111 FERC ¶ 61,184

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. New England Power Pool	Docket Nos. ER05-767-000 ER05-767-001

ORDER ACCEPTING TARIFF AMENDMENTS

(Issued May 6, 2005)

1. On April 1, 2005, ISO New England Inc. with New England Power Pool Participants Committee (hereinafter, ISO-NE) jointly filed revised tariff sheets to restrict the use of market-based reference levels for units located in constrained areas that are needed to maintain reliability (April 1 Filing). Additionally, on April 15, 2005, ISO-NE submitted a Motion for Expedited Consideration of its April 1 Filing, a request for waiver of the 60-day notice requirement in section 205 of the Federal Power Act (FPA),[1] and a revised effective date for its April 1 Filing of one day after the issuance of the instant order (April 15 Filing).[2] In this order we will accept ISO-NE's proposed amendments and request for waiver, as discussed below. This order benefits the public by ensuring just and reasonable rates in transmission-constrained areas.

I. Background

2. In its April 1 Filing, ISO-NE proposed revisions to Market Rule 1[3] to rectify the recent problem of reference levels diverging significantly from marginal costs for certain non-competitive generation units that are frequently run out of economic merit to relieve

[1] 16 U.S.C. § 824d (2000).

[2] ISO-NE made the April 15 Filing pursuant to the Commission's *Guidance Order on Expedited Tariff Revisions for Regional Transmission Organizations and Independent System Operators*, 111 FERC ¶ 61,009 (2005).

[3] *See* Market Rule 1, Appendix A, Section III of the Transmission, Markets and Services Tariff, FERC Electric Tariff No. 3 (the Tariff).

transmission congestion.[4] ISO-NE believes that because in competitive markets a moving average of bids should reflect marginal costs, reference levels significantly above marginal costs represent an inefficient market outcome.

3. ISO-NE finds that the divergence of reference prices from marginal costs is due to the existing reference level methodology that allows certain resources to offer at levels that exceed their marginal costs. ISO-NE notes that it has observed this behavior from "resources located in load pockets that are frequently flagged as volt-ampere-reactive units (VAR), special constraint resource (SCR) or daily reliability-must-run (RMR) resources" and are committed by the ISO as "a reliability requirement." ISO-NE argues that these units rarely face competition, and, thus, have no incentive to submit bids approximating their marginal costs. ISO-NE notes that, occasionally, their above-cost bids are below the locational marginal price (LMP) (and, thus, in-merit), and such in-merit above-cost bids currently can be used to establish their reference prices. ISO-NE states that the consequence has been a sharp increase in uplift payments. In its April 15 Filing, ISO-NE asked for expedited action because ISO-NE claims that the problem had significantly worsened. ISO-NE states that previous monthly uplift payments averaged between $12 and $16 million, but are expected to reach $32 million for April 2005.

4. ISO-NE states that its market power mitigation rules currently provide three methods for establishing a generator's reference price: (1) the average of the generator's recent offers accepted in-merit, (2) the average of recent LMPs during the lowest-priced 25 percent of hours when the generator has operated, (3) an estimate of the generator's short run marginal costs.[5] In its April 1 Filing, ISO-NE proposes to remove the first and second methods for generators that run out-of-merit more than 50 percent of the time. ISO-NE states that this means that units that are often needed for reliability regardless of their bids (because they are flagged as VAR, SCR or daily RMR resources) will no

[4] According to ISO-NE's Market Rule 1, reference prices help ISO-NE to identify resources that may be exercising market power. When an actual supply offer significantly exceeds its reference price, an investigation is triggered that may result in mitigation.

[5] The Commission approved this approach to determining reference prices in its acceptance of the NEPOOL Standard Market Design, 100 FERC ¶ 61,287 (2002). *See* Tariff Section III Market Rule 1, Appendix A Section III A5.6.1(b)(i), (ii) and (iii).

longer receive reference prices based on their offers.[6] Instead, reference prices for these units will be calculated using method 3, whereby the ISO-NE estimates the generator's short run marginal costs based on a specific formula incorporating published spot-fuel prices, engineering-based heat rates, variable and operating maintenance costs and market-based emission costs.

5. ISO-NE states that this change will be applied prospectively only and it will not retroactively adjust reference levels. ISO-NE emphasizes that the proposed revisions do not modify the algorithm by which reference levels are calculated, but change the method for calculating references prices applied to units frequently run out of economic merit order. ISO-NE acknowledges that, in the short-run, the proposed change, which would reduce the level of uplift payments, could lead to an increase in the number of resources seeking long-term RMR contracts because the change would reduce uplift payments.

6. In its initial April 1 Filing, ISO-NE requested an effective date of June 1, 2005 for the proposed revisions. ISO-NE also requested that the Commission issue an order approving these revisions by May 16, 2005, to provide adequate notice to ISO-NE and stakeholders prior to implementation.

7. As mentioned, ISO-NE's April 15 Filing requested expedited action on the April 1 Filing, waiver from the Commission's notice requirement, and a revised effective date. ISO-NE requested expedited action because it states that the problem of reference levels diverging significantly from marginal costs has significantly worsened.

Notice of Filings, Interventions, Comments, and Protests

8. Notice of ISO-NE's April 1 Filing was published in the *Federal Register*, 70 Fed. Reg. 19,749 (2005), with protests due on or before April 22. Notice of ISO-NE's April 15 Filing was published in the *Federal Register*, 70 Fed. Reg. 22,020 (2005), with protests due on or before April 22. Northeast Utilities Service Company on behalf of the Northeast Utilities Operating Companies and Select Energy, Inc., Dominion Energy New England, Inc., and Dominion Energy Marketing, Inc. filed timely motions to intervene. DC Energy L.L.C. and NEPOOL Industrial Customer Coalition (NICC) filed timely motions to intervene and comments. NRG Power Marketing, Inc., Connecticut Jet Power

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[6] ISO-NE states that method 2 is not appropriate for resources that frequently run out of economic order and are flagged as VAR, SCR or Daily RMR Resources. This method is applied to resources that have self-scheduled during the previous 90 days and hence cannot have an offer-based reference level due to lack of data. For the resources at issue here, a reference level calculated using method 2 would likely be below marginal costs. A reference level that would systematically fall below marginal costs is inappropriate.

L.L.C., Somerset Power L.L.C. (collectively, NRG) and Boston Generating L.L.C. (Boston Generating) filed timely motions to intervene and protests.

II. Discussion

A. Procedural Matters

9. Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.214 (2004), the notices of intervention and timely, unopposed motions to intervene serve to make the entities that filed them parties to this proceeding.

B. Commission Acceptance

10. As discussed in detail below, we will accept the proposal of ISO-NE to end the use of market-based reference levels for units that run out-of-merit more than 50 percent of the time. The proposal will help avoid reference levels that significantly depart from marginal costs and will improve the New England energy markets. We will grant ISO-NE's request for waiver of 60-day notice requirement as this will avoid adverse financial impact on ratepayers.

C. Protests, Comments and Commission Responses

1. Undercompensation

11. NRG and Boston Generating protest the proposal to modify the eligibility for offer-based reference levels and request that the Commission reject ISO New England's proposal. Protestors state that this proposal is a piece-meal attempt to "cure" a perceived short-term problem with a long-term solution that will cause mid-term to long-term unacceptable consequences. NRG requests that the Commission require ISO-NE to analyze price formation in its market to identify the causes of uplift payments. NRG argues that the fundamental flaw of the ISO-NE market is not the determination of reference levels, but limitations that do not allow energy prices to rise to levels that reflect the cost of operating the system reliably. NRG maintains that if the market allowed the prices to rise to reflect the commitment of units needed for reliability, there would be very little uplift generated because the price in the market would equal the price of the unit dispatched.

12. Boston Generating claims that ISO-NE, in its Motion for Expedited Consideration, does not explain how the present availability of method (1) presents a long-term problem, even though ISO-NE proposes a permanent change that limits the availability of the method. Boston Generating adds that ISO-NE did not propose monitoring to ensure that

unintended consequences, such as the continued failure of generators that have not sought the protection of RMR contracts to earn just and reasonable compensation, will be monitored and, consequently, minimized.

13. Protestors add that the Commission has repeatedly said that generating projects located inside designated congestion areas, including the Boston/Northeast Massachusetts zone and Southwest Connecticut region, are not receiving just and reasonable compensation under ISO's existing market rules. According to the protestors, the Commission has recognized this under-recovery problem, and has taken steps to correct it through the implementation of a locational installed capacity (LICAP) and peaking unit safe harbor bidding. Both mechanisms are intended to increase opportunities for fixed-cost recovery and to produce signals for investment through higher LMPs in these areas during periods of scarcity.

14. Protestors argue that the same rationale should apply to units addressed in this current proceeding as well. Failure to allow units located in constrained areas to recover all their just and reasonable costs, according to protestors, will force more generators to request long-term RMR contracts. NRG and Boston Generating note that the Commission has gone on record recognizing that, while RMR contracts may be a necessity, they distort the markets and should be avoided unless no other options exist. Boston Generating and NRG also submit that any consideration of this proposed tariff amendment should be deferred until the proposed LICAP market is operational, just as the Commission recently did in *Con Edison Energy*.[7]

15. As a further alternative, NRG proposes that the Commission consider expanding the thresholds for mitigation rules in constrained areas to the lower of $100 or 300 percent above the reference level.[8] However, NRG notes that this proposal to increase the mitigation threshold has been considered by the ISO-NE Markets Committee, but received only 33 percent of the votes.

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[7] *Con Edison Energy, Inc. v. ISO New England, Inc. and New England Power Pool*, 111 FERC ¶ 61,001 at P 13 (2005). In this decision, the Commission declined to modify the zero-bid rule, which is essentially a measure for mitigating the potential for exercising market power through physical withholding of capacity.

[8] Currently, Market Rule 1 provides that if a transmission constraint causes a unit to be dispatched above the level it would have been dispatched absent the constraint, its supply offer will be investigated if it exceeds its corresponding reference value by the lesser of 50 percent or $25.

Commission Response

16. Although we agree with NRG and Boston Generating that cost under-recovery is a serious problem in ISO-NE that must be remedied, we do not agree that permitting generators with market power to intentionally bias their reference prices away from a competitive level is an appropriate response to the concern. The ability of ISO-NE to properly identify and mitigate market power relies critically on reference prices that reasonably reflect the offer that a generator would be expected to make under competitive conditions, which is its marginal cost. ISO-NE's bid-based reference levels are acceptable as long as the supplier has no ability or incentive to raise its offer significantly above its marginal costs. However, the circumstances identified by ISO-NE show that not to be the case for units commonly flagged as VAR, SCR, or RMR resources. These generators must commonly be dispatched for reliability reasons regardless of their bids.

17. Thus, we agree with ISO-NE that these generators have no incentive to bid competitively. When their bids are out-of-merit, the non-competitive offer translates into added uplift payments. Occasionally, market conditions increase energy prices sufficiently so that the LMP rises above their non-competitive offers, and the offers become in-merit. When their offers are in-merit under the existing market rules, the non-competitive offers are used to update their reference prices, thus increasing their future ability to exercise market power under the conduct and impact approach to mitigation. The remedy proposed by ISO-NE is to stop using accepted in-merit offers (method 1) to determine the reference prices of generators that are operated out-of-merit most of the time. Since these generators have no incentive to bid competitively, even during the occasional periods when their offers are accepted in-merit, we conclude that the remedy is reasonable.

18. We also agree with ISO-NE that it would not be reasonable to use the average of the LMPs during the lowest-priced hours when the generator was dispatched (method 2), because such prices would generally be lower than the generator's marginal cost. We agree that is reasonable to use an estimate of the generator's marginal costs based on an approved formula in ISO-NE's tariff (method 3) for calculating reference prices for units that do not run in-merit at least 50 percent of the time. Generators with market power should have no ability to influence their reference prices by bidding non-competitively. Reference prices determined by method 3 satisfy this objective because they are based on objective measures of cost and not on bidding behavior.

19. Competitively offered supply is fundamental to an efficient market for electricity, and we agree with protestors that generators needed for reliability should recover their costs from the markets. We have put in place a process for modifying the market rules by January 1, 2006 to achieve this objective, through a LICAP mechanism.[9] LICAP will

[9] *Devon Power L.L.C.*, 107 FERC ¶ 61,240 at P 32 (2004).

address the concerns raised by NRG and Boston Generating with respect to the long-term just and reasonable compensation for generators. Until LICAP is implemented, RMR contracts are available as an interim measure for generators needed for reliability that are receiving insufficient revenues in the market to keep the facilities in operation. Ultimately, cost recovery must be addressed by a properly designed capacity market mechanism and appropriate scarcity pricing during periods of operating reserve shortages, which ISO-NE has stated it intends to file for in the future.[10] We support and encourage ongoing market design enhancements that permit full cost recovery for generators needed for reliability in a manner consistent with competition. Permitting generators with market power to influence their reference prices is not an acceptable response to the cost recovery problem, even as a short-term measure. Thus, we do not agree that the proposed tariff amendments should be deferred.

20. Finally, we reject NRG's proposal to consider expanding the thresholds for mitigation in constrained areas as beyond the scope of this proceeding. The filing before us considers only the merits of using bid-based reference prices for a generator whose bidding behavior may bias its reference price above the competitive level. We are not reviewing other aspects of the conduct and impact approach to mitigation generally.

2. **Refunds**

21. NICC requests that the Commission direct the ISO-NE market monitor to calculate and report to the Commission the extent to which the market flaw has resulted in an over-collection of costs from customers since the inception of Market Rule 1, and whether customers should be entitled to refunds of the over-collected amounts.

Commission Response

22. We find NICC's request without merit because the rates charged by ISO-NE conformed to the Commission's applicable orders governing ISO-NE's reference levels, and were consistent with ISO-NE's then-effective tariffs, rate schedules and manuals. ISO-NE's proposal is an improvement to the existing energy markets that must be applied prospectively and will ensure that reference levels better track marginal costs as intended.

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[10] *See*, In the Matter of ISO New England, ER02-2330-29, *et al.*, Technical Conference, March 4, 2005, Transcript pp 79-80 and pp 128-134; and ISO New England, Ancillary Service Market Enhancements White Paper, May 6, 2004.

3. Request for Waiver of 60-Day Notice Requirement

23. ISO-NE submitted a request for waiver of the 60-day notice requirement in section 205 of the FPA.

Commission Response

24. The Commission finds that the uplift payment issue has provided the Commission with good reason to grant ISO-NE waiver of the 60-day prior notice requirement.[11]

The Commission orders:

A) ISO-NE's filing is hereby accepted effective one day after the issuance of the instant order, as discussed in the body of this order.

B) ISO-NE's request for waiver of the 60-day notice requirement is hereby accepted, as discussed in the body of this order.

C) ISO-NE and NEPOOL are hereby directed to file, within 30 days of the date of this order, corrected tariff sheets indicating a new effective date, as discussed in the body of this order.

By the Commission. Commissioner Kelliher dissenting with a separate statement attached.

(S E A L)

Linda Mitry,
Deputy Secretary.

[11] *Central Hudson Gas & Electric Corporation*, 60 FERC ¶ 61,106, *reh'g denied*, 61 FERC ¶ 61,089 (1992).

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(Issued May 6, 2005)

Joseph T. KELLIHER, Commissioner *dissenting*:

In this order, the Commission accepts ISO-NE's proposal to modify the methodology it uses to establish a generator's reference price by restricting the use of a market-based methodology in favor of a methodology based on a cost-based estimate of a generator's short-run marginal costs. As I previously indicated, in my view, authorizing an entity such as ISO-NE to establish reference prices constitutes an improper delegation of the Commission's ratemaking authority.[1]

Section 205 of the FPA vests exclusive authority with the Commission to set the rates and charges for wholesale electric sales of energy.[2] As described in ISO-NE's filing, reference prices, while perhaps not "rates" themselves, ultimately dictate the price that generators are paid in certain circumstances.[3] Moreover, while ISO-NE's methodology for establishing reference levels might appear to be somewhat "formulaic," it certainly does not appear to be a formula rate. As modified, the tariff authorizes ISO-NE in making its reference level "determination" to consider "such other factors as the ISO, in consultation with the Independent Market Advisor, shall reasonably determine to be appropriate based on such data supplied by the Market Participant or otherwise available to the ISO…."[4] Thus, in my view, the conclusion is inescapable that by authorizing the ISO-NE to establish reference prices, the ISO is performing a ratemaking function assigned to the Commission under the FPA.

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[1] *Midwest Independent Transmission System Operator, Inc.*, 109 FERC ¶ 61,285 at 62,402 (2004) (Kelliher, dissenting).

[2] 16 U.S.C. § 824d (2000).

[3] *See* Tariff § III.A.5.6.1.

[4] Tariff § III.A.5.6.1(b)(iii).

Under *U.S. Telecomm. Ass'n v. FCC,* [5] federal agencies such as the Commission cannot delegate their authority to outside entities--private or sovereign--absent an affirmative showing of congressional authorization.[6] The FPA contains no provision authorizing the Commission to delegate its ratemaking authority. Since ISO-NE is an outside party, the Commission cannot lawfully delegate its ratemaking authority by authorizing the ISO to establish reference prices. Accordingly, I dissent from the Commission's order.

Joseph T. Kelliher

[5] 359 F.3d 554 (D.C. Cir. 2004)
[6] *Id.* at 565-66.