminate the need for Con Edison to make "out of merit" designations to alleviate real-time security concerns and reduce real-time uplift costs. These changes required the ISO to change its operations and congestion management practices solely in real-time markets. The ISO has justified its decision to change its modeling in the DAM based on the desire for uniformity and consistency in modeling between real-time and the DAM. Select Energy does not disagree that achieving such consistency between the DAM and real-time markets is an appropriate objective, but wishes to emphasize that this was not an immediate necessity, was never ordered by FERC, and does not necessarily override other objectives, such as protecting the legitimate rights of prior TCC holders for a transition period.

During this time period (the second half of 2001), representatives of Select Energy asked the ISO's representatives on numerous occasions to provide more detailed information regarding the impact of modeling changes in the DAM on congestion and thus the value of previously sold TCCs. No analyses were ever performed by the ISO to the best of Select Energy's knowledge, and if they were the results were not shared with market participants. The ISO did not give market participants data and information that would have enabled them to conduct their own analyses of these changes. The ISO's position, reflecting concerns expressed by Con Edison, was that disclosure of one line diagram information, for example, raised physical security concerns in the post-September 11, 2001 environment and at a minimum would be subject to confidentiality protections.[3]

The ISO nonetheless proceeded on a path to change its operations and modeling as of November 2001. However, Con Edison apparently convinced the ISO that it should not make these operational and modeling changes without first considering the impact of the changes on the potential exercise of market power by in-city generators. Shortly thereafter, the ISO, under orders from FERC to file new market power mitigation measures, apparently agreed to defer implementation of these operational changes. Thus, the ISO was willing (as it should have been) to defer the implementation of its proposed operational and modeling changes at Con Edison's request in order to consider the impact on the potential exercise of market power and to coordinate these operational changes with its new FERC-ordered market power mitigation regime. However, it was not prepared to use this deferral to study the impact of these changes on the calculation of LMPs and the value of existing TCCs purchased by Select Energy and others, which also should have been done.

The ISO ultimately decided to make these changes in connection with its comprehensive new market mitigation plan, which was filed with FERC on March 20, 2002. In the market mitigation compliance filing, the ISO mentioned the modeling changes as part of its description that it was asserting operating authority over the in-city transmission system as the FERC had

[3] In the one instance where the ISO provided relevant information, the information provided was apparently incorrect. In August 2001, the ISO provided market participants with a one-line diagram showing the location of various generators in NYC relative to the 138kV load pocket. This one-line diagram appears to incorrectly placed the KIAC and Arthur Kill generating units on the wrong side of these load pockets, leading to a misanalysis of the situation.

previously ordered. It stated that, in connection with this change in operations, it had undertaken development of software modifications that would permit it to model load pockets inside New York City and manage congestion "using its normal least-cost dispatch methods." (Compliance Filing at 35). The changes were further described in an attached affidavit of Ricardo T. Gonzales, Manager of NYISO Market Operations. The filing went on to state that "no tariff changes are needed to implement the enhanced SCD modeling." (Id. at 37). In other words, the ISO did not request FERC's approval to make these changes. Nor did the ISO explicitly disclose to FERC that the operational and modeling changes included changes in the way the DAM would be cleared, which could significantly affect congestion charges and the value of pre-existing TCCs.[4] It is also worth pointing out that the ISO never obtained MC approval of this modeling change for the DAM before the filing. Select Energy believes that the ISO simply did not understand the impact of this change on TCCs previously sold under different assumptions because the matter had never been studied.

The ISO implemented these modeling changes in the DAM for June 19, 2002. Indeed, there was no compelling need to implement the DAM and real-time changes simultaneously as demonstrated by the fact that the ISO had implemented the real-time load pockets sixteen days earlier, on June 3, 2002. Immediately on June 19, the calculation of LMPs internal to New York City changed dramatically. The assumptions under which parties purchased TCCs in prior

[4] Mr. Gonzales' affidavit cryptically mentions, in Paragraph 8, that the ISO "also intends to add the modeling of the Sub Load Pockets to its SCUE and BME software coincident with the implementation of the SCD modeling described above. This will ensure consistent evaluation of the NYC transmission capability between the NYISO-administered Day-Ahead Market and Real-Time Market." This was the only indication in the filing that the ISO intended to change the way it administered the DAM.

auctions and bilateral transactions were simply rendered invalid. Select Energy had no basis to anticipate these significant changes in the congestion because it was never given the data to analyze the impact of the modeling change, and because the ISO, to the best of Select Energy's knowledge, never analyzed the situation itself.[5]

III. Request for Relief

Select Energy believes that the ISO has, through unilateral action, fundamentally changed the assumptions under which TCCs are calculated with the result that it has undermined the value of the TCCs that it sold and that were subsequently traded bilaterally in the market. Select Energy believes that a party which enters into a contract to sell a product or service (such as a TCC) has an obligation not to take later action that undermines the value of what it has sold, thereby frustrating the commercial purpose of the contract for the buyer. The fact that the ISO may not have understood the effect of what it did is not an excuse, because the ISO had the capability to evaluate the situation in advance and because it was not necessary for the ISO to make the changes in modeling for the DAM immediately effective in order to satisfy FERC's mandate to assume operating control over the New York City system.

For these reasons, Select Energy asked that the MC defer implementation of the modeling changes to the DAM for approximately nine months so that the parties may study the impacts of this change on the market, including existing TCCs holders. This was a modest request for relief that merely asked the ISO and the applicable market committees to do something that should

[5] Select Energy presumes that, if the ISO had performed its own analyses, it would have provided the results to market participants. If the ISO studied the change and then failed to disclose the results, that would be a serious matter.

have been done earlier in the normal course of business. It was also an attempt to avoid litigation over this matter and provide an opportunity for the parties to consider a fair resolution of any remaining disagreements. Select Energy urges the ISO Board to reverse the MC's precipitous decision to reject this fair and reasonable proposal.

Respectfully submitted,

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