

Client Alert

Global Transactions Practice Group

October 28, 2011

FERC Issues Final Rule on Frequency Regulation Compensation

For more information, contact:

Neil L. Levy
+1 202 626 5452
nlevy@kslaw.com

David G. Tewksbury
+1 202 626 5454
dtewksbury@kslaw.com

Bruce L. Richardson
+1 202 626 5510
brichardson@kslaw.com

Stephanie S. Lim
+1 202 626 8991
sslim@kslaw.com

Brandon C. Johnson
+1 202 626 5409
bcjohnson@kslaw.com

Grace Su
+1 202 626 2952
gsu@kslaw.com

King & Spalding
Washington, DC
1700 Pennsylvania Avenue, NW
Washington, D.C. 20006-4706
Tel: +1 202 737 0500
Fax: +1 202 626 3737

www.kslaw.com

In Order No. 755, the Federal Energy Regulatory Commission (FERC) orders revisions to the frequency regulation compensation practices of regional transmission organizations (RTOs) and independent system operators (ISOs). Finding that the existing practices are unjust, unreasonable and unduly discriminatory, FERC directs RTOs and ISOs to adopt a two-part market-based compensation method, under which: (1) all resources that clear the frequency regulation market receive a uniform capacity payment, including standardized opportunity costs, for standing ready to provide frequency regulation service; and (2) all resources that clear the market receive a performance payment for their service.

FERC states that the changes will ensure that compensation through the organized frequency regulation markets administered by the RTOs and ISOs accounts for the “inherently greater amount of frequency regulation service being provided by faster-ramping resources,” including storage and demand response, as well as faster ramping generator resources.

Existing Frequency Regulation Compensation

In order to provide reliable service, a transmission system’s frequency must remain within an acceptable range. When there are frequency deviations, transmission operators stabilize the system by signaling generators and other capable resources to inject real power into or withdraw real power from the transmission system. This injection and withdrawal is known as frequency regulation service. Compensation methods for frequency regulation service vary depending on the RTO or ISO, but generally consist of a capacity payment, which includes opportunity costs, to all resources that clear the frequency regulation market, as well as payment for the net energy that a resource injects into or withdraws from the system. At present, frequency regulation service is largely provided by generators.

In Order No. 755, FERC concludes that existing compensation methods are unjust, unreasonable and unduly discriminatory for three reasons. First, opportunity costs are based on a specific resource’s costs rather than the marginal resource’s costs. FERC finds that using “unit-specific opportunity cost distorts the market by basing the commitment of regulating units on incomplete market information.” Second, the methods do not account for the actual service provided by specific resources. FERC notes that because

Client Alert

Global Transactions Practice Group

existing compensation methods net injections and withdrawals, the absolute value of service provided is not taken into account, and many resources are not proportionately compensated when directed “to provide more frequency regulation service than other resources.” Third, current methods do not take into consideration whether resources provide an accurate response to transmission operator signals. FERC finds that resources that have faster ramp up times are better able to provide an accurate response to signals, and thus provide an economic benefit that should be compensated.

Frequency Regulation Compensation Under Order No. 755

Order No. 755 mandates that RTOs and ISOs implement a revised two-part compensation method for frequency regulation service. The first part is a uniform clearing price derived from market-participant bids for the provision of frequency regulation, and includes the marginal resource’s opportunity costs. FERC determines that such a rule would “ensure that all appropriate costs are considered and will send an efficient price signal to current and potential market participants.” The second part is a performance payment that takes into consideration the amount of work done by a resource in absolute terms, and the accuracy of a resource in responding to a transmission operator’s signal.

FERC emphasizes that the rule is “resource-neutral” and requires that compensation reflect the actual frequency regulation service provided “no matter the resource.” This facilitates entry into the frequency regulation market by new technologies, such as storage devices and demand response resources, by placing value on their ability to respond quickly to signals by transmission operators.

Next Steps

FERC is requiring each RTO and ISO to work with its stakeholders to develop proposals to comply with the requirements of the final rule and make any necessary compliance filings with FERC. Those compliance filings are due within 120 days of the effective date of the final rule. After making their compliance filings, RTOs and ISOs have 180 days to implement their revised compensation methods. The effective date of the rule will be 60 days from publication of the final rule in the *Federal Register*.

Celebrating more than 125 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 800 lawyers in 17 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality and dedication to understanding the business and culture of its clients. More information is available at www.kslaw.com.

This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice.