

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

California Independent System Operator Corporation)
Docket No. ER99-1971-000)
)
)

**ANSWER OF
CALIFORNIA INDEPENDENT SYSTEM OPERATOR
CORPORATION TO MOTIONS TO INTERVENE, REQUEST
FOR CLARIFICATION, COMMENTS AND PROTESTS**

On March 1, 1999, the California Independent System Operator Corporation (“ISO”) filed Amendment No. 14 to the ISO Tariff.¹ Amendment No. 14 consists primarily of a series of revisions to the ISO Tariff and Protocols that constitute Phase I of the ISO’s comprehensive redesign of its Ancillary Service markets, in compliance with the Commission’s Order of October 28, 1998.²

Pursuant to Rule 213 of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.213, the ISO submits its Answer to the Motions to Intervene, Request for Clarification, Comments and Protests submitted in the above captioned docket.

The ISO does not oppose the intervention of any of the parties that have sought leave to intervene in this proceeding. The opposition and requests for substantive modifications of some parties to portions of Amendment No. 14, however, are unsupported. As explained below, the ISO

¹ Capitalized terms not otherwise defined herein are used in the sense given in the Master Definitions Supplement, Appendix A to the ISO Tariff.

² See *AES Redondo Beach L.L.C., et al.*, 85 FERC ¶ 61,123 (1998) (“October 28 Order”).

does agree to make certain non-substantive modifications to Amendment No. 14 based on the comments and suggestions of a number of parties. The Commission should accordingly accept Amendment No. 14 without substantive modification.

I. INTRODUCTION

A. Amendment No. 14

As explained in detail in the transmittal letter submitted with the March 1 Amendment No. 14 filing, since the ISO commenced operations slightly over a year ago, a number of issues related to the ISO's Ancillary Service markets have arisen, leading to the Commission's directive in the October 28 Order that it initiate a comprehensive effort to redesign those markets. Even before the October 28 Order was issued, the ISO had already embarked on a process to discuss with Market Participants and other stakeholders improvements in the ISO's Ancillary Service markets. Those redesign efforts intensified following the issuance of the October 28 Order. The end of 1998 and the start of 1999 saw extensive and comprehensive activity on the part of the ISO and the interested stakeholders to develop a revised approach to the procurement of Ancillary Services to remedy defects that have been identified in the Ancillary Service markets and to facilitate broader and more competitive participation in those markets.

Through that process, the ISO and the interested stakeholders have identified a number of areas for improvement in the ISO's Ancillary Service markets. Recognizing that all of the necessary and desirable improvements

cannot be implemented at once, the ISO has developed a phased approach.³ Amendment No. 14 contains amendments to the ISO Tariff and Protocols necessary to implement the six components of the redesign of the ISO's Ancillary Service markets that have been determined to have the highest priority, each of which is proposed to take effect on the later of May 1, 1999 or the date when the ISO gives notice that the necessary software has been delivered, installed, and tested. These elements of the Ancillary Service Market Redesign proposal are as follows:

- Modifications to the ISO's Ancillary Service procurement process to enable the ISO to purchase additional quantities of one Ancillary Service that can substitute for another Ancillary Service, in order to reduce total costs (the "rational buyer" proposal).
- Modifications to the amounts payable to the operators of resources that fail to comply with ISO dispatch instructions (the "effective price" proposal), together with a plan to purchase additional quantities of Replacement Reserves to cover any forecast deficiencies in available energy, in order to reduce reliance on out-of-market purchases for that purpose.
- Automation of the communication of Dispatch instructions to resources supplying Imbalance Energy to allow the ISO to make better use of those

³ One intervenor, Electric Clearinghouse, Inc. ("ECI"), criticizes the ISO for failing to base the priority of redesign elements strictly on the preferences of the participants in the stakeholder process. ECI at 32-34. This criticism is invalid. The purpose of the stakeholder process is to give Market Participants and other interested parties an opportunity to voice their concerns and their preferences, for the ISO to receive and consider that input, to explain to the stakeholders its view of the problems to be addressed, the options for addressing them, and the criteria and process it will use to select among them and for all participants to consider alternative approaches. See March 1 Filing, Attachment C. The ISO has an obligation to apply its judgment to the issues, rather than simply to ratify the choices of those stakeholders whose representatives attend meetings, as ECI apparently would prefer. In this case, the ISO's management took account of the views of the stakeholders, explained the bases upon which it made priority determinations, and presented its recommendations to the ISO Board of Governors, on which representatives of all stakeholder classes are represented. In some cases, noted in the discussion that follows, the ISO's recommendations were modified to reflect suggestions and compromises presented during the course of the stakeholder process. The Board made the final decision regarding the priorities to be assigned to different elements of the Ancillary Service Market Redesign. The ISO squarely rejects ECI's contention that this process made a mockery of the extensive opportunities provided for stakeholder input.

resources, thereby reducing its requirements for Regulation service (no changes to the ISO Tariff or Protocols are required).

- Introduction of separate pricing for the upward and downward components of Regulation service to increase the efficiency of the Regulation market.
- Development of a form of agreement to facilitate the participation of dispatchable Loads in Ancillary Service markets (no changes to the ISO Tariff or Protocols or to ISO software are required).
- Modifications to permit Scheduling Coordinators to engage in trades of Ancillary Services to provide alternative means for them to fulfill their Ancillary Service obligations.

Amendment No. 14 also includes additional modifications to the ISO Tariff and Protocols that have been found to be necessary to implement two measures that were approved as part of Amendment No. 13 – the allocation of responsibility for Ancillary Services based on metered Demand, rather than scheduled Demand, and the withholding of payment for uninstructed deviations from Ancillary Service capacity (the "no pay" proposal). Finally, Amendment No. 14 also includes: (1) proposed modifications to the Ancillary Services Requirements Protocol ("ASRP") to reflect the ISO's new requirements concerning communications and direct control systems for units providing Regulation service; (2) a proposed modification to the ISO Tariff to provide for the payment of amounts due for Ancillary Service capacity dispatched under certain Reliability Must-Run ("RMR") Contracts to the relevant Participating Transmission Owner; and (3) a change to the Market Monitoring Information Protocol to clarify the relationship between the ISO and the independent Market Surveillance Committee ("MSC").

The redesign of the ISO's Ancillary Service markets also includes measures other than those included in Amendment No. 14. These include the reform of contracts for the purchase of RMR generation and the manner in which such generation is dispatched. An offer of settlement addressing many RMR issues was filed in Docket Nos. ER98-441 et al. on April 2, 1999. In connection with that offer of settlement, the ISO also filed proposed Amendment No. 15 to the ISO Tariff in Docket No. ER99-2407-00 on April 7, 1999. In addition, the ISO will proceed with additional enhancements to its Ancillary Service markets that have been identified through the stakeholder process. These additional enhancements will be implemented through tariff changes that will be filed at a later date, after implementation of the items included in Amendment No. 14. Any proposals for additional enhancements will also reflect the success of the measures proposed in the instant filing as evaluated by the ISO with input from Market Participants. The ISO will continue to work with Market Participants and other stakeholders to evaluate, develop and prioritize additional improvements in its Ancillary Service markets.

B. Interventions

A notice of intervention was filed by the Public Utilities Commission of the State of California ("CPUC") and motions to intervene were filed by numerous parties.⁴ Most intervenors indicated support for the majority of the changes proposed by Amendment No. 14. Many of the intervenors, however,

⁴ Timely motions to intervene were filed by Bonneville Power Administration ("BPA"); California Department of Water Resources ("DWR"); California Electricity Oversight Board; California Power Exchange ("PX"), the Cities of Redding and Santa Clara, et al. ("Redding"), Duke Energy Trading and Marketing; Duke Energy Moss Landing, LLC, et al.; ECI; Energy Producers and Users Coalition, et al. ("EPUC"); Los Angeles Department of Water & Power ("LADWP"); Member Systems of the New York Power Pool; Metropolitan Water District ("MWD");

accompanied their interventions with Comments and/or Protests to portions of Amendment No. 14. In addition, a number of intervenors submitted two separate joint pleadings commenting on specific issues related to Amendment No. 14.⁵

The ISO does not oppose the intervention of any of the parties that have sought leave to intervene. The ISO does not believe, however, that any of the substantive modifications to portions of Amendment No. 14 proposed in any of the interventions has merit.

Modesto Irrigation District ("Modesto"); Northern California Power Agency ("NCPA"); Pacific Gas & Electric Company ("PG&E"); Portland General Electric Company; PSEG Resources, Inc.; Reliant Energy Power Generation ("Reliant"); Sacramento Municipal Utility District ("SMUD"); Salt River Project Agricultural Improvement & Power District; San Diego Gas & Electric Company ("SDG&E"); Sempra Energy Trading Corporation; Southern California Edison Company ("SCE"); Southern Energy California, L.L.C., et al.; Transmission Agency of Northern California ("TANC"); Turlock Irrigation District ("Turlock"); The Utility Reform Network, et al. ("TURN"); U.S. Generating Company; the Western Area Power Administration ("WAPA"); and Williams Energy Marketing & Trading Company ("Williams"). A motion for leave to intervene out of time was filed by Enron Power Marketing, Inc. ("EPMI").

⁵ This group is referred to hereafter as the "Joint Parties."

II. ANSWER TO COMMENTS AND PROTESTS⁶

A. Tariff Modifications to Implement Ancillary Service Redesign

1. The ISO's Rational Buyer Proposal Represents an Important and Significant Advance in the Design of the California Ancillary Service Markets.

In Amendment No. 14, the ISO proposed modifications to its Ancillary Services procurement process that will enable the ISO to purchase additional quantities of one Ancillary Service that can substitute for another Ancillary Service. These modifications, known as the "rational buyer" proposal, are designed to reduce the ISO's total costs of procuring Ancillary Services by giving the ISO the flexibility to make additional purchases of higher quality Ancillary Services where the higher quality service is available at a lesser price than lower-quality Ancillary Services.

The ISO developed its rational buyer proposal in response to observations by both the MSC and the Commission identifying the limited flexibility afforded to the ISO in procuring different capacity necessary to meet its requirements for different Ancillary Services as a significant shortcoming in the design of the ISO's Ancillary Service markets. These observations are premised on the fact that

⁶ Some of the intervenors commenting substantively on Amendment No. 14 do so in portions of their pleadings variously styled as "Comments," "Statement of Position," "Request for Clarification" or "Comments and Protest," without differentiation. There is no prohibition on the ISO's responding to the comments in these pleadings. The ISO is entitled to respond to these pleadings and requests notwithstanding the label applied to them. *Florida Power & Light Company*, 67 FERC ¶ 61,315 (1994). In the event that any portion of this answer is deemed an answer to protests, the ISO requests waiver of Rule 213 (18 C.F.R. §385.213) to permit it to make this answer. Good cause for this waiver exists here given the nature and complexity of this proceeding and the usefulness of this answer in ensuring the development of a complete record. *See, e.g., Enron Corporation*, 78 FERC ¶ 61,179 at 61,733, 61,741 (1997); *El Paso Electric Company*, 68 FERC ¶ 61,181 at 61,899 & n.57 (1994).

capacity which meets the requirements of a higher quality Ancillary Service, such as Spinning Reserve, generally also meets the requirements for a lower quality service, such as Replacement Reserve. Currently, the ISO determines separately the amount of capacity that it needs for Regulation, for Spinning Reserve, for Non-Spinning Reserve and for Replacement Reserve, and procures the capacity to meet each of those requirements in separate, sequential markets. Without the proposed rational buyer tariff modifications, the design of the ISO's Ancillary Services markets would not permit the ISO to increase its purchases of capacity bid into the Spinning Reserve market and to decrease its purchases of capacity bid into the Replacement Reserve market if prices in the former market are lower than prices in the latter market. In its August 19 *Preliminary Report On the Operation of the Ancillary Services Markets of the California Independent System Operator*, the MSC recommended the implementation of a rational buyer approach that would enable the ISO to engage in this type of substitution.⁷

In the Amendment No. 14 transmittal letter, the ISO explained that the rational buyer proposal it developed could reduce the ISO's overall costs in procuring Ancillary Services and would reduce the opportunity for Market Participants to game the sequential auction in hopes of receiving a high price for Replacement Reserve, the last service procured (and the lowest quality service). The ISO also noted that the MSC supports this proposal. The MSC confirmed its support for the ISO's rational buyer procurement proposal (together with

⁷ The Commission subsequently directed the New York Independent System Operator to modify its procurement of ancillary services to incorporate a rational buyer approach. *Central Hudson Gas & Electric Corp., et al.*, Docket Nos. ER97-1523-000, *et al.*, "Order Conditionally

comments on one aspect of the proposal and a recommendation that the ISO go further in this direction, when it is feasible to do so) in its March 25, 1999 *Report on Redesign of Markets for Ancillary Services and Real-Time Energy* (“MSC Report”).⁸

No intervenor completely opposes the ISO's rational buyer approach and the majority of those commenting on the proposal support its adoption as filed. One intervenor contends that implementation of the proposal should be delayed until Market Participants have gained experience with other components of Ancillary Services redesign, such as inter-Scheduling Coordinator trades of Ancillary Services. (ECI at 5-7). This intervenor suggests that the rational buyer proposal is based on outdated concepts of the price relationships between Ancillary Service markets and attempts to impose a hierarchy of pricing which is contrary to the valuation of Ancillary Services in a competitive marketplace. The intervenor suggests that there may be no need for the rational buyer approach to be implemented once Market Participants have greater flexibility through measures such as inter-Scheduling Coordinator trades and the Ancillary Service markets become more competitive.

ECI misses the point. The rational buyer proposal does not impose any preconceived view of the relative “value” of different services on the market. Instead, it permits the ISO to respond to the market’s signals in order to reduce its overall costs for procuring Ancillary Services, which costs are passed on to

Accepting Tariff and Market Rules, Approving Market-Based Rates, and Establishing Hearing and Settlement Judge Procedures” (January 27, 1999).

⁸ The ISO is separately submitting its comments on the MSC Report, as well as the report prepared by the PX’s Market Monitoring Committee (“MMC”).

Market Participants. When, for example, the market signals that Spinning Reserve has a lower value than Non-Spinning Reserve by making more Spinning Reserve capacity available, at lower prices, even though the technical requirements for the service are more restrictive, the rational buyer proposal permits the ISO to purchase more Spinning Reserve capacity and use that capacity to meet its requirements for Non-Spinning Reserve. The ISO certainly supports measures such as inter-Scheduling Coordinator trades which allow for greater flexibility in the Ancillary Service markets, but there is no reason to prevent the ISO itself from having the flexibility to act rationally.

ECI also states that, if adopted, the rational buyer approach should be applicable to Scheduling Coordinators as well as to the ISO. (ECI at 7-10). Otherwise, it claims, the rational buyer approach gives the ISO an advantage over Scheduling Coordinators seeking to meet their Ancillary Service needs through inter-Scheduling Coordinator trades. Scheduling Coordinators, however, already have the same flexibility that the ISO seeks in its rational buyer proposal. Scheduling Coordinators already have the ability to use capacity that meets the specifications for a more restrictive Ancillary Service, such as Spinning Reserve, to meet their obligations for a less restrictive or lower quality service, such as Non-Spinning Reserve. The rational buyer proposal merely revises the tariff provisions governing the ISO's procurement of Ancillary Services to give the ISO similar flexibility in purchasing Ancillary Services, where doing so is expected to reduce its total cost of procurement.

The same intervenor suggests that further explanation of the allocation of costs under the rational buyer proposal should be provided prior to implementation of the proposal (ECI at 10-11). The intervenor does not raise any specific issues with respect to this cost allocation, but merely comments that certain background materials on the development of the proposal could provide further information. The allocation of costs and payments under the rational buyer proposal was the subject of significant discussion prior to the finalization of the Ancillary Services redesign. The approach embodied in Amendment No. 14 was the result of a consensus among stakeholders actively addressing the issue. In the absence of specific questions or issues, the ISO does not believe that any additional explanation of this approach is necessary.⁹

Another intervenor generally supports the rational buyer proposal, but comments on certain discrete issues potentially arising under the proposal. The intervenor suggests that there are certain circumstances where a rational buyer approach could result in an increase in overall costs of procuring Ancillary Services. (PG&E at 5-6). The ISO's proposal explicitly limits substitution of one Ancillary Service for another to those circumstances where doing so is expected to reduce the overall cost of procuring Ancillary services. The ISO will monitor its implementation of this proposal, if approved, to ensure that the ISO's Ancillary Services procurement practices do not result in increased overall procurement costs. This intervenor expresses concerns that Amendment No. 14 does not make clear that the settlement of Ancillary Services procurement costs will be

⁹ The ISO addresses questions raised in the *MSC Report* on cost allocation under the rational buyer proposal in its separate comments on that report.

based on "the originally procured quantities (prior to application of Rational Buyer)." (PG&E at 6). This is essentially the approach for settlement of Ancillary Services procurement costs under rational buyer agreed as agreed to by the stakeholders, and is reflected in the proposed tariff changes set forth in Amendment No.14, including the revisions to Section 2.5.20.1 and the "Rational Buyer Adjustment" set forth in C 2.2.4 of Appendix C to the Settlement and Billing Protocol. Specifically, the ISO notes that the sentence "Scheduling Coordinator obligations for each Ancillary Service will be calculated based on the requirement for each Ancillary Service as the ISO determines prior to the adjustments set forth in Section 2.5.3.6" was added to Section 2.5.20.1.¹⁰

Lastly, several intervenors raise issues concerning whether certain Ancillary Services can be substituted for other Ancillary Services. One suggests that Regulation cannot be used to substitute for Spinning or Non-Spinning reserve due to differences in the ramping, contingency reserve, and the pricing of the instructed energy output for these services. (PG&E at 6). Another raises similar concerns and opposes any redefinition of Regulation, which currently has a 30 minute ramping requirement, as a "10-minute product" like Spinning or Non-Spinning Reserve. (SDG&E at 4-5).

The rational buyer software being developed in connection with the ISO's proposal addresses these concerns. No change is contemplated in the definition

¹⁰ This sentence can be found on Sheet 82 of Attachment A and in Attachment I to the March 1 filing. This addition was unintentionally omitted from the blacklined language in Attachment E.

of Regulation under the ISO Tariff and Protocols. Instead, the rational buyer software will incorporate a mechanism that takes account of the differences in the definition of the various Ancillary Services. Under this mechanism, the ISO will only purchase additional Regulation capacity to utilize as a substitute for the ISO's requirement for 10-minute contingency reserves, such as Spinning and Non-Spinning Reserve, after it has checked that the purchased Regulation capacity includes enough capacity that may be reached within ten minutes to meet, in combination with procured and self-provided contingency-reserve capacity, the total ISO requirement for those reserves. This check will limit the ability of the ISO, under its rational buyer proposal, to make use of Regulation for contingency reserves, in line with the actual capabilities of the units bid into the Regulation auction. The ISO reiterates that it has made no proposal to redefine Regulation as a 10-minute product in Amendment No. 14, or to adjust the characteristics of Regulation within the range permitted by the ISO Tariff, so any comments on that issue go beyond the scope of the instant proceeding.

2. The Proposal To Procure Reserves To Cover Deviations from Demand and Generation Schedules and To Assign the Resulting Costs to the Entities That Contribute to the ISO's Need for the Incremental Reserves Is Reasonable.

The Ancillary Services Market Redesign proposed in Amendment No. 14 includes two elements designed to address the incentives for Scheduling Coordinators to engage in "uninstructed deviations" and certain disincentives for suppliers to participate in the ISO's Ancillary Service markets. As explained in the Amendment No. 14 transmittal letter, Scheduling Coordinators and the resources they represent can gain certain economic advantages when those

resources act contrary to their forward market schedules and/or in the absence of ISO dispatch instructions. These "uninstructed deviations" are a source of significant real-time operational problems. Moreover, there are currently perverse incentives for suppliers to withhold capacity from the ISO's Ancillary Service markets in the hope that they might receive a higher price if bids available to meet real-time Imbalance Energy needs are insufficient, and the ISO calls on their resource to generate energy "out of market." These incentives and disincentives result in significant unscheduled demand, and the ISO is required to make costly out-of-market energy purchases to cover this demand.

The ISO examined various approaches to address these problems. In conjunction with the stakeholders, the ISO developed a compromise solution to these issues. This compromise solution includes a proposal for the ISO to procure additional Replacement Reserves to account for the difference between the load scheduled by Scheduling Coordinators and the ISO's load forecast, after taking into account the energy that the ISO expects to be available from other sources, including Supplemental Energy bids in the real-time energy market. The costs of Replacement Reserves so procured will be allocated to Scheduling Coordinators based on the extent to which their actual Demands exceed scheduled Demands or their actual generation falls short of scheduled generation.

This allocation approach reflects basic cost causation principles: when the ISO must procure additional resources to meet unscheduled Energy requirements because some generators fail to produce electricity in accordance

with their schedules and some buyers buy more than their scheduled Demands, it is preferable to allocate the resulting costs to those Market Participants, rather than to spread them among all Market Participants, including those who generated or purchased in accordance with their schedules.¹¹

One intervenor opposing this proposal argues that assigning the costs of procuring additional Replacement Reserve to demand inelastic purchasers based on deviations from schedules deprives them of the opportunity to rely on the ISO's Imbalance Energy market to protect themselves against high prices in the PX's forward energy markets. (SCE at 10-12). The intervenor claims that the ISO's proposal will penalize buyers of energy who attempt to make rational purchasing decisions when the PX day-ahead price was expected to be higher than the ISO Imbalance Energy price. Similarly, this intervenor contends that the ISO's proposal could cause sellers to withhold capacity from the PX's forward markets, with a resultant increase in PX energy prices.¹² (SCE at 12-14, 15-17). The intervenor also suggests that the proposal will exacerbate "overscheduling" problems associated with energy supplied by Reliability Must-Run units due to the same "restrictions" on load shifting from the forward markets to the real-time market. (SCE at 17-20).

The ISO believes these concerns are exaggerated. The ISO does not agree that its proposed Replacement Reserve procurement and cost allocation

¹¹ See *California Independent System Operator Corp.*, 86 FERC ¶ 61,122 at 61,423-24 (1999); *California Power Exchange Corp.*, 85 FERC ¶ 63,007 at 65,122 (1998) (ALJ decision discussing the Commission's long-standing policy of basing rates on cost causation principles).

¹² These comments reflect and are based, in part, on the March 9, 1999 *Second Report on Market Issues* of the PX Market Monitoring Committee. As noted above, the ISO is submitting separate comments on that report in Docket Nos. ER98-2843 et al.

method will significantly interfere with the ability of generation and demand to shift between the forward and real-time markets. While buyers who shift demand to the real-time market will incur additional costs as a result of that decision – the costs that their action causes the ISO to incur – generators who shift their production of energy to the real-time market will receive balancing and identical payments. Any net change in the incentives to participate in forward markets vs. the real time market is based entirely on differences between buyers and sellers regarding expectations of the market-clearing price for energy in each market. Any resulting incentive for generators to favor the real-time market over the forward markets would be outweighed by the elimination of the current incentives for generators to withhold output from forward markets in the hope or anticipation of receiving a more remunerative out-of-market call.

The ISO believes that its proposal will have the far more significant effect of encouraging generators to participate in either the forward PX scheduled-energy markets or the ISO's Imbalance Energy market as opposed to the less transparent informal "markets" for either out-of-market dispatch or uninstructed and unscheduled generation. A generator that pursues either of these informal markets foregoes either (1) the expected Replacement Reserve market-clearing capacity price, plus the expected payments for dispatched Imbalance Energy, or (2) the expected market-clearing prices in the forward scheduled-energy markets. The net incentive to move generation capacity into the PX forward markets or the ISO's Imbalance Energy markets will make these formal markets deeper and more efficient.

The ISO agrees that buyers, as well as sellers, should be free to choose the markets that best meet their needs. However, features of the market design that bias that choice, by subsidizing some Market Participants' participation in the real-time energy market, should be eliminated where feasible. That is the objective of the ISO's proposed use and allocation of Replacement Reserve to cover unscheduled requirements in the real-time Imbalance Energy market. Currently, when an insufficiency of resources requires the ISO to turn to expensive out-of-market purchases to meet the needs of buyers that present unscheduled Demands in the Imbalance Energy market, the buyers that cause the ISO to incur those costs do not bear their appropriate share of such costs. The present proposal would change that anomalous result, ensuring that buyers whose needs exceed their scheduled Demands, as well as sellers that fail to generate the amounts specified in their schedules, bear the costs their decisions impose on the ISO.

The intervenor contends that the ISO's proposal could effectively double the price cap for ISO power with a resulting impact on the PX energy markets. (SCE at 14 -15). The intervenor suggests that the potential price for non-PX energy could rise as high as the cost for Imbalance Energy at the price cap with additional MWh for MWh payments for Replacement Reserves, at the cap for that service. Price caps of \$250/MWh and \$250/MW respectively are currently in effect, leading to a potential combined energy cost of \$500.

The ISO agrees that such a result, while unlikely, is not an impossibility. It is not, however, a product of the Replacement Reserve proposal. Similar effects

have been a possibility since last summer and have not had the dire consequences on prices in the PX suggested by the intervenor. Since July 1998, when the Commission determined that Replacement Reserve was not subject to cost-based rate caps, suppliers could earn both capacity and energy prices totaling \$500/MW by holding generation out of the forward energy market, and bidding into the Replacement Reserve markets. Yet, the forward energy prices remained substantially below \$250/MWh. While it is possible that the changed Replacement Reserve policy will increase the frequency and probability of high combined capacity and real-time energy prices, which drive up the opportunity costs faced by potential suppliers into the PX market, nothing in the ISO's proposal results in an obvious change in the market fundamentals. The ISO therefore does not believe that its proposal substantially increases the likelihood of combined high capacity and real-time energy prices, or has the suggested impacts on prices in the PX energy markets.

The intervenor also argues that requiring Market Participants to bear the costs of Replacement Reserves that the ISO procures to cover their unscheduled Demand is inconsistent with allocating the costs of Replacement Reserves zonally when the product is procured zonally in anticipation of Inter-Zonal Congestion in accordance with Amendment No. 13. (SCE at 21-22). It imagines a situation in which every projection made by the ISO is wrong: anticipated Inter-Zonal Congestion fails to materialize; unscheduled Demand in one Zone is anticipated, but does not materialize; and unscheduled Demand in another Zone is not anticipated, but does materialize, so that Replacement Reserves procured

in one Zone for use within that Zone are actually used to meet unexpected Demand in the other Zone. It asserts that this unusual situation creates a conflict between the cost causation principles reflected in Amendment Nos. 13 and 14.

In fact, there is no conflict, even in this unusual situation. As shown in the proposed revision to Section 2.5.28.4 of the ISO Tariff (in Attachment F to the March 1 filing), the Replacement Reserve cost allocation procedure proposed in Amendment No. 14 is applied to determine the allocation of Replacement Reserve costs to Scheduling Coordinators serving Demand within a Zone, after it is determined whether to allocate Replacement Reserve costs zonally in accordance with Amendment No. 13. More to the point, the intervenors' example assumes that the ISO will blindly procure additional Replacement Reserve whenever there is a threat that scheduled Resources will be insufficient to meet unscheduled Demand. In fact, the ISO employs procurement criteria that are designed to minimize instances of over-procurement by giving consideration to all potential sources of Imbalance Energy, including delaying procurement of Ancillary Services to the Hour-Ahead Market, where feasible. The circumstance imagined by the intervenor is simply of insufficient weight to justify a departure from basic cost causation principles.

Another intervenor expresses concern that the ISO's proposal to procure and allocate the costs of additional Replacement Reserve should not result in a "socialized" allocation of the additional costs to all Market Participants. (ECI at 15-16). These concerns are misplaced. As explained above, the ISO's proposal is premised on cost causation principles. The costs of additional Replacement

Reserve procured will be allocated to Scheduling Coordinators based on their deviations from scheduled generation and demand.

Lastly, one intervenor requests additional explanation of the intended effect of the tariff modifications designed to implement this proposal. (TANC at 12-13). This intervenor does not identify any specific portions of the proposed Replacement Reserve tariff modifications that are unclear, but rather requests general clarification. The ISO believes that the intended effect of its proposal, as reflected in the tariff changes, is amply explained in its various filings in this docket, including the supporting materials set forth in Attachment C to the March 1, 1999 filing.

3. The Effective Price Proposal Is a Reasonable Approach To Curtailing Generator's Incentives To Disregard ISO Dispatch Instructions.

The other component of the compromise solution to uninstructed deviations described above is a proposal to modify the amounts payable to resources that disregard an ISO dispatch instruction (either by failing to generate additional energy when the ISO issues an incremental dispatch instruction or by failing to reduce generation when the ISO issues a decremental dispatch instruction) in order to eliminate the opportunity for Scheduling Coordinators to profit by ignoring the ISO's dispatch instructions. This would be accomplished by conditionally providing for the settlement of uninstructed deviations from an ISO dispatch instruction at the weighted average of the prices applicable to resources that complied with that dispatch instruction, referred to as the "effective price." This proposal is designed to address the opportunity to "game" the price

differential between the BEEP Interval Price, used to settle for Instructed Imbalance Energy, and the hourly average of the BEEP Interval price, used to settle for uninstructed deviations. When a Market Participant believes that the hourly average price will diverge from the BEEP Interval price, it will have an incentive to disregard the ISO's dispatch instructions and thereby increase the payments it receives. The ISO's proposal will eliminate this incentive by paying or charging resources an "effective price" which zeroes out any net benefit to resources that do not follow the ISO's incremental and decremental dispatch instructions. This "effective price" is based on the weighted average of the BEEP Interval Prices during the duration of the dispatch instruction.

One intervenor states that certain opportunities for gaming will remain even after the effective price proposal is implemented. (SCE at 22-23). This intervenor suggests that a generator providing energy from Regulation Up capacity can shield itself from financial penalties for undelivered dispatched energy because the ISO settlement system is unable to distinguish between Regulation Up energy and undelivered dispatched energy.

A resource providing Regulation must be on control the entire hour. If a Supplemental Energy or Ancillary Service bid is exercised, then that unit's preferred operating point will be moved in accordance with the associated instruction. There is no gaming opportunity, since a unit providing Regulation in compliance with its obligation has no opportunity for uninstructed deviations on any portion of its capacity, including capacity outside its accepting regulating range.

4. The Proposal to Implement Trades of Ancillary Services Between Scheduling Coordinators Is Reasonable.

One element of the Ancillary Services redesign included in Amendment No. 14 which was identified as a high priority item by a great many Market Participants during the stakeholder process is the proposal to permit Scheduling Coordinators to engage in trades of Ancillary Services. Under this proposal, the ISO has agreed to develop the software necessary to recognize bilateral trades of Ancillary Service obligations or capacity between Scheduling Coordinators. As explained in the Amendment No. 14 transmittal letter, the ISO believes that the development of this feature could enhance the ability of Scheduling Coordinators to self-provide Ancillary Services and thereby reduce the ISO's demand for Ancillary Services. The ISO accordingly included tariff changes intended to implement this proposal, once the necessary software has been developed, in Amendment No. 14.

Every intervenor commenting on this proposal supports it. One intervenor requests clarification that the tariff amendments designed to implement inter-Scheduling Coordinator trades of Ancillary Services permit Scheduling Coordinators to rely on a combination of such trades and self-provided generation to satisfy their Ancillary Services obligation. (SMUD at 8-9). The ISO believes the tariff revisions are clear on this point: Scheduling Coordinators may utilize a mix of self-provided Ancillary services, purchases from the ISO's Ancillary Service markets and/or inter-Scheduling Coordinator Ancillary Services trades to satisfy their obligations.

Another intervenor which strongly supports the benefits of inter-Scheduling Coordinator Ancillary Services trades raises several issues with respect to the ISO's proposal. First, this party expresses concerns that a Scheduling Coordinator which self-provides or enters into an inter-Scheduling Coordinator Ancillary Services trade in excess of its obligations will be required to sell the excess into the ISO's market for Ancillary Services. (ECI at 14-15). The ISO's proposal, however is presented to address precisely concerns of this sort. Without the inter-Scheduling Coordinator Ancillary Service trade modifications included in Amendment No. 14, a Scheduling Coordinator that self-provided in excess of its obligations has no other options with respect to the excess capacity other than to make it available to the ISO. Under the ISO's proposal, a Scheduling Coordinator with capacity in excess of its obligations can arrange to trade or sell this capacity to another Scheduling Coordinator. Such capacity is made available in the ISO market only if a Scheduling Coordinator has not made such other arrangements. This provision therefore permits a Scheduling Coordinator to be paid for a commodity it failed to make arrangements to sell bilaterally.

This intervenor also contends that the ISO's proposal, without reason or justification, limits trades of Ancillary Services between Scheduling Coordinators to resources within the ISO Control Area. (ECI at 14). This argument misreads Amendment No. 14 by focusing exclusively on Section 2.5.7.4.1 of the ISO Tariff. That provision, which applies only to Ancillary Services provided from resources within the ISO Control Area, was modified to make provision for Inter-Scheduling

Coordinator Ancillary Service Trades. This was in no way intended to imply that inter-Scheduling Coordinator Trades could not be based on Ancillary Services provided by units from outside the Control Area. Imports of Ancillary Services are covered by Section 2.5.7.4.2 through 2.5.7.4.4. No changes were made to those provisions, based on a judgment that the existing language does not preclude trades of Ancillary Services in light of other tariff modifications proposed in Amendment No. 14, including the modifications to Section 2.5.20.2 of the ISO Tariff and Section 3.2 of the Ancillary Service Requirements Protocol. In sum, the restriction for which the intervenor seeks an explanation was not intended and does not exist. Nevertheless, the ISO would have no objection to adding language to Section 2.5.7.4.2 similar to the proposed language in Section 2.5.7.4.1 to eliminate any potential confusion.

5. Amendment No. 14 Refinement of Billing Based on Metered Demand Does Not Force Scheduling Coordinators To “Buy Back” Ancillary Services; It Requires Them To Adhere to Their Ancillary Service Schedules.

Consistent with the Commission’s determination in the October 28 Order to accept one interim ISO filing addressing Ancillary Service procurement issues before submission of the comprehensive redesign proposal by March 1, 1999, the ISO included several elements related to Ancillary Services in its Amendment No. 13 filing. Those elements included both a proposal to begin billing Scheduling Coordinators for Ancillary Services based on their metered Demands, rather than their scheduled Demands, and the "no pay" proposal to withhold payments to suppliers of Ancillary Services that generate energy from capacity

that has been committed to the ISO as reserves (whether through the ISO's auctions or through self-provision). In its order on Amendment No. 13, the Commission approved both proposals to take effect, upon notice by the ISO that the software necessary to implement them has been implemented and tested.

During the course of developing the software to implement these proposals, the ISO has determined that additional modifications to the ISO Tariff and Protocols are appropriate to clarify the operation of these provisions. Therefore, the ISO included a number of clarifications and refinements to the billing based on metered Demand and no pay provisions in Amendment No. 14.

One of these refinements addresses a potential gaming opportunity which arises as a result of implementation of billing based on metered Demand. Currently, the Day-Ahead Market and the Hour-Ahead Market are settled separately, and there is no opportunity to self-provide in the Hour-Ahead Market for Day-Ahead scheduled Load. However, with billing based on metered Demand, final Hour-Ahead self-provision schedules are netted against a Scheduling Coordinator's obligation, and a Scheduling Coordinator will be able to make significant changes to bids and self-provision schedules in the Hour-Ahead Market. This ability to meet those obligations either by self-supplying qualifying capacity or by purchasing Ancillary Service capacity in the ISO's Hour-Ahead Market allows a Scheduling Coordinator to profit at the expense of others. For example, a Scheduling Coordinator that anticipates an increase in the price of an Ancillary Service from the Day-Ahead Market to the Hour-Ahead Market could self-provide its obligation for that Ancillary Service in the Day-Ahead Market, then

withdraw that self-provision and sell the capacity in the ISO's Hour-Ahead Market for the service. It would, under the Tariff and Protocol provisions as revised in Amendment No. 13, pay for its non-self provided Ancillary Service requirements at the ISO's "average" cost, while it sells the withdrawn capacity at the higher Hour-Ahead price. This would shift costs to other Scheduling Coordinators that rely on the ISO's Ancillary Service markets.

To address this gaming opportunity, the ISO proposed in Amendment No. 14 to revise the ISO Tariff and Protocols to provide that a decrease in self-provided Ancillary Service capacity reflected in Day-Ahead Schedules will be replaced by the ISO with Ancillary Service capacity procured at the Hour-Ahead price. With this change, capacity self-provided through the ISO's Day Ahead Market will be treated identically to bid capacity, and Scheduling Coordinators will be held financially responsible for the binding obligation represented by final Day Ahead Market schedules.

Intervenors have submitted a wide range of comments on this proposal. Generally, the protesting intervenors allege that the ISO's proposal will inequitably "force" Scheduling Coordinators to buy back their Day-Ahead Ancillary services schedules at great cost under a variety of circumstances. These intervenors miss the point of the ISO's proposal. Day-Ahead Ancillary Services schedules are a commitment that must be honored by the supplier, whether the commitment reflects an obligation to self-supply Ancillary Service capacity or an accepted bid to provide Ancillary Service capacity to the ISO. Where a Scheduling Coordinator fails to supply the Ancillary Services it

committed to supply in the Day-Ahead Market, whether that capacity was bid or self-supplied, the ISO must make other arrangements to meet the shortfall. Prices bid in the Day-Ahead market are no longer available for that purpose. It would be far more inequitable for the ISO to pass the costs associated with that shortfall on to those Scheduling Coordinators who met their Day-Ahead commitments, especially where there is the potential for the gaming behavior described above.

Many of these intervenors suggest that the ISO's proposal will penalize those who sell Ancillary Services to the ISO or who self-provide such services and that the likely response of Market Participants to incentives created by the proposal will result in thinness and increased volatility in both the Day-Ahead and Hour-Ahead Markets for Ancillary Services and substantially increased costs to Market Participants. (Joint Parties at 7-14; MWD at 11-14; Modesto at 7-11; PG&E at 6-7; TANC at 7-10). Most of these concerns are overstated, and ignore the fact that the ISO ultimately will have to make up the shortfall in available Ancillary Services and pass those costs on to some subset of Market Participants.

As explained above, the proposal does not change the treatment of capacity that is the subject of an accepted bid to supply Ancillary Service capacity to the ISO for the Day-Ahead Market. Currently, if a seller does not meet its schedule for the supply of Ancillary Service capacity to the ISO's Day-Ahead Market, it must replace the shortfall at the Hour-Ahead Market price. Any other approach would require other Market Participants to subsidize that seller's

failure to live up to the binding commitment reflected by its Schedule. The ISO's proposal applies the same principle to self-provided Ancillary Service commitments in the Day-Ahead Market. A failure to treat self-provided Ancillary Service commitments comparably would increase the risks faced by suppliers in the ISO's Ancillary Service market, thereby discouraging participation in that market and increasing existing concerns about bid insufficiency. Moreover, the ISO does not distinguish between Ancillary Service capacity bid through its markets and that which is self-provided. The ISO relies on both equally in satisfying its Control Area responsibilities to ensure that adequate capacity is available in case of contingencies.

Many intervenors point to circumstances in which a reduction is due to a forced outage, derating of a line, or congestion. (Joint Parties at 3-5; NCPA at 3-5; PG&E at 7). They claim that it would be inequitable to require Scheduling Coordinators to pay increased costs for failing to satisfy their Day-Ahead schedule commitments under such circumstances. Some suggest that the ISO's proposal should be revised so that Scheduling Coordinators are not required to purchase Ancillary services at the Hour-Ahead price when the reduction from the Day-Ahead schedule is due to events beyond their control, such as transmission curtailments. (Redding at 7-8). Another suggests that the Scheduling Coordinator should merely be required to buy back the reduced capacity at the Day-Ahead price. (Joint Parties at 15-16).

Each of these proposals reflects a desire to reduce the firmness of the commitment made by Scheduling Coordinators that self-provide Ancillary

Services capacity by shifting various risks to the ISO and ultimately to other Scheduling Coordinators. These intervenors do not explain who should be required to bear the costs of additional Ancillary Services that must be procured when they fail to live up to their commitments under the circumstances for which they seek absolution. They present no cogent justification for imposing those costs on other Market Participants other than a desire to require the ISO to serve an insurance function that was not intended and is nowhere provided in the ISO Tariff. The ISO simply cannot absolve a Market Participant from cost responsibilities in some or all circumstances where that entity fails to fulfill a commitment due to circumstances beyond its control. In order to maintain a level playing field, the ISO cannot take an active role in mitigating the risk to Market Participants for certain contingencies but not for others. Risk mitigation is a function better left to market forces.

Certain of these parties also suggest that the ISO is proposing the current Tariff revisions to justify past instances where the ISO had "forced" Scheduling Coordinators that had sold Ancillary Services in the Day-Ahead Market to buy back those services in the Hour-Ahead Market if a grid curtailment arises between the close of the Day-Ahead Market and the opening of the Hour-Ahead Market. (Joint Parties at 3-5; SDG&E at 6-8). The ISO has not requested a retroactive effective date for the billing based on metered Demand refinements proposed in Amendment No. 14. Comments related to these past occurrences are therefore beyond the scope of the instant proceeding.

The ISO also wishes to respond to claims that this proposal was withheld from the stakeholder process and that the gaming opportunity the proposal was designed to address is a "red herring" which was articulated for the first time in the ISO's transmittal letter. (Joint Parties at 14-18; NCPA at 4-5). This attempt to ascribe devious motives to the ISO is demonstrably false. While it is true that the need to address this issue did not become apparent until later in the stakeholder process, this proposal was presented to stakeholders at a meeting in early February (See MWD at 12). Moreover, the need to address the potential for gaming under metered Demand was described, in terms almost identical to the Amendment No. 14 transmittal letter, in a memorandum dated February 23 to the ISO Market Issues/ADR Committee accompanying the proposed tariff language.¹³ Moreover, the ISO added language which relieved Scheduling Coordinators from their obligation to replace reductions in the Ancillary Services schedules if the reductions are due to the negligence or willful misconduct of the ISO in direct response to stakeholder concerns on this issue. Given the time frame, the ISO made every effort to present this issue for stakeholder review. Thus the request of one intervenor that a limit on Scheduling Coordinator liability under this provision be established and that the Commission require the ISO to refine its proposal through a subsequent stakeholder process is unfounded. (PG&E at 6-7).¹⁴ Stakeholder concerns are being addressed both through the

¹³ A copy of that memorandum is attached to this Answer as Appendix A.

¹⁴ This intervenor also calls for the ISO to publish total metered Demand values and total Ancillary Services purchased for each hour on the ISO Home Page to aid Scheduling Coordinators' verification of their bills and seeks Commission action on the ability of Market Participants to dispute "new charges" on Final Settlement Statements. (PG&E at 8-9). Neither of these comments are related to the refinements to billing based on metered Demand proposed in

ISO's stakeholder process and the present opportunity for intervenors to submit comments on the ISO proposal to the Commission.

Intervenors offer a variety of revisions to the ISO's proposal. One party suggests that the ISO should have to wait until the close of the Hour Ahead Market before taking any action as a result of a reduction of a supplier's failure to adhere to its Day-Ahead Ancillary Services schedule. (SDG&E at 8). Apparently, this suggestion would impose different consequences on the supplier, depending upon the relationship of the prices for the product in the Day-Ahead and Hour-Ahead Markets. This suggestion represents an unnecessary and inappropriate complication. Simply put, the supplier's schedule to self-supply the Ancillary Service in the Day-Ahead Market is a binding commitment. The consequences of a failure to live up to that commitment should not vary based on the serendipitous relationship between Day-Ahead and Hour-Ahead prices.

A number of intervenors suggest that the buyback provisions should not apply to Scheduling Coordinators who reduce self-provided AS capacity when load decreases. (MWD at 14-16; SMUD at 10-11; Turlock at 3-4). Similarly, one party believes that the buyback provisions should not apply when a scheduling Coordinator's resource changes from thermal to hydro generation and that limitations on increases in a Scheduling Coordinator's self-provided Operating Reserve should not apply where there is the reverse change in generating resources. (MWD at 14-16). These suggestions, too, represent attempts to

Amendment No. 14 or any other aspect of Amendment No. 14. As such, these comments are beyond the scope of the instant proceeding.

force the ISO (and through the ISO's recovery of the resulting costs, other Market Participants) to bear the risks of a Scheduling Coordinator's management of its portfolio to meet the demands for which it is responsible. No Scheduling Coordinator is disadvantaged by the requirement to replace decreases in scheduled self-provided Ancillary Services at the Hour-Ahead price. If a Scheduling Coordinator is uncertain about the level of its demand or its mix of resources, it may defer a portion of its self-provision schedule to the Hour-Ahead Market and thereby avoid the imposition of charges to replace committed, but unneeded Day-Ahead capacity. Alternatively, the Scheduling Coordinator can keep to its Day-Ahead schedule, even though its load has declined or its resource mix has changed, in which case it will receive a credit for the excess. No purpose would be served by giving Scheduling Coordinators the additional option of shifting their responsibility to manage their own Ancillary Service obligations to other Market Participants.

6. The ISO Agrees to Make Certain Revisions to the Tariff Modifications Proposed In Amendment No. 14 and Clarifies Other Modifications

One intervenor requests that, in connection with the ISO's proposal to establish separate prices for upward and downward Regulation, the ISO state separate formulae for each service in the relevant provisions of the ISO Tariff and Protocols. (TANC at 10-12.) The ISO believes that this suggestion could eliminate the potential for confusion and agrees to make the necessary additions of formulae for downward Regulation in a compliance filing to be submitted in this docket.

Another intervenor requests that the ISO make a number of clarifying changes to the tariff revisions proposed in Amendment No. 14 (SCE at 27-28). The ISO agrees that all but two of the proposed changes are reasonable and commits to make them in a compliance filing. The requested change to the definition of "G_s" does not relate to any of the revisions proposed in Amendment No. 14, and it is not clear what the intervenor seeks to accomplish with the change. The ISO therefore does not believe this change is justified. The intervenor also requests that the ISO include a definition for "Participating Load" in the Master Definitions Supplement to the ISO Tariff. As explained, below, the ISO is developing a draft Participating Load Agreement to be presented for stakeholder review and comment. The definition of "Participating Load" will be addressed as part of that process, and is therefore not properly the subject of any tariff revisions at present.

One intervenor requests clarification and/or revision of a number of other proposed tariff changes in Amendment No. 14. First, the intervenor suggests that the term "total payments to users" used in the rational buyer tariff provisions should be changed to read "total charges to users." (MWD at 24). The intervenor also requests that the term "SelfProv" as used in certain formulae in these provisions be defined and certain inconsistencies in subscripts used in these formulae be addressed. (MWD at 24-25). The ISO agrees to make the proposed changes.

The same intervenor requests clarification of certain tariff changes which require that quantities of Ancillary Services procured be "non-negative" and

others that state that "Ancillary Services obligations may be negative." (MWD at 25-26). The ISO states that Section 2.5.3.6(h) precludes the bidding of any negative *quantity* of Ancillary Services. In contrast, a Scheduling Coordinator may, by virtue of a *positive* quantity of Ancillary Service self-provided, incur a negative obligation for which a credit may be due. If a Scheduling Coordinator self-provides, using certified resources, in excess of its obligation in the Day-Ahead Market, a credit will always be given for that excess self-provision. Incremental self-provision by certified resources in the Hour-Ahead Market, however, may be subject to limitations on credits for excess self-provision.

The intervenor also wants clarification of the use of the term "metered output" in certain tariff revisions. (MWD at 27). The ISO explains that this term is used to determine obligations on a Scheduling Coordinator's actual output based on meter data, consistent with the previously-approved tariff revisions which will base billing upon metered, rather than scheduled Demand.

This intervenor also points out that, in the tariff sheets filed with Amendment No. 14, Section 2.5.20.3 is misnumbered as a repeated Section 2.5.20.2. (MWD at 27-28). This is a typographical error which the ISO commits to correct in a compliance filing to be filed in the above-captioned docket.

Another intervenor offers certain technical revisions to the formulae proposed to implement the ISO's "effective price" proposal. (PG&E at 7, Att. A). The ISO has already discussed these revisions with the intervenor and has agreed to make the requested changes. In addition, the ISO notes that the proposed revisions to Section D 2.1 of Appendix D to the Settlement and Billing

Protocol designed to implement the "effective price" proposal and to clarify certain aspects of the "nonpayment for uninstructed deviation" proposal approved in Amendment No. 13 will also need to be made to the currently applicable "temporary" version of Section D 2.1 found in Section 23.5 of the Tariff.¹⁵ The ISO commits to make these changes in a compliance filing in this docket.

Finally, the ISO states that a number of tariff sheets were inadvertently omitted from the March 1 Amendment No. 14 filing. These tariff sheets, including Sheet Nos. 619-A, 836-A, 914-A and 914-B, do not reflect any substantive changes to the ISO Tariff, but are merely the result of the need to create supplemental pages containing existing provisions of the ISO Tariff as a result of the insertion of the new and expanded tariff provisions proposed in Amendment No. 14. The ISO will submit these supplemental tariff sheets in the compliance filing described above.

¹⁵ As reported in the ISO's March 11, 1999 Report submitted in Docket Nos. ER98-3760 et al., the ISO will commit to eliminate all the "temporary" sections of the ISO Tariff and incorporate the necessary changes into the "permanent" provisions of the Tariff, as part of a negotiated settlement being finalized addressing hundreds of unresolved issues.

B. Additional Issues Related to the Ancillary Services Redesign

1. The ISO's Proposal To Raise Price Caps Upon the Occurrence of Specified Market Improvements and to Continue To Monitor Market Conditions Under Its Safety Net Proposal Strikes a Reasonable Balance.

In the October 28 Order, the Commission confirmed the need for price caps in the California Ancillary Service markets, as well as the ISO's authority to determine the appropriate level of purchase price caps.¹⁶ The Commission directed the ISO, as part of its Ancillary Service Market Redesign filing, to indicate whether it intends to continue to apply purchase price caps and, if it did, to propose a formula or specific level for the price caps.¹⁷ The Commission subsequently confirmed the ISO's corresponding authority to impose purchase price caps in the Imbalance Energy market "at whatever level it deems necessary and appropriate," subject to the requirement that it "explain and justify its longer term plans" in the March 1 filing.¹⁸

The ISO shares the Commission's dissatisfaction with price caps as a tool for addressing market flaws. In the March 1 filing, the ISO accordingly explained that one of its principal criteria in assigning priority to different Ancillary Service Market Redesign projects was its assessment of the importance of each project in improving the competitiveness of the Ancillary Service and Imbalance Energy markets such that the purchased price caps could be raised to levels substantially higher than the current \$250 per MW or MWh. The ISO also

¹⁶ October 28 Order, 85 FERC at 61,461, 61,463.

¹⁷ *Id.* at 61,464.

¹⁸ *California Independent System Operator Corp.*, 86 FERC ¶ 61,059 at 61,202 (1999).

explained that, in consultation with the MSC, the ISO has concluded that the implementation of the first five elements of the Ancillary Service Market Redesign proposal (the rational buyer modification to the auction, revised pricing for uninstructed deviations, the use of Replacement Reserve to minimize out-of-market purchases, the automation of BEEP instructions, and separate pricing of upward and downward regulation), together with the implementation of those portions of Amendment No. 13 addressing Ancillary Service issues and the elimination of perverse incentives created by the structure of RMR Contracts and the dispatch of RMR Generation, meets this threshold. The ISO stated its intention to retain the \$250 price caps until these conditions are satisfied and to review progress toward satisfying these conditions in May of this year. If the conditions are not satisfied at that time, the ISO will periodically review progress on the implementation of the Ancillary Service redesign elements and the reform of the RMR contracts to determine whether workably competitive conditions, which would support the raising of the price caps, exist.

The ISO also laid out its longer term plans for the exercise of price cap authority in a Market Design Safety Net policy that was included with its March 1 filing. The ISO explained:

- The ISO will observe the performance of Ancillary Service markets and the Imbalance Energy markets to identify price patterns indicative of market failure and supply conditions indicative of insufficiency. The Safety Net policy includes a non-exclusive list of examples of patterns and conditions that could lead to a conclusion that intervention to mitigate market failures is appropriate. The ISO stated explicitly that the observation of high prices for Ancillary Service is not, in itself, always an indication that markets are not functioning well.

- Where the ISO's observation leads to a determination that intervention is appropriate because serious evidence of a major market failure presents the risk of serious harm to the market in the absence of mitigation, the ISO would announce the imposition of lower caps in one or more markets, taking into account interactions among markets. Whenever it determines that such action is necessary, the ISO would report its observations, analysis and findings to the ISO's Governing Board.

Various intervenors take divergent positions on the ISO's approach. Some parties argue that the Safety Net policy does not meet the FERC's requirements for continuation of price cap authority because it lacks "objective criteria " to guide the exercise of the ISO's discretion and lacks a definitive commitment to remove price caps at a particular point in time. (EPUC at 10-13; ECI at 17-25; Reliant at 15-16; Williams at 11-14). Other intervenors contend, in contrast, that the policy is deficient because it does not provide that the purchase price cap will be lifted only after experience over a significant period provides assurance that the markets are workably competitive. (SCE at 5-10; SDG&E at 11-12; SMUD at 5-8).

The ISO believes its description of how it will exercise the authority the FERC has confirmed to cap the prices it pays for Ancillary Services and Imbalance Energy is reasonable and consistent with the Commission's directives. The ISO set forth the objective criteria upon which it would base a decision initially to raise price caps to substantially higher levels: the implementation of specified Ancillary Service Market Redesign proposals and the reform of RMR Contracts. The ISO also presented the Market Design Safety Net policy to "explain and justify its longer term plans" for the exercise of its price cap authority, as the Commission required.

The ISO notes that this approach to the continued exercise of its price cap authority is supported by the MSC. In its report on the Ancillary Service Market Redesign proposal, the MSC supports raising the price caps in the Ancillary Service and Imbalance Energy markets to \$750 per MW or MWh, respectively, when the conditions described in the ISO's March 1 filing are met. *MSC Report* at 43-44. The MSC supports a further increase in the price caps to \$2500, which is the level of the cap currently applicable in the PX markets "after the ISO and the PX have been through a summer peak season without major observed market disfunctions." *Id.* at 44. In determining when the price caps in the ISO markets may be lifted, the MSC thus focuses on the same criteria identified by the ISO in its March 1 filing.¹⁹

The MSC also endorsed the ISO's Safety Net proposal as striking "an appropriate balance between the need to protect the market from events like last July's price spikes, on the one hand, and the need to avoid unnecessary market intervention, on the other." *MSC Report* at 45. It also committed to work with the ISO to develop further the ISO's market observation plan that is a key feature of the Safety Net proposal.

The two groups of intervenors each insists that the ISO be placed at one end of the spectrum described by the MSC. One group demands an end to price caps by a date certain, regardless of market conditions, lest the market's

¹⁹ The ISO notes that it also incorporated these criteria and the price cap levels supported by the MSC in Amendment No. 12 to the ISO Tariff. The ISO did not interpret the Commission's rejection of this proposal in favor of confirming less restrictive price cap authority as a rejection of the particular criteria and levels proposed. Rather, the Commission's discomfort with "hard-wiring" the level of a price cap in the ISO Tariff reflected a recognition of the uncertainty that necessarily surrounds a determination of when a market is sufficiently competitive that price caps can be raised or removed.

mechanism to signal the need for increased supply be muted. The other group urges the compilation of strong evidence that the potential for the exercise of market power has been eliminated before price caps are lifted and a readiness to reimpose them quickly to protect consumers against high prices that may reflect market power. Both of these objectives are worthy of consideration. The ISO endeavored to strike a balance between them, to raise price caps in phases, when identified criteria are met, and to maintain vigilance over market conditions without becoming over-reliant on price caps. The Commission should second the MSC's conclusion that the ISO has struck a reasonable balance between these competing objectives and has satisfied the Commission's requirements.

2. The Limitation on the Proportion of Ancillary Service Capacity Procured From Outside the ISO Control Area Is Reasonable and Appropriate.

Several intervenors complain about the ISO's failure, as part of the Ancillary Service Market Redesign proposals in Amendment No. 14 to raise the existing 25 percent ceiling on the proportion of Ancillary Service capacity that may be procured from outside the ISO's Control Area. (Joint Parties at 2-17; SDG&E at 12-14; Modesto at 11-12). They argue that the limit is unjustified and discriminatory, and that, if any limit on outside procurement of Ancillary Services is appropriate, it must be based on a detailed analysis of the effect of a constrained inter-Control Area interface on the supplies of Ancillary Service capacity available to the ISO. These claims are both beyond the scope of this proceeding and substantively unfounded.

As an initial matter, even if these arguments had merit, they would constitute no basis for the Commission to reject or modify any of the proposals included in Amendment No. 14. They are directed to provisions of the ISO Tariff and Protocols that are unchanged by Amendment No. 14 and are, accordingly outside the scope of this docket.²⁰ There is simply no need for the Commission to address here claims that have no bearing on the proposals before it.²¹

The ISO Tariff specifically authorizes and requires the ISO to take the geographic dispersion of its sources of Ancillary Service capacity into account in procuring its Ancillary Service requirements. Section 2.5.4 of the ISO Tariff states as follows:

For each of the Ancillary Services, the ISO shall determine the required locational dispersion in accordance with ISO Controlled Grid reliability requirements. These standards shall be used as guidance only. The actual location of Ancillary Services on a daily and hourly basis shall depend on the location spread of Demand within the ISO Control Area, the available transmission capacity, the locational mix of Generation, and historical patterns of transmission and Generation availability.

This provision, which was not changed in Amendment No. 14, is the source of the ISO's authority and obligation to take the location of resources supplying Ancillary Services, including whether they are within the ISO Control Area, into account in its procurement decisions.

²⁰ If these complaints relate to any ISO Tariff filing, it would be Amendment No. 10, which was filed on July 27, 1998 and conditionally accepted, subject to subsequent intervention and comment, on July 31, 1998. *California Independent System Operator Corp.*, 84 FERC ¶ 61,121 (1998). That filing amended Section 2.5.7.4 of the ISO Tariff to permit the ISO to procure Ancillary Services (other than Regulation) from resources outside the ISO's Control Area, where technically feasible and subject to the ISO Protocols and to the ISO's obligation, discussed below, to determine an appropriate locational dispersion of Ancillary Service capacity. None of the parties now complaining about the ISO's Ancillary Service procurement policies raised this issue in connection with Amendment No. 10.

It is plainly appropriate for the ISO to retain the discretion to ensure that the geographic mix of Ancillary Service resources is appropriate to maintain reliability. Absent that flexibility, the ISO could find itself required to buy greater quantities of Ancillary Service capacity to provide the requisite level of reliability. As Section 2.5.4 reflects, numerous factors go into determining the appropriate locational dispersion of Ancillary Service capacity. It is not simply a matter, as Joint Parties would lead one to believe, of evaluating the limits on individual transmission paths. In November 1998, the ISO's Chief Operating Officer explained to the Board of Governors the factors that were taken into account in establishing a 25 percent limit on the acquisition of Ancillary Services from external resources and which must be considered before that ceiling is raised.²²

Principal factors cited included the following:

- Under Western System Coordinating Council ("WSCC") rules, Operating Reserves must be capable of responding to the Control Area operator's dispatch within 10 minutes. The feasibility, from a practical standpoint, of achieving the required response time from resources in adjacent Control Areas is sufficiently questionable to warrant a limitation on the extent to which the ISO can rely on them.
- Absent a ceiling, all Operating Reserves could potentially be scheduled on a single tie, which would obviously violate the geographic dispersion requirement of the ISO Tariff.
- Procurement of Ancillary Services from external resources means that the effect of a loss of an inter-area tie on reliability would be multiplied: both Energy scheduled across the tie and reserves scheduled across the tie would be lost.
- The ISO was concerned that there had been repeated instances in which Scheduling Coordinators did not comply in a timely manner with

²¹ See *California Independent System Operator Corp.*, 84 FERC ¶ 61,234 at 62,197 (1998) (declining to address issues not implicated by a tariff amendment filing).

²² A copy of that memorandum is attached to this Answer as Appendix B.

ISO requests for Energy from imports of Operating Reserve capacity from external imports.

- At present, the ISO's scheduling system gives Energy deliveries higher priority than Ancillary Service deliveries when both are using the same inter-area tie. As a result, when the intertie is curtailed, all Ancillary Services scheduled on the tie may be eliminated, compounding the problem created by the curtailment.

The ISO determined that these considerations were insufficient to warrant a blanket exclusion of Ancillary Service imports, once the capability to accept them was established. They cautioned, however, against unlimited reliance on imports to meet the ISO's Ancillary Service needs. Based on these considerations, the ISO decided that a 25 percent limit struck a reasonable and appropriate balance between reliability concerns and the desirability of increasing the range of suppliers who could participate in the ISO's Ancillary Service markets.

The application of the standard in Section 2.5.4 to suppliers of Ancillary Services from external resources is not discriminatory, as the intervenors contend. The ISO evaluates the geographic dispersion of Ancillary Service resources both within and beyond the boundaries of the ISO Control Area. It is not unduly discriminatory for the ISO, in fulfilling its primary mission of preserving reliability, to take account of the factors that affect the procurement of reserves from external sources.²³

The ISO is currently performing studies and evaluating alternatives for increasing imports of Operating Reserves from sources outside the ISO's Control

²³ See, e.g., *Missouri Power & Light Company*, 5 FERC ¶ 61,086, at 61,139-41 (1978) (discrimination must be undue to violate the Federal Power Act).

Area. When completed, the results of the studies will be shared with Market Participants. Until that work is completed and the results assessed, however, the 25 percent limit on Ancillary Service imports should be maintained.

3. Stakeholders Have Been Involved, and Will Continue To Be Involved, in the Development of Automated Imbalance Energy Dispatch Instructions.

In addition to the components of the ISO's Ancillary Service Market Redesign proposal that involve modifications to the ISO Tariff and Protocols, and are accordingly included in Amendment No. 14, other redesign elements do not require a change in tariff language. In its transmittal letter, the ISO explained that one of these elements involves the enhancement of its software and communications system to enable the ISO to transmit dispatch instructions automatically to resources selected to supply Imbalance Energy. These enhancements should enable the ISO to reduce its requirements for Regulation by improving its ability to rely on the resources in the BEEP stack to meet load following requirements.

One intervenor stresses the need for stakeholder involvement in developing this automated Imbalance Energy dispatch process (MWD at 22-23). The ISO has discussed the need for and benefits of this enhancement during the Ancillary Service Redesign stakeholder process. Further, a stakeholder group was involved in selecting the contractor that is developing this capability for the ISO. That stakeholder working group continues to meet as progress continues on the project, which is on schedule for completion in June 1999. Also, the ISO is scheduling training sessions for ISO and Scheduling Coordinator personnel

for May. The ISO plans to hold markets trials before the news system becomes operational. It is therefore clear that stakeholders have been involved and will continue to be involved in the implementation of the new system.

Another intervenor argues that the automation of Imbalance Energy dispatch instructions does not go far enough, because it does not completely eliminate the potential for the ISO to have to re-run its BEEP software to determine market clearing prices for Imbalance Energy (ECI at 16-17). This complaint, of course, has nothing to do with any of the ISO Tariff and Protocol changes proposed in Amendment No. 14. It is, in any event, groundless. The ISO has to re-run the BEEP software to recalculate the market clearing price for Imbalance Energy when operator dispatch decisions depart from the theoretical dispatch calculated by the software. The automation of Imbalance Energy dispatch instructions should reduce substantially the already rare instances in which the recalculation is required. It will not, however, eliminate entirely the potential need for the ISO's dispatchers to issue instructions that are different than those the software would issue, in order to protect reliability. In those circumstances, it would be inappropriate to calculate market clearing prices on the basis of the theoretical dispatch calculated by the software, when real world conditions precluded the implementation of that dispatch. The ISO is discussing with Market Participants a procedure through which, even when the Imbalance Energy must be re-run, that will be accomplished and the resulting market clearing prices posted on a final basis, within a defined time after the close of the

Settlement Period. No Commission action is necessary on this issue, which is not directly implicated by the changes presented in the instant filing.

4. The Participating Load Agreements Will Be Filed With the Commission Before They Take Effect.

In its transmittal letter for Amendment No. 14, the ISO explained that it is proceeding with the development of a form of agreement that would facilitate the participation of operators of dispatchable Loads in Ancillary Service markets. Some intervenors argue that the Participating Load Agreement, once developed, should be filed for Commission review on a *pro forma* basis. (SCE at 23; MWD at 23-24; TANC at 13-14). These claims, however, are premature. The Participating Load Agreement is still under development. The ISO plans to circulate a draft agreement to interested stakeholders in the near future and to consider their comments before it is finalized. The ISO would expect that stakeholder process to encompass issues such as the desirability of filing the resulting agreement on a *pro forma* basis before individual agreements are executed and filed with the Commission.

C. Other Tariff Modifications

1. The Generator Communications Project Proposal Is Reasonable and Does Not Give Undue Discretion to the ISO.

One component of Amendment No. 14 relates to the ISO's efforts to improve its control over Generating Units supplying Regulation and thereby enable it to use those resources more efficiently and reduce its requirements for that service. The ISO has initiated a Generator Communications Project to install

an advanced communications and direct control system, referred to as the Remote Intelligent Gateway System or “RIGS,” at all Generating Units providing Regulation by the end of 1999. To ensure that the responsibility of generators to have equipment in place meeting the standards of the RIGS system is clear, the ISO proposed changes to Section 4.2.1 and Appendix A of the ASRP to specify that the communications and control equipment in place at Generating Units supplying Regulation meet the standards of the proposed RIGS system, by installing and using either RIGS equipment or alternative equipment proposed by the generator, which the ISO agrees provides an equivalent level of communications and control.

The RIGS proposal is a product of a stakeholder process that began last fall to address the best means of providing data and voice communications among the ISO, its Energy Management System (“EMS”) and Generating Units. This process led to the ISO Board’s approval of a prototype and pilot project for the development of the RIGS system in November 1998. Concurrently, the ISO and stakeholders discussed the need for clarification of the operating characteristics and technical capabilities of equipment at Generating Units supplying Regulation. As part of this process, draft tariff revisions that would clarify these matters and implement the RIGS requirement for Regulation units were discussed with stakeholders in February 1999.

A number of intervenors oppose different aspects of the RIGS proposal for units supplying Regulation. Some argue that the proposed changes to the ASRP give the ISO too much control over Generating Units (ECI at 25-27; SMUD at 11-

13). They express concerns, in particular, that hydroelectric generators could be required to take actions inconsistent with the other purposes served by those facilities, such as water supply, or environmental restrictions on their operation (DWR at 2-9; SCE at 24-26; PG&E at 10-11).

These complaints lose sight of the fact that the current RIGS proposal, including the requirement that a unit respond automatically to the ISO's dispatch instructions, without manual intervention, is limited to units that have bid and been selected (or been self-selected by a Scheduling Coordinator) to supply Regulation service. That service, by definition, can be provided only by units :

. . . equipped and operating with AGC [automatic generation control] which will enable such units to respond to the ISO's *direct digital control signals* in an upward and downward direction to match, on a real time basis, Demand and resources, consistent with established NERC and WSCC operating criteria.

ISO Tariff, Appendix A (definition of "Regulation") (emphasis added). The requirement that generating resources supplying Regulation have the capability to respond to the ISO's "direct digital control signal" is already explicit in the ISO Tariff and Protocols. Manual operator intervention in the response of units supplying Regulation service to the ISO's direct control signal is inconsistent with the nature of the service and its importance in maintaining reliability. It is up to the owner of each Generating Unit that lacks automatic equipment to decide whether the benefits of being able to sell Regulation justify the costs of installing that equipment. The ISO cannot, consistent with WSCC requirements, relax the requirements for Regulation resources for the convenience of some Market Participants.

Because of the importance of Regulation capacity in enabling a Control Area to match demand and resources and maintain system frequency, NERC policy requires Control Area operators, such as the ISO, to have the capability to control directly the generation within the Control Area that is supplying Regulation. Currently, the ISO relies on the EMS systems of California utilities and relays Regulation signals through their control centers. This inefficient arrangement degrades the reliable operation of the ISO Control Area.²⁴ Amendment No. 14 describes the means through which the ISO will take direct control, rather than indirect control, over Regulation resources and provides details of the digital control and communications system that will be required for this purpose, but it does not create a fundamental change in the requirements for Regulation resources.²⁵ However, by clearly specifying the requirements applicable to resources supplying Regulation and by improving the ISO's control over those resources, Amendment No. 14 allows the ISO to use them more efficiently and reduce the amounts of Regulation it purchases to meet its Control Area responsibility.

Recognizing that the RIGS requirements proposed in Amendment No. 14 apply only to resources selected (or designated through self-provision) to supply Regulation answers the concerns regarding the control that the ISO will exercise through those requirements. A generator will only be required to follow the ISO's control signal automatically within the parameters of its accepted Regulation bid

²⁴ Continued reliance on this arrangement, for longer than it is required by technical limitations, is inconsistent with maintaining the ISO's independence.

(or self-provision commitment). See ASRP Appendix A, § A 1.2.1.2. A generator can incorporate any limitations on its operations into its Regulation bid. This applies to hydroelectric resources, as well as non-hydroelectric resources.

Several intervenors argue that the Tariff or the ASRP must contain more specificity regarding the technical requirements for units providing Regulation and the standard under which waivers will be granted. (EPUC at 3-7; Williams at 8-9; Reliant at 13-15). The ISO believes that the provisions proposed in Amendment 14 provide sufficient detail. They describe the technical requirements for digital communications and control and back-up voice communication that Generating Units supplying Regulation must meet to be able to interface with the ISO through the RIGS system, leaving discretion to the units' operators regarding how they will meet those requirements. The requirements set forth are more detailed than those usually reflected in a filed tariff.

Including a provision that criteria for temporary exemptions are to be posted on the ISO Home Page, rather than included in the Tariff or Protocols is reasonable and appropriate. The ISO cannot anticipate in advance the various bases upon which generators might seek temporary exemptions from one or more of the requirements. In addition, the existing arrangements for the control of some units, such as the generating units at the Hoover Dam, are complex and unique. The ISO and those Market Participants with rights to the capacity of those units should have the flexibility to develop appropriate arrangements for the transition from a system where communications and control signals are

²⁵ Many of the units currently supplying Regulation are already configured to respond automatically to signals from the EMS systems of the utilities that operated their own control

routed through intervening systems of former Control Area operators (such as SCE's "controller") to the ISO's direct communication and control, using the RIGS technology developed for that purpose. The critical requirements are that the criteria be made publicly known to prospective Regulation suppliers, which they will be, and that the ISO apply them in a non-discriminatory fashion, which it will do. Any claim that the ISO does otherwise will be subject to dispute resolution under the ISO Tariff and, if necessary, a complaint to the Commission.

Another intervenor argues that the cost of the RIGS system has not been justified (EPUC at 8-10). In fact, in August 1998, before proceeding with development of the RIGS prototype, the ISO determined that the RIGS system was the lowest-cost alternative that meets the functional requirements established jointly by the ISO and stakeholders. Using RIGS' digital technology to transmit control capability, meter data, and voice communications was found to yield significant benefits by avoiding the need for redundant systems.²⁶ RIGS also eliminates the need for intermediate control centers, with the resulting reduction of control and delays in communications and the consequent degradation in reliability.

Amendment No. 14 nevertheless permits Generators to propose alternatives that would provide an equivalent level of communication and control. See ASRP, Appendix A, § A 6. Concerns expressed by some intervenors that the RIGS system may not be suitable for particular generator locations or

areas before the ISO was established.

²⁶ Direct voice communication capability is needed because Regulation resources also constitute a portion of the contingency reserves upon which the ISO relies to assure reliability consistent with NERC and WSCC requirements.

configurations are addressed by the ability to obtain the ISO's agreement to alternative arrangements. The determination that an alternative arrangement would provide the ISO with "an equivalent level of communication and control" over a Regulation resource is the functional equivalent of a "permanent exemption" sought by some intervenors (PG&E at 10-11). A broader provision for permanent exemptions, or one that uses a different standard, would be inappropriate. It would deprive the ISO of the direct control capability over Regulation resources that it needs to perform its function as the Control Area operator and would inappropriately favor some Market Participants over others. The best way to let the market function to meet the ISO's reliability needs is to apply the same permanent technical standards for communications and control to all Regulation suppliers.

2. The Proposal To Ensure That Double Payments Are Not Made for Ancillary Services Provided by a Reliability Must-Run Unit Is Reasonable and Appropriate.

Amendment No. 14 includes a proposal to remedy an inconsistency between the ISO Tariff and the procedures adopted to implement its provisions, on the one hand, and certain contracts between the ISO and owners of RMR generation, on the other. As the Commission is aware, through contracts with owners of generating units designated as RMR units, the ISO can call on those units to support the reliable operation of the grid during certain conditions, in exchange for payments to support a portion of the RMR units' costs. Those units can also be called upon to provide Ancillary Services, when necessary, in exchange for a cost-based payment under their contracts with the ISO. Those

payments are made by the Participating Transmission Owner in whose service territory the unit is located and, ultimately, by the Transmission Owner's customers. In addition, when RMR generating units supply Ancillary Service capacity, either voluntarily or in response to a call by the ISO, they also receive (through the Scheduling Coordinators that represents them) the market clearing price for the Ancillary Service provided.²⁷

The ISO Tariff was based on the premise that, when RMR generating units are dispatched (and paid cost of service rates under their respective RMR contracts), market revenues received with respect the units' output. Would be credited to the Participating Transmission Owner and its customers, as an offset. This design is embodied in Section 5.2.7 of the ISO Tariff, under which the Participating Transmission Owner that is responsible for payments under an RMR contract is entitled to a credit against those payments for amounts received by the RMR unit owner from a Scheduling Coordinator for Energy and Ancillary Services. The procedures that implement this provision were adopted, for administrative convenience, on the premise that the Scheduling Coordinator for the RMR unit owner would receive the market revenues for such sales and use them as an offset against the cost-based charges under its RMR contract. In most cases, this mechanism works as intended. Some RMR unit owners, however, contend that their contracts do not require them to credit amounts received from Scheduling Coordinators for Ancillary Services against amounts owed to them to recover their costs of providing support to the grid when called

²⁷ RMR units can typically also sell energy in competitive markets, including the ISO's Imbalance Energy market.

upon by the ISO and have refused to apply such credits in the invoices they submit to the ISO for payment.

The ISO believes that this practice is contrary to the design of the ISO Tariff and Section 5.27 in particular. If continued, it would permit the owners of RMR units with such contracts to recover twice for costs of supplying Ancillary Services: once from Participating Transmission Owners (via the ISO) under their RMR contracts and again when they receive market revenues from their Scheduling Coordinators. Furthermore, allowing RMR unit owners to retain the market revenues they receive from providing Ancillary Services under their RMR contracts could adversely impact the Ancillary Services markets by creating a perverse incentive for RMR unit owners not to bid, or to bid very high, into those markets. The perverse incentive results from allowing the RMR owners to keep market revenues from providing Ancillary Services under their RMR contract, thereby inappropriately providing them with an incentive to drive up market clearing prices by bidding high or not bidding at all, thinning the markets and requiring the ISO to dispatch their units for Ancillary Services under their RMR contracts. Whether they bid into the markets, or whether they are called under the RMR contract, the RMR unit owner would receive the market clearing price. Without Amendment No. 14, this RMR contract backstop creates an incentive for RMR unit owners to bid very high or not at all.

To remedy these problems and to restore the operation of the intended market design, Amendment No. 14 includes a proposed new subsection 2.5.27.7 of the ISO Tariff, which provides that when an RMR contract does not provide for

a credit for Ancillary Service capacity revenue received by the RMR owner from its Scheduling Coordinator, the ISO may make payments for such capacity to the Settlement Account of the relevant Participating Transmission Owner, rather than to such Scheduling Coordinator. In this way, the inconsistency of some RMR contracts with the design of the ISO Tariff is remedied by redirecting the market revenues for Ancillary Service capacity provided by an RMR unit as the result of a dispatch notice issued by the ISO. Any RMR unit owner affected by this change will continue to receive the payments to which it is entitled under its RMR contract.

Intervenors that own such RMR units oppose the change to avoid double-payments. (Williams at 4-8; Reliant at 4-10; ECI at 30-32). They argue that the proposed change to the ISO Tariff is contrary to the terms of their RMR contracts with the ISO and deprives them of compensation for the Ancillary Services they provide.

The opposition of these intervenors is unfounded. The proposed change to the ISO Tariff does not affect the contract rights of any RMR unit owner. Each RMR unit owner will continue to collect the full payments to which it is entitled under its RMR contract, including cost-based payments for Ancillary Service capacity called by the ISO. The ISO proposes instead to modify the provisions of the ISO Tariff relating to its Ancillary Service market to implement a payment procedure that is consistent with the intended design. None of the intervenors points to any provision in any RMR contract restricting the authority of the ISO to modify provisions of the ISO Tariff relating to payments for Ancillary Services or

entitling an RMR owner for payments from Scheduling Coordinators for Ancillary Services in addition to the payments from the ISO (and ultimately from the local Participating Transmission Owner) to which the contract entitles it.

In the absence of a contractual bar that prohibits the proposed change to the ISO Tariff – and the intervenors have identified none -- the only question is whether the change deprives an affected RMR unit owner of adequate compensation when it supplies Ancillary Services to the ISO. The answer is that the proposed change does nothing of the kind. An RMR unit owner affected by the proposed change still receives compensatory cost-based rates under its RMR Contract when it provides Ancillary Services to the ISO. Permitting an RMR unit owner to earn market revenues for Ancillary Services in addition to the RMR contract payments for those same services called under the RMR contract would constitute a windfall. Under well-settled Commission precedent, revenues earned in such market transactions must be credited against cost-based rates to avoid double-recovery.²⁸ It is this principle that is reflected in the crediting provision of Section 5.2.7. An RMR owner cannot establish a right to recover again, through market revenues, for Ancillary Services for which it is already being compensated under its RMR contract.

Where an RMR unit owner relies on the terms of its contract to retain market revenues that, under Section 5.2.7 of the ISO Tariff, are appropriately credited to the obligated Participating Transmission Owner, it is entirely

²⁸ See, e.g., *IES Utilities, Inc., et al.*, 81 FERC ¶ 61,187 at 61,831-32 (1997) (discussing the Commission's policy for crediting transmission revenues from off-system sales in excess of costs included in cost-based rates in the post-Order No. 888 environment).

reasonable and appropriate for the ISO to redirect those revenues to the Participating Transmission Owner and thereby avoid a windfall. The RMR unit owner continues to receive the cost-based rates for Ancillary Services established by its RMR contract. It receives everything to which it is contractually entitled, but no more. The intervenors' complaints against this solution to the double-recovery problem created by certain RMR contracts are baseless.²⁹

3. The Proposal To Confirm the Independence of the Market Surveillance Committee Is Reasonable.

In Amendment No. 14, the ISO also proposed a clarifying change to Section 5.1 of the Market Monitoring Information Protocol ("MMIP"). That provision describes the role of the ISO Market Surveillance Committee and its relationship to the ISO. The proposed change confirms the status of the members of the MSC as independent from the ISO by clarifying that its members are neither employees nor agents of the ISO. Consistent with this independence, the proposed change also makes clear that the members of the MSC are not automatically available to the ISO or any other party to provide expert witness service in a FERC proceeding relating to the ISO.

A number of intervenors raise concerns about or oppose the proposed change to the MMIP, arguing that it attempts to limit review of MSC reports submitted to the Commission and/or represents an inappropriate attempt to shield the MSC from proper discovery (ECI at 29-30; Reliant at 10-13; Williams at 9-10). These intervenors suggest that the filing of a report by the MSC with the

²⁹ The ISO understands that a number of parties are submitting a joint answer, as a "buyers group," to the comments of the RMR unit owners on the ISO's proposal. The ISO supports the position taken by this "buyers group."

Commission should automatically trigger a technical conference or a right to commence discovery procedures. Such an approach would actually subject the MSC to unnecessarily heightened scrutiny. Currently, when the MSC files a report with the Commission, that filing is noticed and all parties, including the ISO, are afforded the opportunity to comment on the analysis and findings of the MSC. This approach provides a more than adequate opportunity for review of MSC reports and any additional measures are unnecessary.

Moreover, as an independent entity that is not subject to the ISO's control, the MSC is appropriately treated as a separate party for discovery purposes.³⁰ The proposed amendment makes clear, for instance, that neither the ISO nor any other party has any special right to call upon the MSC to serve as expert witnesses in a FERC proceeding. The ISO believes the proposed change to the MMIP does nothing more than confirm the intended independent role of the MSC, consistent with Commission orders³¹, and therefore should be approved.

³⁰ See Rule 404(a), *18 C.F.R. § 385.404(a)*, (distinguishing between depositions taken by notice of a participant, employee or agent of a participant, or person retained as potential witness for a participant, and by subpoena for nonparticipants); Rule 405(a), *18 C.F.R. § 385.405(a)*, (distinguishing among permissible uses of a deposition based on a deponent's status); and Rule 406(a), *18 C.F.R. § 385.406(a)*, (limiting requirement to answer data requests and requests for documents to participants).

³¹ See October 28 Order, 85 FERC at 61,462 (noting the value of the "independent analysis" to be provided by the MSC to the Commission concerning the stakeholder market redesign process).

III. CONCLUSION

For the foregoing reasons, the Commission should accept Amendment No. 14 to the ISO Tariff without modification other than those non-substantive modifications which the ISO has committed to make above.

Respectfully submitted,

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Dated: April 12, 1999

CERTIFICATE OF SERVICE

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

Dated at Washington, D.C. this 12th day of April, 1999.

Sean A. Atkins