132 FERC ¶ 61,088
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Jon Wellinghoff, Chairman;
Marc Spitzer, Philip D. Moeller,
John R. Norris, and Cheryl A. LaFleur.

Midwest Independent Transmission System Operator, Inc. — Docket No. ER10-1361-000

ORDER REJECTING PROPOSED TARIFF REVISIONS

(Issued July 30, 2010)

1. On May 28, 2010, Midwest Independent Transmission System Operator, Inc. (Midwest ISO) filed proposed revisions to Midwest ISO's Open Access Transmission, Energy and Operating Reserve Markets Tariff (Tariff) to further refine the allocation of the costs of Operating Reserves. In this order, we reject the proposed revisions based on our determination that the proposed cost allocation is not just and reasonable.

I. Background

2. On February 15, 2007, Midwest ISO submitted in Docket No. ER07-550-000 proposed revisions to its Tariff relating to the implementation of Day-Ahead and Real-Time Ancillary Services Markets (Original ASM Filing). The Original ASM Filing proposed comprehensive Tariff modifications regarding, among other things, the procurement and deployment of Operating Reserves, including Contingency Reserves (i.e., Spinning Reserves and Supplemental Reserves) and Regulating Reserves. Midwest ISO proposed allocating the costs of Contingency Reserves to Load and Exports on a Market Load Ratio Share[1] basis, and allocating the costs of Regulating Reserves to Load and to Resources subject to Excessive/Deficient Energy Deployment Charges.[2]

[1] In the Market Load Ratio Share method, "the total procurement cost for each Operating Reserve product is allocated to the appropriate Cost Allocation Distribution Volume defined as Market Load in the case of Regulation Reserve or Market Load plus physical exports for Spinning and Supplemental Reserve. This method produces one allocation rate per Reserve product for the entire footprint and does not account for variances between reserve clearing in individual Reserve Zones, variation in Market

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3. On June 22, 2007, the Commission issued an order that rejected the Original ASM Filing due to two particular deficiencies but also provided guidance on aspects of the Original ASM Filing that were acceptable.[3] Among the elements of the Original ASM Filing that the Commission found just and reasonable was the proposed allocation of the costs of Operating Reserves based on Market Load Ratio Share.[4] However, the Commission encouraged further discussions with stakeholders to address potential refinements:

> As a general matter, we consider a market-wide allocation of ancillary services costs to be 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. At the same time, it would be beneficial for Midwest ISO to continue discussions with stakeholders on cost allocation issues, in recognition of circumstances such as self-supply that may require refinements to the proposal to ensure that costs are allocated based on cost causation principles to the extent possible.[5]

4. On September 14, 2007, as amended on September 19, 2007,[6] Midwest ISO submitted its revised ASM Filing in Docket No. ER07-1372-000 (Revised ASM Filing). In this filing, Midwest ISO divided its reserves markets into zones and specified a zonal

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Clearing Prices between Reserve Zones, obligation and actually cleared reserve volumes." *See* Midwest ISO Filing at Tab C – *Midwest ISO Operating Reserve Cost Allocation Study*.

[2] ASM Filing at 33.

[3] *Midwest Indep. Trans. Sys. Operator, Inc.*, 119 FERC ¶ 61,311, at P 2 (2007) (ASM Guidance Order).

[4] *Id.* P 92, n.70, P 104, and 106.

[5] *Id.* P 106.

[6] *See* Midwest Independent Transmission System Operator, Inc. Electric Tariff Filing To Reflect Ancillary Services Markets, Docket No. ER07-1372-000 (filed September 14, 2007) and Midwest Independent Transmission System Operator, Inc. Amendment To Tariff Filing Regarding Ancillary Services Markets, Docket No. ER07-1372-001 (filed September 19, 2007).

requirements analysis in order to allow for the reliable dispersion of Operating Reserves throughout the Midwest ISO Balancing Authority Area. The Revised ASM Filing proposed allocating the costs of Regulating and Operating Reserves via two rates in schedules 3, 5 and 6. Midwest ISO characterized this cost allocation proposal as a Modified Hybrid Allocation to distinguish it from an original hybrid method that was also considered during the stakeholder process.[7] Midwest ISO also stated that entities resorting to self-scheduling (which is functionally equivalent to self-supply) should not be exempted from reserve procurement charges because they, as do all other Market Participants, derive reliability benefits from Midwest ISO's procurement of reserves.[8]

5. On February 25, 2008, the Commission issued an order conditionally accepting Midwest ISO's Revised ASM Filing, subject to certain compliance and reporting requirements.[9] However, although the Commission agreed with Midwest ISO's view that self-scheduling entities should not be exempted from reserve procurement charges,[10] it found Midwest ISO's revised zonal rate proposal unjust and unreasonable due to resulting inequities between market participants in reserve zones with low reserve requirements and those in reserve zones with high reserve requirements.[11] The Commission required Midwest ISO to file a revised allocation "that allocates costs of reserves in a zone to load in the zone."[12]

6. On March 26, 2008, Midwest ISO submitted its compliance filing to the ASM Order, including a revised zonal cost allocation method (Grouped Zonal Method) applicable to schedules 3, 5 and 6. The Grouped Zonal Method allocates net Operating Reserve procurement costs within Binding Settlement Zones[13] to real-time

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[7] Revised ASM Filing's Attachment E at 12.

[8] Midwest ISO's Answer dated November 6, 2007 at 85.

[9] *Midwest Indep. Trans. Sys. Operator, Inc.*, 122 FERC ¶ 61,172 (2008) (ASM Order).

[10] *Id.* P 324.

[11] *Id.* P 412.

[12] *Id.* P 421.

[13] Binding Settlement Zones are Reserve Zones with market clearing prices for reserves greater than the minimum market clearing price for reserves in all Reserve Zones in the day-ahead and real-time reserve markets. (*See* section 1.51 of Midwest

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Load[14] within the Binding Settlement Zone, and allocated net Operating Reserve procurement costs within Non-Binding Settlement Zones[15] to real-time Load within the Non-Binding Settlement Zones.

7. On June 23, 2008, the Commission issued an order denying rehearing of the ASM Order's requirement that reserve costs in a zone be allocated to load in the zone.[16] On the same day, the Commission issued an order that, among other things, accepted Midwest ISO's Grouped Zonal Method, and further required a compliance filing to provide a revised cost allocation for Carved-Out GFAs.[17] On December 18, 2008, the Commission

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ISO's Tariff).

[14] All Loads used to calculate reserve charges exclude Carved-Out Grandfathered Agreement (GFA) load.

[15] Non-Binding Settlement Zones are the combination of all Reserve Zones that are not Binding Reserve Zones. (*See* section 1.459 of Midwest ISO's Tariff).

[16] *Midwest Indep. Trans. Sys. Operator, Inc.*, 123 FERC ¶ 61,297, at P 19 (2008) (ASM Rehearing Order):

> We deny the requests for rehearing of the Commission's requirement that reserve costs in a zone be allocated to the load in the zone, but provide some clarification. Contrary to the arguments of certain parties, we consider this cost allocation reflective of cost causation, since reserves are procured to manage local reliability. We interpret Midwest TDUs' argument to be that there is some amount of reserves that are procured in a zone that are above and beyond the requirements of the zone, and therefore the costs of these reserves should not be allocated to the zone. We do not dispute Midwest TDUs' argument that reserves in one zone can benefit another zone, but, as the Commission acknowledged in the ASM Order, the primary purpose of the reserves in a zone is to manage local reliability in the zone; a zonal cost allocation thus best reflects cost causation. Simply put, the Midwest ISO will not purchase reserves unless it can manage reliability in the zone in which the reserves are located.

[17] *Midwest Indep. Trans. Sys. Operator, Inc.*, 123 FERC ¶ 61,296, at P 26-30 (2008).

reaffirmed its prior rulings, and accepted Midwest ISO's further compliance filings, regarding the allocation of reserve procurement costs.[18]

II. Midwest ISO's Filing

8. Midwest ISO's filing explains that several stakeholders expressed concerns with the Grouped Zonal Method after its approval by the Commission. Specifically, it states that Organization of Midwest ISO States (OMS) requested that Midwest ISO conduct a study of the ASM cost allocation one year after implementing the Grouped Zonal Method. OMS recommended that the following items be included in the study: a description of Reserve Zones and the reasons for creating them; the average Ancillary Service product cost for each Reserve Zone; the allocation rates that each zone paid under the existing rate, or would have paid under either a Market Load Ratio Share or the Modified Hybrid Allocation proposal; and any recommendations and further actions.

9. Therefore, Midwest ISO states, it conducted a cost allocation study for the period between the ASM start date (January 6, 2009) and December 31, 2009. The study culminated in a report entitled Midwest ISO Operating Reserve Cost Allocation Study (ASM Cost Allocation Study).

10. Midwest ISO further explains that the ASM Cost Allocation Study noted that in 2009 each Reserve Zone's minimum reserve requirement was less than its Market Load Ratio Share of the market-wide minimum reserve requirement. Midwest ISO explains that due to its topology, and the configuration of the Reserve Zones, Midwest ISO expects this difference between the zonal and market-wide minimum reserve requirements to persist in the foreseeable future. Thus, the ASM Cost Allocation Study found that the current Grouped Zonal Method allocates a lower percentage of Regulating Reserve costs to constrained Reserve Zones that frequently bind on minimum zonal Regulating Reserve requirements. Midwest ISO states that since such zonal reserve requirements are less than the constrained zones' Market Load Ratio Share of the market-wide minimum Regulating Reserve requirement, the difference is made up through the clearing of more Regulating Reserves in non-constrained Reserve Zones. As a result, Midwest ISO states that it determined that a larger amount of Regulating Reserve costs are shifted to non-constrained Reserve Zones.

11. Based on the results of the ASM Cost Allocation Study, Midwest ISO states that it concluded that the currently effective Grouped Zonal Method needs to be replaced in order to balance the equities between the cost of reserves on a zonal and market-wide

[18] *Midwest Indep. Trans. Sys. Operator, Inc.*, 125 FERC ¶ 61,332, at P 16-19, 23-26 and 40-42 (2008).

basis, taking into account the reasons for binding constraints and for price separation, and the parties that are paying for reserves.

12. Midwest ISO explains that it evaluated two potential replacement methodologies for allocating Operating Reserve costs. First, Midwest ISO evaluated allocating such costs based on an Adjusted Grouped Zonal Method that adjusts the current Grouped Zonal Method by incorporating the fundamental calculations of the Modified Hybrid Allocation previously rejected by the Commission. Then Midwest ISO evaluated allocating such costs based on Market Load Ratio Share, excluding Exports in the case of Regulating Reserve costs, and including Exports in the case of Spinning and Supplemental Reserve costs.

13. Midwest ISO notes that its ASM Cost Allocation Study found that the average rates were highest and most volatile with the original hybrid method and the Modified Hybrid Allocation, both of which involve the sharing of procurement costs between constrained and unconstrained Reserve Zones. It also notes that the lowest average rates were produced by the existing Grouped Zonal Method, while only slightly higher and comparable average rates resulted from an allocation based on Market Load Ratio Share.

14. Midwest ISO states that its comparison shows that an allocation based on Market Load Ratio Share produces results that: (1) with regard to the costs of Spinning and Supplemental Reserves, are identical for all practical purposes with those of an allocation based on the Adjusted Grouped Zonal Method; and (2) with regard to the cost of Regulating Reserves, are comparable to the results of an allocation based on the Adjusted Grouped Zonal Method, yielding almost identical results for four of the seven Reserve Zones, and minor variations for Reserve Zones that frequently bind (Zone 5), or frequently clear above their Market Load Ratio Share of the market-wide reserve requirement for regulation. Therefore, Midwest ISO states that it determined that an appropriate replacement allocation method should be based on Market Load Ratio Share, rather than an Adjusted Grouped Zonal Method.

15. Midwest ISO asserts that the Market Load Ratio Share Method avoids the disproportionately larger allocation of Regulating Reserve procurement costs to non-constrained Reserve Zones under the current Grouped Zonal Method. Midwest ISO states that an allocation based on Market Load Ratio Share ensures that Market Participants are charged the costs of all reserves procured on behalf of their Load and/or Exports. Further, Midwest ISO notes that the Commission found that allocating reserve costs based on Market Load Ratio Share is just and reasonable and previously rejected the Modified Hybrid Allocation, key elements of which are used by the Adjusted Grouped Zonal Method. In addition, Midwest ISO explains that using the Market Load Ratio Share Method would be consistent with certain Tariff revisions that the Midwest ISO plans to subsequently file, proposing changes that would enhance the procurement of Operating Reserves by addressing binding constraints.

16. Midwest ISO's proposed tariff revisions reflect the allocation of Operating Reserve costs based on Market Load Ratio Share, and the removal of language pertaining to zonal and constraint-based allocation. In particular, Midwest ISO modified Module A to delete the following terms and definitions: Binding Settlement Zone in section 1.51 (Tariff Sheet No. 91); and Non-Binding Settlement Zone in section 1.459 (Tariff Sheet No. 229).

17. Midwest ISO explains that references to the deleted terms, Binding Settlement Zone and Non-Binding Settlement Zone, and associated zonal and constraint-related language, have accordingly been deleted from schedule 3 (Regulating Reserve) at Tariff Sheet Nos. 1796 through 1805; from schedule 5 (Spinning Reserve) at Tariff Sheet Nos. 1820 through 1828; and from schedule 6 (Supplemental Reserve) at Tariff Sheet Nos. 1833 through 1843. In addition, Midwest ISO proposes to make other minor Tariff modifications related to its proposal. Midwest ISO requests that the proposed ASM Tariff sheet revisions become effective on August 1, 2010. Finally, Midwest ISO states that none of its stakeholder meetings produced significant input or concerns with its proposal.

III. Notice of Filing and Responsive Pleadings

18. Notice of Midwest ISO's proposed Tariff revisions was published in the *Federal Register*, 75 Fed. Reg. 32,939 (2010), with interventions or protests due on or before June 18, 2010. Coalition of Midwest ISO Transmission Customers, American Municipal Power, Inc., The Detroit Edison Company, MidAmerican Energy Company, Constellation Energy Commodities Group, Inc. and Constellation NewEnergy, Inc., Indianapolis Power & Light Company, Ameren Services Company, Xcel Energy Services, Inc., and Wisconsin Electric Power Company filed timely motions to intervene without substantive comments. Consumers Energy Company filed a late motion to intervene without substantive comment. Illinois Commerce Commission (Illinois Commission) and OMS filed timely notices of intervention without substantive comments. Midwest TDUs[19] filed a timely motion to intervene with substantive comments. Duke Energy Corporation (Duke Energy) filed a timely motion to intervene with substantive comments.

19. Illinois Commission filed comments and a protest to supplement its notice of intervention. Midwest ISO filed an answer to Midwest TDUs' comments and Illinois

[19] Midwest TDUs in this proceeding consist of Madison Gas & Electric Company, Midwest Municipal Transmission Group, Missouri Joint Municipal Electric Utility Commission, Missouri River Energy Services, Municipal Energy Agency of Nebraska, Southern Minnesota Municipal Power Agency and WPPI Energy.

Commission's protest. Midwest TDUs filed an answer to Illinois Commission's protest. Illinois Commission filed an answer to Midwest ISO's and Midwest TDUs' answers.

IV. Discussion

A. Procedural Matters

20. Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.214 (2010), the notices of intervention and timely, unopposed motions to intervene serve to make the entities that filed them parties to this proceeding. We will also grant Consumers Energy Company's motion to intervene out-of-time given its interest in the proceeding, the early stage of this proceeding, and the absence of any undue prejudice or delay.

21. Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(2) (2010), prohibits an answer to a protest unless otherwise ordered by the decisional authority. We will accept Midwest ISO's, Midwest TDUs', and Illinois Commission's answers because they have provided information that assisted us in our decision-making process.

B. Substantive Matters

1. Comments

22. Duke Energy generally supports the filing and believes that the Market Load Ratio Share proposal is a more appropriate method from a cost causation perspective of allocating Operating Reserve costs to market participants. Duke Energy states that this method better ensures that market participants are charged the costs of all reserves procured on their behalf for their Load, including the costs of imported reserves from a non-constrained zone. Duke Energy notes that this revised methodology has been approved by the Market Subcommittee and other Midwest ISO committees without significant concerns. However, Duke Energy requests that the Commission order Midwest ISO to conduct a study, similar to the one conducted at the request of OMS, in approximately one year from the effective date of the proposed modifications, to analyze the impacts of the Market Load Ratio Share allocation on the market, including whether there are any cost shifts and to determine whether additional revisions should be made to the allocation process.

23. Illinois Commission states that the Adjusted Grouped Zonal cost allocation is the only just and reasonable approach among Midwest ISO's reviewed options. Illinois Commission asserts that the Adjusted Group Zonal Method recognizes the correct prices for procured reserves and the correct quantities procured for each Reserve Zone. Illinois Commission explains that the Adjusted Grouped Zonal Method is superior to the Grouped Zonal Method because the Grouped Zonal Method does not allocate the cost for

the correct quantity of Operating Reserves procured for Reserve Zones whose minimum Zonal Operating Reserve Requirement binds. Illinois Commission states that the Adjusted Grouped Zonal Method is also superior to the Market Load Ratio Share Method because it charges the higher Operating Reserve clearing prices to the Binding Reserve Zone where a relative scarcity of low cost Operating Reserves exists.

24. Illinois Commission explains that the type of constraint which causes a Reserve Zone to bind is the Minimum Zonal Operating or Regulation Reserve Requirements, and not the type of transmission line loading constraint which causes energy price separation. Therefore, a Binding Reserve Zone does not imply that the Reserve Zone cannot import Operating Reserves, but that the lowest cost dispatch/procurement of Operating Reserves does not include at least the minimum quantity of Operating Reserves as dictated by the off-line reserve zone requirement study. Illinois Commission explains that this fact has been the source of some confusion in the evolution of Midwest ISO's Operating Reserve cost allocation.

25. Further, Illinois Commission explains that the Grouped Zonal Allocation is unjust because it allocates the cost of the quantity equal to the arithmetic difference between a Binding Reserve Zone's load ratio share of reserves and the minimum Zonal Operating Reserve Requirement to Non-Binding Reserve Zones. The procurement of this quantity is caused by and is done for the benefit of the Binding Reserve Zone and it is, therefore, discriminatory to charge the Non-Binding Reserve Zone for reserves that are intended for the benefit of the Binding Reserve Zone.

26. Additionally, Illinois Commission asserts that the Market Load Ratio Share Method is unjust and unreasonable because it charges higher than the Non-Binding Reserve Zone's clearing price to the Non-Binding Reserve Zone. Therefore, Non-Binding Reserve Zones are paying higher prices because other Reserve Zones have failed to construct low cost Operating Reserve capacity and must be served by higher cost Operating Reserve capacity when a minimum zonal Operating Reserve requirement is violated. Illinois Commission argues that this subsidization is discriminatory in nature and fails to recognize the fact that higher prices are caused by the relative scarcity of Operating Reserves in distinct Reserve Zones and that those Operating Reserves are procured for the benefit of Load in those distinct Reserve Zones.

27. Illinois Commission provides a numerical example to illustrate the subsidization that occurs under the Midwest ISO proposal due to the fact that this method charges higher than the Non-Binding Reserve Zone's clearing price to the Non-Binding Reserve Zone. Illinois Commission considers this subsidization to be discriminatory and contrary to cost causation principles.

28. Finally, Illinois Commission notes that the Reserve Zones that Illinois is part of would have been allocated fewer costs if the Market Load Ratio Share Method had been in place relative to what they would have been allocated had the Adjusted Grouped Zonal

Method been in place based on the data for 2009 provided by Midwest ISO. However, Illinois Commission makes the argument here for the Adjusted Grouped Zonal Method in accordance with the economic principles of cost causation and beneficiaries pay. Illinois Commission contends that while the Market Load Ratio Share Method would have tempered the disproportionately larger allocation of Regulating Reserve procurement costs to non-constrained Reserve Zones in the year 2009, it will not necessarily do so in the future.

29. Midwest TDUs support Midwest ISO's proposal to replace the existing Grouped Zonal Method with a region-wide allocation. However, they contend that the filing raises another issue, though it should not stand in the way of approving the proposed allocation change as it relates to Midwest ISO Balancing Authority area load. Midwest TDUs assert that under both the existing and proposed tariff language, charges under schedules 5 and 6 will be assessed not only to load serving entities, but also to "Exporting Entities" (to the extent they are not exempted from those charges pursuant to recognized "alternative comparable arrangements," as recited in the first paragraph of each schedule). Midwest TDUs allege that the proposal may increase the allocation to Exporting Entities, by increasing the quantity of reserves above the Non-Binding Reserve Zone level for which Exporting Entities are presently responsible. Midwest TDUs question the basis for applying schedules 5 and 6 to Exporting Entities or Export Schedules used to serve Load outside the Midwest ISO Balancing Authority area. If that basis is not adequately explained by Midwest ISO in this proceeding, Midwest TDUs assert that it should be addressed within the upcoming stakeholder and filing processes.

30. OMS states that it continues to analyze the filing and has not yet been able to form conclusions on whether the Market Load Ratio Share Method yields results reasonably similar to the more precise Adjusted Grouped Zonal Method and whether such results will be consistent over time.

2. Answers

31. Midwest ISO responds that it is willing to perform a follow-up study of the impacts of the proposed Market Load Ratio Share Method one year after its initial implementation. Midwest ISO notes that its filing originally stated that it was amenable to conducting a follow-up study within six months or one year after Midwest ISO makes a separate filing involving certain enhancements to the Tariff's reserve procurement process. However, Midwest ISO indicates that it has determined that due to the system adjustments needed to implement its contemplated reserve procurement enhancements, those enhancements would not be ready for implementation until on or about September 1, 2011. Although, Midwest ISO states, it is open to performing the follow-up study of the Market Load Ratio Share Method one year after it is initially implemented, ahead of the implementation of the contemplated reserve procurement enhancements.

32. Midwest ISO points out that the current Tariff already applies schedule 5 and 6 to exports. Midwest ISO explains that its proposed Tariff revisions do not modify, but instead continue, this aspect of schedules 5 and 6 and that the Commission has already found the application of schedules 5 and 6 to Export Entities just and reasonable.

33. Midwest ISO submits that its Operating Reserve Cost Allocation Study, provided as Attachment C to the cost allocation filing, adequately shows that an allocation based on Market Load Ratio Share yields results that: (1) with respect to the costs of Spinning and Supplemental Reserves, are identical for all practical purposes with those of an allocation based on the Adjusted Grouped Zonal Method; and (2) with respect to the cost of Regulating Reserves, are comparable to the results of an allocation based on the Adjusted Grouped Zonal Method, with almost identical results for four of the seven Reserve Zones, and minor variations for Reserve Zones that frequently bind (Zone 5), or frequently clear above their Market Load Ratio Share of the market-wide reserve requirement for regulation. Midwest ISO explains that Load in Non-Binding Reserve Zones can and does benefit from Regulating Reserves cleared and deployed in Binding Reserve Zones because, as Illinois Commission points out, such Reserves could be imported to a Non-Binding Reserve Zone.

34. Midwest ISO contends that there is no basis for Illinois Commission's claim that the Adjusted Grouped Zonal Method is the only just and reasonable option. Midwest ISO asserts that although Illinois Commission shows a hypothetical scenario where the Market Load Ratio Share approach could allocate to non-constrained/Non-Binding Reserve Zones costs that are higher than would be allocated by the current Grouped Zonal Method, the fact that such a result could occur under Illinois Commission's assumptions does not make the Market Load Ratio Share Method unjust or unreasonable. Midwest ISO argues that it is reasonable for the Midwest ISO to select a cost allocation approach based on the results of the data-supported study.

35. Midwest ISO notes that its stakeholders, including Illinois Commission, have had ample opportunities to review the results of its study, as well as Midwest ISO's proposal, and to raise any objections and/or alternative proposals. It states that neither Illinois Commission nor any other stakeholder brought up any such matters at the Market Subcommittee or the Advisory Committee for consideration by the entire stakeholder community.

36. Midwest ISO disagrees with Illinois Commission's argument that any increased per megawatt cost of Regulating Reserves due to the co-optimized dispatch binding on the minimum zonal Regulating Reserve requirement would only benefit and should only be borne by the Reserve Zone that is binding. Midwest ISO also argues that Illinois Commission is wrong in claiming that the Market Clearing Price produced when a Reserve Zone is binding on the minimum zonal requirement represents scarcity or scarcity pricing. Midwest ISO asserts that scarcity pricing only occurs when insufficient reserves are offered in a zone to clear the minimum requirement.

37. Midwest ISO contends that Illinois Commission's concerns about an alleged "logical error" or "common misunderstanding" regarding binding constraints have no application to the Tariff as well as the proposed revisions. Midwest ISO asserts that the currently effective Tariff provides sufficiently clear definitions of Binding and Non-Binding Settlement Zones (sections 1.51 and 1.459, respectively), as well as detailed descriptions of the Energy and Operating Reserve Market's simultaneous co-optimized formulations (schedule 29). It states that Illinois Commission has not identified, and Midwest ISO is not aware of, any logical errors in these Tariff provisions, or in the filing's descriptions and formulations of cost allocation based on Market Load Ratio Share Method, Grouped Zonal Method, or Adjusted Group Zonal Method.

38. Midwest TDUs assert that Illinois Commission falls short of the showing required to demonstrate that the Midwest ISO proposal is outside the zone of reasonableness. According to Midwest TDUs, dispersion of reserves does not exist solely for the benefit of Load located where regulating resources are relatively expensive. Midwest TDUs assert that Operating Reserves that are dispersed geographically provide reliability benefits for the entire region, which are necessitated by region-wide concerns. Midwest TDUs contend that a region-wide Market Load Ratio Share allocation matches cost incurrence and is not unreasonable.

39. In its answer, Illinois Commission corrects a typographical error in its comments by explaining that it intended to state "[i]t was commonly assumed that that a ~~non~~-binding Reserve Zone could not import reserves, and therefore reserves procured in the non-binding Reserve Zone could not be procured for the benefit of the binding Reserve Zone."[20] Illinois Commission contends that Midwest ISO's assertion that Appendix B to the filing shows benefits accruing to each Reserve Zone that outweigh the costs assigned is unsubstantiated. Illinois Commission asserts that the data in Appendix B only contains information on 2009 cost causation (i.e., frequency of binding constraints) and costs themselves, not benefits.

40. Further, Illinois Commission argues that the idea that load in the Non-Binding Reserve Zone may benefit from reserves procured in the Binding Reserve Zone does not justify a uniform rate. Illinois Commission explains that the benefit accruing to the Binding Reserve Zone is greater than that accruing to the Non-Binding Reserve Zone given the relatively larger quantity of reserves per unit of load procured in the Non-Binding Reserve Zone relative to the Binding Reserve Zone. In addition, Illinois Commission contends that Midwest ISO does not and can not refute the mathematical fact that its primary objective in making the proposed revisions may not be realized under the Market Load Ratio Share Method if future market conditions are not consistent with

[20] Illinois Commission Answer at 1-2.

those market conditions observed in the year 2009. Illinois Commission argues that the Adjusted Grouped Zonal Method would not only reduce, but eliminate the disproportionate allocation of costs to the Non-Binding Reserve Zones.

41. Additionally, Illinois Commission argues that Midwest ISO's criticism of Illinois Commission's use of the word "scarcity" is irrelevant and Illinois Commission understands the technical concept of scarcity as it is addressed in the Midwest ISO's Tariff. Illinois Commission also contends that the Midwest TDUs are incorrect in asserting that the Illinois Commission's logic is circular.

42. Therefore, Illinois Commission believes that settling for an inferior, less accurate, method when a superior, more accurate, method is known and formulated, is not reasonable, and would not serve the public interest.

3. Commission Determination

43. We reject Midwest ISO's proposal to allocate Operating Reserve costs on a Market Load Ratio Share basis. We find, as discussed below, that Midwest ISO's proposal is unjust and unreasonable because it does not follow the Commission's cost causation principles.[21]

44. Midwest ISO has two processes that determine the location of Operating Reserves. First, the simultaneous co-optimization process determines the lowest cost resources for providing reserves and energy. Second, the Reserve Zone requirement process adjusts the low cost resources to account for zonal constraints by obtaining a minimum amount of more expensive reserves in constrained zones, or Binding Settlement Zones.[22] Midwest ISO obtains a minimum amount of resources within the Binding Settlement Zone, on the assumption that reserves outside the Binding Settlement Zone can be called on to manage reliability within the Binding Settlement Zone when needed. As Midwest ISO explains, "[s]ince such zonal reserve requirements are less than the constrained zones' Load Ratio Share of the market-wide Regulating Reserve requirement, the

[21] *See, e.g., KN Energy, Inc., v. FERC,* 968 F.2d 1295, 1300 (D.C. Cir. 1992). (It has been traditionally required that all approved rates reflect to some degree the costs actually caused by the customer who must pay them.)

[22] This process is described in section 39.2.1A.e of Midwest ISO FERC Electric Tariff, Fourth Revised Volume No. 1.

difference is made up through the clearing of more Regulating Reserves in non-constrained Reserve Zones."[23]

45. We agree with Midwest ISO and commenters that Midwest ISO's ASM Cost Allocation Study and experience to date has identified shortcomings of the existing Grouped Zonal Method. The Grouped Zonal Method, which only allocates the cost of the minimum amount of reserves in the Binding Settlement Zone to Load in that zone, does not include the costs of all the reserves that may be required to manage reliability within the Binding Settlement Zone.

46. However, we do not consider the proposed Market Load Ratio Share Method to be an appropriate solution since it does not take into account how Midwest ISO purchases reserves nor the reasons for the incurrence of reserve costs. We agree with Illinois Commission that under Midwest ISO's Market Load Ratio Share proposal, if a Reserve Zone binds, then that Binding Settlement Zone is subsidized by the Non-Binding Settlement Zones because the higher price for reserves in the Binding Settlement Zone is averaged with the lower price for reserves in the Non-Binding Settlement Zones. This method mixes the high cost of reserves in the Binding Settlement Zone with lower cost reserves for all market participants, thereby burdening Load in low-cost Non-Binding Settlement Zones with the cost of reserves that they did not cause. In its answer, Midwest ISO justifies the Market Load Ratio Share Method based on the argument that Load in the Non-Binding Settlement Zones could benefit from reserves deployed in Binding Settlement Zones because those reserves could be imported to the Non-Binding Settlement Zone. However, the reserve procurement process, as set forth in the Midwest ISO Tariff and described above, does not show a benefit of Binding Settlement Zone reserves to Non-Binding Settlement Zones. Rather, reserves from the Non-Binding Settlement Zones are benefitting the Binding Settlement Zones by providing reserves in excess of the minimum amounts purchased in the Binding Settlement Zones.

47. The result of Midwest ISO's proposed Market Load Ratio Share Method would be that all zones would pay the same per megawatt hour rate for Regulating Reserves, even though some zones, such as Zone 5, are significantly more constrained than other zones[24] and have significantly higher cost reserves than other zones.[25] We agree with Illinois

[23] Midwest ISO Transmittal Letter at 6.

[24] Zone 5 had binding constraints in 71.3 percent of the hours in 2009 for Regulating Reserves compared to no hours of constraints in Zone 4 and constraints in only 5.4 percent of the hours in adjoining Zone 3. *See* Comprehensive Market Results Analysis Study (Analysis Study), Attachment B of Midwest ISO's Filing.

[25] During 2009, the premium above the Non-Binding Settlement Zone 4 price for

(continued…)

Commission that this subsidy from low-cost zones to high-cost zones is unduly discriminatory. The higher prices in Binding Settlement Zones are caused by Midwest ISO obtaining reserves for these zones based on a reliability analysis[26] and those higher-cost reserves are procured specifically for the benefit of Load in those Binding Settlement Zones.

48. Further, we disagree with Midwest ISO's and Midwest TDUs' contention that given that the geographic dispersion constraint is caused by region-wide reliability needs and brings region-wide reliability benefits, a region-wide cost allocation through the Market Load Ratio Share proposal matches cost incurrence and is not unreasonable. Based on Midwest ISO's reasoning, in essence, there would not be a need for specific zone requirements and zonal prices because Midwest ISO proposes to socialize the cost of procuring reserves throughout its footprint. Our reason for disagreement is that the facts do not support this interpretation. In its current reserve requirements construct, Midwest ISO determines a minimum zonal reserve requirement based on a reliability analysis for each respective zone. We agree with Illinois Commission that the minimum reserve requirements were implemented because Midwest ISO recognized that there may not be enough low cost reserves throughout the footprint to guarantee geographic dispersion under an unconstrained least cost dispatch. Therefore, Midwest ISO created zones to manage reliability using higher cost reserves. Since Midwest ISO has zonal reserve requirements, a proper methodology would require the Load beneficiaries in each Binding Reserve Zone to pay for the higher cost of meeting the reserve requirements for the zone.

49. Additionally, we find Midwest ISO's reliance on earlier Commission statements supporting a Market Load Ratio Share Method to be misplaced. Those statements were made prior to the Market Monitor's analysis of Midwest ISO reserve markets and its identification of constrained areas and identification of the need for specific reserve zones.

Regulating Reserve prices in Zone 5 ranged from $1.22/MWh to $4.03/MWh and from $.02/MWh to $.27/MWh in Zone 3. *Market Monitor November-December Market Report,* January 2010 (January – March 2009 data), *Market Monitor Quarterly Report, First Quarter 2010,* April 14, 2010 (April – December 2010 data).

[26] As Midwest ISO indicates in its answer, "[t]he increased MCPs when binding occurs in the zonal minimum requirement reflects the cost of clearing more reserves in that Reserve Zone than would otherwise be cleared based solely on economics." Midwest ISO Answer at 9.

50. Therefore, we encourage Midwest ISO and its stakeholders to develop a proposal that takes into account cost causation principles. Inasmuch as Midwest ISO indicates in its answer that its reserve market enhancements will not be ready before September 1, 2011, we do not expect that our ruling will adversely impact the development of these enhancements.

51. Further, we note that the Adjusted Group Zonal Method is a step in the right direction since it includes the price and quantity of reserves purchased in each zone in the allocation of costs to Load in the zone, and adjusts the zonal costs to reflect that some reserves are procured in Non-Binding Settlement Zones for the benefit of Binding Settlement Zones, and therefore reflects the zonal requirements analysis and purchasing of Midwest ISO, as described in its Tariff. However, we also note that the Adjusted Group Zonal Method allocates the cost of reserves in Non-Binding Settlement Zones to Binding Settlement Zones based on the average costs of *all* reserves, including high cost reserves from Binding Settlement Zones. Under this method, because the Non-Binding Settlement Zones do not reflect the high prices of the Binding Settlement Zones, a subtraction from the Non-Binding Zone's costs based on these high-cost reserves creates a subsidy to Non-Binding Settlement Zones.

52. Finally, we will not address Midwest TDUs' concern that Midwest ISO's proposal may increase the allocation to exports since we reject Midwest ISO's proposal.

The Commission orders:

Midwest ISO's proposed tariff revisions are hereby rejected, as discussed in the body of this order.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.