

In Pursuit Of Fair Compensation For Grid Reliability

Law360, New York (July 06, 2010) -- A major issue that perhaps has received less attention than it is due concerns the intersection of reliability of the electric grid and the compensation from competitive markets paid to parties that help provide that reliability.

In a completely free market, reliability of the grid would be degraded as compared to today's level of reliability, absent the willingness of market participants to pay the full costs of ensuring reliability at the current level. For instance, based upon a cost/benefit analysis, some market participants might be willing to pay only for a lesser level of reliability than has been achieved under traditional cost-of-service regulation.

However, there is no such thing as a completely free market for wholesale electric energy in the United States in which individual market participants are given the opportunity to choose their desired level of reliability.

Rather, under authorizations by the Federal Energy Regulatory Commission, Regional Transmission Organizations ("RTOs") are operating markets that are supposed to produce prices that roughly mimic those that would be produced in a workably competitive market, while at the same time providing the traditional regulated level of reliability.

Given that construct, cost recovery mechanisms in respective RTO markets should be designed to avoid degradation of reliability while still assuring market participants that their competitive position will not be negatively impacted when they provide services



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that enhance reliability. Unfortunately, cost-recovery mechanisms are not always designed in that fashion.

In at least some instances, RTO rules impose costs upon participants who provide reliability services, but do not provide the participants the opportunity to recover those costs. The New York Independent System Operator Inc.'s ("NYISO") implementation of New York State Reliability Council ("NYSRC") Rule I-R3 is an example of such a rule.

NYSRC Rule I-R3 provides that "[t]he NYS Bulk Power System shall be operated so that the loss of a single gas facility does not result in the loss of electric load within the New York City zone." Rule I-R3 is intended to prevent a loss of electric load caused by gas-fired generating units tripping off-line in response to the sudden and unexpected loss of gas or pressure in the natural gas facilities that serve them.

To avoid electric generating units that are fired by natural gas from tripping off, or at least to mitigate the impact to the electric system in the event of a natural gas pressure drop or loss, Rule I-R3 requires certain generating facilities to burn a minimum amount of fuel oil at specified load levels so that those generating facilities will have a better chance of remaining on-line and generating electricity during such an event.

On May 27, 2010, in two filings it made with FERC, TC Ravenswood LLC brought to the fore the issue of how the NYISO's implementation of that rule places generators that respond to it at an economic disadvantage. One of the two filings TC Ravenswood made concerning Rule I-R3 is a complaint against the NYISO.

In its complaint, TC Ravenswood seeks additional compensation for reliability services it provided as a result of having been ordered to burn fuel oil in 2009. TC Ravenswood stated in its complaint that it submitted detailed requests for reimbursement to the NYISO for variable costs that it incurred to comply with the Rule I-R3 orders, none of which it would have incurred but for responding to the I-R3 orders.

The variable costs included charges for barges to deliver the fuel oil and charges associated with storing the fuel oil applicable to the days when TC Ravenswood was ordered to burn fuel oil in furtherance of Rule I-R3. TC Ravenswood also incurred unreimbursed incremental operation and maintenance expenses to operate certain equipment in order to respond to the I-R3 orders.

The NYISO declined to reimburse TC Ravenswood for those three categories of costs based upon a contention that its Services Tariff did not authorize such reimbursement. TC Ravenswood argued in support of its complaint that if it is not reimbursed for those costs, it will have been placed at a competitive disadvantage relative to generators that did not burn fuel oil and therefore did not provide that reliability service.

The irony of the situation described in TC Ravenswood's complaint is that suppliers providing the reliability service required by Rule I-R3 orders get paid less than suppliers that do not, creating a perverse incentive to provide a lower quality service. TC Ravenswood's second filing seeks to address this circumstance on a prospective basis.

In its second filing, TC Ravenswood proposed a rate schedule that, if approved by FERC, would authorize it to pass through to the NYISO amounts that TC Ravenswood pays to third-parties to procure fuel oil. Thus, TC Ravenswood through its proposed rate schedule is seeking to mitigate, at least to some extent, the cost recovery challenges and detrimental financial impact of burning fuel oil, which generally is a more expensive fuel source than natural gas at the Ravenswood Plant.

TC Ravenswood argued in support of its proposal that it neither is efficient nor fair for any generator, let alone one that provides a reliability service that is a major contributor to keeping the lights on in the nation's largest city, to provide that service in a circumstance in which its variable cost recovery is uncertain and subject to litigation.

However, that being said, approval of TC Ravenswood's proposal still would enable it to recover only a portion of its variable costs. Fixed costs associated with providing the service are not addressed in TC Ravenswood's filings and efforts to recover those costs are being pursued on a different track.

Given that TC Ravenswood made its two filings with FERC on May 27, 2010, it is premature to know what action FERC will take with respect to the filings. However, the filings highlight the conundrum FERC faces in attempting to assure reliability while at the same time promoting imperfect competitive markets.

The filings also highlight the potentially difficult choice faced by end-users and their representatives before FERC. In particular, is it fair to ask representatives of consumer interests, what level of reliability they are willing to pay for, and to ask FERC whether it is reasonable, or lawful, to impose obligations upon market participants to provide reliability services without fully compensating them when they provide those services?

The answers to those questions are particularly important in organized markets dominated by rule-induced market clearing prices and reliability requirements, rather than competitive prices and service levels based upon bi-lateral arrangements. When FERC considers those questions, it needs to take into account all the costs market participants incur to provide reliability services.

As indicated above, TC Ravenswood's complaint and its proposed rate schedule only seek to recover variable costs. However, to provide most types of reliability services, burning fuel oil pursuant to Rule I-R3 as an example, a market participant requires infrastructure. Under FERC's extant order applicable to Rule I-R3 service, generators cannot recover the fixed costs of infrastructure they maintain to enable them to burn fuel oil.

FERC has directed the use of a stakeholder process to develop a mechanism for the recovery of those types of costs. Unfortunately, it is now more than three years since FERC provided that direction and the stakeholder process has yet to develop such a mechanism.

As a result, dual-fired generators in New York that have the ability to burn an alternate fuel in lieu of natural gas continue to be prejudiced in their ability to recover legitimate costs they incur to provide a valuable service that enhances the reliability of the grid.

While the focus of this article is the inability of generators in New York to recover their full cost of burning an alternate fuel to avoid natural gas-fired electric generating units tripping off, that is by no means the only reliability service that market participants are required to provide on a less than compensatory basis.

For instance, in ISO-New England Inc.'s forward capacity market, non-traditional suppliers, both internal and external to New England, can bid in to a capacity auction and drive down the price paid to New England generators for their capacity without making the long term reliability commitments that generators make.

The result is that the New England generators with "iron in the ground" receive less than fully compensatory capacity prices, and inadequate prices signals are sent to incent necessary investments in generating capacity that is continually relied on to provide the highly reliable service New England expects.

Further, even where a specific reliability rule does not exist, generation resources are subject to the broad dispatch authority of transmission operators and transmission owners. Under certain transmission system conditions, generation resources are directed to operate in a manner that may increase their costs and risk.

For example, traditional generators can be directed to switch to 100 percent oil to provide additional diversity or switch output connections to provide voltage support. These activities increase costs and risks that are not always accounted for in market-based tariffs.

The time has come for FERC to address these types of issues so that market participants that provide reliability services will be fairly compensated under competitive market tariffs for their service.

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The authors of this article are counsel for TC Ravenswood with respect to the filings discussed in this article.

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