

Ancillary Services Market
Organization of MISO States Market Work Group Comments to the Midwest ISO
January 26, 2007

The Organization of MISO States (OMS) Market Work Group thanks MISO for the opportunity to provide its comments regarding the Ancillary Services Market (ASM) business rules and draft tariff sheets. In the effort to provide MISO with timely comments, this document has not been considered or voted upon by the OMS Board of Directors. Therefore, this effort should be considered as an initial expression of concerns and issues that require further understanding. The Market Work Group looks forward to working with stakeholders and MISO on this important matter.

Cost Allocations

We have concerns with the cost allocation of MISO's Administrative Charges for ASM and the three ASM products of Regulation, Spinning Reserve and Supplemental Reserve. The MISO Administrative Charges for ASM are described in MISO's Schedule 17. The three ASM products of Regulation, Spinning Reserve and Supplemental Reserve are found in MISO's Schedules 3, 5 and 6, respectively.

In regards to who pays for the ASM Administrative Charges, we note that, according to the December 14 and 15, 2006 presentation of ASM Design Meeting, MISO considered three possible methods for allocating costs:

- Load Serving Entities,
- Cost Causers and Market Participant beneficiaries,
- Some combination of the above.

It is our understanding that Schedule 17 costs are assigned to load. OMS has supported in prior comments and in issues involving cost allocation principles the practice of allocating costs on a cost-causative and beneficiary-pays basis.

In regards to who pays for Regulation, the we note that according to the December 14 and 15, 2006 presentation at the ASM Design Meeting, MISO supports allocating the costs of Regulation to all LSE market participants. We consider Regulation as defined on page 5 of the MISO presentation as "positive and negative resources capacity set aside for the purpose of managing interconnection frequency and balancing generation with demand plus net scheduled interchange with a specific balancing authority on a Real-Time basis." Put more simply, Regulation is balancing the positive and negative frequencies between the control areas. As a result, we consider Regulation an ASM product that benefits everyone in the MISO Market and therefore, should be assigned to all mega watt hours.

In regards to who pays for Spinning Reserve and Supplemental Reserve, we note that the MISO presentation suggests the reserve costs should be assigned to load. We disagree that these reserve costs should be assigned purely based on load. We believe that the Spinning and Supplemental Reserve costs are clearly driven by events, such as generator outages, and as a

result these reserve costs should be assigned on a more cost-causative basis based to those who caused the cost within the pricing zone.

Overall, given the level of complexity and tools of the new ASM platform, we believe that costs be allocated to those creating the need for the reserves deployment.

Hedging and Benefits to Customers

Based on a limited review of the proposed tariff, it is not clear that load-serving entities and their customers can adequately hedge risk in ASM to ensure that significant costs are not incurred in the future. Simply put, load-serving entities must be able to fully schedule ASM reserves for customers without being at risk for high prices resulting from after-the-fact determinations of capacity needed to serve load.

Today, ancillary services in states with rate regulated utilities are priced at cost, so it is very important not to unfairly shift market risks to the customers. We ask MISO and load-serving entities to help better understand this issue and to work together to ensure that customers do truly receive the benefits MISO has promised.

Invoices

In responding to utilities' ASM cost-recovery requests, State regulators are likely to raise issues related to the nature of the ASM costs incurred. The OMS Market Working Group is concerned about the sufficiency of information to be included in MISO invoices and settlement statements. Specifically, the OMS Market Working Group is interested in the ability of regulators to consider operating information in order to make findings of prudence and reasonableness of ASM costs, particularly with respect to energy and ASM offers, real-time performance, and the amount of any penalties that may accrue. Similarly, the OMS Market Working Group is concerned that utilities have the ability to identify areas for operational or market participation improvements to control costs on behalf of their customers.

It is the OMS Market Working Group's understanding that MISO invoices typically reflect net amounts from which a detailed analysis cannot be performed to ascertain whether a regulated utility has operated in a manner consistent with state cost-recovery statutes. For example, the invoices for the existing Schedules 3, 5, and 6 for Regulating, Spinning, and Supplemental Reserves, respectively, are presented weekly with daily net amounts. Without a separately identified line item, the invoices will not indicate whether penalties have been applied, nor in what amounts.

It was suggested in a recent meeting of the Rate Design Task Force on January 24, 2007, that MISO Settlement Statements provide the detail necessary to ascertain whether penalty provisions have been applied. However, it was also suggested that the settlement statement details have not all been established and that the Market Settlements Working Group will be addressing such details in future meetings. To the extent that the tariff does not or cannot provide such details,

the Market Work Group strongly suggests that MISO make a commitment to address this issue in its tariff affidavit.

Finally, the OMS Market Working Group suggests that settlement statements contain sufficient detail to support independent efforts to evaluate the costs and benefits of the ASM. The OMS Market Working Group is aware that efforts are underway via the Data Collection Working Group and the Rate Design Task Force to address the mechanisms for performing cost benefit analysis and cost recovery issues. While these efforts allow for stakeholder participation, we want to ensure that MISO makes a direct commitment to working with the states in understanding impact the ASM on current state ratemaking, since different states have different rate structures. We look forward to working with MISO and stakeholders to refine and improve the ASM design, settlements and recovery mechanisms.

Complexity

Given the complexity of the ASM, significant time is required to develop, put in place, and test operational and financial systems and procedures and to develop participant preparedness. Some have suggested that MISO is rushing to provide sufficient and thoughtful details and perhaps compromise on significant aspects of the market in order to meet a self-imposed filing deadline.

The OMS Market Work Group suggests that MISO step back from its self-imposed deadline and invest in the further development of key aspects necessary to achieve a successful ancillary services market. A key aspect of the market is full participation by the Balancing Authorities. However, on January 24, 2007, during a Rate Design Task Force meeting, stakeholders learned that the Balancing Authorities agreement signatories have delayed the vote on Balancing Authority functional consolidation until the week of February 26, after the ASM tariff is filed at FERC. Since the balancing authorities' full participation in the ASM is a critical design element of the new market, MISO should ensure that the full agreement and the cooperation of the balancing authorities are in place before filing a tariff. Without this key element firmly in place in a complex market design, the tariff may simply be a place holder for a later revised filing. MISO should carefully consider the decision to file the tariff without the Balancing Authorities' approval of the consolidation agreement.

Given the importance of the ASM, proper due diligence requires that sufficient time be taken to accomplish complex changes, to weigh the implications and consequences from a perspective of the individual aspects and the market as a whole, and to build in diagnostic, audit, and contingency safeguards. For example, with the launch of the new ASM, the energy market and the ASM will be simultaneously co-optimized. Given the complexity of the important changes to the market, the Market Work Group wonders if the audit functions will be in place to assure that the co-optimization is done prudently at the least cost. Will MISO know if the choices are not just and reasonable?

Demand Response Resources

Demand response is key design element to a successful ASM. The FERC said “for a workable EOM, robust DSM programs are of vital importance.” (9/26/06 order ER06-1112 at P55). It is difficult, however, for state commissions to simply take on faith that ASM will automatically lead to increases in demand response that are sufficient to lessen the need for scarcity prices. Instead, more assurance that demand response resources will actually participate will help alleviate concerns about high scarcity prices. If the preferred method to increase demand response participation is simply allowing customers to be exposed to high prices, the states would have already done so.

Although the Final Business rules and draft tariffs provide details for participation of Type 1 and Type 2 demand response, work still remains to ensure full participation. Type 2 demand response must provide telemetering. Participation may be slow at first, and the extra expense, while necessary, may slow participation. While MISO has agreed to allow utility load control programs to participate, the response must have the ability to record 10-second data. In other words, wholesale market participation by any demand response resource requires hardware able to collect data on 10-second intervals. (ASM Business Rules Sec s 3.1.2.2, 3.2.2.5; draft Module C tariff sheets 482H, 482J, 553A, 553C) Demand response resources that do not have this ability may be prevented from participating in MISO’s ASM.

We are still concerned that the specifications for participation may be so narrowly defined that many demand response resources will not be able to participate in the market and have the ability to temper scarcity prices. If response is not sufficient, state regulatory approvals of retail market changes will take time. The OMS Market Work Group strongly urges MISO to analyze if sufficient demand response resources are able to participate in wholesale or retail markets to assist in the need for scarcity pricing.

Must-Offer Requirement

The must offer requirement for regulation reserves is an important element of the ancillary services market design because of:

- the short-term nature of the arrangements for operating reserves (which do not create incentives to construct capacity);
- provisions in the MISO’s proposal that create an incentive not to participate in the ASM (such as the claw-back penalty for inadequate response in business rule 10.2.2);
- the MISO’s proposal for scarcity pricing which imposes a good deal of price risk exposure on customers;
- the MISO’s proposal for allocating the ancillary services costs to load;
- the specification of Regulating Reserve Zones and Contingency Reserve Zones create new possibilities to exercise market power.

Misaligned Financial Consequences

The ASM, as designed, appears to have misaligned financial consequences for the deployment of the last quantities of reserves. Spinning Reserves are required to immediately offset deficiencies in energy supply that result from a resource contingency or other abnormal event (Schedule 5), yet there is no financial consequence for failure to start responding upon receipt of the deployment request.

Similarly, Contingency Resources must be capable of deploying 100% of the cleared amount within the Maximum Contingency Reserve Deployment Time, yet market participants suffer no financial consequences if only 95% is delivered. The market should not be required to pay for a higher level of contingency reserve reliability than is actually delivered. For example, the Hourly Uninstructed Deviation rules, in combination with the 95% deployment standard, create a financial incentive for smaller generation units (57 MW or less) to increase their contingency reserve offers by 5% more than they are capable of providing. A financial incentive to offer more capacity than is actually available is at odds with the design objectives of reliability at least cost.

Zonal Boundary Changes for Regulation and Contingency Reserves

While MISO's Business Rules and draft tariffs describe deliverability studies and potential daily changes to reserve zones, the documents do not clearly explain the timing of the deliverability studies and of posting results to participants in the ASM. Although MISO provided verbal explanations for defining zonal reserves, the tariff and business rules should provide additional specificity on the exact timeline. Differing zones suggest different ASM requirements for any given day. Logically, zones might be created transmission constraints occur. Because a constrained area could require a larger contingency, the resulting reserves requirements could trigger scarcity pricing. Given the possibility of higher prices due to changing zones, please consider allowing adequate time to respond and plan for changing zonal requirements. Will market participants be given enough advanced warning to be able to hedge ASM prices? For those planning to self-schedule reserves, will they have enough time to react to changes in requirements?

Deadband

Section 8.2.1 of the ASM Business Rules specifies a 2% tolerance before an excessive energy threshold is imposed. Comments by the IPP sector at the January 2007 Advisory Committee meeting suggest that this tolerance is less than the tolerances in other organized markets and does not reflect practical unit operating characteristics. While it is reasonable to hold generators to high standards, the tolerance band must be consistent with operating reality. Also, an overly restrictive tolerance band may act as a disincentive for participation in the ancillary service market. Although MISO is currently proposing a must offer provision for internal resources, the business rules also allow for external resources to participate in the market. Such external resources may elect to participate in other markets if operational parameters in MISO's ancillary services market are too strict. It would be helpful if MISO were to provide support for its proposed 2% tolerance band to better understand this design element.

Emergency Procedures

Although Section nine of business rules described the emergency operations steps from the day-ahead through the real-time markets, the proposed tariff structure does not provide the steps of the ASM emergency operations in one section of the tariff. Therefore since it is difficult to ascertain if the tariff language agrees with the business rules, we request that MISO review the steps during the February 1, 2007 stakeholder meetings.