UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
Nora Mead Brownell, Joseph T. Kelliher,
and Suedeen G. Kelly.

ISO New England, Inc. Docket No. ER04-121-000

ORDER ADDRESSING ISSUES RAISED AT TECHNICAL CONFERENCE

(Issued March 25, 2004)

1. In an order issued in this proceeding on December 30, 2003, we established a technical conference to address certain cost allocation issues raised in connection with the calendar year 2004 administrative costs tariff submitted for filing by ISO New England Inc. (ISO-NE).[1] These issues included, among others, the impact of ISO-NE's proposed cost allocation methodology on virtual trading activity in the New England energy markets. The technical conference was convened on January 23, 2004, after which the parties submitted comments and reply comments addressing the issues in dispute.

2. For the reasons discussed below, we will require ISO-NE to revise its as-filed rates on a prospective basis to incorporate the three-tiered rate design methodology outlined by ISO-NE in its comments. This rate design, while requiring virtual traders to make a fair and reasonable contribution to the fixed costs incurred by ISO-NE, will also acknowledge the unique role played by virtual traders in these markets.

Background

3. On October 31, 2003, ISO-NE submitted for filing revised tariff sheets to collect its administrative costs for calendar year 2004. In it filing, ISO-NE proposed, among other things, to modify the rate design reflected in its Schedule 2 (Energy Administration

---

[1] ISO New England, Inc. 105 FERC ¶ 61,397 (2003) (December 30 Order).

Services) charge.[2] ISO-NE proposed to include as billing determinants, in calculating its Schedule 2 charges, transactions occurring in its recently implemented day-ahead market, including transactions related to virtual trading.[3]

4. ISO-NE proposed to allocate its Schedule 2 costs based, in part, on its proposed application (and continued use) of a Settlement Agreement rate design previously approved by the Commission.[4] ISO-NE explained that under the Settlement Agreement, 15 percent of its Schedule 2 revenue requirement is collected based on a customer's Transaction Units (TUs) in the energy market, i.e., based on the number and duration of transactions to which the customer is a party (the TU charge), while the remaining 85 percent of these Schedule 2 costs are collected based on two volumetric measures (VMs) (calculated in MWh).[5] Thus, in its filing, ISO-NE proposed to use this currently-effective Schedule 2 rate design as modified by the inclusion of additional billing determinants attributable to participant activity occurring in the ISO-NE day-ahead market.

5. Epic Merchant Energy, Inc. (Epic), formerly Outback Power Marketing, Inc., and SESCO Enterprises L.L.C. (SESCO) (collectively, Financial Marketers) protested ISO-NE's filing. In their joint protest, Financial Marketers asserted that ISO-NE's proposed TU charge, as applied to the day-ahead market, would have the effect of shifting an onerous and disproportionate share of ISO-NE's system costs to virtual traders, whose participation in these markets would be deterred, if not precluded altogether, as a result. Financial Marketers also stated that the allocation of these

[2] ISO-NE's annual revenue requirement is currently recovered under three cost recovery schedules: Schedule 1, relating to transmission expenses, Schedule 2, relating to ISO-NE's administration of the New England energy markets (the costs at issue here), and Schedule 3, relating to reliability matters.

[3] ISO-NE's day-ahead market was implemented on March 1, 2003 in conjunction with ISO-NE's Standard Market Design proposal approved by the Commission in New England Power Pool and ISO New England Inc., 100 FERC ¶ 61,287 (NE-SMD Order), order on reh'g, 101 FERC ¶ 61,344 (2002).

[4] See New England Power Pool, 96 FERC ¶ 61,261 (2001). The Settlement Agreement expired by its terms on December 31, 2003 but the NEPOOL Participants Committee unanimously approved an extension of the Settlement Agreement through December 31, 2004. The Commission approved that extension in a letter order dated September 29, 2003 in Docket No. ER03-1181-000.

[5] These volumetric measures consist of: (i) a Monthly Real-Time Load Obligation; and (ii) a Monthly Real-Time Generation Obligation (collectively, the VM charge).

proposed charges to the day-ahead market had not been adequately supported or otherwise justified by ISO-NE.

6. In the December 30 Order, we held that the issues raised by Financial Marketers would be best addressed in a technical conference. Accordingly, we accepted and suspended ISO-NE's filing, to become effective January 1, 2004, subject to refund and subject to our further orders in this proceeding. We also directed Commission Staff to convene a technical conference to obtain additional information about the concerns and issues raised by the Financial Marketers in their protest.

Issues Set for Technical Conference

7. In a notice issued by the Commission on January 16, 2004, the parties to the technical conference were invited to address four issues, consistent with our ruling in the December 30 Order. First, the parties were invited to address the impact of ISO-NE's filing and proposed cost allocation on participants engaged in financial or virtual trading activities. Second, the parties were invited to address the underlying costs and benefits attributable to these transactions. Third, the parties were invited to address the cost/benefit differences as between higher-volume financial marketers/traders and other, lower-volume financial marketers. Finally, the parties were invited to consider possible alternatives to the cost allocation methodology reflected in ISO-NE's filing.

8. Following the technical conference, the parties were further invited, in a notice issued January 30, 2004, to address the following three issues in their comments and reply comments, namely (i) full refund relief versus prospective relief, in the event that ISO-NE's as-filed rates are required to be revised; (ii) the maximum per-bid charge for financial marketers/traders that would, if approved, provide an appropriate cost contribution in this case, while not resulting in theses entities' exit from the market; and (iii) whether the cost allocation settlement, as extended to December 2004, permits a change in the 85/15 percent division of costs as between the VM charge and the TU charge, without a Mobile-Sierra public interest finding.

Comments and Reply Comments

9. Post-technical conference comments were submitted by ISO-NE, Financial Marketers, the New England Power Pool Participants Committee (NEPOOL), Braintree Electric Light Department[6] (Braintree, et al.), DC Energy, LLC (DC Energy), the Massachusetts Municipal Wholesale Electric Company (MMWEC), Dominion

---

[6] Joined by Reading Municipal Light Department and Taunton Municipal Lighting Plant.

Resources, Inc.[7] (Dominion), USGen New England, Inc. (USGenNE), and Vermont Public Power Supply Authority (VPPSA). Reply comments were submitted by ISO-NE, Financial Marketers, MMWEC, and USGenNE. These comments and reply comments are summarized below as they relate to each issue set for the technical conference. MMWEC, NEPOOL, Braintree et al., USGenNE, and VPPSA generally agree with ISO-NE's position on the issues addressed in the comments.

Impact on Financial Traders

10. ISO-NE states that because its proposed cost allocation has been in effect for only a short period of time (i.e., since January 1, 2004), it cannot assess the long-range impact this rate design may have on financial traders. ISO-NE points out, however, that based on its analysis of volume and MW-based virtual bidding statistics for the period from March 1, 2003 (its implementation date of the day ahead market) through January 31, 2004, there has been a significant increase in both the volume and MWs of submitted decrement bids (Decs)[8] beginning in early October 2003 and ending in mid-December 2003, which is two weeks before the new rate design went into effect. ISO-NE states that a relatively constant volume and MWs of submitted increment offers (Incs)[9] were submitted for the entire period, with relatively high levels in early and late January 2004. ISO-NE notes that in January 2004, some large virtual traders greatly reduced MWs and volumes of virtual bidding, while other virtual traders had activity levels that stayed the same or either slightly declined or increased. ISO-NE asserts that cold weather in mid-January and attendant volatile energy pricing may have dissuaded some traders from submitting virtual bids during this period.

11. Financial Marketers argue that ISO-NE's as-filed TU charge has caused most high volume financial trading (approximately 80 percent) to cease.[10] Financial Marketers assert that this decline in activity has led to reduced trading at many system nodes and to less liquidity in the market as a whole. Financial Marketers further assert that with the TU charge now in effect, ISO-NE's costs will likely be under-collected, based on the average bids per day reflected in the as-filed rate (55,000 bids) as compared to

---

[7] Joined by Dominion Energy Marketing, Inc. and Dominion Nuclear Connecticut, Inc.

[8] Decrement Bids are bids to purchase energy at a specified location in the day-ahead energy market (or virtual market) which is not associated with a physical load.

[9] Increment Offers are offers to sell energy at a specified location in the day-ahead energy market (or virtual market).

[10] Financial Marketers note in their reply comments that Epic has been required to reduce its bidding activity in the New England market by over 90 percent, while both Epic and SESCO have found it no longer economic to bid during almost 40 percent of all trading hours in New England.

January activity (5,000 to 6,000 bids). Financial Marketers assert that this decline in activity will lead to an under-recovery of ISO-NE's costs. Financial Marketers also point out that when ISO-NE under-collects its TU revenue requirement, the true-up mechanism in its tariff permits these costs to be recovered in the VM charge, i.e., that the alleged cost shifts ISO-NE seeks to avoid by subjecting virtual trades to its Schedule 2 charges will occur in any event if the virtual bidders are forced out of the market.

Costs and Benefits Attributable to Virtual Trading Activities

12. ISO-NE states that while price convergence has been evident as between its day-ahead and real time markets (and while, in theory, virtual trading would be expected to enhance price convergence), a causal link between this financial bidding activity and price convergence cannot be measured at this time. ISO-NE states that what is lacking is longer-term clearing price data and a more comprehensive analysis that would consider the other factors potentially driving price convergence.

13. Financial Marketers argue, to the contrary, that financial trading provides tangible and certifiable benefits to the New England markets, including price convergence, price discovery, liquidity, and trading options, without adding any appreciable costs.[11]

Cost/Benefit Differences Attributable to the Level of Trading Activity

14. ISO-NE states that it has not been able to measure the existing costs and benefits (relative to price convergence) as between higher-volume and lower-volume financial trading activities. However, ISO-NE states that in theory, a low volume participant would be capable of clearing a large amount of efficiency-enhancing trades, while conversely, a high volume participant may clear only a small amount of efficiency-enhancing trades. Financial Marketers, while not identifying any differences in costs and benefits as between higher volume and lower volume financial trading, argue that both provide important benefits to the New England market.

Cost Allocation Options

15. ISO-NE states that while it has calculated various cost allocation options as an alternative to the cost allocation methodology reflected in its as-filed rates (these options are discussed below), it continues to believe that the TU rate design reflected in its as-filed rates in this case is reasonable. ISO-NE states that this rate design is based in large part on the hard-fought settlement among all stakeholders in Docket No. ER01-316-000 and that the costs at issue then, as now, are fixed costs that are not susceptible to an

---

[11] See also DC Energy comments at 3-4.

allocation based on cost causation principles.[12] ISO-NE further points out that even if one assumes cost causation principles be applied in this case, it cannot be denied that virtual traders use and need the New England system. Specifically, ISO-NE asserts that if this full market infrastructure did not exist and was not available to the virtual traders, these market participants could not trade and thus could not generate their profits. As such, ISO-NE concludes that some level of cost contribution should be required from virtual traders and that the methodology it has proposed to collect these costs is reasonable because it treats all bidding activity the same for rate purposes, whether this activity is physical or virtual.

16. In the alternative, ISO-NE argues that even if a variation of the billing determinants formula reflected in its filing were required in this case (e.g., based on a cleared bids formula or other formula, as discussed below), the Commission should nonetheless preserve the 85-15 percent split in the collection of ISO-NE's Schedule 2 costs, as between the VM charge and the TU charge.[13]

17. With respect to cost allocation options, ISO-NE calculates four alternative approaches in its comments based on its as-filed cost requirements and for comparative purposes provides a weighted average rate reflecting its as-filed TU rate design, as calculated across ISO-NE's three existing rate blocks.[14] ISO-NE summarizes these four alternative options (and as-filed rate comparisons) as follows:[15]

- As-Filed Rate ($0.584): ISO-NE states that its as-filed rate, as represented by a single weighted average rate, is $0.584.

- Cleared Bids Only ($4.279): ISO-NE states that if it were to calculate its TU charge based on cleared bids only, the rate would increase significantly, from $0.584 to $4.279.

---

[12] See also Braintree, et al. comments at 3-4; NEPOOL comments at 5.

[13] Financial Marketers concur. See Financial Marketers reply comments at 2.

[14] Under ISO-NE's block rate structure, the TU charge, while not reflecting the size (MWhs) of any given transaction, nonetheless decreases as the number of transactions increase. Specifically, under the design reflected in ISO-NE's existing rate structure, these rate "blocks" consist of the following as-filed rates: (i) $0.64 (covering TUs from between 1-12,500); (ii) $0.58451 (covering TUs from 12,500 to 39,500); and (iii) $0.52 (covering TUs from 39,500 and above).

[15] It should be noted that the VM charge would not change in respect to these alternative TU options.

- Cleared Bids, As Modified ($1.231): ISO-NE states that a TU charge based on cleared bids plus submitted bilateral contract block hours and energy non-zero settlement hours would produce a TU charge of $1.231

- Three-Tiered Rate Design ($0.005/$0.06/$0.688): ISO-NE states that it has calculated a three-tiered rate design, which would distinguish between virtual activity and physical activity. Virtual traders would be required to pay a TU charge for each submitted "Inc" and "Dec" ($0.005) and would then be required to pay a second charge for each "Inc" and "Dec" that actually clears ($0.06). Physical traders, on the other hand, would be assessed a single charge of $0.688.

- Two-Tiered Rate Design ($0.06/$0.661): Finally, ISO-NE explains that it has a two-tiered rate design that would also distinguish between submitted bids and cleared bids. ISO-NE states that under this two-tiered rate design, a submitted "Inc" and "Dec" would be assessed a TU charge of $0.06, while submitted bilateral contract, demand bids, supply offers, and cleared "Inc" and "Dec" bids and non-zero spot market settlement hours would be assessed an additional charge of $0.661.

18. Financial Marketers state that because of the benefits attributable to virtual trading (discussed above) and the absence of any discernable costs associated with these activities, a zero bid charge is warranted in this case, based on an application of cost causation principles. DC Energy concurs, noting that it is not appropriate to allocate fixed system costs to virtual bids, because these fixed costs were incurred in order to match load and generation bids, not virtual bids.

19. Financial Marketers also note, however, that a low charge on all cleared "Incs" and "Decs" would keep financial traders in the New England market. Accordingly, Financial Marketers state that they would be prepared to accept, as a settlement position, a charge of $0.06 per MWh on all cleared Incs and Decs.[16] Similarly, DC Energy concludes that a fee applicable to virtual bidding may be appropriate in order to discourage frivolous bidding in the virtual market, i.e., to avoid the potential for an unlimited numbers of bids, which could ultimately burden the software capabilities of the system.

20. NEPOOL states that its members are in the best position to know how alternative cost allocation options under the ISO-NE Tariff might affect the overall level and type of market activity. NEPOOL adds that without a reasonable balance of market participant

[16] ISO-NE notes in its reply comments that this proposed charge would result in a corresponding weighted average TU charge of $0.689 applicable to submitted bilateral contracts, demand bids, supply offers and energy non-zero spot market settlement hours.

perspective and participation, the Commission would substantially increase the risk that it may order changes that might create other problems not expected or anticipated. Braintree, et al. asserts that because the costs at issue in this case are fixed costs and thus not susceptible to cost causation principles, it would be appropriate to refer this proceeding to settlement judge procedures.[17]

Refund Options

21. ISO-NE urges that any change in the TU rate design approved in this proceeding be made on a prospective basis only, given the fact that any refund obligation that might otherwise be imposed in this case would prohibit ISO-NE from recovering its full 2004 revenue requirement. ISO-NE notes that if it is ordered to pay refunds (without offsetting surcharges), it will be required to lay off operational, reliability and market personnel, and postpone needed improvements, because the reduction in its receipts due to the refund payments would not sustain the needing staffing levels throughout the year. In addition, ISO-NE states that if it is required to pay these refunds, under these circumstances, it would be in violation of a covenant included in all of ISO-NE's loan documents that requires ISO-NE, on a current fiscal (calendar) year basis, to fully collect its operating expenses.

22. Financial Marketers assert that any rate differential approved by the Commission should be implemented with full refund protection with interest from January 1, 2004, when the rates went into effect, until the date when either a new and lower rate is implemented or when Incs and Decs are excluded from the TU charge.

Cost Contribution Considerations as Balanced by the Goal of Encouraging Virtual Trading Activities

23. ISO-NE states that some contribution by financial marketers to the TU revenue requirement is appropriate in order to prevent these market participants from being a "free rider" relative to these costs. While ISO-NE states that it is unable to measure the point at which a TU charge would require a virtual trader to exit the system, it notes that the as-filed charge has not had this effect, given the fact that virtual traders continue to submit a significant number of Incs and Decs currently. As noted above, Financial Marketers state that they would be willing to pay $0.06 per MWh charge on all cleared Incs and Decs.

[17] In their reply comments, however, Financial Marketers state that settlement discussions would not be productive. Similarly, ISO-NE urges the Commission to promptly resolve this proceeding.

Mobile Sierra Considerations

24. Commenters agree that the Settlement Agreement approved by the Commission in Docket No. ER01-316-000 does not prohibit ISO-NE from filing a different rate design in this proceeding.

Discussion

Procedural Matters

25. Motions to intervene out-of-time were filed by Braintree, et al. (on January 22, 2004); Dominion; the Connecticut Municipal Electric Energy Cooperative (CMEEC); VPPSA; DC Energy (on February 9, 2004); PSEG Energy Resources & Trade LLC (PSEG); the Mirant Parties;[18] and by TransCanada Power Marketing Ltd (TransCanada) (on February 26, 2004). Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure,[19] these unopposed motions to intervene serve to make these entities parties to this proceeding.

Analysis

26. For the reasons discussed below, we will require ISO-NE to implement, on a prospective basis, its proposed three-tiered rate design methodology, as outlined in its comments, to recover its TU costs included in Schedule 2 of its tariff -- with a reasonable contribution to be made by the region's virtual traders participating in this market. The new rates will be effective April 1, 2004. The April 1, 2004 effective date will make it administratively easier for ISO-NE to implement these new rates since it is the beginning of the month and it will afford the Financial Marketers some relief from the currently effective rates.

27. At issue in this proceeding is the equitable allocation of ISO-NE's fixed costs relating to its administration of the New England energy market and, in particular, whether and to what extent these costs should be allocated to virtual traders. While the existence of virtual trading in this market raises a number of factual issues regarding the specific impact of this activity on the market, including questions relating to price convergence (which, as ISO-NE claims, may not be fully answerable at this time), the comments filed by the parties following the technical conference have narrowed the scope of these issues significantly as they relate to the instant proceeding.

---

[18] The Mirant Parties consist of Mirant Americas Energy Marketing, LP, Mirant New England, LLC, Mirant Canal, LLC, and Mirant Kendall, LLC.

[19] 18 C.F.R. § 385.214 (2003).

28. First, ISO-NE, Financial Marketers, and the majority of the other active participants agree, as do we, that ISO-NE's existing Schedule 2 rate design as it relates to the split of responsibility as between the TU charge and the VM charge (the 85/15 percentage split) need not and should not be reconfigured here. In fact, this aspect of ISO-NE's Schedule 2 rate design was the product of a settlement agreement that was broadly supported within the NEPOOL stakeholder process and previously approved by the Commission.

29. Second, the parties generally agree that it would be reasonable (or in the case of Financial Marketers, not unreasonable) to allocate at least some of the fixed costs reflected in the TU charge to virtual traders. The Financial Marketers, for example, acknowledge that a TU charge of $0.06 per MWh on all cleared Incs and Decs would not result in their exit from the market, while ISO-NE suggests that this survivability threshold may, in fact, be significantly higher.[20]

30. Accordingly, we will approve ISO-NE's calculation of a three-tiered rate design applicable to only these Schedule 2 TU costs as reasonable.[21] These rates, as noted above, will rely principally on the existence of cleared bids, as they relate to a virtual trader's Incs and Decs, on the same basis and in the same amount as proposed by Financial Marketers. In addition, this allocation will also assess a nominal charge ($0.005) on all Incs and Decs submitted by a virtual trader, which will discourage frivolous bidding and allow the virtual traders to pay their fair share of ISO-NE's expenses since they benefit from the existence of ISO-NE's market infrastructure. While the accommodation reflected in this allocation will necessarily raise the TU charge payable by all other market participants to whom this charge will be assessed (from $0.584 to $0.688), we believe this allocation is reasonable, here, given the benefits that virtual trading can bring to the marketplace as a whole, even if the precise quantification of these benefits may not be possible at this time, and the distinct possibility (based on the limited experience in this case), that a higher per-bid charge would reduce the bidding by virtual traders, with the reallocation of uncollected costs to the TU charge, in any event.[22]

---

[20] As noted above, ISO-NE states that since January 1, 2004 (when its as-filed rate went into effect, subject to refund), a significant number of Incs and Decs have been submitted.

[21] It should be noted that the three-tiered rate design is not the product of a settlement agreement between the parties.

[22] The per-bid charge, in theory, should be set at the rate that does not reduce the bidding of financial marketers to a level that decreases their contribution to overall cost recovery and consequently increases the allocation to other customers. While such a rate cannot be perfectly determined, the three-tiered proposal is a reasonable method of satisfying this goal.

31. Finally, we will require ISO-NE to make these revisions on a prospective basis only, given its legitimate needs regarding the full recovery of its current year costs. We will also require ISO-NE to file a report detailing the effect of virtual transactions on the energy markets it administers and whether or not virtual transactions have in fact led to price convergence between the real-time and day-ahead markets. This report must be filed along with ISO-NE's annual filing for approval of its 2005 administrative costs. Plus, the report must address whether virtual trading has led to price discovery, liquidity, and trading options, without adding any appreciable costs. Lastly, the report must address what other factors, if any, are potentially driving price convergence. ISO-NE's concern about the lack of long-term clearing price data should be alleviated since this report will be filed with ISO-NE's annual filing on or around November 1, 2004 and by that time ISO-NE will have almost a year and half of data (SMD began on March 1, 2003).

The Commission orders:

(A) We will accept ISO-NE's Schedule 2 costs, subject to the three-tiered rate design discussed in the body of this order, effective April 1, 2004.

(B) ISO-NE is hereby required to make a compliance filing within 30 days of the date of this order, reflecting its use of three-tiered rate design, as discussed in the body of this order.

(C) ISO-NE is hereby required to file a report along with its annual filing for approval of its 2005 administrative costs detailing the impact of virtual trading on the New England energy market.

By the Commission.

(S E A L)

Magalie R. Salas,
Secretary.