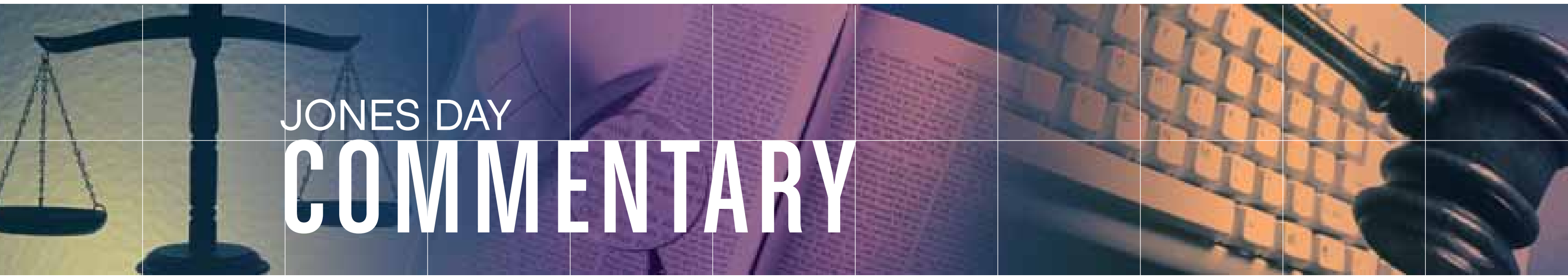
JONES DAY

OCTOBER 2011



FERC ISSUES ORDER NO. 755: FREQUENCY REGULATION COMPENSATION IN THE ORGANIZED WHOLESALE POWER MARKETS

On October 20, 2011, the Federal Energy Regulatory Commission ("Commission") issued a final rule establishing a two-part market-based rate compensation methodology for the provision of frequency regulation service in Regional Transmission Organization ("RTO") and Independent System Operator ("ISO") markets. *Frequency Regulation Compensation in the Organized Wholesale Power Markets*, Order No. 755, 137 FERC ¶ 61,064 (2011) ("Order No. 755"). When generation and load (plus losses) are not balanced, the frequency of the electric grid deviates from its design frequency of 60 hertz (*e.g.*, 60 cycles per second). Frequency regulation service corrects actual and anticipated deviations in the frequency of the electric grid, which are measured by Area Control Error, by continuously balancing resources with load. The cost of providing regulation service generally is borne by customers serving load in the balancing authority area where the relevant resources are located.

At present, different markets have different methods for compensating providers of frequency response service. Order No. 755 reforms the approach used to compensate these suppliers but does not require changes in the way in which related costs are allocated to load.

Frequency regulation service is provided by online generation whose output is raised or lowered (primarily through the use of automatic generating control equipment) and by other nongeneration resources such as flywheels or energy storage resources capable of providing this service. Under Order No. 755, generators or other entities providing this service will be compensated in a two-part structure. First, regulation service providers will receive a capacity payment reflecting the opportunity costs of the marginal resource providing frequency regulation service during the settlement period. This approach acknowledges that a frequency response resource must hold some of its capacity in reserve to provide frequency regulation service when such service is needed, and therefore the resource forgoes the revenue it could otherwise earn through energy market sales.

Order No. 755 also allows for the recovery of inter-temporal opportunity costs, such as costs incurred by an energy storage device that must provide frequency response service at a time of day when it would be more cost-effective for it to buy energy to recharge the storage device. Order No. 755 leaves the specific methods for calculating such opportunity costs to individual regional markets, explaining that the operators of the separate regional organized markets are "in the best position to perform accurate cross-product opportunity cost calculations." With regard to inter-temporal costs, Order No. 755 requires that such costs be verifiable, but it allows individual regional market operators to determine whether these costs should be determined by the ISO or RTO or by market participants.

The second component of regulation service compensation is "performance-based" and will reflect the amount of the up or down movement a resource provides in response to the system operator's dispatch signal and the resource's accuracy in responding to the dispatch signal. This approach accounts for the fact that a resource with faster ramping capability can provide a greater amount of capacity into the regulation market than can a slower-ramping resource.

In Order No. 755, FERC explains that the current system for compensating providers of frequency regulation service is unjust and unreasonable because it "fail[s] to acknowledge the inherently greater amount of frequency regulation service being provided by faster-ramping resources," and because the practices of some ISOs and RTOs result in economically inefficient dispatch of frequency regulation resources. As a result, Order No. 755 is expected to lead to more regulation service being provided by faster-responding resources and by technologies that are more efficient at providing frequency regulation service, while fewer slow-response resources will be called upon. This approach is intended to promote market efficiency by better aligning incentives and performance by ensuring that resources that provide greater benefits are appropriately compensated. FERC also noted that these efficiencies may lead to lower prices for regulation service and for energy.

Order No. 755 becomes effective 60 days after publication in the Federal Register, i.e, on or about January 1, 2012. ISOs and RTOs are required to submit compliance filings amending their tariffs to incorporate the requirements of the rule within 120 days of the effective date of the rule. The Commission noted that implementing the required changes could require significant work on the part of ISOs and RTOs, and accordingly it will allow an additional 180 days from the date ISOs and RTOs make their initial compliance filings for the ISOs and RTOs to implement the changes. As such, it is likely that the changes mandated by Order No. 755 will not take effect for approximately one year.

While Order No. 755 applies only to organized ISO and RTO markets, FERC may act to broaden its application. On June 11, 2011, FERC issued a Notice of Inquiry ("NOI") seeking comment on whether the cost-based compensation methods for frequency regulation in regions outside of organized markets should be adjusted to address the same issues addressed in Order No. 755. *Third-Party Provision of Ancillary Services; Accounting and Financial Reporting for New Electric Storage Technologies*, Notice of Inquiry, 135 FERC ¶ 61,240 (2011). In the NOI, FERC sought comments on different frameworks under which the speed and accuracy of frequency regulation resources might be appropriately valued in non-RTO and non-ISO markets. The matter is pending before FERC.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

James C. Beh
Washington
+1.202.879.3430
jcbeh@jonesday.com

Kenneth B. Driver
Washington
+1.202.879.7629
kbdriver@jonesday.com

Kevin J. McIntyre
Washington
+1.202.879.3917
kjmcintyre@jonesday.com

Jonathan F. Christian
Washington
+1.202.879.4644
jchristian@jonesday.com