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March 13, 2006

**VIA ELECTRONIC FILING**

Honorable Magalie Roman Salas  
Secretary  
Federal Energy Regulatory Commission  
888 First Street, N.E.  
Washington, DC 20426

**Re: Long-Term Firm Transmission Rights in Organized Electricity Markets,  
Docket No. RM06-8-000; Long Term Transmission Rights in Markets  
Operated by Regional Transmission Organizations and Independent System  
Operators, Docket No. AD05-7-000**

Dear Ms. Salas:

Transmitted electronically for filing in the above-referenced dockets are the Comments of ISO New England Inc.

If there are any questions concerning this filing, please call me at (202) 661-2205.

Very truly yours,

/s/

Howard H. Shafferman  
Counsel for  
ISO New England Inc.

Enclosure

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

Long-Term Firm Transmission Rights in Organized Electricity Markets	) ) )	Docket No. RM06-8-000
Long Term Transmission Rights in Markets Operated by Regional Transmission Organizations and Independent System Operators	) ) ) )	Docket No. AD05-7-000

**COMMENTS OF ISO NEW ENGLAND INC.**

ISO New England Inc. (“ISO-NE”) submits these comments on the Notice of Proposed Rulemaking (“NOPR”) issued by the Commission regarding long-term firm transmission rights (“LTTRs”) in organized electricity markets.<sup>1</sup>

**I. INTRODUCTION**

The LTTR NOPR arises from the enactment of Section 1233 of the Energy Policy Act of 2005 (“EPACT”). Section 1233 added a new Section 217 to the Federal Power Act (“FPA”).

New section 217(b)(4) of the FPA provides:

The Commission shall exercise the authority of the Commission under this Act in a manner that facilitates the planning and expansion of transmission facilities to meet the reasonable needs of load-serving entities to satisfy the service obligations of the load-serving entities, and enables load-serving entities to secure firm transmission rights (or equivalent tradable or financial rights) on a long-term basis for long-term power supply arrangements made, or planned, to meet such needs.

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<sup>1</sup> *Long-Term Firm Transmission Rights in Organized Electricity Markets; Long-Term Transmission Rights in Markets Operated by Regional Transmission Organizations and Independent System Operators*, Notice of Proposed Rulemaking, 71 Fed. Reg. 6693 (2006) (the “LTTR NOPR”).

Section 1233(b) of EPACT requires:

Within 1 year after the date of enactment of this section and after notice and an opportunity for comment, the Commission shall by rule or order, implement section 217(b)(4) of the Federal Power Act in Transmission Organizations, as defined by that Act with organized electricity markets.

In the LTTR NOPR, the Commission proposes to amend its regulations to require each transmission organization that is a public utility with one or more organized electricity markets to make available LTTRs that satisfy guidelines established by the Commission. The Commission proposes to require each such transmission organization to file, no later than 180 days from the date of publication of the final LTTR rule in the Federal Register, either: (1) tariff sheets and rate schedules that make available LTTRs that are consistent with the guidelines set forth in the final rule; or (2) an explanation of how its current tariff and rate schedules already provide LTTRs that are consistent with the guidelines set forth in the final rule.

By way of background, since March 2003, New England's current market design has incorporated locational marginal pricing, financially binding day-ahead and real-time energy markets, and financial transmission rights ("FTRs"). FTRs are currently available on a short-term (monthly) and long-term (annual) basis. All FTRs are allocated through an auction mechanism. FTRs may be reconfigured on a monthly basis, providing market participants with the flexibility to meet their changing needs and supply strategies. FTR holders may participate in a secondary FTR market by transferring their FTRs (or monthly portions thereof) directly to other entities, or by making a whole-month portion of their annual FTRs available in the monthly auction.

Allocation of other FTR-related rights also occurs as part of the market design. Specifically, Auction Revenue Rights ("ARRs") are allocated directly to Load Serving Entities ("LSEs"), and to other entities with certain long-term power supply arrangements. ARRs give

these entities a share of the revenues from the periodic FTR auctions. Qualified Upgrade Awards (“QUAs”) are allocated directly to entities that pay for transmission upgrades that increase transfer capability on the New England Transmission System. QUA recipients are entitled to an award of ARR in the ARR allocation. ARR holders (whether LSEs, grandfathered contract holders, or QUA recipients) can use the FTR auction revenues as they see fit, including using these funds to obtain FTRs in the FTR auctions. The existing New England system of FTRs, ARRs and QUAs is described in greater detail in Section III of these comments.<sup>2</sup>

Prior to New England’s implementation of the current (i.e., “Standard Market Design”) markets in March 2003, ISO-NE and the New England market participants had considered whether long-term FTRs (“LT-FTRs”)<sup>3</sup> should be offered. Due in part to concerns about funding and transferability, and because retail access was already in place in much of New England by that time (thereby reducing the volume of long-term power supply contracting requiring long-term hedging mechanisms), LT-FTRs were not incorporated in the market design at that time.

More recently, in connection with developing the ISO-NE comments last year on the Commission staff’s discussion paper regarding LTTRs, ISO-NE had brought to the market participants through the New England Power Pool (“NEPOOL”) stakeholder process the question of whether LTTRs were needed or desired. At that time, only one or two market

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<sup>2</sup> Greater detail regarding FTRs, ARRs and QUAs is also available in the ISO New England Manual for Financial Transmission Rights (M-06), posted on the ISO-NE website at: [http://www.iso-ne.com/rules\\_proceeds/isone\\_mnls/M-06\\_Financial%20Transmission%20Rights\\_\(Revision%205\)\\_05-06-05.doc](http://www.iso-ne.com/rules_proceeds/isone_mnls/M-06_Financial%20Transmission%20Rights_(Revision%205)_05-06-05.doc).

<sup>3</sup> Because, as discussed below, EPACT permits the use of financial transmission rights (such as are offered in New England) to satisfy its mandate, in these comments ISO-NE will refer to such rights as LT-FTRs, rather than LTTRs, except when referring to the LTTR NOPR or final rule, or where the context dictates otherwise.

participants expressed serious interest in LTTRs.<sup>4</sup> Subsequently, at the Markets Committee meeting held on August 24-25, 2005, there was insufficient support to form a working group regarding LTTRs.<sup>5</sup> More recently, on February 17, 2006, ISO-NE and NEPOOL held a meeting with market participants to gather input regarding the comments invited by the Commission in response to the LTTR NOPR. While one market participant expressed a strong interest in LTTRs, most other market participants appeared to have a number of questions about the implications of LTTRs and expressed a variety of concerns that support the need for flexibility in the final LTTR rule.

These comments are designed to reflect the input received from stakeholders at that meeting.

## **II. EXECUTIVE SUMMARY**

ISO-NE urges the Commission to allow flexibility, in two respects, in the LTTR final rule. First, ISO-NE asks the Commission to maintain the “guidelines” approach utilized in the NOPR, rather than pursue a more prescriptive, “one size fits all” approach. Second, ISO-NE urges the Commission to allow flexibility within the guidelines themselves, to accommodate

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<sup>4</sup> See the agenda and minutes for the June 6-7, 2005 meeting of the Markets Committee, posted on the ISO-NE website at [http://www.iso-ne.com/committees/comm\\_wkgrps/mrks\\_comm/mrks/index.html](http://www.iso-ne.com/committees/comm_wkgrps/mrks_comm/mrks/index.html).

<sup>5</sup> Interested parties were urged to get together and develop a specific Working Group charge or their proposal for future Markets Committee action. To ISO-NE’s knowledge, no further action was taken by interested parties following that meeting. See agenda and minutes of the August 24-25, 2005 Markets Committee meeting, *id.*

In response to the Commission’s issuance of the LTTR NOPR, the Markets Committee (at its meeting on March 7, 2006) initiated a process to form an LTTR Working Group. The Working Group’s next meeting is tentatively scheduled for March 29, 2006.

regional differences and market needs. In particular, ISO-NE seeks flexibility so that the LTTR requirements of EPACT may potentially be satisfied through:

- financial rights (i.e., LT-FTRs), rather than physical rights, in organized markets using locational marginal pricing;
- LT-FTRs that represent an extension of the term and basic structure (as obligations) of existing New England FTRs;
- allocation of LT-FTRs by auction; and
- financial rights having lengths of term (and renewal features) that can be administered in a manner that does not have adverse effects on FTR market liquidity or other hallmarks of a competitive marketplace.

In addition, ISO-NE asks the Commission to lengthen, beyond 180 days, the period within which a Transmission Organization must file its proposal for compliance with the final LTTR rule. As the Commission is aware, ISO-NE and the NEPOOL stakeholders have developed an annual Wholesale Markets Plan that sets priorities for developing market rule and tariff changes and preparing the requisite filings. Many important projects are already queued in that plan for the remainder of the year. A strict requirement to formulate a compliant LTTR mechanism within 180 days, and implement it shortly afterward, may adversely impact the scheduled deployment of other important market improvements that are already underway.

### **III. THE EXISTING FTR/ARR/QUA SYSTEM IN NEW ENGLAND**

ISO-NE's comments in Section IV below, regarding the eight guidelines set forth in the LTTR NOPR, have been formulated in the context of the system of Financial Transmission Rights, Auction Revenue Rights and Qualified Upgrade Awards in New England's current market design. This system is described below.

**A. Allocation, Scheduling and Pricing of Transmission Under New England’s Current Market Design**

Under New England’s current market design, ISO-NE’s unit commitment software executes a security-constrained day-ahead schedule that, by selecting generation resources while taking into account transmission constraints, also results in a “schedule” of power flows on the transmission system. The scheduling of the transmission system is based entirely on energy supply offers (including start-up and no-load bids), generation self-schedules and the known characteristics of the transmission system.

In the day-ahead market, generating units are selected to provide energy based on their supply offers and bid in load. Neither generation nor load needs to schedule transmission service. The capacity of the transmission system is allocated to transmission users through energy market scheduling that results in the calculation and payment of locational marginal prices (“LMPs”). To “schedule” transmission, in effect, a market participant may also submit a self-schedule to inject (sell) energy at one node and withdraw (buy) it at another. In so doing, a market participant puts itself at risk for the energy price differential between the two locations. The energy price differential represents the marginal cost of moving power between two points on the transmission system. It is not, however, a payment for the use of the transmission system.<sup>6</sup>

This scheduling system is purely financial and achieves dispatch efficiency by assuring that New England’s wholesale load is served with the lowest-priced energy available given the

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<sup>6</sup> Market participants pay for access to the transmission system through regional network service rates (the RNS Rate) under the ISO-NE Open Access Transmission Tariff (“OATT”). The OATT is Section II of the ISO New England Inc. Transmission, Markets and Services Tariff, FERC Electric Tariff No. 3 (the “ISO Tariff”).

constraints of the transmission system. Under ISO-NE's central dispatch system, a generating unit that elects to self-schedule agrees to be a price-taker.

As a backdrop, the FTRs described in the succeeding subsection are only one of the means available under the New England market system to manage locational pricing risk. Bilateral contracts – operating outside the spot energy markets but accounted for in those markets – offer market participants a very flexible alternative. For instance, a market participant might negotiate a bilateral contract that guarantees firm, fixed energy prices at a particular node or set of nodes.<sup>7</sup>

### **B. FTR Attributes and Payments**

An FTR is a financial instrument that entitles the holder to receive compensation for congestion costs that arise when the transmission grid is congested in the day-ahead energy market. Each FTR is unidirectional and is defined in megawatts from a point of receipt (where the power is injected onto the New England grid) to a point of delivery (where the power is withdrawn from the New England grid). For each hour in which congestion exists on the New England Transmission System between the receipt and delivery points specified in the FTR, the holder of the FTR is awarded a share of the congestion charges collected for that hour.

### **C. FTR Auctions**

In New England, FTRs are not allocated directly. FTRs are acquired in the following two ways:

- FTR Auction - Periodic auctions to allow bidders to acquire monthly and long-term FTRs. The auction also allows holders of long-term FTRs an opportunity to sell

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<sup>7</sup> In New England, many bilateral contracts are struck at the trading hub, which is a set of nodes identified by ISO-NE pursuant to Section III.2.8 of the ISO Tariff. In these circumstances, both parties to the bilateral contract may desire to use FTRs to complement their bilateral contract by hedging congestion costs.

those that they are currently holding. All FTRs are initially “created” in the FTR Auction.

- Secondary Market - Bilateral trading may be done independently or through an ISO-administered trading system that automatically transfers ownership and adjusts monthly billing statements accordingly.

In the FTR auction, bidders submit bids to purchase a quantity of FTRs at a price quoted in dollars per megawatt for a unidirectional path between two specified locations. Similarly, existing FTR holders may offer to sell a quantity of FTRs at a reservation price, below which the FTR will not be sold.

The winning quotes are determined by the set of simultaneously feasible FTRs with the highest total auction value, as determined by the bids of the buyers and taking into account the reservation prices of the sellers. Although the winning simultaneously feasible FTRs are selected by maximizing the auction value of buy bids and sell offers, the actual revenue collected is less than the auction value. This is because only FTR bidders on the margin of the auction pay their actual bid price. All other FTR bidders pay the FTR clearing prices, which are less than the bid price.<sup>8</sup>

#### **D. ARR and QUAs**

ARRs and QUAs are the mechanisms through which the revenues (net of payments to FTR sellers) from each FTR auction are transferred to the entities that are responsible for paying congestion costs and the costs of certain transmission upgrades. The revenues are distributed

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<sup>8</sup> Economists refer to the difference between the bidders’ prices and the clearing price as “consumer surplus.”

Note that for “counter flow” bids the FTR clearing price is equal to or greater than the accepted counter flow bid prices.

after the FTR auction is conducted, so that the market's pricing of FTRs can be used in the process.

Auction revenues are allocated first to entities that pay for transmission upgrades directly (but not for upgrades paid for through the RNS Rate), if and to the extent that the upgrade makes it possible to award additional FTRs in the FTR Auction (by virtue of increasing transfer capability on the New England Transmission System). These QUAs allocate FTR Auction revenues by direct measurement of the difference in revenues generated in "mock auctions" run with and without the subject upgrades (and their effect on transfer capabilities) and using the original FTR Auction bids. The FTRs that clear in the "mock auctions" are then priced at the original FTR Auction clearing prices to determine the amount of the QUA.

The auction revenues remaining after the QUA allocations are allocated, through the ARR allocation process, to the entities responsible for paying the congestion costs incurred in association with serving load. Entities responsible for congestion charges will receive FTR Auction revenues when they have load on the congested side of a binding constraint for which FTRs were awarded and auction revenues were collected. This is achieved through a four-stage ARR allocation process designed to allocate auction revenues in relation to the amount of load served in the Load Zone (or, in the case of Long-Term Firm Through or Out Transmission Service, at an External Node) and in relation with where the bidders in the FTR Auction anticipate congestion to occur.

An entity qualifying for an ARR allocation does not have to participate in an FTR Auction to receive its allocated revenues. The ARR holders could choose not to seek FTRs and instead apply their allocation of auction revenues to payment of any hourly congestion charges that may accrue. However, this choice risks under-valuation of the associated FTRs by other

bidders resulting in an ARR allocation that could be insufficient to cover hourly congestion charges. This is because the total dollar value of an ARR allocation depends on both the amount (in MW) resulting from the four-stage ARR allocation and the auction clearing prices associated with the ARR paths.

If the same entity chose to participate in the FTR Auction and bid consistently with their anticipated worth of the FTR, but was outbid, that entity should expect the resulting auction clearing prices to provide a revenue allocation at least as great as it would have received had its bid been successful.

#### **IV. COMMENTS**

ISO-NE has a number of general comments, as well as specific comments concerning the eight guidelines proposed by the Commission in the LTTR NOPR. ISO-NE also has concerns about the timing of the development of regional proposals in response to the final rule, and the implementation of those proposals once accepted by the Commission.

##### **A. General Comments**

###### **1. The Final Rule Should Reflect the Flexibility Evident in Section 217(b)(4)**

ISO-NE's most fundamental comment, perhaps, is that EPACT's LTTR rulemaking mandate allows substantial flexibility and the Commission's final rule should allow similar flexibility.

As described above, EPACT § 1233(b) requires implementation of FPA § 217(b)(4) in Transmission Organizations with organized electricity markets. FPA § 217(b)(4), in turn, simply states that Commission should facilitate planning and expansion to meet the *reasonable* needs of LSEs to satisfy service obligations, and to enable LSEs to secure firm transmission rights (*or* equivalent tradable *or financial rights*) on a long-term basis for long-term power supply

arrangements. Thus, FPA § 217(b)(4) *specifies* that financial rights are an acceptable solution to LSE needs.

It is worth noting that FPA § 217(b)(4) does *not*:

- require a *perfect hedge* for LSEs, but only requires addressing their “reasonable needs;”
- specify a *particular length* for LTTR terms;
- specify a *priority mechanism* for supporting LSEs’ long-term arrangements;
- *require* re-assignability of LTTRs; or
- *forbid* the use of auctions as an allocator of LTTRs.

By contrast, the LTTR NOPR’s guidelines would establish a priority LTTR right for LSEs, require re-assignability of LTTRs and significantly circumscribe the use of auctions as an LTTR allocator.

Given the overall flexibility provided in the statute, ISO-NE urges the Commission to permit ISO-NE and New England’s stakeholders to explore options that include keeping the existing FTR framework (in which an FTR is an obligation, rather than an option), and simply extending the term length of FTRs to create LT-FTRs. Indeed, the LTTR NOPR recognizes that for regions such as New England that have well-established markets in place “*the most straightforward method* to develop long-term firm transmission rights would be to extend the term of the auction revenue rights or FTRs that they currently allocate.”<sup>9</sup> A significant advantage of this straightforward approach is that fewer changes to existing systems can lead to earlier – and less costly – implementation.

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<sup>9</sup> LTTR NOPR at P 46 (emphasis added).

2. Given the Statutory Flexibility, the Commission Should Not Rule Out or Impose Particular Approaches to Satisfying the Statutory Requirements

Based on the statutory flexibility discussed above, the Commission is not required to, and should not: (i) rule out allocations of LT-FTRs by an auction mechanism; (ii) mandate a particular amount of LT-FTRs to be made available; (iii) preclude entities other than LSEs from obtaining LT-FTRs; or (iv) require the use of physical transmission rights in regions that utilize an LMP-based market system.

As explained in greater detail below, auctioning (rather than direct allocation to LSEs) of LT-FTRs may lead to greater efficiency and attendant cost savings. The experience of PJM with both methodologies is particularly instructive, and is discussed in further detail in subsection IV.H, below.

The Commission should also grant flexibility to Transmission Organizations to develop (with their stakeholders) particular approaches to gauging the “right amount” of LT-FTRs to make available at any given time. Maintaining the feasibility of LT-FTRs in light of changing system topology, preserving the liquidity of the shorter-term FTR markets, accounting for the interplay between state retail access programs and the degree of prevalence of long-term supply arrangements, and avoiding a “hair trigger” approach to transmission upgrades designed to protect LT-FTR feasibility, require customized regional analysis and calibration of the proportion of FTRs that can and should be issued on a long-term basis.

Issuance of LT-FTRs would also reduce the volume in the annual and monthly FTR market. This would likely result in higher prices for the monthly and annual FTR purchasers. Over-allocation of LT-FTRs could make desired FTRs infeasible altogether in the monthly and annual auctions, depriving monthly and annual FTR buyers of a crucial hedge. Furthermore, many market participants rely on ARR revenues to hedge their congestion costs. Any direct

allocation of LT-FTRs would reduce the value of the ARR hedging mechanisms.<sup>10</sup> Accordingly, ISO-NE requests that the Commission not arbitrarily require the allocation of a particular percentage of feasible FTRs to the long-term FTR mechanisms.

ISO-NE also asks the Commission to ensure flexibility to allow consideration with regional stakeholders of the extent to which entities other than LSEs<sup>11</sup> may obtain LT-FTRs. For example, a generator that signs a fixed-price, long-term contract to deliver power to an LSE (or another entity) may by contract bear the congestion risk and have a need or desire to acquire LT-FTRs as a hedging mechanism.

ISO-NE requests, as well, that the Commission refrain from requiring the introduction of *physical* transmission rights into a financial, LMP-type system such as New England's current market design. As recognized by the Commission in the proceedings regarding the establishment of New England's current market design, even the holders of grandfathered contracts (*i.e.*, Excepted Transactions) who receive ARRs on account of these contracts have never had the right (even before implementation of the current market design) to physically schedule transactions internal to the New England Control Area.<sup>12</sup> ISO-NE and NEPOOL, at the time, also expressed concern about the potential harms of attempting to accommodate physical

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<sup>10</sup> An auction of LT-FTRs is expected to lead to lower prices than for shorter-term instruments. This is because congestion patterns are more uncertain over longer periods. Accordingly, bidders for LT-FTRs would be expected to bid more conservatively.

<sup>11</sup> In this regard, it is not entirely clear whether the definition of "LSE" proposed in the NOPR (lifted from FPA Section 217) would encompass retail marketers that take on load obligations in retail-access states, given the use of the generic terms "electric utility" and "distribution utility." ISO-NE asks the Commission to clarify the definition of LSE in this regard.

<sup>12</sup> *See, e.g., New England Power Pool and ISO New England Inc.*, 101 FERC ¶ 61,344 at P 76 (2002).

scheduling rights within a financially based system.<sup>13</sup> These concerns are no less real today, and include: (i) the economic loss to the region from use of transmission (by virtue of physical priority) for transactions that potentially do not represent the lowest-priced energy delivery; (ii) significant administrative burdens for system users as well as ISO-NE, and the necessity for extensive software changes (including the requirement that LSEs request hourly schedules, with hourly notification times and curtailment priorities); and (iii) the establishment of internal “seams” within New England.<sup>14</sup>

**B. Comments on Guideline (1): “*The long-term firm transmission right should be a point-to-point right that specifies a source (injection node or nodes) and sink (withdrawal node or nodes), and a quantity (MW)*”**

In New England, an array of FTR types is currently offered, in order to meet the varying needs of the market participants and other FTR holders. The source or sink for an FTR can be a node, a zone or the trading hub. Thus, FTRs for various combinations of these sources and sinks are offered and purchased at auction, such as node-to-node, node-to-zone, zone-to-zone, etc. This flexibility allows hedging of a wide variety of bilateral contracts, as well as spot purchases.

In moving to a system of LT-FTRs, the Commission should clarify that it will permit the statutory mandate to be met through a similarly varied array of LT-FTRs, and not require that all LT-FTRs be issued on a point-to-point basis. Zone-to-zone LT-FTRs may be particularly appropriate in New England, as spot market purchases by load are priced zonally, and the

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<sup>13</sup> See Joint Answer of NEPOOL and ISO-NE filed in Docket No. ER02-2330-003, at p.18 (November 27, 2002).

<sup>14</sup> The tariff provisions to create hourly physical rights within New England would need to include a 30- to 60-minute notice time, rules for priority curtailment, provisions for NERC tagging, etc. These measures would create “seams” within New England of a type that the Commission and Transmission Organizations have worked so hard to reduce, and would reduce the extensive benefits of pool-wide economic dispatch that New England has enjoyed (in various formulations) since NEPOOL was established in 1971.

estimation of future zone-to-zone LT-FTR feasibility would be more robust than estimates of node-to-node LT-FTR feasibility. Fundamentally, LSEs and other market participants should be permitted to retain the considerable benefits associated with the flexibility of the existing system.

- C. Comments on Guideline (2):** *“The long-term firm transmission right must provide a hedge against locational marginal pricing congestion charges (or other direct assignment of congestion costs) for the period covered and quantity specified. Once allocated, the financial coverage provided by the right should not be modified during its term except in the case of extraordinary circumstances or through voluntary agreement of both the holder of the right and the transmission organization.”*

With respect to Guideline 2, ISO-NE has a variety of comments and concerns, including:

(i) the potential disruption of the existing New England approach to FTR funding; (ii) the difficulty of assigning funding responsibility were full-funding to be required; (iii) the risks created by LT-FTRs that carry a full-funding “guarantee;” (iv) the scope of “extraordinary circumstances” that can justify changes in financial coverage provided by an LT-FTR; and (v) the broad impact of provisions governing the modification of LT-FTRs.

The LTTR NOPR provides that:

When conditions arise that cause the transmission organization to receive congestion revenues that are not sufficient to meet payment obligations to FTR holders, the transmission organization must have in place a mechanism to fully fund the rights by collecting the needed revenues from a set of market participants.<sup>15</sup>

As the Commission is aware, the present New England system of FTRs does not guarantee full funding. Again, ISO-NE urges the Commission to use its flexibility under EPACT to avoid requiring fundamental change (such as imposing a full-funding requirement) in existing systems, especially where an existing system offers a substantial degree of the security sought for LT-FTR holders. In New England, for example, FTR-only revenues as a percentage of costs

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<sup>15</sup> LTTR NOPR at P 49.

(i.e., excluding congestion costs, ARRs, and excess congestion revenue) for market participants with load obligations were 196 percent in 2003, 94 percent in 2004, and 112 percent in 2005.

If the Commission nonetheless requires that *all* LT-FTR funding shortfalls be reimbursed to LT-FTR holders,<sup>16</sup> the Commission and the region will face daunting challenges regarding the types of entities that should bear the risk of funding any shortfalls. As the Commission is aware, the region has had a continuous and strenuous debate (now pending, in one proceeding, before the U.S. Court of Appeals for the District of Columbia Circuit<sup>17</sup>) regarding the proper allocation of residual and other types of orphaned costs, where justifications exist for allocating such costs to almost any potential class of entities. Although a stakeholder process may result in majority support for one allocator over another, the unlucky recipients of the economic burden will almost certainly protest and potentially seek judicial review: an attempt to insulate LSEs from risks, after all, only creates new risks (here, for funding LT-FTR shortfalls) for other types of entities. Accordingly, ISO-NE urges the Commission, if it addresses funding shortfalls in the final rule, to conserve stakeholder, Transmission Organization and Commission resources.

In sum, especially when combined with the alternative ability of LSEs (under New England's current market design) to enter into long-term supply contracts with third parties for delivery at particular nodes which result in zero congestion, the existing New England system

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<sup>16</sup> If LT-FTRs are required to be fully funded, it may be necessary that shorter-term FTRs be fully funded, as well, increasing the risk of those entities that would be required to fund the shortfalls. Differential treatment of long- and short-term FTRs with respect to full funding could also create short-term FTR auction distortions.

<sup>17</sup> See *Mass. Municipal Wholesale Elec. Co. v. FERC*, Case No. 05-1329 (Petition for Review filed August 18, 2005) (regarding allocation of local second-contingency protection resource charges, as specified in *ISO New England, Inc.*, 110 FERC ¶ 61,250 (2005), *order on reh'g*, 111 FERC ¶ 61,442 (2005)).

provides a mechanism to “meet the reasonable need” of LSEs, as required in FPA Section 217(b)(4).<sup>18</sup>

ISO-NE also encourages the Commission to clarify, in the final rule, the definition of “extraordinary circumstances” that would permit modification of the financial coverage provided by LTTRs. In so clarifying, ISO-NE notes that modification (or a prohibition against modification) could affect not only the LT-FTR holder and the Transmission Organization, but other FTR holders and prospective purchasers, too.

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<sup>18</sup> In this context, the lack of a “guaranteed” hedge is only a problem for entities desiring to build remote generation and deliver its output to their load. But congestion pricing is intended to make the economic consequences of these decisions transparent, and this signal should not be undermined by inappropriately shielding entities from these consequences. In other words, LSEs should continue to have the ability to manage the consequences of relying on remote generation through bilateral contracts or the FTR system, but LT-FTRs should not introduce a means for some market participants to obtain preferential access to the transmission system to the disadvantage of other market participants. ISO-NE is concerned that certain of the LTTR guidelines proposed by the Commission could result in unreasonable discrimination and cross-subsidization of some market participants.

- D. Comments on Guideline (3):** *“Long-term firm transmission rights made feasible by transmission upgrades or expansions must be available upon request to any party that pays for such upgrades or expansions in accordance with the transmission organization’s prevailing cost allocation methods for upgrades or expansions. The term of the rights should be equal to the life of the facility (or facilities) or a lesser term requested by the party paying for the upgrade or expansion.”*

As part of New England’s current market design, New England implemented a Qualified Upgrade Award (“QUA”) system that seeks to meet the goals set forth in Guideline 3. The QUA system, reflected in Section III.C.8 of the ISO Tariff and generally described in Section III.D of these comments, results in an allocation of ARR’s in a value consistent with the incremental revenues resulting from the FTR’s awarded in an FTR Auction that were made possible by the transmission upgrade. The term of QUAs continues as long as the costs of the upgrade are supported (either through upfront payments or periodic installments) or for the life of the upgrade (such as in the case where the upgrade is supplanted by a prior-planned, but subsequently installed, upgrade), if shorter.

- E. Comments on Guideline (4):** *“Long-term firm transmission rights must be made available with term lengths (and/or rights to renewal) that are sufficient to meet the needs of load-serving entities to hedge long-term power supply arrangements made or planned to satisfy a service obligation. The length of term of renewals may be different from the original term.”*

Guideline 4 – regarding term lengths – raises a number of concerns for ISO-NE, in light of: (i) the difficulty in analyzing the feasibility of LT-FTR’s; (ii) uncertainty of how to evaluate LSE’s arrangements that are “planned” to satisfy a service obligation; (iii) the necessity for administrative arrangements by which Transmission Organizations could review long-term power-supply arrangements as “qualifying” an LSE for LT-FTR’s and for policing mechanisms by which gaming could be detected and addressed; and (iv) the need to take into account potential terminations of and modifications to long-term supply arrangements. In light of these and related concerns, the Commission should remain open in its final rule to considering the

term-length proposals developed by the Transmission Organization with its stakeholders, because it may turn out that the desired length of LTFRs and renewal terms is not as long as one might hypothesize in advance.<sup>19</sup>

In providing guidance concerning the appropriate length of LT-FTRs, the Commission should at the outset take into account the difficulty of estimating the feasibility of LT-FTRs.<sup>20</sup> Forecasting the amount and location of generation retirements and load growth, and anticipating changes in transmission topology and outages, are by their nature prone to result in a great degree of uncertainty. Changes in fuel costs, which are probably even more difficult to predict than load growth and transmission upgrades, can also change congestion patterns due to the locations of oil versus gas plants, for example. Accordingly, the Commission should avoid specifying excessive term lengths, and allow Transmission Organizations and their stakeholder processes to develop appropriate proposals.

Mirroring these uncertainties is the range of means by which an LSE could decide to meet its service obligation over a long-term period, and how much of its load will remain subject to a service obligation in light of the prerogatives of the states to change retail access policies. It is difficult for an LSE to plan a specific long-term strategy for meeting its load obligations, and correspondingly difficult for a Transmission Organization to evaluate the firmness of any given long-term strategy if it is forced to “decide” on a quantity and term length of LT-FTRs that

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<sup>19</sup> Indeed, given the potential risks to the holder of an LT-FTR (stemming, for example, from shifts over time in congestion direction or gradual deterioration of FTR value due to transmission upgrades and/or generation construction), it might be imprudent for an LSE to seek such an FTR.

<sup>20</sup> Given the difficulties in analyzing long-term feasibility, the length of LT-FTR term and the quantity of LT-FTRs issued should be viewed as trade-offs. That is, the larger the quantity of LT-FTRs issued, the shorter the term for which LT-FTRs should be issued.

should be administratively allocated to an LSE. ISO-NE and New England stakeholders should be allowed to consider this problem and whether it justifies permitting allocation of LT-FTRs by auction, rather than direct allocation.<sup>21</sup>

If the Commission were to limit the availability of LT-FTRs to LSEs or grant a priority for LT-FTR acquisition to LSEs, and this were determined based on the existence of firm long-term supply arrangements, a multitude of questions would arise and it is likely that Transmission Organizations' administrative costs would increase due to the necessity of reviewing and policing such supply arrangements. For example, for what sort of LT-FTR would an LSE "qualify" if its contract does not specify generators from which the power is sourced? How "firm" would the contract have to be (*e.g.*, what sort of "regulatory out" or other escape clauses would be permissible)? Would it be feasible to develop objective criteria by which a Transmission Organization could judge the firmness and duration of supply contracts for purposes of an initial or renewal term? If LSEs have a priority in obtaining LT-FTRs and become a more valuable type of FTR than short-term FTRs, will there be an incentive for an LSE to exaggerate its load or enter into sham supply contracts?<sup>22</sup> In those circumstances, too, will LSEs have an incentive after obtaining LT-FTRs to make them "surplus," by a strategic shift of

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<sup>21</sup> As discussed more extensively in subsection IV.H, below, if LSEs are charged an appropriate cost (through auction or otherwise) for LT-FTRs, some of these concerns could be reduced or resolved.

<sup>22</sup> The difficulty of policing supply arrangements is illustrated by the following scenario. An LSE in New York signs a power supply contract with a generator in Massachusetts, demands an LT-FTR to the border, and retains the power in New York to sell at a profit in New York City, rather than to serve its own load.

ISO-NE also urges the Commission to use care that an LSE's peak load not automatically dictate the quantity of LT-FTRs to be issued, given the subsidy that the surplus of LT-FTRs during non-peak hours would represent.

load to another entity or a renewed reliance on the spot market or by other means, so that these LT-FTRs can be sold at a profit? What should happen if a default or other unilateral termination occurs under a long-term power-supply contract?

In sum, efforts by Transmission Organizations to police gaming (due to “free” or preferential issuance of LT-FTR to LSEs) and monitor contract vicissitudes would be very difficult and could place costly and burdensome monitoring obligations on Transmission Organizations. However, a variety of mechanisms could be used to reduce the possibility of gaming, and the administrative costs of detecting and remedying it. The Commission should not preclude, for example, requiring an LSE LT-FTR holder to relinquish the FTR when its load obligation shifts, so that it could be reconfigured for a new LT-FTR or shorter-term FTRs, thereby increasing liquidity. Of course, if the LSE “paid” for the LT-FTR (rather than receiving a “free” direct allocation), a compensation mechanism for the remaining term could be necessary.

Similarly, the Commission should not preclude: (i) a prohibition on an LSE LT-FTR holder’s relinquishment of the FTR other than for service obligation changes, due to the unfair opportunity granted thereby to shed the risk of congestion shifts; (ii) requiring an LSE to reassign the LT-FTR to the LSE that picks up the load (subject to a compensation mechanism); or (iii) placing restrictions on secondary market trading of LT-FTRs (see also ISO-NE’s comments on Guideline 6, below). These approaches have advantages and disadvantages. For example, if trading limits are imposed and an LSE decides to build generation locally, the LT-FTR becomes superfluous and others are denied its use at any price.

**F. Comments on Guideline (5): *“Load-serving entities with long-term power supply arrangements to meet a service obligation must have priority to existing transmission capacity that supports long-term firm transmission rights requested to hedge such arrangements.”***

As indicated in ISO-NE’s comments on Guideline 7 below, ISO-NE strongly urges the Commission to permit Transmission Organizations and their stakeholders to consider allocation of LT-FTRs by auction. The use of an auction does not preclude achievement of the Commission’s goals, as expressed in Guideline 5, through – for example – the use of a tie-breaker mechanism. That is, if an LSE with a long-term power supply arrangement and another bidder offer the same amount for the same LT-FTR, the LSE would win the FTR.

A “priority” for LSEs, especially if not accomplished via an auction/tie-breaker mechanism, could create inequity and undue discrimination between those LSEs relying on long-term supply arrangements and those that rely on shorter-term supply arrangements. As indicated in ISO-NE’s comments regarding Guideline 8 below, a priority could in turn create discrimination detrimental to LSEs in retail access states (where load responsibilities shift more frequently and long-term supply arrangements are less common) versus those in non-retail access states by making fewer shorter-term FTRs feasible due to the issuance of LT-FTRs.

From a broader policy perspective, a “priority” for LSEs’ acquisition of LT-FTRs should be examined closely. Generators may need these FTRs as much as LSEs, because generators’ bilateral contracts with load can place the congestion risk on the generator. Moreover, the availability of LT-FTRs may be crucial to the financing and development of new generating resources in a region, and especially to developers of renewable resources that can enhance regional fuel diversity.

In addition, a direct, costless allocation of LT-FTRs, or an auction in which only LSEs may purchase LT-FTRs, would amount to a wealth transfer to the LSEs at the expense of other

market participants. This is because the LSEs would acquire the LT-FTRs at a price below their value and have every incentive to resell them on the secondary market for a profit. As noted before, any under-pricing of LT-FTRs would result in penalizing ARR holders who depend on FTR auction revenues as a hedge.

**G. Comments on Guideline (6): “A long-term transmission right held by a load-serving entity to support a service obligation should be re-assignable to another entity that acquires that service obligation.”**

Given the interrelation of Guidelines 4, 5 and 6, ISO-NE refers the Commission to its comments on Guidelines 4 and 5. In particular, the Commission should permit a Transmission Organization and its stakeholders to develop proposals that could incorporate mandatory rather than permissive re-assignment. However, the Commission should examine such proposals for mandatory re-assignment carefully where the LSE picking up the service obligation has a different set of long-term supply arrangements that may not correspond with the path for the existing LT-FTR, or if the successor LSE may not wish to utilize a long-term supply strategy at all. For these reasons, the Commission should refrain from specifying particular requirements and instead let Transmission Organizations and stakeholders work through the issues related to re-assignment.

ISO-NE also notes that if a final guideline is developed that values LT-FTRs appropriately (through auction or otherwise), the proper corollary guidelines for LT-FTR assignability will be readily discernable, and gaming concerns will be reduced as well.

**H. Comments on Guideline (7): “The initial allocation of the long-term firm transmission rights shall not require recipients to participate in an auction.”**

ISO-NE strongly urges the Commission to provide for Transmission Organizations and their stakeholders the flexibility to consider allocating LT-FTRs by auction, consistent with existing New England practices. The economic benefits of auction-based allocation are well

understood and have been accepted by the Commission in its orders on New England’s current market design and in other proceedings. ISO-NE expects to consider direct allocation proposals during stakeholder discussions, but it is far too early in the process to rule out continued use of auctions for all FTRs.

Indeed, entities such as PJM that initially allocated FTRs directly to load have shifted to an auction-based allocation for compelling reasons. When accepting PJM’s proposal to replace its annual FTR allocation with an annual FTR auction, the Commission found the proposal would “benefit the market by enabling both potential buyers and sellers of FTRs to obtain better information about the value of FTRs.”<sup>23</sup> In addition, the Commission found that the annual auction would expand customer options; provide a more flexible means of addressing congestion; more accurately communicate the true value of FTRs in the market by encouraging greater competition; and allow FTRs to be more readily reconfigured by PJM’s customers when and where new capacity becomes available.<sup>24</sup>

If, on the other hand, the Commission were to preclude an allocation by auction, it is unclear how the LT-FTR acquired by an LSE ARR holder would be valued. ISO-NE believes that the direct allocation of LT-FTRs could create perverse incentives. For example, a system that gives an LSE an LT-FTR for free could permit a pure windfall through usage or resale of the LT-FTR. This would create: (i) incentives for an LSE to “qualify” for the maximum number of LT-FTRs, even if not needed, in order to resell the surplus, and (ii) an inequitable result where

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<sup>23</sup> *PJM Interconnection, L.L.C.*, 102 FERC ¶ 61,276 at P 19 (2003).

<sup>24</sup> *Id.* at 20. The Commission also rejected allegations that PJM’s auction procedures will encourage the exercise of market power or otherwise lead to gaming or market manipulation; determined that gaming of the FTR auction is unlikely; and found that the existing practice of allocating congestion management rights to network and firm point-to-point transmission customers (as opposed to the ultimate consumer) was appropriate. *Id.* at 21-23.

others have to pay for FTRs through an auction mechanism. To the extent that a non-auction-based allocation of LT-FTRs is mandated, within the existing ARR system in New England, certainly a reduction of ARRs relating to shorter-term FTRs likely would need to be made for those LSEs receiving LT-FTRs. However, calibrating the reduction of ARRs could be complicated. For example, some ARR allocations to LSEs arising from grandfathered agreements can involve point-to-point service. Other ARR allocations to the same LSEs are based on load ratio. Thus, a general “netting” rule may be difficult to construct.

Fundamentally, the Commission should not preclude an auction-based allocation of LT-FTRs, and should permit the allocation mechanism to be developed in the stakeholder process.

**I. Comments on Guideline (8): *“Allocation of long-term firm transmission rights should balance any adverse economic impact between participants receiving and not receiving the right.”***

In its foregoing comments, ISO-NE has identified a number of adverse economic impacts that could occur if a prescriptive LT-FTR design were mandated. As noted above, direct allocation of LT-FTRs to (or priority for) LSEs wishing to support long-term supply arrangements could create a favored position for those LSEs versus those LSEs relying on shorter-term arrangements. Indirectly, a direct allocation of LT-FTRs to (or priority for) LSEs could favor LSEs in non-retail access states where service obligation can shift with significant frequency. Allocation of “free” LT-FTRs to LSEs versus an auction of LT-FTRs to generators, traders and other entities creates similar equity and distortion issues.

For these reasons, ISO-NE supports Guideline 8 as an appropriate equitable standard by which other guidelines (and the implementation of those guidelines) should be judged.

## **J. Comments on other questions/issues posed by the Commission**

The Commission seeks comments (at P 89) as to whether Transmission Organizations should be required to file their transmission planning and expansion procedures and their specific transmission plans.

ISO-NE has already filed its transmission planning and expansion procedures with the Commission. Indeed, the Commission required ISO-NE to include comprehensive and detailed planning provisions in its tariff as ISO-NE was transitioning to the regional transmission organization structure that initiated operations on February 1, 2005.<sup>25</sup>

ISO-NE opposes a requirement to file its Regional System Plans (“RSPs”), because it would constrain needed flexibility to adjust plan elements to respond quickly to market and external developments. In addition, the filing of RSPs would not increase the amount of transmission built, because the New England transmission owners have already assumed the contractual obligation (subject to specific and limited caveats) to build transmission projects included within the RSP for reliability and market efficiency purposes.

Moreover, a requirement to file RSPs would represent a significant departure from past Commission practice. Similar types of highly technical studies generally have not been subject to a filing requirement. For example, interconnection studies represent a type of study akin to the core of RSPs, have never been filed with the Commission, and their filing would be highly burdensome both to the Commission and the filing parties.

## **K. Timing Issues**

A 180-day period following issuance of the final LTTR rule for development of a New England proposal through the stakeholder process is insufficient, especially in light of

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<sup>25</sup> See *ISO New England Inc., et al.*, 106 FERC ¶ 61,280 at PP 210-15 (2004).

commitments in New England's Wholesale Market Plan to use the stakeholder process during 2006 and early 2007 to develop proposals (or implementing rules or manuals) for Phase II of the Ancillary Services Markets, the Forward Capacity Auction, combined-cycle unit modeling, special case nodal pricing, the pilot for demand participation in reserves, cold weather reliability measures, reform to pricing of external nodes, Southwest Connecticut energy zone creation and other important initiatives and mandates.

Moreover, the implementation of the resulting proposal (and especially if incremental change to the FTR system is not permitted) could require extensive software changes. ISO-NE has already committed the available ISO technology resources during 2006 and early 2007 to implement the foregoing projects.

Accordingly, a requirement to develop a proposal within 180 days following final rule issuance, with implementation required immediately thereafter – absent clear Commission guidance regarding which projects to delay or defer – would present nearly insurmountable challenges for New England.

**V. CONCLUSION**

For the reasons stated above, ISO-NE requests the Commission to permit flexibility in responding to the requirements of EPACT Section 1233(b).

Respectfully submitted,

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