

113 FERC ¶ 61,055
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

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

ISO New England, Inc.

Docket No. ER04-121-003

ORDER ON REMAND

(Issued October 20, 2005)

1. This case is before the Commission on voluntary remand from the United States Court of Appeals for the District of Columbia Circuit.¹ At issue are the rulings set forth in our March 25 and August 4, 2004 orders regarding a section 205 cost allocation proposal made by ISO New England, Inc. (ISO-NE) in connection with its recovery of its administrative costs for calendar year 2004 (Administrative Costs Tariff).² In those orders, the Commission found that ISO-NE had failed to justify its proposal to collect costs from bidders in the Day-Ahead market, but accepted an alternative proposal. For the reasons discussed below, we reaffirm the findings set forth in the March 25 and August 4 Orders.

Background

2. On October 31, 2003, ISO-NE filed its proposed Administrative Costs Tariff, which included a modified rate design based, in part, on its proposed application and continued use of a Settlement Agreement rate design approved by the Commission in 2001.³ Under the Settlement Agreement, 15 percent of ISO-NE's Schedule 2 revenue

¹ *Braintree Electric Light Dept. v. Federal Energy Regulatory Commission*, No. 04-1335 (D.C. Cir., filed Oct. 1, 2004) (motion for voluntary remand granted May 11, 2005).

² See *ISO New England, Inc.*, 106 FERC ¶ 61,294 (March 25 Order), *order on reh'g*, 108 FERC ¶ 61,138 (2004) (August 4 Order).

³ See *New England Power Pool*, 96 FERC ¶ 61,261 (2001).

requirement (for its fixed cost of providing Energy Administration Service) 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). The remaining 85 percent of these Schedule 2 costs are collected based on two volumetric measures.

3. The costs recovered through the TU charge are the subject of this filing. Under the Settlement Agreement, these costs were recovered only from bids in the Real-Time energy market. In its filing, ISO-NE proposed to modify this rate design for calendar year 2004 to include as TUs transactions unique to the Day-Ahead market that were not previously included in the allocation of TU billing determinants (*e.g.*, increment offers and decrement bids⁴). As ISO-NE explained, it was proposing in this filing to assign cost responsibility to bids that had previously not been assigned costs:

With the commencement of SMD 1.0, the 2003 ISO Tariff contained billing determinants for real-time market ("RTM") activity and some DAM [Day-Ahead Market] activity, such as activity that automatically carried forward to the RTM (*e.g.*, supply offers and internal bilateral transactions). Certain elements unique to the DAM (*e.g.*, Increment Offers/Decrement Bids, and price-sensitive and fixed-price Demand Bids) were not included within the Transaction Unit billing determinant definitions. As a result, during 2003, Participants engaging in the latter activities have not been incurring ISO Tariff charges in connection with those activities.⁵

4. As a result of this proposal, market participants whose bidding in the Day-Ahead market had not been subject to charge would start incurring Schedule 2 charges based on their bids in the Day-Ahead market. Specifically, ISO-NE's proposed rates for TUs consisted of three rate blocks: a \$0.64 rate applicable to TUs between 1-12,500; a \$0.58451 rate applicable to TUs between 12,500-39,500; and a \$ 0.52 rate applicable to TUs at or above 39,500. ISO-NE's proposed tariff also included a true-up mechanism which allows it to reallocate undercollections of revenue primarily to physical market participants (load and generation).

⁴ A decrement bid (Dec) is a bid to purchase energy at a specified location in the Day-Ahead energy market (or virtual market), *i.e.*, it is not associated with physical load. An increment offer (Inc) is an offer to sell energy at a specified location in the Day-Ahead energy market.

⁵ Filing of ISO New England Inc. For Recovery Of Its 2004 Administrative Costs, Docket No. ER04-121-000, at 7 (Oct. 31, 2003).

5. ISO-NE's filing was protested by arbitrageurs (also called virtual or financial traders) participating in ISO-NE's Day-Ahead market. Arbitrageurs are companies that arbitrage differences between Day-Ahead and Real-Time markets. For example, if an arbitrageur perceives that the Day-Ahead price is lower than what will be encountered in Real-Time, the arbitrageur will buy power in the Day-Ahead market and re-sell that power in the Real-Time market for what it expects to be a higher price. Conversely, if the arbitrageur believes the Day-Ahead price is higher than it will be in the Real-Time market, the arbitrageur will sell energy in the Day-Ahead market and buy that energy at a lower price in the Real-Time market. Virtual trades help to bring convergence between Day-Ahead and Real-Time prices.

6. As a result of ISO-NE's proposal, arbitrageurs, whose bids in the Day-Ahead market had previously not been subject to charge, would now have to pay charges for those bids. The arbitrageurs asserted that ISO-NE's proposed TU charge, based on the number of bids submitted, would shift to them an onerous and disproportionate share of ISO-NE's system costs, the effect of which would deter virtual trading activities. They alleged that financial arbitrage is beneficial to organized markets by creating convergence between Day-Ahead and Real-Time markets, that high charges for Day-Ahead bidding would seriously limit the ability of arbitrageurs to participate in the market, and that arbitrageurs differed from those bidding for physical delivery in that arbitrageurs submit a high volume of Day-Ahead bids, few of which are accepted. Thus, they claimed that applying the TU charge for each bid would impose a significant and disproportionate burden on them.

7. In an order issued by the Commission on December 30, 2003, we accepted and suspended ISO-NE's filing to become effective January 1, 2004, subject to refund and the outcome of a technical conference.⁶ We stated that the technical conference would be convened for the purpose of: (i) obtaining additional information regarding the impact of ISO-NE's proposed cost allocation methodology on virtual trading activity in the New England energy markets; (ii) identifying the underlying system costs and system benefits attributable to arbitrageurs; (iii) examining any relevant differences between high-volume and low-volume arbitrageurs; and (iv) considering alternative cost allocation options.

8. The technical conference was convened on January 23, 2004, after which the parties submitted comments and reply comments addressing the relevant issues. ISO-NE stated in its comments that because its proposed cost allocation had been in effect for only a short period of time, it could not definitively assess the long-range impact that this rate design might have on arbitrageurs. ISO-NE also stated, however, that in theory, virtual trading activities can be expected to enhance price convergence. ISO-NE's

⁶ *ISO New England, Inc.*, 105 FERC ¶ 61,397 (2003) (December 30 Order).

arbitrageurs, in their comments, agreed with this assertion and also warned that ISO-NE's as-filed TU charge had caused most high volume arbitrage (approximately 80 percent) to cease. These arbitrageurs further asserted that this decline in activity had led to reduced trading at many system nodes and to less liquidity in the market as a whole.

9. ISO-NE, in its comments, included four alternative cost allocation approaches to its as-filed rate of \$0.584 that had been discussed at the technical conference: (i) a rate based on cleared bids (\$4.279); (ii) a rate based on cleared bids, as modified by the addition of bilateral contract block hours and energy non-zero settlement hours (\$1.231); (iii) a three-tiered rate, with arbitrageurs required to pay a TU charge for each Inc and Dec they submit⁷ (\$0.005) and a second charge for each Inc and Dec that clears (\$0.06), while physical traders would be required to pay a single rate (\$0.688); and (iv) a two-tiered rate, with a single TU rate (\$0.06) for each Inc and Dec submitted and a second charge (\$0.661) applicable to submitted bilateral contracts, demand bids, supply offers, cleared Inc and Dec bids, and non-zero spot market settlement hours.

10. In its comments, the ISO-NE stated that while it continued to support its filed rate design as just and reasonable, there "may be several"⁸ equitable approaches and that it was willing to accept the rate design that would achieve consensus among the parties. It maintained that such a rate design must permit full recovery of its revenue requirement, be consistent with the operation of robust, efficient markets, and avoid free riders on market infrastructure.⁹ On this last point, it stated that "The ISO believes that *some* contribution by financial marketers/traders to the TU revenue requirement is appropriate, consistent with the 'no free rider' principle enunciated [above]." (emphasis in original).¹⁰

11. In the March 25 Order, we accepted the three-tiered rate design, which achieved the greatest amount of support, as the most equitable and reasonable method for ensuring the continued participation of arbitrageurs in ISO-NE's markets while, at the same time, requiring arbitrageurs to bear a reasonable portion of ISO-NE's costs. In accepting this three-tiered rate design, we stated that, 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), this allocation was reasonable for two reasons: first, because of the benefits that virtual trading can bring to the marketplace as a whole, even if the precise quantification of these benefits may not be

⁷ See n. 4, *supra*.

⁸ Post-Technical Conference Comments of ISO-NE, at 7.

⁹ *Id.* at 8-9.

¹⁰ *Id.* at 16.

possible at this time; and second, because of the distinct possibility that a higher per-bid charge would reduce bidding by arbitrageurs, resulting in the need to reallocate these uncollected costs to physical traders in any event.¹¹ ISO-NE never objected to the acceptance of this rate design.

12. The Commission further required ISO-NE to file a report detailing the effect of virtual transactions on the energy markets along with its yearly 2005 filing to recover its administrative costs. The report was required to discuss whether virtual transactions have led to price convergence between the real-time and day-ahead markets, whether virtual trading has led to price discovery, liquidity, and trading options, without adding any appreciable costs, and what other factors are potentially driving price convergence. The Commission found that 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 to include.

13. ISO-NE filed the required report on January 11, 2005 in Docket No. ER05-134-000. According to ISO-NE, the report showed that financial trading has a generally positive effect on the market price of risk and increase Day Ahead-Real Time price convergence, inherently increases liquidity by increasing the number of entities which are able to participate in the market, and increases trading options by providing substantial additional flexibility to participants in managing their day-ahead market position. In the Docket No. ER05-134-000 filing, ISO-NE proposed to continue the three-tiered design for recovery of administrative costs, which the Commission accepted.¹²

14. Rehearing of the March 25 Order was sought by a coalition of New England municipal utilities¹³ (New England Municipals). In its rehearing request, the New England Municipals asserted that there were no findings of fact cited by the Commission in the March 25 Order supporting the Commission's conclusion that there are benefits that virtual trading can bring to the marketplace as a whole. The New England Municipals assert that, to the extent there is any general acknowledgement of the benefits

¹¹ March 25 Order, 106 FERC ¶ 61,294 at P 30.

¹² *ISO-New England, Inc.*, 109 FERC ¶ 61,383 (2004).

¹³ Massachusetts Municipal Wholesale Electric Company, Braintree Electric Light Department, Reading Municipal Light Department, Taunton Municipal Lighting Plant, Vermont Public Power Supply Authority, and Connecticut Municipal Electric Energy Cooperative.

of financial trading, this acknowledgement is limited to agreement on an abstract principle -- that theoretically, financial trading can increase price convergence and market efficiency.

15. New England Municipals also cite as error the Commission's reliance on statements made by financial marketers regarding rate levels that they were, and were not, capable of paying in order to remain in the market. The New England Municipals assert that these claims were unsubstantiated and thus could not have justified a discriminatory rate exemption applicable to financial marketers. The New England Municipals further assert that the rate discount approved by the Commission for financial marketers could not be imposed absent a finding made under section 206 of the Federal Power Act (FPA)¹⁴ that ISO-NE's existing rates were unjust, unreasonable, or unduly discriminatory or preferential.

16. In the August 4 Order, we rejected the New England Municipals' assertion that the Commission's approval of a three-tiered rate design required a Commission finding under section 206 of the FPA. We noted that, in fact, ISO-NE's rate filing had been submitted for our review under section 205 of the FPA¹⁵ and included a proposed rate applicable for the first time to ISO-NE's Day-Ahead market. We found that, as such, our order accepting that filing, subject to revisions, had not required us to determine that an existing rate was unjust or unreasonable, or unduly discriminatory or preferential.

17. The August 4 Order also addressed our substantive determination regarding the appropriateness of a three-tiered rate design. We found that the three-tiered rate design was just and reasonable, since it reflects the benefits virtual traders bring to the market while assuring that they bear of fair share of the costs. We found that the three-tiered rate design was further justified given the distinction between virtual trading activities and physical trading – a distinction that the New England Municipals, on rehearing, had not contested.

18. In addition, we found that the March 25 Order had made a carefully balanced determination. We found, for example, that arbitrageurs should not be granted retroactive relief (back to January 1, 2004), and should be required to contribute their fair share both with respect to cleared bids and (to discourage frivolous bidding) with respect to their submitted bids. Moreover, we noted that ISO-NE's rate design would apply only to a nine-month period in which the rates at issue will remain in effect, subject to our further review of this rate design in ISO-NE's calendar year 2005 filing. Specifically, we

¹⁴ 16 U.S.C. § 824e (2000).

¹⁵ *Id.* at § 824d.

required ISO-NE to file a report in its 2005 filing detailing the effect of virtual transactions on the energy markets it administers.

Discussion

19. For the reasons discussed below, we affirm our prior orders. We find that ISO-NE filed under section 205 to change its existing rate design for recovering administrative costs from Day-Ahead market bids. We further find that the record does not satisfy the section 205 burden to justify ISO-NE's initial proposal and that the alternative three-tiered rate design, which ISO-NE found acceptable, is just and reasonable.

A. Section 205 vs. Section 206

20. The New England Municipals contend that the Commission failed to meet the standards of section 206 in rejecting ISO-NE's proposal and requiring it to adopt the three-tiered proposal. They maintain that the ISO had proposed "to apply to financial marketers the same Transaction Unit (TU) structure imposed upon other market participants." They argue this is a revision to an existing filed rate and that the Commission failed to make a finding that the filed rate is unjust and unreasonable.

21. We disagree that ISO-NE simply sought to apply to Financial Marketers an existing rate. ISO-NE filed a section 205 proposal in this case to recover its administrative costs from the Day-Ahead market that had been instituted within the past year. ISO-NE also proposed tariff changes that would result in assessing new charges for bids in the Day-Ahead market, charges that had not previously been imposed on these transactions and that would result in charges to a new class of customers, *i.e.*, arbitrageurs. To recover these costs, ISO-NE proposed to apply to the Day-Ahead market a rate design similar to that which it used for bidding in its Real-Time energy market.

22. Under section 205, the applicant bears the burden of justifying a proposed rate change. Here, ISO-NE bears the burden of showing that the rate design it is proposing for Day-Ahead transactions is just and reasonable. The Commission recognizes that the court has found that the FPA section 206 burden applies when the Commission is requiring alteration in an unchanged part of a proposed higher rate.¹⁶ However, in this case, the rate design applied to the Real-Time market had never been applied before to transactions in the Day-Ahead market or to the new class of customers participating in that market. Thus, the rate design for the Real-Time energy market was not an unchanged portion of ISO-NE's tariff applicable to the Day-Ahead market; the proposal

¹⁶ See *Sea Robin Pipeline Co. v. FERC*, 795 F.2d 182, 186 (D.C. Cir., 1986) (*Sea Robin*).

to apply this rate design to the Day-Ahead market was a new proposal applicable to a different market and to a different customer class.

23. In its initial application, ISO-NE recognizes that it was filing a new proposal to charge for Day-Ahead billing determinants that had not previously been assessed a charge:

With the commencement of SMD 1.0, the 2003 ISO Tariff contained billing determinants for real-time market ("RTM") activity and some DAM [Day-Ahead Market] activity, such as activity that automatically carried forward to the RTM (e.g., supply offers and internal bilateral transactions). Certain elements unique to the DAM (e.g., Increment Offers/Decrement Bids, and price-sensitive and fixed-price Demand Bids) were not included within the Transaction Unit billing determinant definitions. As a result, during 2003, Participants engaging in the latter activities have not been incurring ISO Tariff charges in connection with those activities.¹⁷

24. ISO-NE's existing TU charge was developed prior to the institution of a Day-Ahead market and the advent of financial trading, and the Commission's acceptance of this rate design was not based on consideration of its impact on these new activities. Thus, ISO-NE's filing was a new proposal under section 205. As discussed below, contrary to the New England Municipals' position, the record does not satisfy the section 205 burden to justify this proposal as just and reasonable.

25. In the December 30, 2004 Order, the Commission was concerned about the justness and reasonableness of ISO-NE's proposal, and provided ISO-NE and the parties with the opportunity, through the technical conference, to address such concerns and develop an alternative just and reasonable proposal. Through this process, four alternative rate designs were developed for allocating costs to arbitrageurs in the event the Commission found ISO-NE's initial proposal unjust and unreasonable. While ISO-NE, in its technical conference comments, asserted that its initial proposal was just and

¹⁷ Filing of ISO New England Inc. For Recovery of Its 2004 Administrative Costs, Docket No. ER04-121-000, at 7 (Oct. 31, 2003). *See, e.g.*, Proposed First Revised Sheet No. 18C which defined Energy Transaction Units by adding Increment and Decrement bids: "Energy Transaction Units (or "Energy TUs"): Energy TUs are the sum for the month for an EAS Customer of Bilateral Contract ~~Energy~~ **Block-Hours, Decrement Bid Block-Hours, Demand Bid Block-Hours, Increment Offer Block-Hours, Supply Offer Block-Hours;** and Energy Non-Zero Spot Market Settlement Hours. (proposed additions to the effective tariff marked in bold and underline, deletions marked by strike-through).

reasonable, it also included in its comments these four rate designs, and made clear that it was willing to accept an alternative proposal acceptable to a consensus of its members, as long as the proposal allowed it to fully recover its costs, was consistent with an efficient market, and avoided free riders by ensuring “some contribution by financial marketers/traders to the TU revenue requirement.”¹⁸ (emphasis in original).

26. The Commission accepted as just and reasonable one of the four proposals included in ISO-NE’s comments, the three-tiered rate design, which was acceptable to the arbitrageurs and was not opposed by the other customers, with the exception of the New England Municipals. ISO-NE did not object to the acceptance of this rate design, nor file for rehearing of the Commission’s acceptance.¹⁹

27. The court has recognized that rates are set, in the first instance by the utilities,²⁰ and that utilities may file, and the Commission may accept, alternative tariff proposals accepted by the utility in the event that the utility fails to meet its burden of justifying its primary proposal as just and reasonable.²¹ Here, the technical conference developed an alternative rate acceptable to ISO-NE. Moreover, the Commission, upon finding that a utility has failed to meet its burden to justify a proposed new rate, can accept an

¹⁸ Post-Technical Conference Comments of ISO-NE, at 16.

¹⁹ See *Municipal Defense Group v. FERC*, 170 F.3d 197, 201 (D.C. Cir. 1999) (finding that the utility’s failure to seek rehearing of an order accepting a filing indicated the utility accepted the decision of the Commission).

²⁰ *Sea Robin*, 795 F.2d 182 at 183-84; *Western Resources Inc. v. FERC*, 9 F.3d 1568, 1579 (*Western Resources*) (finding that in the absence of the utilities’ acceptance of rate, the Commission must act under section 206 to impose a rate); *ANR Pipeline Co.*, 109 FERC ¶ 61,138, at P28 (2004) (in an NGA section 5 proceeding, pipeline should be permitted to choose among possible alternatives to its unjust and unreasonable rate).

²¹ *Southern Natural Gas Company v. FERC*, 877 F.2d 1066, 1070 (D.C. Cir. 1989) (when the Commission finds that some aspect of the primary filing was unjust and unreasonable, the Commission has permitted an alternative tariff to be refiled and exercised its discretion to permit it to go into effect immediately); *Consolidated Edison Co. v. FERC*, 165 F.3d 992, 998, 1002-1004 (D.C. Cir. 1999) (*Con Ed*) (when a range of permissible rates are available, the pipeline under the statute gets to choose a just and reasonable rate); *Western Resources*, 9 F.3d at 1579 (Commission may accept an alternative tariff provision with the utility’s consent).

alternative rate by finding that alternative rate to be just and reasonable.²² While ISO-NE did not propose the three-tiered rate design in its initial filing, ISO-NE's acceptance of this rate design, which the Commission finds just and reasonable, establishes that this rate design has not been imposed unwillingly on the utility under section 206.²³

B. The Commission Acted Properly in Accepting the Alternative Three-Tiered Rate Design as Just and Reasonable

28. The New England Municipals' rehearing petition contends that the Commission failed to adduce substantial evidence to reject ISO-NE's initial proposal (charging the same rate to all participants in the Day-Ahead market). However, under section 205, the burden is on the utility to justify its proposal. Although ISO-NE in its technical conference comments asserted that its proposal was just and reasonable, when we analyze the record in this case, we reaffirm our finding, which ISO-NE has not challenged, that there was insufficient evidence to satisfy the burden of justifying this proposal. We also find that the alternative rate design, which ISO-NE willingly accepted in its place, is just and reasonable.

1. The Record Does Not Satisfy the Section 205 Burden to Justify the Proposal to Charge the Same Rate to All Participants in the Day-Ahead Market

29. Financial transactions are beneficial to bid-based markets, and application of the same charges to financial transactions and to physical transactions would seriously limit or eliminate this contribution by imposing significant costs on financial trades. Moreover, financial transactions are sufficiently different from physical transactions to warrant different rate treatment.

²² See *Tennessee Gas Pipeline Co. v. FERC*, 860 F.2d 446, 455 (D.C. Cir. 1988) (where no existing rate for a new service exists, the "FERC has the authority to impose a new rate in a proceeding initiated under § 4 if the pipeline cannot carry its burden on its proposed rate provided that the FERC reaches the determination that the rate it seeks to impose is just and reasonable"). Unlike *Western Resources*, 9 F.3d 1568, in which a prior rate existed, in this case, there was no pre-existing rate for the Day-Ahead market. See August 4 Order, 108 FERC ¶ 61,138, P 8 n.8 ("there was no pre-existing rate on file to cover the day-ahead market, since this filing was made to establish that rate").

²³ Unlike *Western Resources*, 9 F.3d 1568, in which the pipeline challenged the alternative rate adopted by the Commission, ISO-NE has not challenged the acceptance of the alternative three-tiered rate design.

30. Arbitrageurs provide important benefits to bid-based markets by helping to ensure that Day-Ahead and Real-Time prices do not diverge significantly, as well as by providing price discovery and liquidity to the market. For example, suppose load underschedules expected demand in the Day-Ahead market, *i.e.*, submits bids in the Day-Ahead market at a location that reflects demand less than what could be considered reasonable based on weather and other data. Because scheduled demand is less, the Day-Ahead price would be reduced and load could benefit (even if its scheduled Day-Ahead quantity is incorrect) by procuring a portion of its actual load at a Day-Ahead price less than the price that would have resulted if a larger quantity had been scheduled Day-Ahead.²⁴ Arbitrageurs, however, seeing such bidding activity, would have an economic incentive to buy power in the Day-Ahead market at the Day-Ahead price because of the expectation that prices in the Real-Time market will be higher due to higher demand. The arbitrageurs' bids in the Day-Ahead market would increase the Day-Ahead price, bringing it into closer convergence with the Real-Time price.

31. ISO-NE, in fact, acknowledged in its reply comments that arbitrage can provide real benefits in bid-based markets:

The ISO believes that the participation of financial marketers and traders in the New England markets is beneficial. In particular, the bidding activity of financial marketers and traders should, theoretically, enhance the degree of price convergence between the DAM and the real-time market ("RTM"). Price convergence means more efficient markets, with attendant benefits to all participants.²⁵

32. Arbitrageurs will provide this valuable market function, however, only when their participation in the market can be expected to be profitable, *i.e.*, when they can expect to make money on their anticipated spread between the Day-Ahead price and the Real-Time price, adjusted for the risk of misestimating the spread. The costs of submitting bids reduces the expected value of any transaction and therefore as the cost of submitting bids is increased, the potential profit for any transaction will decrease and arbitrageurs will

²⁴ In bid-based markets, generators are dispatched based on price bids to meet the demanded load. The market price is established by the highest bid price needed to clear demand. Thus, if demand is lower, the corresponding market price is likely to be lower since a lower cost generator would establish the market clearing price. Thus, if demand is underscheduled in the Day-Ahead market, load could lock-in a potentially lower price for that portion of its demand than it would have paid if load had scheduled more accurately. Load would have to pay a potentially higher price in the Real-Time market only for the amount taken in excess of the Day-Ahead quantity.

²⁵ ISO-NE Post-Technical Conference Comments, at 6 (Feb. 6, 2004).

participate less. The cost of bidding also will increase potential spreads between Day-Ahead and Real-Time prices because the expected profit from any bid must exceed the cost of submitting the bid. Application of ISO-NE's prior TU rate design component to arbitrageurs, therefore, could result in decreasing their valuable participation in the market and increasing potential spreads between Day-Ahead and Real-Time prices.

33. There also are differences in bidding behavior between arbitrageurs and those bidding physical transactions that warrant different rate treatment in this case, a distinction that was not challenged by the New England Municipals on rehearing. Those submitting physical transactions submit a relatively low number of bids for the primary purpose of moving power from generators to load, with a high percentage of these bids being accepted. Arbitrageurs, on the other hand, may submit hundreds of bids for the purpose of seeking market information and arbitrage opportunities, with only a small percentage of those bids clearing the market. Thus, the per-unit charge of \$ 0.584 applied to each bid under ISO-NE's as-filed cost allocation methodology would have affected arbitrageurs to a much greater extent than those rate payers bidding for physical transactions, given the significant distinctions between these separate classes of rate payers.

34. In their rehearing request, the New England Municipals maintain that the Commission did not possess sufficient evidence to justify its findings that application of ISO-NE's TU bid charge to the new Day-Ahead market would have adverse effects on arbitrageurs. The New England Municipals also maintain that the record in this case does not show that financial trading is of sufficient benefit to the market to warrant a lower per-bid rate.

35. However, because the Day-Ahead market had not been in effect for a long period of time, at the time that ISO-NE made its filing in this case, there could not be extensive data on the effect of various charges on market behavior. Indeed, ISO-NE's proposed billing determinants were based on past data, without knowledge of how those rates would affect market participants', particularly arbitrageurs', conduct. In designing prospective rates, the Commission must make reasonable assumptions based on the facts before it and can accept justified rate proposals subject to the utility filing reports on the way those proposals operate, as was done here.²⁶

²⁶ See *Electricity Consumers Resource Council v. FERC*, 407 F.3d 1232, 1239 (D.C. Cir. 2005) (Commission can adopt a program based on "predictive judgments and policy choices," as long as it articulates a reasonable basis for its decision) (*Electricity Counsel*); *Interstate Natural Gas Ass'n of America v. FERC*, 285 F.3d 18, 30 (D.C. Cir. 2002) (Commission can take action based on available evidence as part of an experiment); *Associated Gas Distributors. v. FERC*, 824 F.2d 981, 1008 (D.C. Cir.,

(continued...)

36. Here, there was evidence that the application of the high \$ 0.584 per-bid charge to arbitrageurs would reduce their participation in the market, given that their profit depends on the spread between the Day-Ahead and Real-Time prices and their higher bidding activity. Indeed, despite the short time in which the higher prices were in effect, the record shows that such prices contributed to a decline in financial trading activity. In its comments submitted following the technical conference, ISO-NE acknowledged that, in January 2004, after these charges were implemented, several of its largest arbitrageurs had greatly reduced the MWs and the volumes of their bids.²⁷ The level of financial trading in January 2004 was also far below the level projected in ISO-NE's filing. As the Financial Marketers point out, the projected TUs for January 2004 in ISO-NE's filing was 1,690,238, or approximately 54,500 bids per day; yet the total number of Virtual Transactions bid in January 2004 would be slightly above 5,000 per day.²⁸ These findings were also corroborated by two arbitrageurs, who asserted that ISO-NE's as-filed TU charge had caused approximately 80 percent of all high volume financial trading in the New England markets to cease.²⁹

37. The Commission reasonably concluded, based on the record in the proceeding, that financial trading does provide benefits to the market by increasing price convergence between the Day-Ahead and Real-Time markets and increasing liquidity. ISO-NE itself recognized, in this case and in a later filing, that financial trading should in theory

1987) (agencies may rely on economic predictions); *Mojave Pipeline Company*, 79 FERC ¶ 61,347 (1997) (when actual past experience does not exist, Commission must derive a reasonable rate).

²⁷ ISO-NE's Post-Technical Conference Comments, Docket No. ER04-121-000, at 5-6 (Feb. 6, 2004) (data shows that "in January as compared with prior months –some large virtual traders greatly reduced MWs and volumes of virtual bidding"). For example, Attachment 6 shows that the total number of Dec bids bid by day in January was the lowest it had been since the start of the Day-Ahead market in March 2003. Attachment 6.

²⁸ Comments of Financial Marketers, Docket No. ER04-121-000, at 7 (Feb. 6, 2004). This result can be seen by comparing ISO-NE's Exhibit 3, GWP-7 (Schedule 2) in its initial October 31, 2003, filing, showing a projected TU of 1,690,238 for January 2004 and ISO-NE's Post Technical Comment filing showing slightly over 5000 Virtual Transactions bid per day in January 2004. ISO-NE's Post-Technical Conference Comments, Docket No. ER04-121-000, Attachment 8 (Feb. 6, 2004).

²⁹ Comments of Financial Marketers, at 7 (Feb. 6, 2004).

enhance price convergence.³⁰ In other cases, moreover, the Commission has determined that underscheduling of load in Day-Ahead markets can lead to inefficient and otherwise unjustifiable price spikes.³¹ Arbitrageurs are positioned to observe any such pattern of underscheduling and to buy power at the lower price, thereby providing for price convergence. The Commission's findings are supported by the affidavit filed by Dr. Peter Cramton in which he stated: "arbitrage strategies improve liquidity, increase both supply and demand response, and reduce the incentive and ability to exercise market power in [the] real-time energy market."³²

38. The Commission's conclusions also are in line with accepted economic principles. Speculative trading and arbitrage has been recognized as benefiting markets by increasing liquidity and stabilizing the market.³³ ISO-NE, in fact, published a report

³⁰ March 25 Order, 106 FERC ¶ 61,294 at P 12; ISO-NE Post-Technical Conference Comments, at 6 (Feb. 6, 2004). *See also* ISO-NE's January 11, 2005 filing in Docket No. ER05-439-000 at p. 9 ("virtual trades facilitate statistical arbitrage when market participants believe they observe price divergences that lead to expected payoffs above the expected costs of placing virtual trades, resulting in improved price convergence and greater liquidity in the Day-Ahead energy market.").

³¹ *See San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Services*, 93 FERC ¶ 61,294 (2000) (underscheduling of load in Day-Ahead markets contributed to price spikes in California).

³² Motion to Intervene and Protest of Outback Power Marketing, Inc. And SESCO Enterprises L.L.C., Docket No. ER04-121-000, Affidavit of Dr. Peter Cramton, at P 5, (Nov. 21, 2003).

³³ Adam Smith, *The Wealth of Nations*, Ch IV, at 564 (1776) (<http://www.econlib.org/library/Smith/smWN.html>) ("the popular fear of engrossing and forestalling [arbitrage or speculation] may be compared to the popular terrors and suspicions of witchcraft"); John Stuart Mill, *Principles of Political Economy*, Book IV, Chap. 2, Sec. 5 (1848) (<http://www.econlib.org/library/Mill/mlP57.html#Bk.IV,Ch.II>) (The interest, in short, of the speculators as a body, coincides with the interest of the public; and as they can only fail to serve the public interest in proportion as they miss their own, the best way to promote the one is to leave them to pursue the other in perfect freedom); Milton Friedman, *Essays in Positive Economics*, 157-203 (1953) (speculation will stabilize exchange rates); Energy Information Administration, U.S. Department of Energy, *Derivatives and Risk Management in the Petroleum, Natural Gas, and Electricity Industries*, at 64 (2002) (summary of 150 reviews of academic literature show that use of derivatives (form of speculation) either reduced or had no effect on market volatility).

explicitly recognizing the benefits provided by financial trading in increasing liquidity by increasing the number of entities that are able to participate in the market and by increasing trading options by providing additional flexibility to participants in managing their Day-Ahead market positions.³⁴ The report further finds that, as the Commission concluded here, increasing the costs of virtual trading will cause decreases in such trading.³⁵

39. The rehearing request relies on *Electricity Consumers Resource Council v. FERC*,³⁶ for the proposition that reliance on economic theory cannot substitute for substantial evidence and the articulation of a rational basis for the agency's decision. However, the court in *Electricity Consumers* found that, although the Commission purported to rely on economic theory, it in fact "inexplicably distorted the theory in its application."³⁷ Indeed, the court later affirmed a Commission determination based on the same marginal cost theory without the unjustified distortions.³⁸ Here, the Commission relied on the evidence in the record as well as accepted economic principles in finding that financial trading benefits markets.³⁹

40. The rehearing request also fails to recognize that, to the extent a high per bid charge reduces virtual trading, the remainder of the market would have to incur greater costs, because the same fixed costs would be spread over a smaller number of bids, with the result that uncollected costs would need to be reallocated to the remainder of the market.⁴⁰ ISO-NE's proposed tariff includes a true-up mechanism which allows it to reallocate undercollections of revenue primarily to physical market participants (load and

³⁴ See Report on Impact of Virtual Transactions on New England Markets, filed by ISO-NE on November 1, 2004, in Docket No. ER05-134-000, at 3 (Virtual Transactions Report) (virtual transactions both improve Day-Ahead – Real-Time price convergence and reduce the market price of risk).

³⁵ *Id.* at 44-45.

³⁶ 747 F.2d 1511 (D.C. Cir. 1984) (*Electricity Consumers*).

³⁷ *Id.* at 1514.

³⁸ *Town of Norwood v. FERC*, 962 F.2d 20 (D.C. Cir. 1992).

³⁹ See *Electricity Council*, 407 F.3d 1232 (relying on economic predictions about operation of sloped demand curve).

⁴⁰ March 25 Order, 106 FERC ¶ 61,294 at P 30. No argument was made by any party that ISO-NE had to invest in increased infrastructure to handle bids by arbitrageurs.

generation). As discussed above, the projected number of TUs for January 2004 (1,690,238 or approximately 54,500 per day) was far above the actual number of Virtual Transactions in January 2004 (slightly above 5,000 per day). Thus, under ISO-NE's tariff, the undercollection of revenue would primarily be reallocated to physical market participants. Lowering substantially the number of bids submitted by arbitrageurs in the Day-Ahead also would likely reduce the number of their cleared bids, which would reduce their contribution to cost recovery as well. While it might facially appear unfair to charge arbitrageurs a different, or lower, rate than other market participants who engage in physical transactions, in fact, the record in this case demonstrates that charging the same rate actually would reduce virtual trading, decrease arbitrageurs' contribution to fixed cost recovery, and increase the costs to the rehearing applicants and to other market participants.⁴¹

41. The New England Municipals maintain that charging the same rate to all customers is not unduly discriminatory. Although the courts have found that charging identical rates to differently situated customers, absent differences in the cost of serving those customers, may be justified in some instances, they have recognized that due to particular circumstances, charging the same rate may be unduly discriminatory.⁴² Here, the arbitrageurs are differently situated than physical traders due to the benefits they provide to the market, the types and volume of bids they make, the important influence of bid charges on their participation in the market, and, the effect high Day-Ahead bid charges have on the number of bids arbitrageurs will submit, such that high bid prices could reduce their contribution to fixed cost recovery. For these reasons, the Commission denies the rehearing request, finding that the record evidence does not satisfy the burden under section 205 burden of justifying ISO-NE's initial proposal as just and reasonable.

2. The Three-Tiered Rate Design, Accepted by ISO-NE, is a Reasonable Alternative

42. The Commission went beyond simply ruling on ISO-NE's initial proposal. It recognized that different rate designs for allocating costs could be just and reasonable and provided ISO-NE and its customers with an opportunity, through the technical

⁴¹ See *Market St. R. Co. v. Railroad Comm'n*, 324 U.S. 548, 563 (1945) (utility regulator could reasonably find that higher rate would bring in less revenue through reduced usage).

⁴² See *Con Ed*, 165 F.3d at 1013 (charging the same rate to differently situated customers can be discriminatory when it is unreasonable). See also *Alabama Electric Cooperative, Inc. v. FERC*, 684 F.2d 20 (D.C. Cir. 1982).

conference, to craft acceptable alternative rate designs. One of these, the three-tiered rate design was acceptable to the arbitrageurs and ISO-NE as well as most of ISO-NE's customers.⁴³ Under this proposal, arbitrageurs pay a rate for each submitted bid (\$ 0.005) and pay a second charge (\$ 0.06) for each bid that clears. Physical traders, on the other hand, are assessed a single charge of \$ 0.688 per bid (as opposed to ISO-NE's as-filed rate of \$0.584).

43. As discussed above, determining the rate for arbitrage activity must take into account the fact that setting a rate too high will actually decrease cost recovery from financial traders by decreasing the number of bids. As the Commission found in the March 25 Order, the per-bid charge for arbitrageurs should, in theory, be set at a rate that does not reduce the bidding of arbitrageurs to a level that decreases their overall contribution to cost recovery.⁴⁴ But such a rate cannot be determined precisely, and a number of just and reasonable methodologies could be proposed for determining that rate. For example, it may be reasonable to charge only for cleared bids, but not submitted bids, to charge only on the basis of the number of megawatts bid, or to charge a combination of a per-megawatt charge and a per-bid charge.

44. While determining an appropriate allocation of costs to financial trading is not "a matter for the slide rule,"⁴⁵ the Commission finds the three-tiered rate design, which ISO-NE found acceptable, is an appropriate just and reasonable approach.⁴⁶

45. This rate design provides an appropriate balance between ensuring the benefits of financial trading and providing that financial trades contribute to the collection of administrative costs, as advocated by ISO-NE. The three-tiered rate design does not discourage arbitrageurs from participating in the market (which, as discussed above, better assures their continued contribution to ISO-NE's recovery of costs). In particular, the lower rate for Day-Ahead bids helps ensure that the arbitrageurs are not discouraged from submitting bids that will help bring about convergence between Day-Ahead and

⁴³ See *Electricity Council*, 407 F.3d at 1239 (giving weight to the fact that a proposal reflected negotiations and discussions among affected companies).

⁴⁴ March 25 Order, 106 FERC ¶ 61,294 at P 30, n. 22.

⁴⁵ *Colorado Interstate Gas Co. v. Federal Power Comm.*, 324 U.S. 581, 589 (1945) ("allocation of costs is not a matter for the slide-rule. It involves judgment on a myriad of facts. It has no claim to an exact science").

⁴⁶ The New England Municipals have not asserted that a rate design other than the three-tiered rate design should have been adopted in the event that ISO-NE's original proposal was found unjust and unreasonable.

Real-Time prices due to the high cost of submitting such bids. This rate design further recognizes the difference between arbitrageurs and physical traders in terms of volumes bid, as well as the difference in the percentage of Day-Ahead bids accepted from these two groups. On the other hand, invoking a low charge for Day-Ahead bidding meets ISO-NE's request that all participants make "some contribution" to Day-Ahead bid recovery⁴⁷ to help protect ISO-NE's computer system from the submission of large numbers of bids with low profit potential.⁴⁸

46. While the three-tiered rate design results in a ten cent increase in the TU charge payable by all other market participants (from \$0.584 to \$0.688), as ISO-NE recognizes, these market participants benefit from the trading activities engaged in by arbitrageurs through price convergence between the Day-Ahead and Real-Time market, a more stable market, increased price discovery and market liquidity. Moreover, this rate design is better calculated to maintain the overall contribution of financial trading to ISO-NE's cost recover. Since ISO-NE's tariff provides that any amounts not collected from financial trading will be reallocated principally to physical traders, a high Day-Ahead bid charge, which discourages arbitrageurs from participating in the market, will lead to an undercollection of projected costs by ISO-NE and a reallocation of those costs to the physical traders.

47. The Commission also went beyond acceptance of the three-tiered rate design. Recognizing the limited amount of information available, the March 25 Order required ISO-NE to file a report on financial trading coincident with its next administrative cost filing. As discussed above, that report confirmed that arbitrage transactions improve Day-Ahead – Real-Time price convergence and reduce the market price of risk and that increased charges for Day-Ahead bids would reduce the amount of trading. After this review, ISO-NE proposed no change in the three-tiered rate design.

C. Request for Hearing

48. The New England Municipals also contend that this dispute should have been set for hearing to resolve factual disputes. However, the Commission finds that a trial-type hearing is not required here. There are no issues regarding motive, intent, or credibility

⁴⁷ ISO-NE's Post-Technical Conference Comments, at 16.

⁴⁸ The ISO-NE was concerned that a "very high volume" of bids/offers can extend the 'solve time' of the software," potentially causing the software's performance to degrade. ISO-NE's Post-Technical Conference Comments, at 7 (Feb. 6, 2004).

which would require such a hearing.⁴⁹ ISO-NE filed in its technical conference comments all of the data available at the time on the effect of bid charges on arbitrageurs, and the New England Municipals fail to show that there is any past data that would be available at hearing that was not provided.⁵⁰ The New England Municipals request for a hearing consisted of one sentence alleging that “significant disputes” existed.⁵¹ They failed to show that any additional factual evidence would have been available to a trial-type hearing.⁵² Moreover, unlike typical utility rate cases, where captive buyers will continue to buy power during the period in which the hearing is conducted, in competitive markets, such as those operated by ISO-NE, arbitrageurs would not participate in an uncertain market where they could not evaluate their potential costs. In this environment, the Commission had sufficient evidence with which to rule on ISO-NE’s proposal and the New England Municipals failed to show that a trial-type hearing is necessary.

The Commission orders:

The prior orders are affirmed as discussed in the body of the order.

By the Commission.

(S E A L)

Magalie R. Salas,
Secretary.

⁴⁹ A trial-type hearing is not necessary where motive, intent, or credibility are not at issue. *Union Pacific Fuels, Inc. v. FERC*, 129 F.3d 157, 164 (D.C. Cir. 1997). See *CNG Transmission Co. v. FERC*, 40 F.3d 1289, 1293 (D.C. Cir. 1994) (paper hearing can be sufficient).

⁵⁰ *Id.* at 164 (no dispute over a past event); *CNG Transmission Co. v. FERC*, 40 F.3d 1289, 1293 (D.C. Cir. 1994) (paper hearing can be sufficient);

⁵¹ New England Municipals Request for Rehearing, at 8.

⁵² "Mere allegations of disputed facts are insufficient to mandate a hearing; petitioners must make an adequate proffer of evidence to support them." *Pennsylvania Public Utility Comm. v. FERC*, 881 F.2d 1123, 1126 (D.C. Cir. 1989) (quoting *Cerro Wire & Cable*, 677 F.2d at 124, 129 (D.C. Cir. 1982); citing *General Motors Corp. v. FERC*, 656 F.2d 791, 798 n.20 (D.C. Cir. 1981)).