October 19, 1999

Mr. Jan Smutny-Jones
Chair
Board of Governors
California Independent System Operator
151 Blue Ravine Road
Folsom, CA 95630

Dear Mr. Smutny-Jones:

We are submitting this letter respecting the Report on Redesign of California Real-Time Energy and Ancillary Services Markets (Report), by Dr. Frank Wolak, Chairman of the Market Surveillance Committee (MSC) of the California Independent System Operator (CA-ISO), in our capacity as members of the MSC. Dr. Wolak's analysis of the recent market developments was not completed in time for us to fully participate in the drafting of the Report. However, we have reviewed the Report and can state that we concur, as a general matter, in its findings and conclusions with respect to the design and operation of the ISO's ancillary services and real-time energy markets, and with respect to the standards used to assess whether, the ISO's markets are "workably competitive".[1]

In concurring with these findings and conclusions of the Report, we would like to emphasize several key points. First, we note that the Report reviews the performance of the ISO's ancillary services and real-time energy markets as well as the overall competitiveness of the restructured California electric power markets only through mid-summer 1999. The Report's analysis indicates that the performance of these markets has improved since summer of 1998, but that

[1] Mr. Nordhaus does not participate in Committee discussion of new generation interconnection policy and expresses no view on that aspect of the Report.

there remains credible evidence of continuing exercise of market power, particularly during high demand periods. (According to the Report, based on an analysis limited to the month of July 1999, it does appear that the wholesale energy market traded significantly above the clearing prices that would have been expected in a perfectly competitive market (p. 8)). Because of the unavailability of data, Dr. Wolak was not able to undertake a comprehensive analysis of the effectiveness either of the ancillary services market redesign initiatives that were implemented beginning in mid-August or of the Reliability-Must-Run (RMR) contract reforms that were implemented on June 1. That analysis will have to await the completion of the market redesign (which will occur after submission of the Report) and the availability of data respecting post-redesign market performance.

Second, in the light of this uncertainty as to the effectiveness of the market redesign and RMR contract reform in mitigating market participants' apparent ability to exercise market power, we believe it is essential for the ISO to retain the authority to impose purchase price caps at least for the next 12 months, and to exercise that authority to keep $750/MW caps in place through summer 2000, so that the efficacy of the market redesign and RMR reforms can be tested under high demand conditions. Thereafter, assuming experience indicates that the $750 caps are no longer necessary, we believe the ISO can raise the caps to $2500 or perhaps even eliminate them, so long as it retains "safety net" authority to reimpose them in the event of subsequent market design failure or apparent exercise of market power. (Report, pp. 125-131.)

Third, we recommend that the ISO complete the job of RMR contract reform. The predispatch policy and the requirement that RMR output be included in balanced day-ahead schedules, as recommended in the Report, should be put in effect. Once implemented these changes will significantly improve the operation of the ISO's markets, and lower real-time energy prices.

Fourth, as the Report recommends, the ISO and FERC should give careful attention to the terms and conditions of divestiture of PG&E's hydroelectric facilities in Northern California. Properly structured, the divestiture could be a major step toward a more competitive ancillary services market in California.

Fifth, we agree with the Report's observations that California's regulation of retail electric markets – particularly the operation of the rate freeze and the CTC, the bar on utility distribution company forward purchases outside the PX, and the lack of incentive to implement time-of-day metering – retard end-use demand response to wholesale price changes, and thus tend to make California's electric energy markets less competitive, than they otherwise could be. These issues need to be promptly addressed by the CPUC.

In closing, we would observe that the ISO and its management team have made substantial strides in the last 18 months in redesigning the ISO's real-time energy and ancillary services markets, and in operating those markets more effectively. But more remains to be done.

Yours very truly,

Robert R. Nordhaus
Carl Shapiro
Members
Market Surveillance Committee
California Independent System Operator