Comments of the Organization of MISO States

On

MISO's Method of Cost Recovery and MISO's Budgeting Process

Executive Summary

The Organization of MISO States (OMS) appreciates this opportunity to comment on two related topics: 1) ways the Midwest Independent Transmission System Operator, Inc. (MISO) could improve budgeting and cost accountability, and 2) MISO's white paper listing alternative methods by which MISO could recover costs.

The OMS has repeatedly emphasized the importance of controlling the costs of MISO. For example, the OMS expressed such sentiments at the inaugural (2005) and 2006 annual stakeholder meetings.

The OMS strongly supports the multi-pronged goal for Regional Transmission Organizations (RTOs) like MISO that the Federal Energy Regulatory Commission (FERC) adopted in Order No. 2000: "to promote efficiency in wholesale electricity markets and to ensure that electricity consumers pay the lowest price possible for reliable service."[1] Thus, the OMS expects MISO's costs to reflect prudent means of achieving the goals that FERC set for MISO in Order 2000. In addition, the OMS recognizes that, in order to avoid perverse and unintended consequences, great care will have to be exercised to not unduly emphasize short-term costs and benefits without due consideration of longer-term costs and benefits.

MISO's white paper highlights, directly and indirectly, some important implications of four alternatives methods by which MISO could recover costs. The white paper puts forth only rudimentary descriptions of four alternative methods of cost recovery, however, and the white paper's discussion of some implications of those alternatives is similarly undeveloped. For example, the OMS needs more detailed

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[1] Order No. 2000, 65 Fed. Reg. 809 (January 6, 2000), FERC Stats. & Regs., ¶ 31,089 (1999), p. 1.

assessments of MISO's expected regulatory costs and borrowing risks under various alternatives. Thus, MISO's white paper does not provide enough information for the OMS to rank, in specific terms, the four cost recovery alternatives.

In these comments, the OMS offers general guidance on MISO cost recovery and cost control. With regard to cost recovery, the OMS recommends that MISO adopt a new method of cost recovery that better promotes prudence as well as accountability for over- and under-recovery of costs. For example, if placing a cap on MISO's current formula rate would require MISO's Board of Directors to identify the causes of significant true-ups and take steps necessary to address those causes while maintaining prudent expenditure, then such an approach could promote prudence and cost accountability.

With respect to cost control, notwithstanding which method of cost recovery MISO chooses, MISO could improve its budgeting process in terms of transparency and stakeholder inclusiveness. The current review process does not provide enough information and time for an adequate stakeholder review of MISO's budget.

In addition, the OMS recognizes the FERC is ultimately responsible for ensuring that MISO's rates are just and reasonable. The OMS thus recognizes the logic of seeking more involvement from the FERC in MISO's cost recovery and budgeting processes. Further, if the FERC is willing and able to review budgets and true-ups in proceedings that afford parties reasonable due process and sufficient access to information, then MISO might improve its budgeting and cost recovery processes by filing, for example, its budgets and true-up requests for FERC approval.

As a matter of law and policy, FERC appears to have carved out a significant role in the process for the MISO's Board of Directors.[2] Thus, improvements in MISO's cost recovery and budgeting processes need not increase the FERC's involvement in these

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[2] The FERC's November 22, 2002 Order in Docket No.ER02-2595 (at ¶ 3) states:

> "We … recognize that RTO development costs must be carefully contained in order to maximize the net benefits of RTO formation and the creation of a common market to customers. Therefore, while we recognize the importance of RTOs recovering their costs associated with the services they provide, we also recognize the importance of cost control measures in system development." Consequently, we expect Midwest ISO's Board of Directors to be proactive in this area. The Midwest ISO Agreement provides that the management of all property, business and affairs of Midwest ISO shall be vested in the Board of Directors. Thus, we expect the Board of Directors to guard against any unreasonable costs being incurred. (¶3, footnote deleted)

processes – especially if the costs exceed the benefits from increased involvement by the FERC. For example, MISO's Board of Directors could formally certify to the FERC that MISO's budgets and true-up requests are just and reasonable, based on careful forecasts and other analyses. The MISO Board of Directors also could issue written reports periodically that explain and justify budgets and deviations from budgets.

I. MISO's Method of Cost Recovery

The OMS lacks enough information to rank alternatives to MISO's current method of cost recovery. The white paper makes several important assertions that raise a number of questions. For example, the OMS needs more information about MISO's expected regulatory costs (including labor and administrative costs) under various alternatives. In addition, given MISO's current credit rating, the OMS would be interested in analyses of the potential effects of the various options on MISO borrowing risks and future credit ratings.

The OMS also notes that at the end of its white paper – almost as an afterthought – MISO directs stakeholders to "assume that all of the options provide for full cost recovery using some form of true up to address any costs over or under collected." Given that assumption, it is difficult to assess the absolute and relative magnitudes of cost recovery risks implied by alternatives.[3]

Notwithstanding these criticisms of the white paper, the OMS recommends that MISO adopt a new method of cost recovery that better promotes prudence as well as accountability for over- and under-recovery of costs. In general, the keys to improving MISO's method of cost recovery are 1) to create stakeholder review processes that ensure the budgeted costs, and thus the corresponding rates, are appropriate; and 2) to create means by which MISO can credibly and practically commit to operating within its

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[3] Based on MISO's directions, these comments will use the term "true-up" in the general sense (i.e., "some form of true-up"). Thus, these comments consider the stated rate approach discussed in the white paper to include a true-up because it allows MISO to raise its rates – albeit only with the FERC's approval – in order to cover cost over-runs. At the same time, the OMS recognizes that the FERC's administrative discretion could largely determine the level of similarity between proceedings for approval of annual true-ups and proceedings for approval of changes to stated rates.

budgets; and 3) to create requirements for MISO to thoroughly justify budget deviations before seeking true-ups.

For example, if placing a cap on MISO's current formula rate would require MISO's Board of Directors to identify the causes of significant true-ups and take steps necessary to address those causes while maintaining prudent expenditure, then such an approach could better promote prudence and cost accountability. Thus, "Option #1 – formula rate with cap" could prove to be an improvement over the status quo.

The relative merits of "Option #2 – file budget at FERC (formula rate with annual true-up)" depend on the costs and benefits of increasing the level of the FERC's involvement in MISO's budgeting and true-ups. If the FERC is willing and able to review budgets and true-ups in proceedings that afford parties reasonable due process and sufficient access to information, then MISO might improve its budgeting and cost recovery processes by filing, for example, its budgets and true-up requests for FERC approval.

Option #2 and Option #3 (i.e., stated rate) would increase the FERC's involvement in MISO's budgeting and cost recovery processes. By virtue of the fact that MISO's rates would be fixed for some extended period (i.e., under Option #2, annually, and under Option #3, until FERC approves changes in the rates), this approach also could compel MISO and stakeholders to thoroughly review budgets. Increasing the FERC's involvement in MISO's budgeting and cost recovery processes also could compel MISO to increase the transparency of its budget process in order to garner stakeholder support for its proposed rates. Further, to the extent that MISO, possibly as a matter of operating within its budget, would seek the FERC's approval of rate increases, including "true-ups," only in extraordinary circumstances, Options #2 and #3 could improve MISO's motivation to operate within its budgets.

The OMS recognizes that under a stated rate approach, a profit motive likely would induce the company operating under stated rates to strive to control costs wherever possible.[4] Therefore, a stated rate approach might first appear better designed to work

[4] A profit motive also could motivate MISO to enhance cost control to the point of *inappropriate* cost reductions. On the other hand, a profit motive, in conjunction with a stated rate and other factors, could motivate MISO to increase or over-state expenditures inappropriately in order to justify its stated rate.

well in a for-profit, regulated company context. However, using a stated rate approach in the not-for-profit RTO context could have the salutary effect of focusing stakeholder involvement on the front end of the process in which the level of the stated rate is set.

MISO's non-profit status and guaranteed cost recovery eliminates cost-control motivations based on maximizing the organization's profit. MISO's management and other employees nonetheless can be motivated to control costs appropriately if their compensation depends on it or there are other properly designed incentives. The OMS expects MISO's Board of Directors to continue to examine ways of appropriately harnessing and focusing motives to control costs appropriately using MISO's incentive pay plans. In addition, given that RTO membership is voluntary, MISO should have sufficient incentives to control costs appropriately, as well as improve its cost recovery and budgeting processes in order to maintain and increase membership.

II. MISO's Budgeting Process

Notwithstanding any method of cost recovery MISO chooses, MISO could improve its budgeting process. The current review process, which relies heavily on the

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In general, the OMS does not support MISO, as an RTO, becoming a for-profit organization. In comments filed in FERC's Inquiry into RTO costs (Docket No. RM04-12-000), the OMS proffered reasons why an RTO's non-profit status is appropriate and not a barrier to cost control. The OMS observed, "With proper incentives and governance, non-profit RTOs can contain costs effectively and appropriately." The OMS elaborated as follows:

> The profit motive is most effective for controlling costs and benefiting society in competitive or workably competitive markets. RTOs have natural monopoly characteristics, including significant economies of scale that do not easily lend themselves to socially beneficial competition characterized by free entry and exit by rival RTOs.
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> Moreover, a profit motive in conjunction with the contractual and regulatory difficulties of changes in RTO membership could exacerbate the natural monopoly problem and may require heavier regulation. Further, RTOs' functions and services create public goods (e.g., non-exclusive consumption of reactive power or capacity) and externalities (e.g., loop flow) that should be provided by monopoly RTOs who, with their members, can most efficiently internalize these benefits and costs. A profit motive could induce social inefficiencies from RTOs providing too many services characterized by externalities and not enough services with public good characteristics.
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> In addition, RTOs must cooperate and coordinate with each other in a number of areas (e.g., seams agreements, planning). A profit motive could produce socially inefficient outcomes from such cooperative activities. (f.n. 13 at 7)

Finance Subcommittee, does not provide enough information and time for adequate stakeholder reviews of MISO's budgets. OMS is concerned that the current budget review process at MISO, which is currently effectively the *only* budget review process, may be insufficient for assessing the justness and reasonableness of MISO's budgets and resulting rates.

At the same time, the OMS appreciates one of the advantages of the status quo noted in the white paper: the current budget review process is "[e]asy to administer." The general improvements OMS suggests need not complicate budget review processes, especially as they mature over time. In fact, stakeholder reviews may run more smoothly if stakeholders have the information they need and reasonable time to review that information.

The OMS is pleased with Mr. Graham Edward's announcement at the May 18 Board of Directors meeting that MISO is moving to multi-year advance budgeting. Expanding the budgeting horizon should provide stakeholders with more information and more opportunity to better understand MISO's development.

Given MISO's non-profit status and guaranteed cost recovery, MISO should be transparent to stakeholders. Transparency in MISO's budgeting process, for on-going operational costs as well as new service development, contributes to the efficiencies of using RTOs to provide open access to transmission service. Moreover, information that MISO compiles to justify its costs could help improve MISO's plans for new or upgraded functions and services, giving stakeholders a better understanding of MISO's operations and costs.

III. Role of the Federal Energy Regulatory Commission in MISO Budgeting and Cost Recovery

The OMS recognizes the FERC is ultimately responsible for ensuring that MISO's rates are just and reasonable.[5] The OMS thus recognizes the logic of seeking

[5] In comments filed in FERC Docket No. RM04-12-000, the OMS stated, "[S]ince RTOs are under the jurisdiction of the Commission, the Commission must conduct any regulatory prudence reviews." (p. 7)

more involvement from the FERC in MISO's cost recovery and budgeting processes.[6] Further, if the FERC is willing and able to review budgets and true-ups in proceedings that afford parties reasonable due process and sufficient access to information, then MISO might improve its budgeting and cost recovery processes by filing, for example, its budgets and true-up requests for FERC approval.

As a matter of law and policy, FERC appears to have carved out a significant role in MISO's budgeting and cost recovery processes for the MISO's Board of Directors.[7] Thus, continued reliance on the Board tempers the level of involvement by the FERC needed for these processes. For example, MISO's Board of Directors could formally certify to the FERC that MISO's budgets and true-up requests are just and reasonable, based on careful forecasts and other analyses. The MISO Board of Directors also could issue written reports periodically that explain and justify budgets and deviations from budgets.

IV. Conclusion

The OMS appreciates MISO's consideration of these comments and recommendations. The OMS stands ready to continue to discuss ways in which MISO can improve its cost recovery and budgeting processes.

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[6] Under MISO's current method of cost recovery, ensuring that MISO's rates are just and reasonable requires thorough prospective (i.e., budget review) and retrospective (i.e., true-up) examinations of MISO's costs.

[7] The FERC's November 22, 2002 Order in Docket No.ER02-2595 (at ¶ 3) states:

> "We … recognize that RTO development costs must be carefully contained in order to maximize the net benefits of RTO formation and the creation of a common market to customers. Therefore, while we recognize the importance of RTOs recovering their costs associated with the services they provide, we also recognize the importance of cost control measures in system development." Consequently, we expect Midwest ISO's Board of Directors to be proactive in this area. The Midwest ISO Agreement provides that the management of all property, business and affairs of Midwest ISO shall be vested in the Board of Directors. Thus, we expect the Board of Directors to guard against any unreasonable costs being incurred. (¶3, footnote deleted)