



operating reserve shortage”<sup>5</sup> and the Commission’s regulations implementing that criterion. In the absence of the requested clarification, NRECA seeks rehearing of the Commission effective rejection of the NRECA alternative pricing proposal without any attempt to address the merits of that proposal, as well as its adoption of pricing proposals unsupported by evidence that they will produce just and reasonable rates, but, on the contrary, shown likely to produce unjust and unreasonable rates.

#### **I. SPECIFICATION OF ERROR**

As required by Rule 713(c)(1), 18 C.F.R. § 385.713(c)(1), NRECA specifies the following errors in Order No. 719-A. To the extent that Order No. 719-A required RTOs and ISOs to provide for a single market clearing price for both demand response and generation resources in periods of reserve shortage:

1. Order No. 719-A erred in arbitrarily and capriciously ignoring evidence to the contrary and prohibiting separate pricing of demand response and supply in periods of reserve shortage while purporting to authorize consideration by RTOs and ISOs of the alternative demand response pricing mechanism that NRECA proposed. Order No. 719-A at P 104; *Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983).
2. Order No. 719-A’s adoption of the four enumerated pricing proposals was unsupported by substantial evidence in the record. Administrative Procedure Act, 5 U.S.C. § 706 (2009); *ChevronTexaco Exploration and Production Co. v. FERC*, 387 F.3d 892, 895 (D.C. Cir. 2004).

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<sup>5</sup> Order No. 719 at P 247.

3. Order No. 719-A's adoption of the four enumerated pricing proposals despite evidence that those pricing proposals will produce unjust and unreasonable rates, harm reliability, and fail to attract additional investment in generation resources without addressing that evidence meaningfully was arbitrary and capricious, as well as unsupported by, evidence of the quantity and quality required to discharge the Commission's burdens under Section 206 of the Federal Power Act and Section 706 of the Administrative Procedure Act .  
Order No. 719-A at PP 94, 102, 104; 5 U.S.C. § 706 (2009); 16 U.S.C. § 824e (2009); Affidavit of Dr. Laurence D. Kirsch and Dr. Matthew J. Morey <sup>6</sup> at PP 59-76; *Cal. ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1014-15 (9th Cir. 2004); *Tesoro Alaska Petroleum Co. v. FERC*, 234 F.3d 1286, 1294 (D.C. Cir. 2000); *Steamboaters v. FERC*, 759 F.2d 1382, 1388 (9th Cir. 1985); *Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486, 1510 (D.C. Cir. 1984).
4. Order No. 719-A erred in inviting RTOs and ISOs to adopt one of the four enumerated approaches to scarcity pricing set out in Order No. 719 while failing to consider evidence demonstrating that those proposals will produce unjust and unreasonable rates and ignoring arguments demonstrating that the proposal advanced by NRECA would address this demonstrable flaw in the Commission's pricing proposals. Order No. 719-A at PP 102, 104; *Cal. ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1014-15 (9th Cir. 2004); *Tesoro Alaska*

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<sup>6</sup> Affidavit of Dr. Laurence D. Kirsch and Dr. Matthew J. Morey on behalf of NRECA, filed in this proceeding as Attachment A to the Comments of the National Rural Electric Cooperative Association filed on April 21, 2008 ("Kirsch-Morey Affidavit")

*Petroleum Co. v. FERC*, 234 F.3d 1286, 1294 (D.C; Cir. 2000). *Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486, 1510 (D.C. Cir. 1984).

## II. STATEMENT OF ISSUES

As required by Rule 713(c)(2), NRECA states that the following issues are raised in its request for rehearing of Order No. 719. To the extent that Order No. 719-A required RTOs and ISOs to provide for a single market clearing price for both demand response and generation resources in periods of reserve shortage:

1. Whether Order No. 719-A erred by ignoring evidence to the contrary and prohibiting separate pricing of demand response and supply in periods of reserve shortage while purporting to authorize consideration by RTOs and ISOs of the alternative demand response pricing mechanism that NRECA proposed. Order No. 719-A at P 104; *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983).
2. Whether Order No. 719-A erred by adopting four enumerated pricing proposals that were unsupported by substantial evidence in the record. Administrative Procedure Act, 5 U.S.C. § 706 (2009); *ChevronTexaco Exploration and Production Co. v. FERC*, 387 F.3d 892, 895 (D.C. Cir. 2004).
3. Whether Order No. 719-A's adoption of the four enumerated pricing proposals, despite evidence that those pricing proposals will produce unjust and unreasonable rates, harm reliability, and fail to attract additional investment in generation resources was both arbitrary and capricious and unsupported by evidence of the quantity and quality required to discharge the Commission's burdens under Section 206 of the Federal Power Act and

Section 706 of the Administrative Procedure Act. Order No. 719-A at PP 94, 102, 104; Kirsch-Morey Affidavit at PP 59-76; 5 U.S.C. § 706 (2009); 16 U.S.C. § 824e (2009); *Cal. ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1014-15 (9th Cir. 2004); *Tesoro Alaska Petroleum Co. v. FERC*, 234 F.3d 1286, 1294 (D.C. Cir. 2000); *Steamboaters v. FERC*, 759 F.2d 1382, 1388 (9th Cir. 1985); *Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486, 1510 (D.C. Cir. 1984).

4. Whether Order No. 719-A erred by requiring RTOs and ISOs to adopt one of the four enumerated approaches to scarcity pricing set out in Order No. 719 while failing to consider evidence demonstrating that those proposals will produce unjust and unreasonable rates and ignoring arguments demonstrating that the proposal advanced by NRECA would address this demonstrable flaw in the Commission's pricing proposals. Order No. 719-A at PP 102, 104; *Cal. ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1014-15 (9th Cir. 2004); *Tesoro Alaska Petroleum Co. v. FERC*, 234 F.3d 1286, 1294 (D.C. Cir. 2000). *Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486, 1510 (D.C. Cir. 1984).

### **III. REQUEST FOR CLARIFICATION**

Throughout this rulemaking, NRECA has advocated an alternative to the four scarcity pricing mechanisms proposed by the Commission. The NRECA approach – as explained in its ANOPR Comments,<sup>7</sup> NOPR Comments<sup>8</sup> and Request for Rehearing of

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<sup>7</sup> Comments of the National Rural Electric Cooperative Association, Docket Nos. RM07-19-000 and AD07-7-000 (September 14, 2007) (“ANOPR Comments”).

<sup>8</sup> Comments of the National Rural Electric Cooperative Association, Docket Nos. RM07-19-000 and AD07-7-000 (April 21, 2008) (“NOPR Comments”).

Order No. 719<sup>9</sup> – explicitly differentiates between the prices paid to generators and the prices paid to demand responders during periods of operating reserve shortage. Under the NRECA approach, RTOs and ISOs would remove bid caps for demand response resources during emergency situations, provided that those higher bids for demand response *do not* set the market-clearing price for all resources. The purpose of the NRECA approach is to encourage additional demand response by allowing demand response resources to obtain a higher price for their response during emergencies, recognizing that demand response in these out-of-market situations is an operational tool for preserving reliability rather than a pure market participant. By differentiating between demand response and generation resources, the NRECA approach would encourage additional demand response in RTO- and ISO-run markets and improve reliability without exposing consumers to unjust and unreasonable prices that are the product of market power in wholesale generation markets.<sup>10</sup>

In Order No. 719-A, the Commission indicated a willingness to allow RTOs and ISOs to consider the NRECA proposal:<sup>11</sup>

With regard to NRECA’s alternative approach for pricing reform, we reiterate that the Final Rule did not mandate any specific approach to shortage pricing. It presented four approaches to shortage pricing, but left the RTOs and ISOs with freedom to develop the solutions that best suit their regions. *RTOs and ISOs may consider NRECA’s alternative proposal*, or others not presented in the Final Rule, as they see fit.

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<sup>9</sup> On November 17, 2009, The American Public Power Association, California Municipal Utilities Association and NRECA filed a Request for Rehearing in this proceeding (hereinafter “NRECA Request for Rehearing”).

<sup>10</sup> As noted in the Kirsch-Morey Affidavit, market power problems are ubiquitous throughout existing RTO/ISO markets (*i.e.*, Midwest ISO (Kirsch-Morey Affidavit at PP 25-29), ISO New England (*id.* at PP 30-32), New York ISO (*id.* at P 33) and PJM (*id.* at PP 34-37)).

<sup>11</sup> Order No. 719-A at P 104 (emphasis supplied).

The Commission's holding in Order No. 719-A was consistent with its holding in Order No. 719, in which the Commission stated:<sup>12</sup>

RTOs and ISOs and their stakeholders are free to consider [the Commission's four pricing proposals] and other possible solutions and propose to us their own method of shortage pricing reform that satisfies the criteria as well as our four approaches.

NRECA takes the Commission at its word and believes that the Commission's intention was to permit RTOs and ISOs to propose the NRECA pricing proposal. To effectuate this holding, however, the Commission must clarify that the NRECA proposal complies with the Commission's five pricing proposal criteria and the regulations implementing those criteria. Such clarification is necessary because the NRECA proposal can be read to conflict with the Commission's rule established in Order No. 719, as confirmed in Order No. 719-A. That rule appears to require that the *same* market-clearing price be paid to both generators and demand response. Section 35.28(g)(1)(iv)(A) provides:

Each Commission-approved independent system operator or regional transmission organization must modify its market rules to allow the market-clearing price during periods of operating reserve shortage to reach a level that rebalances supply and demand so as to maintain reliability while providing sufficient provisions for mitigating market power.

The Commission's regulation, by referring to *the* market-clearing price implies that there is to be a single, identical market-clearing price for all resources. This could be understood as a rejection of the NRECA approach, which, as discussed above, would

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<sup>12</sup> Order No. 719 at P 237.

permit the price paid to demand response to rise during periods of operating reserve shortage, while retaining a mitigated market-clearing price for generation resources.

Likewise, the fifth criterion adopted by the Commission at P 247 of Order No. 719 could be read to require that the same market-clearing price be paid to both generators and demand responders, regardless of the specific approach an RTO or ISO adopts to revise its market pricing rules. That criterion provides that RTOs and ISOs must:<sup>13</sup>

Ensure that the principle of comparability in treatment of *and compensation to* all resources is not discarded during periods of operating reserve shortage.

Again, the NRECA proposal, which, by its terms provides for differing compensation to demand response and generation resources in times of reserve shortage, would appear to conflict with the Final Rule. Accordingly, if the Commission's intent is that the NRECA approach may be considered by RTOs and ISOs, the Commission should clarify that such a proposal will not be an exercise in futility. NRECA therefore requests that the Commission clarify the import of its decision – on two separate occasions – to permit RTOs and ISOs to consider the NRECA proposal. Is it the Commission's position that the NRECA approach, on its face, satisfies the Commission's pricing proposal criteria and Section 35.28(g)(1)(iv)(A)? Or is the Commission simply permitting RTOs and ISOs to consider a proposal that the Commission finds plainly inconsistent with its Final Rule and that will undoubtedly be rejected by the Commission if ultimately proposed by an RTO or ISO?

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<sup>13</sup> Order No. 719 at P 247 (emphasis supplied).

Stated differently, NRECA requests that the Commission clarify that Section 35.28(g)(1)(iv)(A) and the Commission's fifth criterion do not require that demand response and generation resources receive the identical market-clearing price in times of operating reserve shortage.

#### **IV. REQUEST FOR REHEARING**

Absent a clarification that the Commission's shortage pricing rules do not require a single market-clearing price for all resources, the Commission will have committed plain error in Order 719-A by adopting pricing proposals that evidence in the record shows will produce unjust and unreasonable rates. Order 719-A arbitrarily and capriciously ignores that evidence and, at the same time, adopts pricing proposals that are themselves unsupported by substantial evidence. At no point in this rulemaking has the Commission weighed the merits of the evidence supplied by NRECA that by failing to differentiate between the prices received by generators and demand response, the Commission's four scarcity pricing proposals, or any other proposal that meets the Commission's criteria, could subject consumers to unjust and unreasonable rates that reflect supply market power during times of operating reserve shortage, while simultaneously failing to deliver the purported benefits of increased reliability and investment in RTO- and ISO-run markets.

The Commission cannot ignore the issues raised by NRECA and cannot ignore evidence highlighting the flaws in the Commission's pricing proposals. *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983) ("An agency action is arbitrary and capricious 'if the agency has . . . *entirely failed to consider an important aspect of the problem*, offered an explanation for its decision

that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.’”) (emphasis supplied). The Commission has an obligation to engage these arguments and, if it is to adopt the four pricing proposal it has advanced in this proceeding (to the exclusion of the NRECA approach), it must articulate the basis for its decision to do so. *See Mo. PSC v. FERC*, 234 F.3d 36, 41 (D.C. Cir. 2000) (“A passing reference . . . is not sufficient to satisfy the Commission’s obligation to carry out ‘reasoned’ and ‘principled’ decisionmaking. We have repeatedly required the Commission to ‘fully articulate the basis for its decision.’” (citations omitted)). The Commission has failed to meet these obligations in Order No. 719-A.

**A. The Commission has Adopted Pricing Proposals that Have Been Demonstrated to be Unjust and Unreasonable.**

The Commission acknowledged in Order No. 719-A (at P 104) that it has not performed any analysis of the rates that are likely to be produced by the Commission’s pricing proposals and held that “[s]uch analysis is most appropriately left to the compliance process, where the Commission can examine how the RTO’s and ISO’s chosen approach or approaches to shortage prices will work in its region.”<sup>14</sup> And yet, in the absence of such an analysis, Order No. 719’s pricing proposals will, absent the clarification requested by NRECA, require those RTOs and ISOs to utilize a single market-clearing price for demand response and supply to the exclusion of any proposal that would differentiate between the prices paid to generation and demand response resources. Order Nos. 719 and 719-A have offered no justification for this decision, which was made in the face of significant evidence marshaled by NRECA

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<sup>14</sup> Order No. 719-A at P 104.

demonstrating that the Commission's proposals would yield unjust and unreasonable rates. In short, the Final Rule has adopted a "market" solution without any analysis of whether the proposed market will produce just and reasonable rates or whether a different market structure could benefit consumers more by promoting more effective and fair wholesale competition.

As NRECA noted in its request for rehearing of Order No. 719, the Commission may approve market-based rates under the Federal Power Act only if it can point to "empirical proof" that "existing competition [will] ensure that the actual price is just and reasonable." *Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486, 1510 (D.C. Cir. 1984); *see also Cal. ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1014-15 (9th Cir. 2004). In an attempt to justify its adoption of a single market-clearing price structure in Order No. 719-A, the Commission has, in fact, admitted that it has approved a particular subset of market structures (*i.e.* those which permit the market clearing price to rise above mitigated rates for both generation resources and demand response) without performing the analysis necessary to determine whether that subset of market structure can produce just and reasonable rates.

NRECA has submitted significant evidence, in the form of reasoned critique and sworn expert testimony that demonstrates the significant flaws in the Commission's proposal to raise supply prices during periods of operating reserve. The Affidavit of Dr. Laurence D. Kirsch and Dr. Matthew J. Morey on behalf of NRECA submitted in this proceeding identified several reasons why bid and offer caps should not be removed without careful consideration during periods of operating reserve shortage. Those reasons highlighted by Drs. Kirsch and Morey include:

- Market power problems are ubiquitous in RTO-run markets (as demonstrated by the large body of evidence compiled by RTO market monitors themselves). Kirsch-Morey Affidavit at PP 10-37.
- The conduct-impact test of the Midwest ISO, ISO New England, and the New York ISO allow suppliers substantial latitude to manipulate market prices (Kirsch-Morey Affidavit at P 38) and allows inefficient market outcomes (Kirsch-Morey Affidavit at PP 53-55).
- Permitting prices to rise during emergencies may not be sufficient to overcome regulatory and other barriers to entry that preserve the market power of incumbents. Kirsch-Morey Affidavit at PP 57-63.
- Increased demand response will not ensure competitive prices in markets that continue to suffer from high concentrations of generation ownership given the transmission constraints that limit competition. Kirsch-Morey Affidavit at PP 64-65.

Drs. Kirsch and Morey have warned that “in the presence of market power as exists in the organized electricity markets today, raising the caps can result in prices that are inefficiently high...because suppliers with market power will have the ability – and may have the incentives – to raise prices above marginal costs, including a reasonable estimate of scarcity costs.”<sup>15</sup> Order No. 719-A erred by failing to grapple with this evidence before approving a pricing proposal that would remove bid caps for generation resources.

**B. The Commission has Failed to Adduce Substantial Evidence to Support its Pricing Proposals.**

In response to the objections raised by NRECA, Order No. 719-A has offered what amounts to unsupported conjecture that “the entry of demand response over time may lead to lower prices in the long run” and cites the observations of “at least one commenter” that existing market rules may deter investment in demand response and generation resources.<sup>16</sup> The Commission’s analysis suffers from the obvious deficiency

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<sup>15</sup> Kirsch-Morey Affidavit at P 15.

<sup>16</sup> Order No. 719-A at P 96.

that while it gives so much weight to the thoughts of one commenter, it wholly ignores evidence from NRECA and other commenters that the Commission's plan to ameliorate the "problem" of prices that are too low during emergency periods will not produce the benefits it hopes to achieve by doing so. For example, while adopting the position of one commenter in this proceeding that existing market rules may deter investment, the Commission has failed to explain why it has chosen to ignore the argument of Drs. Kirsch and Morey that the long-term impacts of higher offer and bid caps are highly uncertain.<sup>17</sup> Such evident inconsistency without explanation constitutes arbitrary and capricious decision-making.

Indeed, throughout this rulemaking, the Commission has premised its argument for raising the market clearing price on the undemonstrated theory that the existing bid and offer caps make it difficult for RTO- and ISO-run markets to elicit the optimal level of demand or generator response during emergencies by muting the necessary price signal to demand response and generators.<sup>18</sup> While clearly insufficient to meet the Commission's obligation to provide "empirical proof" before relying on a market structure to produce just and reasonable rates, the Commission's argument that higher prices will spur increased investment in demand response and generation resources has been readily dismissed in this rulemaking.

NRECA highlighted several reasons why the Commission's argument that using price signals during emergencies can attract increased investment is fundamentally flawed, namely:

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<sup>17</sup> Kirsch-Morey Affidavit at PP 72-79.

<sup>18</sup> See Notice of Proposed Rulemaking at PP 108, 111; Order No. 719 at 192; Order No. 719-A at P 94.

- Short-term price signals do not give investors the assurance they need to invest millions or billions of dollars in long-lived assets. Investors need certainty that the income stream will continue to be there five, ten, or twenty years in the future. NRECA NOPR Comments at 39
  
- Price signals are ineffective where market power is great enough to exclude competition. NOPR Comments at 39-40. NRECA has highlighted the many barriers to entry in RTO and ISO markets, namely:<sup>19</sup>
  - Limited access to electric transmission facilities;
  - Insufficient planning process that do not obligate public utility transmission providers to construct each facility identified in the transmission planning process;
  - High construction costs;
  - Limited access to gas pipelines;<sup>20</sup>
  - A mismatch between the optimal generating plant sizes (which are typically large) and the (relatively smaller) loads of load pockets where reserve shortages (and “emergencies”) are most likely to occur;<sup>21</sup>
  - The greenfield and brownfield sites that would be most attractive for new entry are often owned by large incumbent suppliers; and other sites are in short supply;<sup>22</sup>
  - State and local siting restrictions;<sup>23</sup>
  - Growing environmental concerns, especially about fossil-fired generation, which has led to a resurgence in opposition to new fossil plant construction, and cancellation of a significant number of fossil projects, coal projects in particular;<sup>24</sup>
  - Uncertainty about greenhouse gas legislation at the national level;<sup>25</sup>
  - Uncertainty regarding inflation, capital market conditions, and the current state of state retail restructuring;<sup>26</sup>
  - Concerns with states’ competitive procurement policies;<sup>27</sup> and
  - Uncertainty regarding transmission cost allocation policy.<sup>28</sup>

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<sup>19</sup> NRECA NOPR Comments at 40-42; *see also* Kirsch-Morey Affidavit at PP 59-76.

<sup>20</sup> Kirsch-Morey Affidavit at P 59.

<sup>21</sup> *Id.* at P 60.

<sup>22</sup> *Id.* at P 61.

<sup>23</sup> *Id.* at P 62.

<sup>24</sup> *Id.* at P 63.

<sup>25</sup> *Id.*

<sup>26</sup> Susan Tierney, Resource Adequacy, Entry and Current Electric Industry Trends (presentation to the American Antitrust Institute – Meeting on Resource Adequacy on March 3, 2008) at [http://www.antitrustinstitute.org/archives/files/Tierney\\_031120080950.pdf](http://www.antitrustinstitute.org/archives/files/Tierney_031120080950.pdf) (last visited Aug. 17, 2009), at 4.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

Order No. 719-A ignored this evidence while failing to offer any substantial evidence of its own to support the affirmation of the four pricing proposals.

NRECA also has noted that the Final Rule's four pricing proposals run counter to considerable experience in RTO and ISO markets with attempts to spur investment through high prices. As NRECA discussed in its NOPR Comments,<sup>29</sup>

When [RTO and ISO] markets were first initiated, the theory was that LMP prices in the real-time markets would provide incentives for efficient generation and transmission investments in the most efficient locations on the system. Yet, despite high congestion prices, insufficient transmission and generation is being built in most regions, with consumers having paid high prices for naught. While short-term price signals may encourage an efficient allocation of resources in real-time, and on an hour-ahead basis, they have not succeeded in encouraging transmission and generation construction to meet long-term needs.

As NRECA noted (NRECA NOPR Comments at 39), the Commission has since found it “necessary to move beyond short-term price signals to ensure resource adequacy. It has ordered the formation of capacity markets in PJM and New England. It has ordered all transmission owners to engage in regional transmission planning for both reliability and economics. And, the Commission is still trying to address the emergencies that continue to arise.” Despite this experience, the Commission proposed what is effectively more of the same failed policy and has offered no evidence distinguishing the instant proposal from its predecessors. The Commission's proposal will undoubtedly raise prices in the short term and, as with its LMP experiments, will likely produce no long-term benefits to consumers. Order No. 719-A, in the absence of any evidence in

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<sup>29</sup> NRECA NOPR Comments at 38.

response to these arguments, has failed to demonstrate that its four pricing proposals are just and reasonable.

**C. The Commission has Arbitrarily and Capriciously Chosen to Raise Bid Caps in this Proceeding while Ignoring Arguments and Evidence Discrediting the Commission’s Approach.**

When, as in the instant proceeding, the Commission acts under FPA Section 206, it bears the burden of showing that the existing rate structure it seeks to modify is unjust and unreasonable. *ChevronTexaco Exploration and Production Co. v. FERC*, 387 F.3d 892, 895 (D.C. Cir. 2004).<sup>30</sup> The Commission has made no showing in the instant proceeding that the offer and bid caps it seeks to remove are in any way related to the lack of generation and demand response investment it seeks to promote. The Commission, providing its rationale for eliminating bid caps in Order No. 719-A claims that by failing to produce rates “that accurately reflect the true value of energy during periods of operating reserve shortages” RTO and ISO bid caps may “harm reliability, inhibit demand response, deter new entry of demand response and generation resources, and thwart innovation.”<sup>31</sup> As discussed below, however, Order No. 719-A has failed to address arguments that the Final Rule’s four pricing proposals will not achieve these

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<sup>30</sup> “When the Commission finds that a previously accepted rate has become “unjust, unreasonable, unduly discriminatory, or preferential,” the Commission, pursuant to § 5 [of the Natural Gas Act], “determine[s] the just and reasonable rate . . . to be thereafter observed and in force.” 15 U.S.C. § 717d(a). In proceeding under § 5, however, the Commission bears the burden of adducing substantial evidence to prove (1) the pipeline’s existing rate is unjust and unreasonable and (2) the rate determined by the Commission is just and reasonable. As we held in *Sea Robin* [*SeaRobin Pipeline Co. v. FERC*, 795 F.2d 182 (D.C. Cir.1986)], these limitations apply as well to rate rules: ‘a Commission initiated change in either the rates or their method of calculation can be accomplished only upon the agency’s compliance with the strictures of section 5.’” 387 F.3d at 895 (citations omitted).

<sup>31</sup> Order No. 719-A at 94.

goals and in some cases, will undermine the very goals the Commission sought to advance.

As a preliminary matter, the Commission’s proposed solution (*i.e.* to let prices rise during periods of operating reserve shortage) fails to grapple with the NRECA argument and evidence that the existence of emergencies is a reflection not of unreasonably low prices during those emergencies, but rather of the failure of the RTO and ISO market design to assure resource adequacy. NRECA highlighted this fundamental flaw in the Commission’s logic in its NOPR Comments:<sup>32</sup>

The Commission has an affirmative obligation under FPA Sections 205, 206, 207 and 215<sup>[33]</sup> to ensure that wholesale electric markets are designed to provide reliable and adequate service except under the most severe operational exigencies such as an N-2 contingency or more severe situation. Markets should not be designed in a manner that allows or even requires emergencies to be a “normal” occurrence or a “normal” part of market operations for generators to recover their investments. Nor should the market be designed to allow emergencies to be frequent, long or severe enough to drive investment decisions. If the system is reaching emergency situations more frequently, there is a serious market failure that must be addressed. Investors should be able to recover their investments in generation or demand-side management resources without resorting to high prices during emergencies. If they cannot, the “missing money,” if any, must be added in somewhere else in the market design. Otherwise the Final Rule would be to blame for approving a market design that is inherently unreliable.

The Commission has not provided a reasoned explanation for why it has settled on its preferred course of raising prices during emergencies rather than looking for alternative market structure solutions that would be consistent with the

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<sup>32</sup> NRECA NOPR Comments at 33.

<sup>33</sup> 16 U.S.C. §§ 824d, 824e, 824f, 824o.

Commission's obligations under the Federal Power Act. Order No. 719-A's failure to do so can not be considered reasoned decision-making. *PPL Wallingford Energy LLC*, 419 F.3d 1194, 1198 (D.C. Cir. 2005).

The Commission's error is made clear by Order No. 719-A's failure to rebut arguments that the short-term increase in prices that are sure to result from the Final Rule are unlikely to produce tangible benefits for RTO- and ISO-run markets. For example, the Commission has identified improved reliability as a goal to be advanced by removing bid caps during emergency periods. On this point, the Commission proposal is internally inconsistent: if the Commission's plan to spur investment eliminates the emergency conditions the Commission seeks to eliminate, any new investors would lose money and could go bankrupt to the extent that they depended on the extremely high prices during emergencies to meet their revenue requirement.<sup>34</sup> Stated differently, if the Commission is correct that high prices are needed during emergencies to eliminate those emergencies, then so too will the investment in new generation destroy the very funding stream that the Commission has found necessary to justify that investment.

Furthermore, Order No. 719-A has ignored arguments and evidence that the Final Rule will, in fact, undermine reliability by encouraging behavior that creates emergencies. As NRECA explained in its NOPR Comments, under the Final Rule, generation resources will have the perverse incentive in the short-term to create emergencies so that they can collect the excessively high prices the Commission's pricing

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<sup>34</sup> NRECA NOPR Comments at 38.

proposals would afford them.<sup>35</sup> And in the long-term, generation suppliers would lack the incentive to develop new resources because without those shortages, they would no longer collect excessive rents.<sup>36</sup> In addition, as discussed above, Order Nos. 719 and 719-A have ignored considerable evidence that the existence of market power and barriers to entry in organized markets will make it impossible to attract long-term investment in new supply resources, regardless of the prices offered during emergency periods. To the extent that the Commission's reliability gains are premised on the attraction and retention of new supply resources, the Commission's reform is destined to fail in the absence of other significant changes to RTO and ISO markets and, among other things, the Commission's transmission construction and planning processes.

Order No. 719-A fails to address these arguments by, once again, glossing-over the evidence submitted by NRECA and several other petitioners:<sup>37</sup>

Several petitioners find fault with the four shortage pricing approaches, stating that they fail to protect customers from the exercise of market power and lead to other adverse consequences. We find that these petitioners have not raised any new arguments on rehearing and deny rehearing on this issue.

The Commission, however, never substantively addressed those arguments when they were raised in the proceeding that produced Order No. 719. Accordingly, NRECA and several other petitioners re-raised those arguments on rehearing. The Commission is therefore correct that these are not "new arguments." But Order No. 719's failure to substantively address those arguments in the first instance does not eliminate the

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<sup>35</sup> NRECA NOPR Comments at 31-32; *see also* Kirsch-Morey Affidavit at PP 11-22.

<sup>36</sup> *Id.* at 32.

<sup>37</sup> Order No. 719-A at P 102.

requirement that a sustainable order under the Federal Power Act cannot ignore those same arguments when they are raised again on rehearing. The Commission’s “failure to respond meaningfully to objections raised by a party renders its decision arbitrary and capricious” and where the Commission has failed to answer objections that on their face seem legitimate “its decision can hardly be classified as reasoned.” *PPL Wallingford Energy LLC*, 419 F.3d 1194 at 1198 (D.C. Cir. 2005) (internal quotations and citations omitted).<sup>38</sup>

A review of the record in this proceeding reveals that substantial evidence and several valid arguments raised by NRECA and other petitioners have not been meaningfully addressed by the Commission in this proceeding. These arguments, discussed below, cast doubt on all four pricing proposals advanced by the Commission. Accordingly, to be sustainable, an order adopting a single market-clearing price approach must, at a minimum, address the following arguments that have been raised by NRECA:

- Order Nos. 719 and 719-A have failed to address NRECA’s argument that the Commission’s four approaches would undermine reliability, rather than preserve it. And to the extent that they preserve reliability, they do not do so in a manner consistent with the Federal Power Act because they would unlawfully permit shifting rents from consumers to generators. *See* NRECA NOPR Comments at 30-32; NRECA Request for Rehearing at 36.
- Order Nos. 719 and 719-A have failed to offer a meaningful response to arguments that the Commission’s four pricing proposals will not attract new supply resources in real time and can not attract long-term investment in new supply resource. *See* NRECA NOPR Comments at 36-42; NRECA Request for Rehearing at 36-37; Kirsch-Morey Affidavit at 57-63.

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<sup>38</sup> *See also*, *City of Seattle v. FERC*, 923 F.2d 713, 715 (9th Cir. 1991) (“Undoubtedly, as [*National Wildlife Fed’n v. FERC*, 801 F.2d 1505 (9th Cir. 1986)] indicates, it would be arbitrary for FERC to ignore the evidence before it or to fail to consider all proper aspects of the issues with which it was faced. *Id.* at 1511-12.”).

- Order Nos. 719 and 719-A have failed to explain how the Commission’s pricing proposals would be superior to the NRECA proposal in attracting investment in demand side resources. In addition, Order Nos. 719 and 719-A have failed to respond to NRECA’s argument that the Commission’s approach would attract demand side resources at a dramatically higher cost to consumers than the NRECA approach. *See* NRECA NOPR Comments at 43-44; NRECA Request for Rehearing at 37.
- Order Nos. 719 and 719-A have failed to respond to NRECA’s argument that by allowing generators to be paid more during emergency situations than they would ordinarily receive under existing market rules, the four approaches would create a perverse incentive and encourage behavior that creates emergencies, thereby undermining reliability during the long-term period required for entry into generation markets. NRECA Request for Rehearing at 37
- Order Nos. 719 and 719-A have failed to address NRECA’s argument that under the Commission pricing proposals suppliers would have the incentive in the short- to mid-term to create emergencies during these periods so that they can collect the excessively high prices the NOPR’s proposals would afford them. Indeed, even in the long-term, suppliers would lack the incentive to develop new resources because without the shortages, they would no longer collect excessive rents. *See* NRECA Request for Rehearing at 37.

Before the Commission can adopt its proposed market structure, it is obligated to engage, and not ignore these criticisms and articulate how the four pricing proposals will produce just and reasonable rates.

NRECA supports the Commission’s overarching goals of promoting wholesale demand response, both to better discipline prices in RTO-run centralized markets, and to maximize the environmental benefits associated with reduced usage of electric power. The Commission, however, is obligated to adopt a pricing solution that can deliver upon these goals while simultaneously ensuring that the Commission meets its primary mandate under the Federal Power Act to ensure just and reasonable rates. And in the absence of a reasoned analysis explaining the rationale behind the adoption of single

market-clearing price approach, the adoption of the Commission's four pricing proposals in the Final Rule cannot withstand scrutiny.

**D. Order No. 719-A Erred in Arbitrarily and Capriciously Holding that the NRECA Approach Could be Considered by RTOs and ISOs in the Compliance Process.**

Absent the clarification that RTOs and ISOs are not required to adopt a single market-clearing price for all resources and that different prices for demand response and supply would not offend the Order's comparability criterion, Order No. 719-A will have erred by holding that RTOs and ISOs are free to propose the NRECA alternative pricing approach while simultaneously requiring a single market clearing price for both demand and supply resources, as well as requiring "that the principle of comparability in treatment of and compensation to all resources is not discarded during periods of operating reserve shortage."<sup>39</sup> Absent Commission clarification to the contrary, the NRECA approach is inconsistent with the Commission's Final Rule for the reasons discussed above in NRECA's request for clarification. The Commission's holding that RTOs and ISOs are free to propose the NRECA approach is therefore arbitrary and capricious. If the Commission is to reject the NRECA approach it is required to articulate the reasons for its decision to do so and not create the impression that it is open to considering the approach in a subsequent proceeding. *See Mo. PSC v. FERC*, 234 F.3d 36, 41 (D.C. Cir. 2000).

**V. CONCLUSION**

Wherefore, for the reasons stated herein, NRECA requests that the Commission clarify that the NRECA pricing proposal is consistent with the Commission's pricing

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<sup>39</sup> Order No. 719 at P 247.

proposal criteria and implementing regulations as affirmed by Order No. 719-A. In the absence of Commission clarification that the Commission's Final Rule does not mandate a single clearing price for both demand response and supply resources during periods of operating reserve shortage, NRECA requests rehearing of the Commission's decision to adopt its four pricing proposals for the reasons stated herein.

Respectfully Submitted,

**NATIONAL RURAL ELECTRIC  
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August 17, 2009

**CERTIFICATE OF SERVICE**

I hereby certify that I have this day electronically served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C., this 17<sup>th</sup> day of August, 2009.

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