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TO: Member Systems

FROM: Elias G. Farrah

RE: Tariff Mechanisms For Recovery Of ISO Administrative Costs

There are five basic tariff mechanisms that typically govern the collection of costs, including administrative or operating costs: 1) cost-based rates; 2) stated rates; 3) formula rate; 4) negotiated rates; and 5) market-based rates. Each we be discussed below. The first four can include incentives or performance adjustments. Moreover, the periodic filing of cost information for informational purposes can be required or accommodated under all five, but is most often used in connection with formula rates and market based rates, to ensure that the formula or the market is not producing unjust and unreasonable prices. The information filing provides the Commission and all interested parties the ability to determine whether the rates continue to be just and reasonable or whether a change should be proposed.

Also keep in mind that FERC's has a statutory obligation to ensure that rates are not unjust, unreasonable or unduly discriminatory. The test is applied to the resulting rate and not the methodology. However, the methodology must provide a mechanism to ensure that the rates will, in the final analysis, be just and reasonable. A strong argument can be made that the existing NYISO tariff does not meet that requirement since there is no FERC review of the NYISO costs and the NYISO can increase its costs without being regard to any formula or standard and without being subject to market forces.

Finally keep in mind that, aside from what the tariff provides in terms of formal rate changes, there is a variety of informal mechanisms that could be put in place with the cooperation of the NYISO. For example, the NYISO could subject its budget to market participant review and/or approval or supply budget data and supporting justification to market participants.

1. Cost of Service Tariffs.

Under this structure, the utility is allowed to collect its actual costs based on a projection and a reconciliation mechanism to ensure that there is no over or under collection. This is similar to what the NYISO has now with a couple of important distinctions. Normally, the utility must file to adjust its rates and demonstrate how its costs compare to the projected rates that are in place. That filing provides all parties-- most notably the Commission, the opportunity to review the costs and determine whether they have been prudently incurred.

There are no longer many instances of cost based rates because the Commission has found that they do not provide adequate incentives for efficiency. It is also both difficult and time consuming to determine prudence after the fact. Thus, the Commission has preferred stated rates which provide a utility some incentive to reduce costs between rate cases. Moreover, just the regulatory lag associated with changing rates creates an incentive for the utility to keep costs down.

2. Stated Rates

Under this mechanism, after a rate filing and Commission review, specific rates are approved and "stated" in the tariff. The stated rates cannot be changed without a subsequent rate filing, Commission review and approval. This is the most common tariff mechanism. As stated above, stated rates provide incentives for efficiency, and allow for rate certainty. However, stated rates may not work well where the ISO does not have assets or shareholders because there is no ability on the part of the ISO to absorb the costs associated with inefficiency or regulatory lag. By the same token, reliance on after-the-fact reviews to determine if costs were prudently incurred is also not very workable in the context of an ISO because it has no ability to absorb costs found to be imprudent.

3. Formula Rates

Under this mechanism, rates can be based upon costs and then subject to adjustment by reference to some external indices. For example, costs can go up or down without a filing by an amount equal to the change in an inflation index (GNP, CPI etc) or an index of fuel prices. Gas transportation rates, for example, are sometimes tied to changes in gas commodity prices at the point of injection and the point of withdrawal to ensure that capacity holders are not hurt competitively (this is often done by negotiation as discussed below). This mechanism could be used in our case by providing that the NYISO can increase its rates as long as they don't go up by an amount that exceeds inflation. Any higher costs would require a filing.

4. Negotiated Rates

A utility and its customers can negotiate a rate which is then subject to FERC review and approval. That rate can provide that it never changes or it can provide for change by reference to a formula or indices etc. As discussed above, it has become fairly common to agree to a rate that only changes by reference to some index (e.g. alternative fuel prices or gas commodity prices in the relevant spot markets). If the NYISO wasn't a non-profit entity without any shareholders, it would be possible to negotiate a rate for administering the NYISO which would require the operator to live within its means and which could provide incentives for the operator to reduce its costs below the agreed upon level. The negotiated rate could change according to an indices. However, this mechanism requires an ability on the part of the operator to assume the risk of operating at or below the agreed upon level.

5. Market-Based Rates

Under this mechanism, as you know, market forces are relied upon to keep rates just and reasonable as long as there are protections against the exercise of market power. This mechanism is not very using in the context of ISO administrative costs.

One Reasonable Mechanism

Under the current non-profit NYISO structure, the mechanism that would seem to work best is a cost-based rate that is reconciled periodically to reflect actual costs incurred. To insure adequate rate review, the rate could vary by some amount without a rate filing as long as the amount of any increases is subject to some objective indices, e.g., inflation. However, the NYISO should provide cost information and analysis annually to Market Participants and the Commission to allow all parties to determine that the rates are still just and reasonable. To the extent the NYISO wants a larger rate increase, it should be required to make a Section 205 filing with the Commission. Under this scenario the NYISO would be well advised to attempt to obtain Market Participant support for any such filing.

The recent California ISO case discussed in our prior memo, demonstrates that a proposed tariff revision along these lines would be well received by the Commission and, at the very least, would lead to serious settlement discussions.