February 2008

Wholesale Competition in Regions with Organized Electric Markets: FERC Notice of Proposed Rulemaking

On February 22, 2008, the Federal Energy Regulatory Commission ("FERC" or the "Commission") issued a notice of proposed rulemaking in Docket Nos. RM07-19-000 and AD07-7-000 (the "NOPR").[1] The NOPR proposes reforms intended to improve the operation of organized wholesale electric power markets in the areas previously identified in FERC's June 22, 2007 advance notice of proposed rulemaking in the same dockets (the "ANOPR")[2] (discussed in Kirkland's July 2007 Client Alert "Wholesale Competition in Regions with Organized Electric Markets: FERC Advance Notice of Proposed Rulemaking"). Significantly, the Commission declined to expand the scope of the proceeding to encompass broader questions about market design as requested by certain parties commenting on the ANOPR. Comments on the NOPR are due 45 days following publication of the NOPR in the *Federal Register*.

Principal reforms proposed in the NOPR include:

- Reforms intended to promote demand response by requiring that independent system operators ("ISOs") and regional transmission organizations ("RTOs"):
    - accept bids from demand response resources in their markets for certain ancillary services, comparable to other resources;
    - eliminate, during a system emergency, charges to buyers for taking less electric energy in the real-time market than purchased in the day-ahead market;
    - allow aggregators of retail customers ("ARCs") to bid demand response on behalf of retail customers directly into the organized energy market;
    - modify their market rules, as necessary, to allow the market-clearing price to reach a level that rebalances supply and demand during periods of operating reserve shortage; and
    - study whether further reforms are necessary to eliminate barriers to demand response in organized markets;
- A requirement that ISOs and RTOs dedicate portions of their websites for postings of offers to buy or to sell power on a long-term basis in order to facilitate long-term contracting;

- Improvements on market monitoring by:
    - requiring that ISOs and RTOs provide their market monitoring units ("MMUs") with access to market data, resources, and personnel sufficient to carry out their duties;
    - having MMUs (or the external MMUs in hybrid structures) report directly to the ISO/RTO board;
    - providing that an MMU's functions include: (1) identifying ineffective market rules and recommending proposed rules and tariff changes; (2) reviewing and reporting on the performance of the wholesale markets to the RTO or ISO, the Commission, and other interested entities; and (3) notifying appropriate Commission Staff of instances in which a market participant's behavior requires investigation;
    - removing MMUs from tariff administration; and
    - reducing the time period before energy market bid and offer data are released to the public; and
- Establishing principles intended to ensure that each RTO and ISO is responsive to customers and stakeholders.

1. Scope of the Proceeding

FERC declined requests by the American Public Power Association ("APPA") and AARP and 40 other entities (collectively, "AARP") to convert the rulemaking proceeding into "a broad, generic inquiry into alleged (but not specified) market design flaws." In so doing, the Commission stated that these requests "not only fail[] to offer any specific solutions, but also fail[] to appreciate the differences in market design that exist in each region." NOPR at P 18. The Commission went on to recite actions it has taken with respect to individual markets to address regional concerns and "direct[ed] each RTO or ISO to provide a forum for affected consumers to voice specific concerns (and to propose regional solutions) to the issues raised generically by APPA and AARP[]." NOPR at P 24.

The Commission also stressed that "those entities that have such concerns have a responsibility to propose solutions to address those concerns." NOPR at P 25. For example, FERC noted that the American Forest & Paper Association ("AFPA") proposed a "Financial Performance Obligation" to address concerns it had regarding the structure of organized markets and Portland Cement Association and others (collectively, "Portland Cement") likewise included a proposed solution to the issues it identified. NOPR at P 25. "[E]ncouraged by entities that actually propose solutions rather than merely identify concerns without proposing any meaningful ways to address those concerns," the Commission directed its Staff to convene a technical conference to consider the AFPA and Portland Cement proposals.

2. Proposed Reforms

(a) Demand Response and Market Pricing

The NOPR proposes several reforms "to further eliminate barriers to demand response in organized energy markets" in order to "ensure that demand response is treated comparably to other resources." NOPR at P 26. The Commission emphasized that facilitating demand response "improves the economic operation of electric power markets by aligning prices more closely with the value customers place on electric power," and asserted that "[d]emand response helps to reduce prices in competitive wholesale markets" by (1) directly impacting wholesale demand when demand response is bid into the market and indirectly affecting the wholesale market by reducing the need of load-serving entities to purchase power in the wholesale market; (2) "tend[ing] to flatten an area's load profile" through "[t]he combination of reductions in peak demand and a shift of at least a portion of this peak demand to non-peak periods"; and (3) "help[ing] reduce generator market power" through the increased risk of not being dispatched to a supplier that bids too high. NOPR at PP 28-31.

First, the NOPR would require that ISOs and RTOs accept bids from demand response resources in their markets for certain ancillary services, comparable to any other resources provided that such resources are technically capable of providing the service and meeting necessary technical requirements and submit bids at or below the market-clearing price, unless State laws or regulations preclude a retail customer from participating. This proposal would apply to competitively-bid markets, if any, for energy imbalance, spinning reserves, supplemental reserves, reactive supply and voltage control, and regulation and frequency response as defined in the pro forma OATT, or to the markets of their functional equivalents in an ISO or RTO tariff.

Second, the Commission proposed to require that ISOs and RTOs eliminate deviation charges (*i.e.*, charges to buyers for taking less electric energy in the real-time market than purchased in the day-ahead market) during system emergencies. FERC agreed with commenters that imposition of such charges constitutes a disincentive to demand response in the real-time market, because they may deter buyers from reducing load during periods when supplies are tight and the real-time price is high. According to FERC, "[r]emoval of this disincentive is important during a system emergency when load reduction is needed (and valued) most." NOPR at P 74. FERC emphasized that it was "not proposing to remove any penalty for a day-ahead bidder of demand response who fails to follow directions to reduce demand in real time." NOPR at P 76.

Third, ISOs and RTOs would be required to permit ARCs to bid demand response on behalf of retail customers directly into the organized energy market, unless State laws or regulations preclude a retail customer from participating. FERC explained that experience with aggregation programs in the PJM Interconnection, L.L.C., the New York Independent System Operator, Inc., and ISO New England Inc. markets has shown that these programs increased demand responsiveness.

Fourth, the NOPR proposes to require that ISOs and RTOs modify their market rules, as necessary, to allow the market-clearing price, during periods of operating reserve shortage, to reach a level that rebalances supply and demand so as to maintain reliability while providing sufficient provisions for mitigating market power. After reviewing the comments on the ANOPR, the Commission said it "continue[d] to believe that existing market rules appear to be unjust, unreasonable and unduly discriminatory or preferential during times of scarcity" inasmuch as such market rules "may not accurately reflect the true value of energy and, by failing to do so, may harm reliability, inhibit demand response, deter new entry of demand response and generation resources and thwart innovation." NOPR at P 107. The NOPR proposes to require each ISO and RTO to make a compliance filing, within six months of a final rule in this proceeding, proposing any necessary reforms to ensure that the market price for energy accurately reflects the value of such energy during periods of scarcity. The compliance filing may adopt one of the four approaches outlined in the ANOPR, or the ISO or RTO may propose an alternative approach. Those approaches, described in more detail in Kirkland's July 2007 Client Alert on the ANOPR, would involve:

- Requiring that RTOs/ISOs increase energy bid caps and price caps above the current levels only during an emergency, to allow each customer to decide the value of its own lost load.
- Raising bid caps above the current level only for demand bids in the day-ahead and real-time markets, while keeping generation bid caps in place.
- Requiring a demand curve for operating reserves in each RTO/ISO market, such that when available generating capacity does not meet combined energy demand and operating reserve requirements, the market price for energy and operating reserves would increase to specified levels and the price would increase with the severity of the shortage.
- Setting the market-clearing price at the payment made to participants in an emergency demand response program, by amending RTO/ISO market rules to allow the payment to emergency demand response providers to set the market-clearing price for all supply and demand resources dispatched, together with necessary amendments to rules on unit commitment and settlement to adjust energy prices outside the normal clearing process.

Fifth, because FERC believes that "[t]he need for, and the focus on, demand response will continue to increase," the NOPR contemplates that the Commission and stakeholders will continue to study additional reforms that may be appropriate. NOPR at P 94. To this end, the Commission directed its Staff to convene a technical conference after comments on the NOPR are filed to consider, among other things: (1) whether there are barriers to comparable treatment of demand response that have not previously been identified; (2) potential solutions to eliminate any potential barriers to comparable treatment of demand response; (3) appropriate compensation for demand response; and (4) whether to standardize terms, practices, rules and procedures associated with demand response. In addition, FERC proposed to require that each ISO and RTO submit a report identifying barriers to comparable treatment of demand response resources and possible solutions within six months of the final rule.

(b) Long-Term Power Contracting

The NOPR proposes that ISOs and RTOs be required to dedicate a portion of their web sites for market participants to post offers to buy or sell power on a long-term basis. This proposal is designed to promote greater use of long-term contracts through improving transparency among market participants. The Commission is concerned that, despite the importance of long-term contracts to working markets, "both buyers and sellers perceive that it is increasingly difficult to enter into long-term contracts, and that fewer long-term contracts are being signed as a result." NOPR at P 134.

(c) Market Monitoring

The NOPR contains a number of proposals "designed to strengthen market monitoring and thereby enhance the performance and transparency of organized RTO/ISO markets." NOPR at P 170. Specifically, FERC proposed that each RTO and ISO provide its MMU with access to market data, resources, and personnel sufficient to carry out its duties and that the MMU (or, where there is a hybrid structure with both an internal and external MMU, the external MMU[3]) report directly to the RTO or ISO board. At the same time, the Commission made clear that it does not view the structure of a MMU as "determinative of either independence or quality of performance" and proposed that "each RTO and ISO decide for itself, through its appropriate stakeholder process, whether it will have an external, internal or hybrid MMU structure." NOPR at P 179. The Commission rejected suggestions that the MMU report to a body other than the RTO or ISO, such as to the Commission or to a federal/state board.

The Commission did not adopt the ANOPR proposal that each ISO/RTO tariff contain a provision directing the MMU to report to the Commission any concerns it has with inadequate access to market data, resources, or personnel, or to describe the steps it has taken with the RTO or ISO to resolve these concerns. FERC explained that it reconsidered this proposal, because it could "suggest that the Commission anticipates non-compliance on the part of the RTOs and ISOs, whereas the opposite is true." NOPR at P 182. Moreover, FERC noted that there are already existing mechanisms by which MMUs could bring such concerns to the Commission's attention.

In addition, the Commission proposed to require that the MMU's functions include: (1) identifying ineffective market rules and recommending proposed rules and tariff changes; (2) reviewing and reporting on the performance of the wholesale markets to the RTO or ISO, the Commission, and other interested entities; and (3) notifying appropriate Commission Staff of instances in which a market participant's behavior requires investigation. The Commission also proposed to expand the list of recipients to receive MMU recommendations regarding rule and tariff changes and to broaden the scope of behavior to be reported to the Commission. It further proposed to remove the MMU from tariff administration, to require each RTO and ISO to include ethics standards for MMU employees in its tariff, and to consolidate all its MMU provisions in one section of its tariff.

The NOPR also proposes expanding the dissemination of MMU market information to a broader constituency, with reports made on a more frequent basis, and reducing the time period before energy market bid and offer data are released to the public. While "acknowledg[ing] that the release of such information in the same season could afford opportunities for collusion," FERC was persuaded by the comments that no harm generally would result from shortening the current six-month lag for the release of offer and bid data. NOPR at P 229. It therefore proposed to reduce the time period to three months but said it will consider a shorter period or, if an ISO or RTO demonstrates a potential collusion concern, a longer period of four months.

(d) Responsiveness to Stakeholders and Customers

The NOPR proposes certain principles intended to ensure that ISOs and RTOs are responsive to customers and stakeholders and that customers and stakeholders have confidence in the decisions that result from ISO/RTO processes. These principles will include:

- *Inclusiveness* — Any customer or other stakeholder affected by the operation of the ISO or RTO, or its representative, must be permitted to communicate its views to the ISO or RTO board.
- *Fairness in Balancing Diverse Interests* — The interests of customers or other stakeholders must be equitably considered, and no single stakeholder category should dominate deliberation and consideration of ISO/RTO issues.
- *Representation of Minority Positions* — In instances where stakeholders are not in total agreement on a particular issue, minority positions must be communicated to the board at the same time as majority positions.
- *Ongoing Responsiveness* — Stakeholders should have input into ISO/RTO decisions and should receive feedback to ensure that information exchange and communication continue over time.

The Commission emphasized that it was not proposing a "one-size-fits-all" approach and that various mechanisms may satisfy these principles. It noted that the ANOPR presented two options, the board advisory committee and the hybrid board, with the former being, in FERC's view, "a particularly strong mechanism for enhancing responsiveness." NOPR at P 277.

Each ISO and RTO will be required to submit a filing within six months of the issuance of the final rule in this proceeding proposing changes to comply with these principles or demonstrating that its practices and procedures already do so. In addition, each ISO and RTO would be required to post on its website a mission statement or charter for its organization. FERC also encouraged ISOs and RTOs to take other steps to increase responsiveness, such as management programs that give appropriate weight to stakeholder responsiveness.

3. Concurring and Dissenting Statements

(a) Commissioner Kelly

Commissioner Suedeen Kelly concurred in part and dissented in part to the NOPR based on her concern about several of the proposals related to demand response, market monitoring, and promoting ISO/RTO responsiveness. She was troubled by the proposal to allow higher market-clearing prices during periods of operating reserve shortage in order to promote demand response, because, she argued, "absent appropriate resource adequacy requirements and the necessary demand response infrastructure to give consumers the ability to respond to higher prices, it is not responsible to allow energy supply offer caps and demand bid caps to rise without regard to the impacts on consumers."

Commissioner Kelly also disagreed with the proposal to remove the MMUs from a role in tariff administration and would also have strengthened the market monitoring proposals. For example, she suggested that, subject to appropriate confidentiality restrictions, FERC should provide an MMU with information on a referral that the MMU makes to the Commission.

Finally, Commissioner Kelly disagreed with the proposal to promote responsiveness by allowing ISOs and RTOs to adopt hybrid boards. In her view, allowing stakeholder representatives on an ISO/RTO board is inconsistent with the independent governing structure that is "the cornerstone of RTO/ISO policy."

(b) Commissioner Wellinghoff

Commissioner Jon Wellinghoff concurred to encourage comments on several specific aspects of the NOPR including: (1) the proposal to require each ISO and RTO to accept bids from demand response resources, on a basis comparable to other resources, for ancillary services that are acquired in a competitive bidding process; (2) the proposed ISO/RTO studies on demand response; and (3) the proposal concerning market rules governing prices during operating reserve shortages.

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1 *Wholesale Competition in Regions with Organized Electric Markets*, 122 FERC ¶ 61,167 (2008).

2 *Wholesale Competition in Regions with Organized Electric Markets*, 119 FERC ¶ 61,306 (2007).

3 In such a circumstance, the internal MMU could still report to management.

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