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. ER05-439-000

ORDER ACCEPTING TARIFF REVISIONS FOR FILING

(Issued March 7, 2005)

1. On January 11, 2005, ISO New England Inc. (ISO-NE) submitted for filing, pursuant to section 205 of the Federal Power Act (FPA),[1] revisions to ISO-NE's Market Rule 1, concerning the allocation of Real-Time Reliability Must Run (RMR) Operating Reserve Charges (Real-Time RMR Charges). For the reasons discussed below, we will accept ISO-NE's proposed tariff revisions for filing, to become effective March 1, 2005, as requested. In doing so, we agree with ISO-NE that its revised allocation methodology will, among other things, encourage greater price convergence between ISO-NE's Day Ahead and Real-Time energy markets, while minimizing the associated inequities attributable to ISO-NE's currently-effective cost allocation methodology.

Background

2. The current need for, and use, of RMR reserves in the New England wholesale electricity markets, and the corresponding incurrence of RMR costs by the generation owners that provide these reserves, has been the subject of a number of orders previously

[1] 16 U.S.C. § 824d (2000).

issued by the Commission.[2] The many issues addressed in these orders need not be reviewed, here, in their entirety. Briefly stated, however, a Real-Time RMR cost is incurred when ISO-NE is required to dispatch a generating unit (an RMR Resource) on an "out of merit order" basis for the purpose of meeting certain system reliability requirements. Specifically, Real-Time RMR costs are incurred when additional, otherwise out-of-merit order Resources are needed by ISO-NE to provide a "second contingency" coverage in a specific Reliability Region.[3]

3. Today, virtually all of ISO-NE's Real-Time RMR costs are incurred in ISO-NE's two most constrained areas: Connecticut and Northeast Massachusetts (NEMA)/Boston. To meet the reliability needs of these regions, ISO-NE relies, in part, on its RMR Resources, which have been designated as such pursuant to agreements entered into between ISO-NE and the owners of the facilities seeking these RMR designations. Among other things, these RMR Agreements identify the costs to run and maintain the owner's unit during an RMR contingency.

4. The issue presented by ISO-NE's filing in this case is how the costs incurred under these RMR Agreements should be allocated to market participants. ISO-NE states that under its existing allocation methodology, Real-Time RMR Charges are allocated to participants based on a participant's Real-Time "deviations" in the local areas where ISO-NE's RMR Resources are located, *i.e.*, based on the extent to which a participant's Real-Time load and/or generation in these areas deviates from the Day-Ahead schedule (except for generation that deviates because it is following ISO-NE's dispatch instructions).

5. ISO-NE notes, however, that these Real-Time deviations represent only a small portion of the overall load (the Real-Time Load Obligation) in the local areas in which

[2] *See, e.g.,* Devon Power LLC, *et al*., 107 FERC ¶ 61,240 (Devon Power Order), *order on reh'g,* 109 FERC ¶ 61,154 (2004); Mirant Kendall, LLC, 109 FERC ¶ 61,227 (2004).

[3] Under the New England Power Pool (NEPOOL) Operating Procedures followed by ISO-NE, a Second Contingency Loss is defined as "the largest capability outage (in MW) that would result from the loss of a single element after allowing for the First Contingency Loss." A First Contingency Loss is defined as "the largest capability outage (in MW) that would result from the loss of a single element." *See* NEPOOL Operating Procedures at OP8 (Operating Reserve and Regulation).

these deviations occur. For example, ISO-NE states that in Connecticut, from March 2003 through December 2004, Real-Time deviations constituted only 8.5 percent of the Real-Time Load Obligation, while in NEMA-Boston, over that same period, Real-Time deviations represented only 3.6 percent of Real-Time Load Obligation.

6. ISO states that this allocation methodology should be revised because it fails to adhere to the Commission’s cost causation ratemaking principles, *i.e.*, because it fails to allocate the costs at issue to those who create the need for RMR Resources to be committed, or to those who benefit from the availability of these resources. ISO-NE asserts that, in fact, its current allocation methodology disproportionately burdens the small segment of its market to whom these charges apply and a single class of transactions, in particular, namely, virtual transactions.[4]

7. ISO-NE explains that under its existing allocation methodology, nearly all cleared virtual trades, by definition, result in Real-Time deviations, given the nature of the arbitrage opportunity that motivates these trades.[5] ISO-NE notes that given the occurrence of these deviations, the virtual trader is required to pay a Real-Time RMR Charge every time it clears a virtual trade, based on the MWhs associated with that trade. Specifically, ISO-NE states that a virtual trade is automatically settled as a deviation in Real-Time because there is no corresponding physical load or generation.

8. ISO-NE states that the Real-Time RMR Charges imposed on virtual bidders in recent months has had a severe impact on the willingness and ability of these entities to actively participant in ISO-NE’s markets. ISO-NE further asserts that without this arbitrage activity, the ability of its markets to achieve price convergence and other system benefits could be undermined.

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[4] Virtual transactions are financial instruments that create arbitrage opportunities based on the price differences between ISO-NE’s Day-Ahead and Real-Time markets. 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, *order on reh’g*, 101 FERC ¶ 61,344 (2002) (NE-SMD Rehearing Order).

[5] ISO-NE notes that the single exception to this rule would involve activity that would not even properly qualify as a virtual trade, *i.e.*, a transaction involving a decremental offer made at a demand node with associated underlying demand.

9. ISO-NE concludes that the high transaction costs currently being imposed on virtual traders, by way of Real-Time RMR Charges, are unwarranted and must be lowered. To accomplish this objective, ISO-NE proposes that Real-Time RMR Charges be allocated to a broader pool of market participants, *i.e.*, to Real-Time Load Obligations (expressed in MWh), as adjusted for any applicable bilateral transactions. ISO-NE asserts that this allocation methodology is appropriate because it is the forecast of Real-Time load (as well as the related reliability considerations for serving this load) that drive the need to dispatch RMR Resources. ISO-NE asserts that, consequently, its proposed allocation is fair and should be approved because it will better allocate Real-Time RMR Charges to those who currently create the need for Daily RMR Resources to be committed and who thus benefit from the availability of RMR Resources.

10. As a procedural matter, ISO-NE notes that its allocation proposal did not receive a two-thirds vote of support, within NEPOOL, necessary to a trigger a NEPOOL filing sponsoring ISO-NE's proposed revisions. However, ISO-NE states that it is authorized to seek these proposed tariff revisions pursuant to its authority under section 6.17(e) of the Interim ISO Agreement.[6] Finally, ISO-NE requests that its proposed tariff revisions be made effective March 1, 2005 and seeks waiver of the Commission's 60-day notice requirement.[7]

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[6] ISO-NE states that under this provision, ISO-NE has the authority to adopt emergency Market Rules and (as in this case) emergency modifications to existing Market Rules, if:

> [ISO-NE] determines in good faith that (i) the failure to immediately implement a new System Rule of Procedure or a modification to the existing System Rules or Procedures would substantially and adversely affect (A) System reliability or security, or (B) the competitiveness or efficiency of the NEPOOL Market, and (ii) invoking the rulemaking procedures of the relevant NEPOOL Committee would not allow for timely redress of [ISO-NE's] concerns, [ISO-NE] may promulgate and implement such new or modified System Rule or Procedure unilaterally upon written notice to the NEPOOL Executive Committee, subject to approval by the FERC, if required.

[7] *See* 18 C.F.R. § 35.3(a) (2004).

<u>Notice of Filing and Responsive Pleadings</u>

11. Notice of ISO-NE's filing was published in the *Federal Register*[8] with interventions and protests due on or before February 1, 2005. Motions to intervene and notices of intervention were timely filed by the Department of Telecommunications and Energy of the Commonwealth of Massachusetts; the Long Island Power Authority and its operating subsidiary, LIPA (collectively, LIPA); Epic Merchant Energy, L.P.[9] (Epic, *et al*.);Calpine Eastern Corporation and Calpine Energy Services, L.P. (collectively, Calpine); NEPOOL; National Grid USA (National Grid); DC Energy, LLC (DC Energy); Exelon Corporation (Exelon); Constellation Energy Commodities Group, Inc. (Constellation); Northeast Utilities Operating Companies and Select Energy, Inc. (collectively, Northeast Utilities, *et al*.); Dominion Retail, Inc. (Dominion Retail); Massachusetts Municipal Wholesale Electric Company[10] (Massachusetts Municipal, *et al*.); and TransCanada Power Marketing Ltd. (TransCanada).

12. In addition, motions to intervene out of time were filed by PSEG Energy Resources & Trade LLC (PSEG), on February 2, 2005, and by The United Illuminating Company (United Illuminating) on February 16, 2005.

13. Comments in support of ISO-NE's filing were submitted by DC Energy and Epic, *et al*. In addition, NEPOOL submitted comments in which it explains the NEPOOL stakeholder process that was undertaken in this case and ISO-NE's failure to obtain the 66.77 percent favorable vote necessary to have secured NEPOOL's endorsement of ISO-NE's filing.[11] NEPOOL submits that given ISO-NE's failure to garner this support, the Commission should only accept the filing in the event that it determines that its failure to accept the filing will substantially and adversely affect the competitiveness or efficiency of ISO-NE's markets.

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[8] 69 Fed. Reg. 5,945 (2005).

[9] Joined by SESCO Enterprises LLC and Black Oak Energy, LLC.

[10] Joined by Connecticut Municipal Electric Energy Cooperative, Connecticut Municipal Electric Energy Cooperative, Braintree Electric Light Department, Reading Municipal Light Department, and Taunton Municipal Lighting Plant.

[11] ISO-NE's proposal received a favorable vote of 63 percent.

14. Protests concerning ISO-NE's filing were filed by Massachusetts Municipal, *et al*., Dominion Retail, Constellation, Calpine, and PSEG. PSEG raises a threshold legal objection concerning the same filing rights issue raised by NEPOOL in its comments. PSEG asserts that, in fact, ISO-NE lacks the authority to make its filing under section 6.17(e) of the Interim ISO Agreement. PSEG argues that given ISO-NE's failure to demonstrate that any imminent harm will occur to its markets in the absence of its filing, the filing cannot be made under section 6.17(e) and should be rejected.

15. Intervenors also question the asserted need for ISO-NE's filing on the merits. Constellation, PSEG, Massachusetts Municipal, *et al*., and Dominion Retail argue, for example, that ISO-NE's proposed allocation of Real-Time RMR Charges has not been adequately studied or empirically supported. Dominion Retail points out that while ISO-NE first made its reallocation proposal before NEPOOL in February 2004, the New England markets have been functioning under the current conditions for some time. Constellation adds that, at a minimum, the Commission should defer ruling on ISO-NE's proposal, given the fact that supplemental commitment of Daily RMR Resources may decrease following the implementation of the Locational Installed Capacity market in January 2006.[12]

16. PSEG also questions the asserted detrimental impact of ISO-NE's existing level of Real-Time RMR Charges on virtual traders. While PSEG concedes that imposing costs on virtual transactions may reduce the number of these transactions, PSEG also notes that currently, virtual transactions at the level now being experienced in the New England markets, have already driven the Day-Ahead price down toward the Real-Time price. PSEG asserts that accordingly, the profit opportunities currently available to virtual traders is a function not of high transaction costs, but rather the lack of price divergence between Day-Ahead and Real-Time prices.

17. Intervenors also raise concerns regarding the effect of ISO-NE's proposed reallocation of Real-Time RMR Charges on those to whom these reallocated costs would be assessed. Specifically, Constellation argues that ISO-NE's reallocation proposal has the potential to adversely affect the Day-Ahead market and other forward contracting strategies in the New England wholesale power market. Constellation notes that under ISO-NE's proposal, all participants with Real-Time Load Obligations, including those that have fully or substantially covered their positions through forward contracting and

[12] *See* Devon Power Order, 107 FERC ¶ 61,240 at P 1.

the Day Ahead market, would be liable for payment of Real Time RMR charges. Constellation asserts that these additional transaction costs would diminish the incentives to engage in forward contracting and full participation in the NEPOOL Day Ahead market. In addition, Constellation submits that ISO-NE's proposed reallocation of these costs could disrupt the settled expectations of parties to long-term bilateral transactions.

18. Dominion Retail agrees, noting that ISO-NE's proposed reallocation would pass costs through to all Real-Time load, regardless of the extent to which parties covered their positions in the Day-Ahead market. Dominion Retail asserts that this policy is contrary to the Commission's previously stated policy that where a Load Serving Entity purchases enough energy in the Day-Ahead market to serve the needs of its loads, it will not be required to pay any additional Operating Reserve costs.[13]

19. Constellation, Calpine, Massachusetts Municipal, *et al.*, and PSEG also challenge ISO-NE's assertion that its proposed re-allocation of Real-Time RMR charges accurately reflects cost causation principles. Constellation argues that the primary cause of Daily RMR Resource commitment by ISO-NE is the failure of Day Ahead Market scheduling by generators, traders and load serving entities to match the real-time load forecast and meet reliability requirements of the physical system. Constellation argues that because of the correlation between under-scheduling in the Day Ahead market and supplemental commitment of Daily RMR Resources by ISO-NE, the Real-Time RMR Charges incurred as a result of these supplemental commitments are properly allocated to participants based on their Real-Time deviations.

20. PSEG asserts that virtual transactions in the Day Ahead market can have a direct impact on the need to commit RMR Resources either in the Real-Time or in the Day Ahead markets, such that cost causation principles would support the maintenance of the *status quo* allocation methodology. PSEG adds that it is the confluence of bids and offers into the Day Ahead market (both physical and virtual) that ultimately determines whether there is a need to commit these units, either in economic dispatch as part of the Day Ahead energy market, as Day-Ahead RMR operating reserve units, or as Real-Time RMR units.

21. PSEG and Calpine also assert that ISO-NE's propose reallocation will increase inefficient market behavior because market participants will not be given the incentive to

[13] Dominion Retail protest at 5, *citing* NE-SMD Rehearing Order at P 50. PSEG makes the same argument. *See* PSEG protest at 15.

balance their schedules consistent with their risk tolerance. PSEG asserts that this will reduce the incentive to cover load obligations in the Day-Ahead market and rely more on the Real-Time market – thus undermining the efficient operation of the New England's multi-settlement system. Calpine argues that ISO-NE's relocation, by muting price signals, will encourage underbidding in the Day Ahead market. Finally, Massachusetts Municipal, *et al*. argue that if the Commission does not simply reject ISO-NE's filing, it should convene an evidentiary hearing pursuant to section 206 of the FPA and direct the use of settlement judge procedures.

22. On February 8, 2005, Select Energy filed an answer in which it urges the Commission to reject ISO-NE's proposed effective date for its filing, pending further consideration of ISO-NE's proposal before NEPOOL's stakeholders. On February 16, 2005, National Grid filed an answer responding to the arguments raised by PSEG in its protest, and ISO-NE filed an answer reiterating the arguments set forth in the transmittal letter accompanying its filing.

Discussion

Procedural Matters

23. Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure,[14] the timely, unopposed motions to intervene and notices of intervention submitted by the entities noted above serve to make these entities party to this proceeding. We will also grant the motions to intervene out of time submitted by PSEG and United Illuminating. Given their stated interests, the early stage of this proceeding and the lack of undue prejudice or delay, good cause exists to permit both PSEG and United Illuminating to participate as parties.[15]

24. Rule 213(a) of the Commission's Rules of Practice and Procedure,[16] prohibits an answer to a protest, unless otherwise permitted by the decisional authority. We will accept the answers filed by Select Energy, National Grid, and ISO-NE. because they have assisted the Commission in our determination, as discussed below.

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[14] 18 C.F.R. § 385.214 (2004)

[15] *See* 18 C.F.R. § 385.214(d) (2004).

[16] *Id. at* § 385.213(a)(2).

Analysis

25. We will accept ISO-NE's filing, without modification or condition, and will grant waiver of the notice requirement to permit ISO-NE's proposed tariff revisions to become effective March 1, 2005, as requested.[17] First, we agree with ISO-NE that section 6.17(e) of the Interim ISO Agreement authorizes ISO-NE to make its filing unilaterally without obtaining the 66.67 percent favorable vote otherwise required from NEPOOL. Failure to implement the changes specified in ISO-NE's filing would substantially and adversely affect the competitiveness or efficiency of ISO-NE's markets to the extent that ISO-NE's current allocation methodology, as discussed below, deters virtual trading. We also agree that further recourse to the stakeholder process would not allow for timely redress of the concerns identified by ISO-NE in its filing. Accordingly, we proceed, below, to a consideration of ISO-NE's filing on the merits.

26. As noted above, ISO-NE's Real-Time RMR Charges are currently allocated to participants based on Real-Time deviations. In practice, this existing methodology has allocated Real-Time RMR costs to only a small subset of transactions in the affected region. In addition, this methodology has allocated a significant level of costs to virtual traders, whose transactions (by their very nature) create deviations.

27. Real-Time RMR costs in ISO-NE, however, cannot be attributed in their entirety to Real-Time deviations, or to the virtual supply transactions that may account for a significant percentage of these deviations. According to ISO-NE, "while the amount of RMR commitments that will be required to serve load are reasonably well-known prior to the Day-Ahead market clearing process, there are a number of practical reasons why the ISO is unable to commit all of the required resources during the Day-Ahead market. First, de-listed resources that are needed for reliability purposes are not available to be committed Day-Ahead when they choose not to submit offers in the Day-Ahead market. Second, if the ISO identifies more than one resource that is able to meet a reliability need, it may wait to see if one of these resources is committed through the normal clearing process in the Day-Ahead market before committing a resource. Thus, the failure to commit Daily RMR Resources Day-Ahead does not mean that the commitments are

[17] *See* Central Hudson Gas & Elec. Corp., 60 FERC ¶ 61,106, *reh'g denied*, 61 FERC ¶ 61,089 (1992).

caused by deviations, but that there are other factors that cause the ISO to commit Daily RMR Resources after the Day-Ahead market closing."[18]

28. The extremely high Real-Time RMR Charges identified by ISO-NE in its filing also validate this assumption. These charges result from allocating the RMR costs incurred by ISO-NE when ISO-NE is required to commit Real-Time RMR Resources to a relatively small quantity of Real-Time deviations. Accordingly, we agree with ISO-NE that Real-Time deviations, including those deviations attributable to virtual transactions, should not be required to bear the entire burden of Real-Time RMR Charges.

29. We also recognize that to the extent Real-Time load deviations (including deviations attributable to virtual supply transactions) do cause additional real-time commitment burdens on ISO-NE, these transactions should bear their fair share of the cost. Accordingly, we encourage ISO-NE to improve its market processes for reliability commitment and Real-Time RMR commitment to facilitate the separation of these costs so that they can be allocated appropriately.

30. It is not appropriate that these costs be allocated disproportionately to virtual traders. In fact, virtual trading activities provide important benefits to the market, including price convergence between the Day-Ahead and Real-Time markets, price discovery, market liquidity, and increased competition.[19] We note, however, that the continued availability of these benefits could be put at risk by a continuation of ISO-NE's existing allocation of its Real-Time RMR Charges. In fact, this allocation methodology has resulted in high charges per MWh of deviations. ISO-NE, for example, points to October 2004 data showing the deviation in the NEMA/Boston reliability region at $74/MWh, and notes a total of three days when the charges were greater than $60/MWh. Clearly, these high transaction costs deter virtual trades and thus limit the ability of these transactions to provide market efficiencies, including price convergence.

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[18] Motion For Leave To Answer And Answer Of ISO New England Inc. filed on February 16, 2005 in Docket No. ER05-439-000 at 12-13.

[19] *See generally*, ISO New England Inc., 106 FERC ¶ 61,294 (2004). *See also* ISO-NE filing at Attachment 3, Six-Month Review of SMD Electricity Markets in New England, Independent Market Advisor to ISO New England Inc. (February 2004) (ISO-NE Six Month Report) at 60.

31. Epic, *et al*. also confirms this trend when it notes, in its comments, that the recent RMR cost spikes giving rise to ISO-NE's filing are not isolated incidents. Epic, *et* al. (relying on their own analysis of ISO-NE's data) point to a high level of RMR charges that have occurred in many periods and throughout 2003 and 2004. Epic, *et al*. assert that because these Real-Time RMR Charges have been both volatile and increasing in their magnitude, financial traders in the New England wholesale markets have had to greatly reduce or completely eliminate their financial trading.[20]

32. Given these realities, we agree with ISO-NE that its existing allocation methodology must be revised without delay. We also agree that ISO-NE's proposed allocation methodology, based on Real-Time Load Obligations, is reasonable and should be accepted. By allocating Real-Time RMR Charges to those who create the need for RMR Resources to be committed, the proper price signal is sent to the market, informing market participants where, and to what extent, new generation may be needed. It is also appropriate to allocate Real-Time RMR Charges to Real-Time Load Obligations because the commitment of these RMR Resources is made to protect the reliability of all loads. In fact, it is the forecast of Real-Time load along with system contingency considerations for serving that load that are the primary indicators determining the need to dispatch RMR Resources. Moreover, by broadening the pool of participants to whom these costs are allocated, ISO-NE's revised allocation methodology will have the effect of significantly reducing the per-MWh cost of the Real-Time RMR Charges.

33. We will reject the argument raised by Constellation and Dominion Retail regarding the asserted lack of incentive that Load Serving Entities would have, under ISO-NE's revised allocation methodology, to purchase enough energy in the Day-Ahead market to serve the needs of the Load Serving Entities' load. In fact, with the exception of Connecticut and Vermont, participants in ISO-NE's markets currently schedule virtually all of their load (between 90 to 100 percent) in the Day-Ahead market, given the hedging benefits provided by this scheduling option. We expect Load Serving Entities to continue this practice. We also expect that the broader allocation of Real-Time RMR Charges, made possible by the revised methodology accepted here, will remove the existing disincentive to engage in virtual trades and price-responsive load scheduling in the Day-Ahead market. In turn, we expect that the alleviation of these disincentives will reduce the existing occurrence of under-scheduling in certain ISO-NE regions, including

[20] *See also* Comments of DC Energy at 5.

Connecticut, where only 78 percent of the actual load is currently being scheduled in the Day-Ahead market.[21]

34. Finally, we will reject Constellation's argument that the Commission should defer ruling on ISO-NE's proposal until such time as ISO-NE's Locational Installed Capacity market is implemented in 2006. In fact, for the reasons noted above, the need for ISO-NE's proposed revisions to its RMR allocation methodology are both clear and present and should not be deferred.

The Commission orders:

ISO-NE's proposed tariff revisions are hereby accepted for filing, to become effective March 1, 2005, as discussed in the body of this order. Waiver of the notice requirement is hereby granted.

By the Commission.

(S E A L)

Magalie R. Salas,
Secretary.

[21] *See* ISO-NE Six-Month Report at 59.