

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

California Independent System Operator Corporation	)	Docket Nos.	EL04-108-000
	)		ER02-1656-017
	)		ER02-1656-018
Public Utilities Providing Service in California under Sellers' Choice Contracts	)		ER04-928-000
	)		

**RESPONSE TO MOTIONS FOR CLARIFICATION,  
MOTION FOR LEAVE TO FILE ANSWER AND ANSWER OF  
THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION  
TO REQUESTS FOR REHEARING**

**I. INTRODUCTION**

On June 17, 2004, the Commission issued an order in the above-captioned proceeding regarding “sellers’ choice” contracts in California.<sup>1</sup> On July 19, 2004, several parties sought clarification and/or rehearing of the *June 17<sup>th</sup> Order* with respect to certain aspects relating to the initiation of a proceeding pursuant to Section 206 of the Federal Power Act to investigate the degree to which “Sellers’ Choice” contracts may not be compatible with the proposed market redesign of the California Independent System Operator Corporation (“CAISO”). The CAISO answers certain issues in the motions for clarification and seeks leave to answer, and answers certain issues in the requests for rehearing.

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<sup>1</sup> *California Independent System Operator Corp.*, 107 FERC ¶ 61,274 (2004) (“June 17<sup>th</sup> Order”).

## **II. MOTION FOR LEAVE TO ANSWER REQUESTS FOR REHEARING**

As noted, part of this pleading is an answer to motions for clarification, which is permitted by Rule 213(a)(3), (d) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(3), (d). To the extent the pleading answers requests for rehearing, the CAISO requests waiver of Rule 213(a)(2), 18 C.F.R. § 385.213(a)(2) and leave to file an answer. Good cause for this waiver exists because the answer to the requests for rehearing will aid the Commission in understanding the issues in the proceeding, provide additional information to assist the Commission in the decision-making process, and help to ensure a complete and accurate record in this case. *See, e.g., Entergy Services, Inc.*, 101 FERC ¶ 61,289, at 62,163 (2002); *Duke Energy Corporation*, 100 FERC ¶ 61,251 at 61,886 (2002); and *Delmarva Power & Light Company*, 93 FERC ¶ 61,098 at 61,259 (2000).

## **III. ANSWER**

### **A. KEY ELEMENTS OF CAISO'S MARKET REDESIGN PROPOSAL, INCLUDING LOCATIONAL MARGINAL PRICING, ARE SUFFICIENTLY DETAILED TO EVALUATE IMPLICATIONS TO SELLERS' CHOICE CONTRACTS, AND SOLUTIONS**

A key element of the CAISO's market redesign proposal is the implementation of locational marginal pricing ("LMP"). Constellation Power Source, Inc., High Desert Power Project, LLC, and Morgan Stanley Capital Group, Inc. (the "Designated Sellers"), in seeking rehearing, contend that the hearing procedures established by the Commission regarding the disposition of sellers' choice contracts are premature, because "the CAISO's proposed MD02 redesign is incomplete and bereft of finalized market elements," and "the manner in which LMP will be established and operated remains unknown at this point." *Designated Sellers* at 11. Similar sentiment was reflected in

Calpine's Request for Rehearing, which stated that the Commission's "action was taken in spite of the fact that the [sic] it is not yet known how LMP will work in the CAISO market redesign and, however configured, LMP will not be implemented until, at the earliest, January 1, 2007." *Calpine* at 9-10. Calpine concluded that "[u]ntil details of LMP are decided, Commission resolution of any issues raised by Sellers' Choice Contracts is premature." *Id.*

Although the detailed design is not yet finalized, there is more than sufficient detail in the CAISO's proposed market redesign to make timely the proceeding ordered by the Commission. Moreover, the CAISO contends that there is adequate knowledge today to conclude that there is a high probability of substantial impact because of the inability to hedge the sellers' choice contracts. While Designated Sellers are correct that the Commission's *June 17<sup>th</sup> Order* identified several issues to be addressed in order for the CAISO to proceed with the market redesign, *Designated Sellers* at 11, none of those issues have to be fully resolved in order for the parties to this proceeding to understand the range of potential effects of a system of LMP on sellers' choice contracts, or the potential solutions.

Specifically, it is only necessary to understand that under the CAISO's proposed system of LMP:

- congestion costs will depend on which of the approximately 3,000 nodes in the CAISO power grid a seller designates for delivery of power;
- a buyer's cost to move power from the sellers' delivery point to the point(s) where it is withdrawn will vary depending on the sellers' delivery point; and,
- because the seller under a sellers' choice contract has a financial incentive to designate the lowest priced point of delivery under its contract, and has a large number of points from which to choose, and because the selection of the delivery point is not constrained by the physical limitations of the network, buyers will

likely be unable to obtain a sufficient quantity of the correct congestion revenue rights (“CRRs”) in order to adequately hedge against the price of congestion.

These fundamental characteristics of the CAISO’s LMP proposal create the predominant problems with sellers’ choice contracts. Because these three characteristics are clear and embodied in the LMP congestion management system that the CAISO filed with the Commission on July 22, 2003 and which on June 17, 2004 the Commission has already approved on a conceptual basis,<sup>2</sup> the issue of sellers’ choice contracts is sufficiently ripe for the parties to address it, both in the settlement discussions recently ordered by the Chief Administrative Law Judge<sup>3</sup> and, if necessary, in hearings before the Presiding Administrative Law Judge. Although there are other unresolved issues about the CAISO’s proposed market redesign, none of them will alter the predominant factors that create the problem with sellers’ choice contracts, and should not, therefore, serve as an obstacle to the ongoing settlement discussions.

**B. IT IS CRITICAL THAT ISSUES SURROUNDING SELLERS’ CHOICE CONTRACTS BE ADDRESSED AS SOON AS POSSIBLE**

In its request for rehearing, Duke Energy argued that “there is no reason to initiate a formal investigation and hearing procedures, or impose an arbitrary time-line on the parties to these contracts, when the implementation of Locational Marginal Pricing and nodal pricing remain [sic] years in the future,” *Duke Energy* at 5; this sentiment was also expressed in requests for rehearing by El Paso (at 7), Calpine (at 9), Williams (at 34) and the Designated Sellers (at 11).

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<sup>2</sup> See *California Independent System Operator Corp.*, 105 FERC ¶ 61,140 at P 50 (2003).

<sup>3</sup> See “Order of Chief Judge Extending Procedural Schedule And Initiating Settlement Judge Procedure,” Docket No. EL04-108 (July 19, 2004).

The CAISO is fully committed to implementing a new market structure in California in early 2007, in order to capture for participants in the California market the benefits of enhanced grid reliability. Contrary to the assertions of Duke Energy and these other parties, however, it is not only necessary that the disposition of the sellers' choice contracts be addressed now; it is critical that the issues associated with these contracts (and other outstanding policy issues) be resolved as early as possible so that the CAISO has sufficient time to complete implementation of the market design, prepare computer code for the programs that will be used to operate the market, and test the systems before an anticipated start date in early 2007. The fact is, the bulk of the time between now and the proposed February 2007 start date of the market redesign and technology enhancement project is necessary to accommodate software development, integration and testing. Absent resolution of the issues surrounding the sellers' choice contracts some time around the end of this year, significant resources will have to be allocated to develop an alternative pricing and settlement approach until such time as it is clearly not needed. In addition, this could affect the ability of the CAISO to complete this project by its February 2007 target completion date. In order to ensure timely implementation of the proposed market design, the ISO has developed a systematic plan for addressing each of the unresolved major policy issues. Each of these issues must be resolved in a timely manner so that the CAISO has sufficient time to complete all design details and to implement market reforms by February 2007. The CAISO has undertaken a series of stakeholder processes to address the outstanding issues and is working aggressively to resolve them so that its LMP-based market redesign may be developed fully, approved, and implemented in a timely manner.

Absent satisfactory resolution of the issues associated with LMP and local market power mitigation (“LMPM”), the ISO may not conclude that it would be prudent to move forward and implement LMP. Because the other elements or facets of the ISO’s market redesign and technology upgrade project are critical to maintaining system reliability, it is prudent for the CAISO to begin developing fallback plans to ensure that the CAISO can still move forward with the core systems. Therefore, the CAISO has begun to develop the functional specifications of a potential alternative to LMP for pricing and settlement. The CAISO will shortly begin a stakeholder process to consider alternatives to LMP. If the outstanding policy issues regarding sellers’ choice contracts and certain other outstanding policy issues are not resolved some time around the end of this year, it will be necessary for the CAISO to begin detailed design work for an alternative to LMP. Only by developing the design for the alternative to LMP in parallel with LMP development would the CAISO be able to ensure that the overall market redesign will be ready for implementation by 2007 -- with or without LMP as the basis of the redesigned market’s pricing and settlement system. Moreover, if the CAISO is not confident by early Summer 2005 that LMP will be a viable basis of its market redesign, it will have to develop the software required to implement an alternative market design to LMP, so that the CAISO is fully prepared to maintain the early 2007 date for implementation of the redesigned market.

Accordingly, it is critical that the issues surrounding sellers’ choice contracts be resolved around the end of this year, in order to eliminate the uncertainty surrounding the implementation of LMP, and to help minimize the cost associated with having to

simultaneously develop two alternative pricing and settlement systems for California instead of just one, for some period of time.

**C. CONTRACTS PROVIDING FOR DELIVERY TO A SPECIFIC EXISTING CONGESTION ZONE MAY BE INTERPRETED AS CALLING FOR THE DELIVERY OF POWER TO A SINGLE DELIVERY POINT**

In seeking clarification from the Commission that “the scope of the hearing and investigation in [this docket] is limited to physical and financial sellers’ choice contracts in which the seller can specify the location of the handoff of power,” Duke Energy characterized the CAISO’s zones NP-15 and SP-15 as single delivery points to which power may be delivered. *Duke Energy* at 1.

NP-15 and SP-15 are existing transmission congestion zones within the CAISO grid. Under LMP, the geographic area covered by each of these zones will contain hundreds of individual nodes; the delivery of power to each of these nodes will have a distinct market clearing price (*i.e.*, LMP). Because the use of each node may have different economic consequences, some might say that one cannot fairly characterize zones NP-15 and SP-15, which will contain hundreds of individual nodes, as “single delivery points.”

However, if what Duke Energy meant by characterizing existing zones as “single delivery points” was that a contract calling for the delivery of power to a zone will mean, under LMP, the delivery of power to a zonal trading hub, then Duke Energy’s characterization of zones as “single delivery points” may make sense. In fact, as requested by the Commission, the CAISO has proposed in its market redesign to establish trading hubs, which would operate effectively as single delivery points based on either the service territories of the investor-owned utilities (load aggregation zone trading hubs) or today’s existing transmission congestion zones (“existing zonal” trading hubs).

Because a trading hub effectively represents an average of the prices in the entire zone to which power was to be delivered, prices at the hub may reasonably approximate the economic bargains agreed to by parties to contracts calling for the delivery of power to a zone or to any point in a zone. Hubs simplify commerce by allowing contracts to develop relative to the hubs instead of between each set of nodes; this, in turn, allows the parties greater opportunity to hedge congestion costs. Accordingly, to the extent that Duke Energy meant that delivery to a zone means delivery to a trading hub, which may operate as the zone's "single pricing point," the CAISO supports Duke Energy's characterization.

**D. THE SCOPE OF THE SETTLEMENT CONFERENCE, AND ANY SUBSEQUENT HEARING, SHOULD ENCOMPASS ALL SELLERS' CHOICE CONTRACTS, UNLESS PARTIES TO SPECIFIC CONTRACTS WITHDRAW THEM FROM CONSIDERATION**

In its Motion for Clarification, Duke Energy claimed that the "Commission intended to limit the scope of this hearing to the CERS State Contracts." *Duke Energy* at 4. Duke Energy based its argument on the fact that a CAISO White Paper on the subject, referenced by the Commission, "clearly distinguished between three broad categories of bilateral contracts: (a) contracts with specified delivery locations; (b) physical sellers' choice contracts; and (c) financial sellers' choice contracts," and that those definitions somehow indicated the Commission's intent to limit the scope of the hearing. *Id.*

While Duke Energy asserts that the reliance on the CAISO's White Paper<sup>4</sup> suggests the limitation it seeks, it does not explain *how* the CAISO's White Paper supposedly limits the scope. Nothing in any of the three definitions in the White Paper

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<sup>4</sup> California CAISO White Paper, "Market Design 2002 Scheduling Rules: Alternatives for Mitigating the Impact of Nodal Pricing on Pre-existing Bilateral Energy Contracts" (Mar. 9, 2004) ("White Paper"), available at <http://www.caiso.com/docs/2004/03/09/2004030909140522185.html>.

cited by Duke Energy mentions the CERS contracts, or limits the application of the definitions to the CERS contracts; nor does anything elsewhere in the paper. The CAISO requests that the Commission not formally limit the scope of the settlement discussions, already underway, to CERS contracts. Of course, if both the buyer and seller agree that their specific contract is not, in fact, a “sellers’ choice” contract, or desire for other reasons, they should, acting together, be able to remove the contract from the settlement discussions (and from the scope of the hearing) by explicitly representing that they will deal with their contract between themselves under any LMP regime.

#### IV. CONCLUSION

Wherefore, for the foregoing reasons, the CAISO respectfully requests that the Commission reject parties' claims that the proceeding ordered by the Commission, and the settlement discussions now underway, are premature, and rule that the parties to a specific contract may mutually and explicitly agree to remove it from consideration in this proceeding.

Respectfully submitted,

/s/ Charles F. Robinson

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## **CERTIFICATE OF SERVICE**

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in the above-captioned proceeding, in accordance with Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated at Folsom, California, on this 3<sup>rd</sup> of August, 2004.

*/s/ Dan Shonkwiler*  
Dan Shonkwiler