



Organization of MISO States

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November 13, 2008

Mr. Graham Edwards
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Midwest Independent Transmission System Operator
701 City Center Drive
Carmel, Indiana

Dear Mr. Edwards:

The Organization of MISO States ("OMS") is sending this letter to express concerns that it has with the Midwest ISO's Ancillary Services Market proposal, and to request that the Midwest ISO take certain actions in response.

As you know, market design, including market competitiveness, is one of the three key issues of focus adopted by the OMS at its recent stakeholder meeting in St. Paul and again at the OMS annual meeting in October. Fair and competitive ancillary services markets are essential to proper market design as we anticipate that those will bring significant benefits to the Midwest. The OMS Board believes strongly that such benefits can best be realized through a stringent and diligent market monitoring approach. Competitive market design and effective independent market monitoring are critical to ensure consumers pay just and reasonable rates. However, the OMS Board is concerned that there exist impediments to market competitiveness two of which must be immediately addressed in order to realize the benefits of a market structure.

Our concerns are in three general ASM areas: (1) ASM zonal cost allocation, (2) determination of ASM reference prices, and (3) the involvement of the independent market monitor ("IMM") in ASM design, testing, and readiness.

First, the OMS is concerned with the way the Midwest ISO will allocate the cost of ASM services to zones. Under the current approved method, there is still the potential that, particularly for lower reserve requirements zones, the Midwest ISO has departed from traditional cost causation cost allocation methods. This could result in an unfair allocation of costs on some customers within the region. Accordingly, the OMS requests that the Midwest ISO analyze and report on the results of the cost allocation methodology one year following the start of the ASM, including the development of recommendations to enhance the cost allocation method consistent with that suggested by the OMS in Comments to the Midwest ISO on October 15, 2007, and as the Midwest ISO agreed to consider on November 6, 2007.

Second, the Midwest ISO's tariff continues to lack a detailed explanation about how the IMM will determine the reference level through the consultative process. The

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benefits of a fair and competitive ASM can only be realized through a strong market monitoring approach that implements a clear and transparent process of setting reference levels.

The OMS therefore requests that the Midwest ISO revise its tariff to: (1) provide additional clarification regarding the Midwest ISO's reference level determination process, both as required in the Commission's June 23 Rehearing Order and as discussed herein; (2) make clear the calculation method(s) used when establishing reference levels as required in the Commission's June 23 Rehearing Order; and (3) describe how reference levels will be developed, as promised in the preamble to the Section 64.1.4.

Finally, the OMS continues to support active involvement of the IMM and use of his expertise in ASM design, testing, readiness, and on-going operations. The OMS requests that MISO provide more detailed information regarding how and to what level of detail the IMM will be involved in operational testing through market launch and daily operations of the ASM. Modifications to market design including the sharing of ramp across multiple products may impact market monitor systems and procedures. In particular, the OMS recommends that, through the process with the readiness advisor and Energy and Ancillary Services Task Force (EARTF), the Midwest ISO confirm market monitor readiness more formally through reverification and documentation of one of the readiness criteria, MMR1 "IMM Certifies Readiness 45 Days Prior to ASM/BA Launch." We anticipate that these two requests actions could be satisfied through the EARTF, an additional OMS conference call with the IMM, or both.

We trust that getting the markets right is also an important goal of the Midwest ISO, and that our recommendations and requests will complement ongoing improvements already planned towards changes in tariffs, business practices and procedures.

Thank you for your attention to these matters. The OMS looks forward to hearing from you, and also working with the Midwest ISO and the Independent Market Monitor towards resolving these important issues. If you have any questions, please don't hesitate to ask.

Very truly yours,

William H. Smith, Jr.
William H. Smith, Jr.
Executive Director

cc: David Hadley
David Patton

OMS Markets and Tariffs Work Group Report on Concerns With the Midwest ISO Ancillary Services Market (ASM) – 11/07/08

The OMS Markets and Tariffs Work Group (MTWG) submits this report to the OMS Board of Directors to highlight details of the MTWG's remaining concerns with the Midwest ISO's proposed Ancillary Services Markets (ASM). This report is intended to provide the OMS Board with background in support of the MTWG's recommended action: that the OMS Board send the attached proposed letter to the Midwest ISO Board of Directors to express these concerns and to recommend particular Midwest ISO actions in order to improve the Midwest ISO's ASM market.

The MTWG has three general concerns regarding ASM: (1) the potential for zonal cost allocations to stray from cost causation principles, (2) continued lack of detail from the Midwest ISO concerning the process for determining ASM reference prices, and (3) continued ASM market power issues, including the need for increased and clarified involvement of the market monitor in ASM market design and testing.

In support of the proposed letter to the Midwest ISO, the MTWG states the following:

A. The Midwest ISO Should Review And Revisit The ASM Reserve Zone Cost Allocation After One Year Of Market Operation.

Recommendation

The MTWG is concerned with the way the Midwest ISO will allocate the cost of ASM services to zones. Accordingly, the MTWG recommends that the OMS request that the Midwest ISO analyze and report on the results of the cost allocation methodology one year following the start of the ASM, including the development of recommendations to enhance the cost allocation method consistent with that suggested by the OMS in Comments to the Midwest ISO on October 15, 2007, and as the Midwest ISO agreed to consider on November 7, 2007.

Background

In the initial Midwest ISO ASM filing to the Federal Energy Regulatory Commission (Commission) in February 2007¹ the Midwest ISO proposed that the costs of ancillary services be allocated to load using a market load ratio share method.

The cost of procuring operating reserves can vary by location. Allocating ASM costs on a market-wide load ratio share basis would not align costs with cost causers. The OMS noted this zonal cost allocation concern in Comments filed on March 30, 2007, and urged the

¹ Midwest ISO initial filing in docket no. ER07-550-000, filed February 15, 2007.

Commission to require the Midwest ISO to develop an allocation methodology that recognized the price differences across the Midwest ISO footprint.²

In its Guidance Order, issued June 22, 2007, the Commission agreed with the Midwest ISO that a market-wide allocation of ancillary services costs was reasonable, because regulation and reserve energy are procured on a system-wide basis in the co-optimization analysis, and therefore ancillary services are provided for the benefit of the entire market. However, the Commission encouraged the Midwest ISO to continue discussions with stakeholders on cost allocation issues in recognition of circumstances that may require refinements to ensure that costs are allocated based on cost causation principles to the extent possible.³

The Midwest ISO subsequently invited and considered alternative cost allocation methods and facilitated analysis and stakeholder consideration of these alternatives. Three cost allocation methods were explored: (1) the market-wide load ratio share method which had initially been filed and which allocated the total cost to all load on a total load ratio share basis, (2) the zonal load ratio share method which allocated the cost of reserves located in a zone to zonal load on a zonal load ratio share basis, and (3) a hybrid method which incorporated aspects of both the market-wide load ratio-share method (to reflect market-wide responsibility for the megawatt amount of reserves to be procured) and the zonal method (to reflect locational procurement prices).

The cost for ancillary services can be significantly higher for zonal allocations because zones are created where constraints exist, creating a situation where both the amount and price of ancillary services inside the zone can be greater. Examples created by the Midwest ISO showed that this could cause costs in zones to be multiple times higher than in non zones. This caused concerns among stakeholders that system constraints could cause them extremely high ASM costs.⁴ The hybrid method was a compromise to soften the potential cost impact of a zonal allocation.

In subsequent stakeholder meetings, two hybrid methodologies were developed: the original hybrid method and the modified hybrid method. The modified hybrid cost allocation method was supported by a majority of stakeholders. In its September 14, 2007 filing, the Midwest ISO proposed the modified hybrid cost allocation method.⁵

² Comments of the Organization of Midwest ISO States and Notice of Intervention, Docket No. ER07-550, March 30, 2007, p. 15.

³ Order on Ancillary Service Filing and Providing Guidance, June 22, 2007, P.106. (119 FERC 61,311).

⁴ This was compounded by the Midwest ISO's proposal to make such zones subject to daily changes, thus making it difficult for LSEs to hedge their ASM costs.

⁵ Midwest ISO, Docket No. ER07-1372-000 filed September 14, 2007

On October 15, 2007, the OMS filed Comments in support of the modified hybrid cost allocation method. The OMS noted that this hybrid approach, though a more superior approach than the Load Ratio Share (LRS) socialization approach included in the original ASM filing, may not necessarily be the most cost causative approach for allocating ASM costs. As a result, the OMS urged the Commission to direct the Midwest ISO to analyze the results of the allocation methodology one year following the start of the ASM market and provide a report to its stakeholders, broken down into each quarter or timeframe for which the reserve zones were static, that provides the following: 1) a description of the zones that were created and the dates the reserve zones were in effect, 2) the average AS cost⁶ for each product in each zone and non-zone, 3) the average revenues from each zone and non-zone, 4) the reasons the reserve zones were created, 5) a table showing what each zone and non-zone would have paid under the original LRS allocation proposal, the August 17, 2007, Market Subcommittee (MSC) approved hybrid proposal, a pure zonal approach, and 6) what each zone and non-zone paid under the modified hybrid proposal in the September 14 ASM filing. The OMS further commented that the Midwest ISO should also include any recommendations it may have as a result of its analysis to reach its ultimate goal of allocating costs on a cost causation basis to provide better ASM hedging opportunities for the Market Participants.⁷

On November 6, 2007, the Midwest ISO expressed appreciation for the comments made by OMS on this issue and indicated it was open to the suggestion by OMS to analyze and report on the results of the cost allocation methodology one year following the start of the ASM including the development of recommendations to enhance the cost allocation method, if necessary.⁸

On February 25, 2008, the Commission issued an Order on Ancillary Service Filing. The Commission determined that both hybrid methods were defective in that they “limited the costs allocated to the higher reserve requirement zones to the share of zone load to market-wide load, and shared costs above this level with other zones.”⁹ In other words, neither method allocated a fair share of the cost of reserves required in a zone to the load in that zone. High reserve requirement zones are zones with higher reserve requirements than their load ratio share of reserves. Constraints prevent the import of sufficient reserves to cover contingencies, so the zone must carry more reserves than it would if there were no constraints. Low reserve requirement

⁶ Ancillary Service (AS) cost = Market Clearing Price (MCP) multiplied by (*) Cleared Operating Reserves (OR)

⁷ Comments of the Organization of Midwest ISO States and Notice of Intervention, Docket No. ER07-1372, October 15, 2007, p. 20-21.

⁸ Motion for Leave to Answer and Answer of the Midwest ISO, Docket No. ER07-1372, filed November 6, 2007, at 44-45.

⁹ Order on Ancillary Services Filing, 122 FERC 61,172, (2008), at 420.

zones are zones with lower reserve requirements than their load ratio share of reserves.¹⁰ Constraints and higher prices cause more reserves to be acquired from outside the zone. The Commission required the Midwest ISO to file a revised cost allocation that allocated the costs of reserves in the zone to load in the zone.¹¹

On March 26, 2008, the Midwest ISO submitted a 30-day compliance filing to reflect a zonal cost allocation method in reserve zones in which the minimum operating reserve requirement is binding,¹² thus causing price separation in either the day-ahead or real-time energy and operating reserve markets. Net operating reserve procurement costs within each binding settlement zone will be allocated to real-time load, excluding load served under carved-out grandfathered agreements, within the binding settlement zones. Net operating reserve procurement costs within the non-binding settlement zones are allocated to all real-time load, excluding load served under carved-out grandfathered agreements, within the non-binding settlement zones.¹³

On February 25, 2008, the Commission issued an Order Granting in Part and Denying in Part Rehearing and Granting Clarification. In it, the Commission denied requests for rehearing of the Commission's requirement that reserve costs in a zone be allocated to the load in the zone.¹⁴

Discussion

While the Midwest ISO's March 26, 2008, zonal cost allocation method addresses the higher reserve requirement zone defect identified by the Commission, it raises a concern regarding lower reserve requirement zones. When a reserve zone is binding, such that the price for operating reserves is higher in the binding zone than it is in the non-binding zones, operating reserves will be purchased in the binding zone at the minimum required amount. The remaining amount of operating reserves will be purchased in the lower priced non-binding zones.

¹⁰ *Midwest Independent Transmission System Operator, Inc.*, Order on Ancillary Services Filing, 122 FERC ¶ 61,172 (2008), [February 25, 2008], P. 414 and 415.

¹¹ *Id.*, , P. 421.

¹² A reserve zone is binding when a constraint, such as a transmission line at or above its limit, causes a change in the dispatch or commitment of one or more electric facilities to meet the reserve zone's minimum operating reserve requirements. As a result, lower cost suppliers outside of the zone are unable to provide reserves to satisfy the requirement and reserves are instead procured at a higher cost from suppliers inside the zone.

¹³ *Midwest Independent Transmission System Operator, Inc.*, Compliance Filing, March 26, 2008, p. 18–19.

¹⁴ *Midwest ISO*, Order Granting in Part and Denying in Part Rehearing and Granting Clarification, 123 FERC 61,297 (2008) [June 23, 2008], P. 19.

Thus, where a reserve zone is binding and the minimum required operating reserves needed are less than the zone's load ratio responsibility for operating reserves, operating reserves acquired for the zone will likely reside both in the binding zone and in the non-binding zone. Under this zonal cost allocation method, load in the binding zone will pay only for operating reserves located in the binding zone., and thus pay less than their fair share. Load in the non-binding zones will pay for the binding zone's load ratio responsibility amount that is located in the non-binding zones, and thus pay for more than their fair share.

It appears that the goals of cost causation and equity among market participants could be impacted by the structure of this zonal cost allocation. The magnitude of the cost responsibility shift that will occur, and hence the materiality, is unclear at this time as factors may offset to some degree.¹⁵ An after-the-fact analysis using actual data will therefore be helpful.

B. The Midwest ISO Should Provide More Detail For Determining The Initial Reference Prices For The ASM

Recommendation

The MTWG finds it disconcerting that the Midwest ISO's tariff continues to lack a detailed explanation about how the IMM will determine the reference level through the consultative process. The MTWG continues to believe that the implementation of a fair and competitive ASM will bring significant benefits to the Midwest. However, such benefits can only be realized through a strong market monitoring approach that implements a clear and transparent process of setting reference levels.

Accordingly, the MTWG recommends that the OMS Board request that the Midwest ISO revise Section 64.1.4 of its tariff to: (1) provide additional clarification regarding the Midwest ISO's reference level determination process, both as required in the Commission's June 23 Rehearing Order and as discussed herein; (2) make clear the calculation method(s) used when establishing reference levels as required in the Commission's June 23 Rehearing Order; and (3) describe how reference levels will be developed for the first 90 days of the operating reserve market, as promised in the preamble to the section. The Midwest ISO has a responsibility for ensuring that its markets operate without the exercise of market power. The Midwest ISO cannot defer all this responsibility to a third party—not even to the Market Monitor.

Background and Discussion

A properly designed and well functioning ASM should bring significant benefits to the Midwest. Accordingly, the OMS has been a consistent supporter of the Midwest ISO's efforts to design and implement a competitive market for ancillary services. However, the OMS has also

¹⁵ As the amount of operating reserves that are required to be located in the zone decreases, the probability of price separation may also decrease.

consistently expressed strong concerns regarding generator concentration levels in the Midwest ISO's footprint, the high potential for exercise of market power in the ASM and the resulting need for a very strong and active market monitoring approach.¹⁶ In particular, the MTWG has concerns about the vagueness and lack of both transparency and oversight regarding how the Midwest ISO sets the reference prices in the ASM.¹⁷

The OMS has expressed its concerns on this issue to FERC and requested that the Commission address the unrestrained flexibility that the reference price-setting provisions of the Midwest ISO tariff provide to the generating companies and the undue discretion that those tariff provisions provide to the IMM regarding the reference price-setting process. In particular, the OMS expressly recommended that more specificity be injected into the process of establishing reference prices and that a role be created for state regulators in reviewing both the reference price-setting process and the reference prices that are established by the IMM.¹⁸

The Commission addressed the reference price issue at Paragraphs 66-74 of its June 23, 2008 Rehearing Order.¹⁹ The Commission specifically stated,

...we grant rehearing with respect to the Midwest ISO's reference level determination process. We will require the Midwest ISO to work with its stakeholders to provide additional clarification regarding the Midwest ISO's reference level determination process, including information regarding the types of data and calculation method(s) used when establishing reference levels using the consultative process.²⁰ To communicate the outcome of this stakeholder process to the Commission, we will require the Midwest ISO to submit, in a compliance filing due within 30 days of the date of this order, tariff revisions to section 64.1.4 to clarify its reference level determination process, or, in the alternative, a statement explaining why such revisions are unnecessary.²¹

In its July 23, 2008, compliance filing, the Midwest ISO did not offer any revisions to Section 64.1.4 of the tariff. Rather, the Midwest ISO stated,

¹⁶ Comments of the Organization of MISO States, Docket No. ER07-1372, at 2; (OMS Comments), Reply Comments of the OMS Following Technical Conference, Docket No ER07-1372, at 2; and Comments of the Organization of MISO States, Docket No. ER07-550, at 3

¹⁷ OMS Comments, at 4-7.

¹⁸ OMS Comments, at 9-10.

¹⁹ *Midwest Independent Transmission System Operator, Inc.*, 123 FERC ¶ 61,297 (2008) (June 23 Rehearing Order).

²⁰ We note that the Midwest ISO states that it will work with its stakeholders to provide additional information regarding its reference level determination process. See Midwest ISO, March 26, 2008 Compliance Filing, Docket No. ER07-1372-004, at 4.

²¹ June 23 Rehearing Order, at P 73. (underlining added).

No revisions to the Tariff are needed because the details on implementation of this process by the IMM have now been appropriately included in the Midwest ISO's Business Practice Manuals (BPMs) and have been addressed in discussions with stakeholders.²²

The additions to the BPM referenced by the Midwest ISO are contained in the recently added Section 6.7.3 of its Market Monitoring and Mitigation BPM.²³ This reference to the Midwest ISO's BPMs does not remove the OMS' concerns, as Section 6.7.3 of the BPM merely lists the types of data that the IMM may collect—it does not “clarify” the Midwest ISO’s “reference level determination process.”

The OMS also notes that the Midwest ISO's tariff does not explain how the IMM will determine and decide that the reference level produced through the consultative process is an accurate representation of the generator's actual marginal cost. For example, Section 64.1.4.a.iii of the Midwest ISO tariff, which describes the consultation process, explains that factors such as “legitimate risks” and “opportunity costs” will be inputs in calculating the reference level. However, these terms are, at best, undefined and would effectively provide the IMM with significant latitude in determining if the risk factors and opportunity costs submitted by a generator in the setting of the reference price are truly legitimate.

The OMS has commented that the reference levels set by the Midwest ISO in the ASM must reflect the true marginal cost of service and should continue to do so in these calculations.²⁴ The inclusion of such nebulous terms in the reference level setting process does little to provide transparency to the consultation process or instill confidence in all parties that the results produced by the process are accurate. Indeed, the criteria used in developing the reference level setting process should be consistent for all generators operating in the ASM and not the result of persuasion or negotiation of individual generators. This transparency is especially critical, given that these negotiations are taking place between the IMM and the very generators that the IMM may ultimately be identifying for mitigation.

A well defined and transparent reference level setting process is in the best interest of every Midwest ISO stakeholder – including the generators that participate in the ASM. Accordingly, for the reasons stated above, the OMS Board should request that the Midwest ISO direct its IMM to clarify the reference level determination process by providing a specific list of items that it will consider as legitimate risks and opportunity costs or identify proxies that it will allow for those items.

²² Midwest ISO July 23 Transmittal Letter, at 4.

²³ Midwest ISO Business Practices Manual No. 009, Section 6.7.3.

²⁴ Reply Comments of the OMS Following Technical Conference, Docket No ER07-1372, at 2.

C. The Midwest ISO Should Address Market Power Issues And Adequate Involvement Of The Market Monitor

Recommendation

The Midwest ISO should more formally confirm the IMM's ASM readiness assessment through reverification and documentation of one of the readiness criteria, MMR1 "IMM Certifies Readiness 45 Days Prior to ASM/BA Launch."

Background and Discussion

Market design, including market competitiveness, is one of the three key issue goal areas recently adopted by the OMS.²⁵ Meeting the goal of a well designed and competitive market means active involvement of the IMM and use of its expertise in ASM design, testing, readiness, and on-going operations.

To meet that goal, the MTWG believes that the Midwest ISO should assure the OMS that it and the IMM have the requisite metrics, data, hardware, software, and personnel to effectively oversee the testing and operations of the ASM. OMS staff did not get adequate information via the Midwest ISO Energy and Ancillary Services Task Force (EARTF) readiness process to have confidence that this is happening. The MTWG recommends that the OMS ask the Midwest ISO to provide more detailed information regarding how and to what level of detail the IMM will be involved in operational testing through market launch and daily operations of the ASM.

The MTWG also believes that competitive market design and effective independent market monitoring are critical to ensure consumers pay just and reasonable rates. Market monitor readiness for implementing the new ancillary services market was officially certified based on an email from Dr. David Patton dated July 17, 2008. Later modifications to market design including the sharing of ramp across multiple products may impact market monitor systems and procedures. Therefore, the Midwest ISO should confirm market monitor readiness more formally through reverification and documentation of one of the readiness criteria, MMR1 "IMM Certifies Readiness 45 Days Prior to ASM/BA Launch."

The OMS Board letter to the Midwest ISO with the recommendations set forth above will add weight to these requests and help to facilitate resolution. OMS staff expects to receive responses through the readiness advisor and Energy and Ancillary Services Task Force (EARTF) and possibly an additional OMS staff conference call with the IMM. However, details in responses received to date have been lacking. The MTWG believes that these issues are significant enough to ensuring a properly functioning ASM market that such further steps are now advisable.

²⁵ The OMS Board of Directors identified three key issue goal areas during its Strategic Retreat on August 19, 2008. The three key areas are transmission cost allocation, regional planning, and market design and value.