UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Investigation of Wholesale Rates of Public Utility Sellers of Energy and Ancillary Services in the Western Systems Coordinating Council	))))	Docket No. EL01-68-000

REQUEST FOR REHEARING OF THE ORDER
TEMPORARILY MODIFYING THE WEST-WIDE PRICE METHODOLOGY

The California Independent System Operator Corporation ("ISO")[1] respectfully submits this Request for Rehearing of the Commission's Order Temporarily Modifying the West-Wide Price Mitigation Methodology in the above-captioned docket, 97 FERC ¶ 61,294 ("December 19 Order"), pursuant to section 313(a) of the Federal Power Act, 16 U.S.C. § 825l(a) (1994), and sections 212 and 713 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §§ 385.212 and 385.713 (2001).

For the reasons presented below, the Commission should revoke the December 19 Order and return to the mitigation methodology adopted in its orders issued April 26, 2001[2] and June 19, 2001.[3]

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[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] *San Diego Gas & Electric Co., et al., 95 FERC ¶ 61,115* ("April 26 Order").

[3] *San Diego Gas & Electric Co., et al.*, 95 FERC ¶ 61,418 ("June 19 Order").

I. INTRODUCTION AND SUMMARY OF POSITION

In the April 26, 2001 and June 19, 2001 orders the Commission adopted a price mitigation plan that included the following elements:

(1) Establishing a mechanism for price mitigation for all sellers bidding into the ISO's real-time imbalance energy market during a reserve deficiency. The Commission established a formula (based on gas-fired generation) that the ISO uses to establish the market clearing price when mitigation applies.[4]

(2) Applying that mitigated clearing price as a maximum price for spot market sales outside the ISO's single price auctions (bilateral sales in California and the rest of the WSCC), with sellers outside the single price auction receiving the prices they negotiate up to this maximum price.

(3) Using eighty-five percent of the highest ISO hourly mitigated reserve deficiency Market Clearing Price established during the hours of the last Stage 1 System Emergency as the limit for the non-reserve deficiency Market Clearing Price for subsequent non-reserve deficiency hours.

(4) Instructing bidders to invoice the ISO directly for the cost to comply with emissions requirements and for start-up fuel costs, which are too varied to be standardized in a single market clearing price.

(5) Allowing sellers other than marketers the opportunity to justify bids or prices above the maximum prices.

In the December 19 Order the Commission modifies its prior mitigation plan for the period beginning on the trading day following December 19, 2001 until April 30, 2002 in the following respects:

(1) Resetting the ISO's current limit on the Market Clearing Price upward from $92/MWh to $108/MWh and

(2) Requiring the ISO to increase this price limit when the average

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4 The mitigated reserve deficiency Market Clearing Price is the marginal cost of the last unit dispatched to serve the last increment of load during a period of reserve deficiency. The marginal cost of each unit calculated by the ISO based on Commission-prescribed inputs is referred to as the "Proxy Price."

> of the three gas indices currently used to establish proxy prices increases at least 10% above the level last used for calculating the mitigated price limit.

As described below, the ISO believes that the modification to the existing price mitigation methodology is unsupported and could lead to unjust and unreasonable prices.

First, the Commission's reliance on the historic differences between Winter peak loads in the Northwest and Summer peak loads in California fails to support the changes in the December 19 Order. It is not the absolute system peak that is necessarily significant in evaluating whether or not suppliers have the opportunity to exercise market power but the relationship between available supply and current demand. Recent history demonstrates that, as a result of planned and unplanned outages in California's aging generation portfolio, California can experience supply shortages during the December to May period.

Second, the December 19 Order starts with a current mitigated price of $92/MWh and increases it by more than 17%. The order fails to recognize that natural gas prices are less than half of what they were when the $92/MWh price limit was set. There is no support for the Commission's further inflated cap.

Third, by stating that the price limit can go up, but not down, the December 19 Order places an inappropriate risk on consumers. This asymmetry is especially problematic in that the Commission's methodology already allowed suppliers to justify bids above the price limit in the event this level is non-compensatory.

The December 19 Order should be revoked. The Commission has failed to demonstrate that the changes to the West-wide price mitigation methodology adopted to remedy the unprecedented crisis in the Western wholesale electric market are warranted. The changes specified in the December 19 Order pose too great a potential for suppliers to exercise market power to garner unjust and unreasonable rates.

II. SPECIFICATIONS OF ERROR

The ISO respectfully submits that the December 19 Order errs in the following respects:

1. The determination that historic differences in peak demand warrant a modification to the existing market power mitigation methodology is arbitrary and capricious.
2. The West-wide price limit of $108/MWh is unjust and unreasonable and unsupported by reasoned decision-making.
3. The limitation that the $108/MWh price limit can be increased based on changes in gas prices but not decreased is arbitrary and capricious and an abuse of discretion.

III. ARGUMENT

A. The December 19 Order Fails To Recognize that California Can Experience Shortages of Power Outside of the Summer Period

The Commission proposes to modify the existing West-wide price mitigation methodology, "[i]n order to address the seasonal diversity of the Northwest (a winter peaking region)." December 19 Order, slip op at 7. Thus, the order no longer makes adjustments "dependent on the occurrence of a reserve deficiency in California (a summer peaking region)". *Id.* Recent experience demonstrates, however, that it is not the season in which a region's peak load historically occurs and the level of a region's peak load that necessarily creates shortages of supply and the opportunity for the exercise of market power, but rather it is the relationship between *available* supply and current demand.

In 2001, the ISO shed firm load on January 17, January 18, January 21, March 19, March 20, May 7, and May 8. These emergencies occurred when system demands were well below the ISO's Summer peak. Due to planned and unplanned outages, among other factors, however, the ISO experienced significant imbalances between supply and demand during these Winter and Spring days.[5] Similarly, the overwhelming number of the 136 Stage 1 emergencies, 107 Stage 2 emergencies, and 39 Stage 3 emergencies experienced by the ISO during 2001 took place prior to May.[6]

The Commission is legally obligated to protect consumers by providing effective relief against the ability of wholesale suppliers with wholesale market-based rate authority to exact unjust and unreasonable charges.[7] It must take

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5 The ISO publishes a daily listing of non-operational generators in California. One has only to look at the total outages of over 14,000 MW for January 14, 2002 (unplanned 2,616 MW and planned 11,758 MW) to recognize that there is still a significant potential for the exercise of market power in California.

6 The ISO publishes this information on its website at http:// www.caiso.com/docs/2001/06/01/200106011228581047.html.

7 The seminal judicial discussion of the interplay between just and reasonable and market-based rates is that of the Court of Appeals for the District of Columbia Circuit in *Farmers Union Cent. Exchange v. FERC*, 734 F.2d 1486 (1984):

> Without empirical proof that it would, this regulatory scheme, however, runs counter to the basic assumption of statutory regulation, that "Congress rejected

either of two actions to fulfill this obligation: (1) revoke suppliers' market-based rate authority and limit suppliers' to rates that do not exceed their demonstrated costs of producing the power they supply or (2) condition suppliers' continued use of market-based rates on the implementation of mitigation measures that the Commission confidently can conclude will be *effective* to prevent the exercise of market power and ensure that *all* wholesale charges are just and reasonable in all hours of all days.[8]

In the June 19 Order, the Commission implemented a comprehensive program for both California and the rest of the WSCC, noting that "[b]ecause these markets are integrated, the mitigation proposal must establish the same prices for all markets in order to prevent arbitrage." June 19 Order, 95 FERC at 62,556. The Commission recognized that its plan was designed to provide "breathing room for the markets to right themselves." *Id*. As the ISO stated in its November 9, 2001 comments in this docket, "[w]hile California avoided disaster in Summer 2001, the fundamental conditions leading to the need for west-wide

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> the identity between the 'true' and the 'actual' market price." *FPC v. Texaco*, 417 U.S. at 399, 94 S.Ct. At 2327. In fact, FERC's "'regulation' by such novel 'standards' is worse than an exemption simpliciter. Such an approach retains the false illusion that a government agency is keeping watch over rates, pursuant to the statute's mandate, when it is in fact doing no such thing." *Texaco v. FPC*, 474 F.2d at 422.

Farmers Union, 734 F. 2d at 1510. *See also*, *Tejas Power Corp. v. FERC*, 908 F.2d 998 at 1005 (D.C. Cir., 1990) (where the Commission's acceptance of a settlement was overturned in the absence of "substantial evidence upon the basis of which the Commission could conclude that market forces will keep Texas Eastern's prices in reasonable check"). In *Entergy Services, Inc.,* 58 FERC ¶ 61,234 (1992), *rev'd on other grounds sub nom., Cajun Elec. Power Co-op, Inc. v. FERC*, 28 F.3d 173 (D.C. Cir. 1994), in granting market-based rate authority, the Commission not only noted that non-traditional rates must be within the "zone of reasonableness," but also that, under *Farmers Union*, a departure from cost-based rates required that "the regulatory scheme act[ ] as monitor to determine whether competition will drive prices to a zone of reasonableness *or to check rates if it does not*." *Entergy Services, Inc.,* 58 FERC at 61,752 (emphasis added).

8 *See Farmers Union,* 734 F.2d at 1510.

mitigation have not improved to the point where the mitigation can be relaxed."[9] The Commission has not presented appropriate justification for its modification of the June 19 Order.

B. There Is No Support in the Record for the Increase in the Price Limit

The price limit of $92/MWh was set based on the price during Hour Ending 1000 on May 31, 2001. At that time, natural gas prices were approximately 144% higher than current prices[10]. If the ISO were to recalculate the price limit today, the price limit would be approximately $44/MWh. Thus, the $92/MWh value already has the potential to significantly overstate suppliers' current operating costs.

The Commission states that "there is no evidence in the record indicating that the current methodology is affecting investment decisions" and that "[t]o the contrary, we note that the market price for sales in the spot markets at the major western trading hubs has consistently been well below the current mitigated price." December 19 Order, slip op at 9. Accordingly, there is no support in the record for a higher price limit.

While the courts have recognized that encouragement of new supply is a permissible objective for the Commission to pursue, the rates *must not be more than is needed for the purpose*:

> While as we have indicated the Commission may be empowered to consider some of these factors *it must also, and always, relate its*

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[9] See ISO comments at 2.

[10] The proxy figure for natural gas costs for January 2002 is $2.72/MMBtu. The proxy figure for natural gas costs establishing the $108/MWh mitigated price is $6.64/MMBtu.

> *action to the primary aim of the Act to guard the consumer against excessive rates*. If the Commission contemplates increasing rates for the purpose of encouraging exploration and development . . . it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose.

City of Detroit v. Federal Power Com'n, 230 F.2d 810, 817 (1955) (emphasis added). The court affirmed this determination in *Farmers Union*, criticizing the Commission for failing to "even attempt to calibrate the relationship between increased rates and the attraction of new capital." *Farmers Union Cent. Exchange v. FERC*, 734 at 1502-03.

Given that current prices "are not affecting investment decisions" there is no basis for the Commission to find that a higher price limit is necessary at this juncture. The $108/MWh value presents a risk, as noted by Commissioner Massey, that if shortages occur, suppliers could drive prices up to a level "which under current conditions is probably a multiple of their current costs." December 19 Order, slip op at 12.

C. The December 19 Order Presents an Unreasonable, Asymmetrical Risk to Consumers

The December 19 Order permits an increase in the $108/MWh price limit if natural gas prices increase above a specified threshold. December 19 Order, slip op at 8-9. There is, however, no corresponding decrease if natural gas prices decline.

With the substantial decrease in natural gas prices noted above, it is unlikely that there will be an increase in the $108/MWh price limit. Nevertheless, the asymmetrical risk the order places on consumers is inappropriate. If suppliers are to be protected from significant increases in fuel costs, consumers should be protected from excessive rates based on outdated assumptions if fuel costs decline. Such an approach is consistent with the Commission's historic treatment of fuel adjustment clauses. 18 C.F.R. § 35.14; *See for example*, *New England Power Company*, 48 FPC 899, 921, *reh'g denied*, 48 FPC 1547 (1972) (the philosophy underlying the design of fuel adjustment clauses is to increase or decrease the charge to customers by an amount reflecting the actual increase or decrease in the cost of fuel).

Moreover, the Commission's mitigation methodology permits individual suppliers to justify costs above the generally-applicable price limit. Given this additional protection, the one-sided treatment of fuel costs is unjust and unreasonable.

IV. CONCLUSION

Wherefore, for the reasons discussed above, the ISO respectfully requests that the Commission revoke the December 19 Order and return to the price mitigation methodology of the June 19 Order.

Respectfully submitted,

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Dated: January 18, 2002

CALIFORNIA ISO

California Independent
System Operator

January 18, 2002

The Honorable Linwood A. Watson, Jr.
Acting Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

Re: Investigation of Wholesale Rates of Public Utility Sellers and Ancillary Services in the Western Systems Coordinating Council Docket No. EL01-68-000

Dear Secretary Watson:

Enclosed for electronic filing please find a Request for Rehearing of the California Independent System Operator Corporation in the above-referenced docket.

Thank you for your assistance in this matter.

Respectfully submitted,

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CERTIFICATE OF SERVICE

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

Dated at Folsom, California, on this 18th day of January, 2002.

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