

UNITED STATES OF AMERICA 85 FERC - 61,123
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: James J. Hoecker, Chairman;
Vicky A. Bailey, William L. Massey,
Linda Breathitt, and Curt H,bert, Jr.

AES Redondo Beach, L.L.C.	)	Docket Nos. ER98-2843-001
	)	and ER98-2843-002
AES Huntington Beach, L.L.C.	)	Docket Nos. ER98-2844-001
	)	and ER98-2844-002
AES Alamitos, L.L.C.	)	Docket Nos. ER98-2883-001
	)	and ER98-2883-002
	)	(Not Consolidated)
El Segundo Power, LLC	)	Docket Nos. ER98-2971-001
	)	and ER98-2971-002
Long Beach Generation, LLC	)	Docket Nos. ER98-2972-001
	)	and ER98-2972-002
	)	(Not Consolidated)
Ocean Vista Power Generation, L.L.C.)	
Mountain Vista Power Generation, L.L.C.)	
Alta Power Generation, L.L.C.)	
Oeste Power Generation, L.L.C.	)	Docket Nos. ER98-2977-001
Ormond Beach Power Generation, L.L.C.	)	and ER98-2977-002
Williams Energy Services Company	)	Docket No. ER98-3106-001
Duke Energy Oakland, L.L.C.	)	Docket No. ER98-3416-001
Duke Energy Morro Bay, L.L.C.	)	Docket No. ER98-3417-001
Duke Energy Moss Landing, L.L.C.	)	Docket No. ER98-3418-001
	)	(Not Consolidated)
Southern California Edison Company	)	Docket No. EL98-62-000

ORDER ON REHEARING, GRANTING CLARIFICATION,
ESTABLISHING FURTHER PROCEDURES, PROVIDING
GUIDANCE AND DISMISSING COMPLAINT

(Issued October 28, 1998)

In this order, we address the requests for rehearing of several orders authorizing market-based rates for Ancillary Services, and the Commission's July 17, 1998 Order, motions for clarification, and market surveillance reports filed in the above-captioned proceedings. As discussed below, we will authorize market-based rates for all sellers of Ancillary

Services and Replacement Reserve services within California,

extend the interim authority of the California Independent System Operator Corporation (ISO) to limit the prices it will pay for Ancillary Services, and direct the ISO to submit a proposal for redesigning the Ancillary Services markets. In addition, we dismiss SoCal Edison's complaint in Docket No. EL98-62-000.

Background

June 30 and July 10 Orders

On June 30, 1998, the Commission accepted for filing without suspension or hearing, the proposed market-based rates for certain Ancillary Services filed by AES Redondo Beach, L.L.C., AES Alamitos, L.L.C., and AES Huntington Beach, L.L.C. (collectively, AES Companies) (the June 30 Order). 1/

On July 10, 1998, the Commission issued two orders accepting for filing, without suspension or hearing, the proposed market-based rates for certain Ancillary Services filed by Long Beach Generation, LLC (Long Beach) and El Segundo Power, LLC (El Segundo); 2/ and Ocean Vista Power Generation, L.L.C., Mountain Vista Power Generation, L.L.C., Alta Power Generation, L.L.C., Oeste Power Generation, L.L.C., and Ormond Beach Power Generation, L.L.C. 3/ (collectively, the July 10 Orders).

In each order, we reviewed the relevant product market for each Ancillary Service and the relevant geographic market and found that the applicants' market shares for Regulation, Spinning Reserve and Non-Spinning Reserve would not exceed levels we previously found acceptable in the context of wholesale power. We stated that Replacement Reserve is not an Ancillary Service under Order No. 888 4/, and that authorizing market-based rates

- 1/ AES Redondo Beach, L.L.C., et al., 83 FERC - 61,358 (1998).
- 2/ Long Beach Generation, L.L.C. et al., 84 FERC - 61,011 (1998).
- 3/ Ocean Vista Power Generation, L.L.C., et al., 84 FERC - 61,013 (1998). The five applicants are affiliates of Houston Industries Power Generation, Inc. (HIPG), and for convenience will be referred to as HIPG Affiliates.
- 4/ Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Order No. 888, 61 Fed. Reg. 21,540 (1996), FERC Stats. & Regs. - 31,036 (1996), order on reh'g, Order No. 888-A, 62 Fed. Reg. 12,274 (1997), FERC Stats.

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for Replacement Reserve separately was not required. We explained that applicants may sell Replacement Reserve under their previously-authorized market-based rates.

In these orders, we also rejected the ISO's request for additional studies reflecting time-differentiated data. We recognized that, at that time, no data existed to use for such a study. We considered the ISO's and other parties' concerns about thin markets, but believed that the proposed remedy, i.e., price caps, would be counter-productive, because it would serve to further reduce the available supply of Ancillary Services.

ISO and SoCal Edison Filings

On July 13, 1998, as corrected on July 16, 1998, the ISO filed an Emergency Motion for Stay, Notice of Action Taken, Request for Rehearing, and Motion for Clarification of the Commission's June 30 and July 10 Orders. Also on July 13, 1998, SoCal Edison filed an Emergency Request for a Stay, Complaint Requesting Suspension of Market-Based Pricing for Ancillary Services and Replacement Reserves, and Request for Rehearing.

The ISO and SoCal Edison stated that, subsequent to the Commission's June 30 and July 10 Orders, the ISO witnessed dramatic spikes in the price for Replacement Reserve capacity. Specifically, during the first two weeks of July 1998, the ISO experienced prices for Replacement Reserves as high as \$5,000 for some hours and as high as \$9,999 in several other hours. The ISO also was concerned about the potential for dramatic price spikes in the three Ancillary Services markets.

Similarly, SoCal Edison contended that there was insufficient supply to permit market-based pricing for Ancillary Services, asserting that the price spikes were the result of market power caused by thinness in the Ancillary Services and Replacement Reserve markets. SoCal Edison contended that only 3400 MW of generation was available for Ancillary Services in the Southern Zone, a level that was barely above the ISO's recent demands for Ancillary Services. SoCal Edison argued that this condition left every seller with market power. SoCal Edison also agreed with the ISO that the problem was not limited to the Replacement Reserves market and was concerned that the problems would be exacerbated during the summer peak period.

Pending Commission action on the ISO's motions, the ISO capped the prices that it would pay to bidders with market-based

4/ (...continued)

& Regs. - 31,048 (1997), order on reh'g, Order No. 888-B,

81 FERC - 61,248 (1997), order on reh'g, Order No. 888-C,
82 FERC - 61,046 (1998).

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rate authority at \$500/MW. The ISO stated that its market surveillance committee would monitor market performances and, if bidding conditions indicated that an adjustment in this level is appropriate, the ISO would take action and would notify the Commission and the market participants at the earliest practicable time. 5/ The ISO also notified all market participants of this procedure on its electronic bulletin board (WENet).

The ISO and SoCal Edison requested a stay of the Commission's June 30 and July 10 Orders until their concerns about the Commission's classification of Replacement Reserves could be addressed and until the Commission could consider a time-differentiated market-power study for the Ancillary Services.

If the Commission declined to stay its orders, the ISO requested the Commission to authorize it to cap all bids above a specified level, as described above. SoCal Edison alternatively requested the Commission to initiate a complaint proceeding under section 206 of the Federal Power Act (FPA), 16 U.S.C. 824e (1994), and immediately suspend market-based pricing authority for Ancillary Services and Replacement Reserves in the California ISO markets. In addition, the ISO requested clarification as to whether the Commission intended that the ISO pay all sellers the market clearing price for Replacement Reserves.

The ISO and SoCal Edison raise basically the same issues in their requests for rehearing. First, they both contend that the Commission erred in finding that Replacement Reserve is not an Ancillary Service. While the ISO acknowledges that Replacement Reserve is not specifically enumerated in Order No. 888, it asserts that the nature of the service that it represents is included. 6/ Both parties argue that, regardless whether Replacement Reserve is an Ancillary Service, an applicant must conduct a separate market analysis and be able to demonstrate a lack of market power. 7/

Second, they argue that the Commission should not have authorized market-based rates for Ancillary Services. SoCal Edison states that there is insufficient supply of Ancillary Services to permit market-based pricing, and faults the applicants' market analyses for counting the capacity from each

5/ On July 24, 1998, the ISO lowered the cap to \$250/MW.

6/ ISO at 20.

7/ SoCal Edison at 13, ISO at 24, 31-33.

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generating unit up to five times. 8/ The ISO repeats the argument that the applicants must conduct a time-differentiated study. The ISO contends that, since the Ancillary Services auction is conducted on an hourly basis, "[e]ach and every hour constitutes a separate market." 9/

Finally, if market-based rates are permitted without a time-differentiated study, then the ISO asserts that it should be permitted to cap bids. 10/

Additional Filings

On July 14, 1998, the California Electricity Oversight Board (Oversight Board) and the California Commission filed in support of the ISO's July 13, 1998 filing. In addition, on July 14, 1998, SoCal Edison filed an answer opposing the ISO's proposed \$500 cap, contending that that level was too high and would result in excessive prices to the severe detriment of SoCal Edison and other buyers. SoCal Edison preferred adoption of an interim price cap based on each supplier's cost.

On July 16, 1998, as supplemented on July 30, 1998, San Diego Gas & Electric Company (SDG&E) filed a Request for Rehearing and Answer in Support of the Motions for Stay, noting that the \$500/MW price levels for certain hours in the Southern Zone on July 14, 1998 were astronomical in comparison with the price for the Northern Zone during those hours of less than \$8/MW. SDG&E reiterated others' arguments that the Commission erred in deciding that Replacement Reserve is not an Ancillary Service and in authorizing sales of Replacement Reserve and other Ancillary Services at market-based rates. In its supplemental filing, SDG&E asserted that, if the Commission decides that the original approval of market-based rates was in error, the Commission should provide for a refund or restitution to the ISO.

On July 30 and August 10, 1998, the Metropolitan Water District of Southern California (Metropolitan) filed requests for rehearing of our June 30 and July 10 Orders, respectively. Metropolitan argued that the Commission erred in determining that Replacement Reserve does not constitute an Ancillary Service and in deciding that approval of market-based rates for Replacement Reserve was granted in the approval of the prior applications for

8/ SoCal Edison at 6.

9/ ISO at 27.

10/ ISO at 33-37.

market-based rates for energy. 11/ Metropolitan asserted that our finding Replacement Reserve not to be an Ancillary Service is inconsistent with previous orders in the California restructuring proceedings and with Order No. 888, and argued that Replacement Reserve service is substantially different from energy service.

Order of July 17, 1998 and Subsequent Filings

On July 17, 1998, the Commission issued an Order Denying Motions for Stay, Authorizing the ISO to Take Interim Action, Requiring Market Monitoring Reports, and Providing Opportunity to Comment. 12/ In that order, the Commission determined that further fact finding was necessary. To assist in its fact finding, the Commission directed the Market Surveillance Committee of the ISO (MSC) and the Market Monitoring Committee of the California Power Exchange (MMC) to conduct independent studies of the bidding behaviors and structural characteristics of the markets that they administer, and to identify the causes of the market concerns raised in the pleadings. Furthermore, the Commission authorized the ISO to reject bids in excess of whatever price levels it believes are appropriate for Regulation, Spinning Reserve, Non-Spinning Reserve, and Replacement Reserve.

Numerous intervenors filed timely motions to intervene, comments, and/or protests in these proceedings, as listed in Appendix A. In addition, an untimely notice of intervention and untimely motions to intervene were filed by the California Commission, the Oversight Board, and Public Service Resources Corp. (PSRC).

While several parties, including the California Commission and the Oversight Board, support the Commission's July 17, 1998 Order, generators such as AES/Williams and Duke, as well as the Electric Power Supply Association (EPSA) oppose the price capping authority on procedural and substantive grounds. These parties contend that the price spikes were not caused by abuse or exercise of market power, but by an immature market that has some structural weaknesses. In addition, AES/Williams request clarification that the Commission's July 17, 1998 Order authorized the ISO to reject bids that are above its purchase cap for these services, rather than to accept bids that are above the cap, but to pay no more than the stated level of the purchase cap.

Metropolitan and SoCal Edison contend that the ISO's price capping authority is insufficient, because the markets are not

11/ Metropolitan at 3-4.

12/ California Independent System Operator Corporation, 84 FERC - 61,046 (1998) (July 17, 1998 Order).

workably competitive. These parties request that the Commission rescind the market-based rate authority in these proceedings until the markets are demonstrated to be workably competitive.

Several parties such as the Northern California Power Agency (NCPA) commented that the Commission should eliminate barriers to municipal utilities providing Ancillary Services under existing contracts, by requiring modifications to the Responsible Participating Owner Agreements (RPTA). Pacific Gas and Electric Company (PG&E) commented that negotiations in the ongoing RPTA proceedings will address these concerns.

On August 7, 1998, El Segundo and Long Beach filed a request for rehearing of the Commission's July 17, 1998 Order allowing the ISO to cap the prices at which it will purchase Ancillary Services and Replacement Reserves. El Segundo and Long Beach argue that the Commission's July 17, 1998 Order is contrary to law because the Commission has no authority to delegate ratemaking to the ISO; that the Commission cannot suspend rates that have been accepted; that the Commission should have allowed those affected to respond or comment to the ISO motion before acting; and that the ISO has no FPA section 205 right to unilaterally and without FERC approval change the price in another party's rate schedule.

El Segundo and Long Beach also contend that the capping authorization in the July 17, 1998 Order is inconsistent with the ISO tariff, prior Commission orders rejecting ISO proposals to cap prices, the premise of the California Restructuring Legislation, the California Commission's previous request to allow one year of experience to examine the net impact of pricing peaks and valleys, and the Commission's holding in a recent order directing certain owners to recover their acquisition premium from the market. 13/ Thus, they argue that the capping authority contained in the July 17, 1998 Order does not let competition work and is unfair to generators. Houston Industries Power Generation, Inc. (HIPG) seeks reconsideration of the July 17, 1998 order on similar grounds.

July 24 and August 17 Orders and Requests for Rehearing

On July 24, 1998, the Commission accepted for filing, without suspension or hearing, the proposed market-based rates for certain Ancillary Services filed by Williams Energy Services Company. 14/ Subsequently, on August 17, 1998, the Commission

13/ Duke Energy Moss Landing, LLC, et al, 83 FERC - 61,318 (1998) (reh'g pending) (Duke Moss Landing).

14/ Williams Energy Services Company, 84 FERC - 61,072 (1998)

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accepted for filing, without suspension or hearing, the proposed market-based rates for certain Ancillary Services filed by Duke Energy Oakland, L.L.C. (Oakland), Duke Energy Morro Bay, L.L.C. (Morro Bay), and Duke Energy Moss Landing, L.L.C. (Moss Landing).^{15/} In these orders, we acknowledged the volatile conditions in the California Ancillary Services and Replacement Reserves markets but explained that, until we had a clearer understanding of the situation, we would continue the existing policy regarding the circumstances when market-based rates are appropriate.

On August 21, 1998, SoCal Edison filed a request for rehearing of Williams raising substantially the same arguments that were raised in its filing of July 13, 1998.^{16/} SoCal Edison raised the same issues in its request for rehearing of Duke Energy filed on September 15, 1998.

The ISO filed requests for rehearing of Williams and Duke Energy on August 24 and September 16, 1998, respectively. While the ISO acknowledges the interim authority to limit the price it is willing to pay for Ancillary Services granted it in the July 17, 1998 Order, it remains concerned that that authority is only temporary.

On September 16, 1998, Metropolitan filed a request for rehearing of Duke Energy. On July 31, 1998, the Oversight Board filed a motion to intervene out of time in the Williams proceeding, raising no substantive issues.

ISO and PX Committee Reports

On August 17 and 19, 1998, the PX Market Monitoring Committee (MMC) and ISO Market Surveillance Committee (MSC), respectively, filed reports as directed by the July 17, 1998 Order.

The ISO MSC's Preliminary Report on the Operation of the Ancillary Services Markets of the ISO describes the auction process used to procure Ancillary Services. An important feature of the process is that the markets clear sequentially, with Regulation first, followed by Spinning Reserves, Non-Spinning

14/ (...continued)
(Williams).

15/ Duke Energy Oakland, L.L.C., et al., 84 FERC - 61,186 (1998)
(Duke Energy).

16/ SoCal Edison filed a motion to intervene and protest out-of-time on July 21, 1998, three days before the Commission issued the Williams order. For good cause shown, we will

grant this motion.

Reserves, and Replacement Reserves. Capacity that wins a previous auction is subtracted out from the capacity that is bid into the subsequent markets. The MSC also points out that suppliers are paid the imbalance energy price for any energy they actually provide, in addition to the capacity payment that results from the auction, with the exception of Regulation energy, suppliers of which earn the Regulation Energy Payment Adjustment.

The MSC based its analysis on several assumptions, including that there is a hierarchy among Ancillary Services (Regulation being superior, then Spinning and Non-Spinning Reserves, and Replacement Reserves being inferior) and that prices should be lower for inferior services. The MSC believes that under "ideal circumstances," 17/ it would expect prices to equilibrate so that firms would earn similar variable profit regardless which market is bid into, and that if there were little or no market power in the PX or imbalance energy markets then it would expect little or no market power to exist in the Ancillary Services markets.

To assess the performance of the markets, the MSC analyzed bid prices, quantities and bid sufficiencies north and south of Path 15 in the four markets, broken down into three time periods. Over the entire period of time, it observed a tremendous amount of price volatility in the markets, although very little activity in the (intermediate) \$50 to \$150 price range. There was little variation in demand except for Regulation reserve. Bid sufficiency's demonstrated much variation, and this increased substantially after the purchase cap was in place (July 14 - 31), particularly for Replacement Reserve. The MSC also analyzed bidding behavior by owners of generating capacity. The Report noted withholding of capacity by market participants beginning on July 8, when the price for Replacement Reserves began to rise considerably. The MSC found that for almost all hours when the price for Replacement Reserves hit the purchase cap, there was a simultaneous trough in the total hourly amount bid by all sectors of market participants.

The MSC concluded that the markets for Ancillary Services and Replacement Reserves have not been functioning as competitively as the ones for electrical energy and identified nine major factors that have limited competition. These factors are summarized below.

Some suppliers can receive market-based rates for Ancillary Services, while others are subject to cost-based rate caps. Cost-based suppliers have no incentive to bring additional supply to the Ancillary Service markets during periods of

17/ See MSC Report at 7.

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high demand as they can earn more by diverting all of their supply to the market-based energy market.

The demand for Ancillary Services is higher than anticipated; the ISO has been purchasing more than had been used to support the California electric systems in the past.

The amount of each Ancillary Service that the ISO purchases does not vary in response to the market-clearing price, and the ISO has limited ability to substitute between services in procuring its system reliability capacity needs. This is due, in part, to the design of the markets which places fairly rigid standards on the ISO and does not allow for substitution between services or for negotiation of contractual protections against price risk. In turn, bidders know with some certainty how much of each service the ISO will need to acquire. While this might not be detrimental in the face of robust supply, it permits price manipulation when supply is thin.

The pricing reflected in the Reliability Must-Run (RMR) agreements creates perverse incentives for bidding into the Ancillary Services market. Suppliers can often earn more by not bidding in the market and waiting to be called upon to provide Ancillary Services under the RMR agreements, and it may not be difficult for these suppliers to predict when the ISO will need to call on RMR services.

Ancillary Services have been purchased on a zonal basis, based on the division of the state-wide market into two smaller zones, sometimes in the face of constraints and at other times when there are no constraints.

Dispatch and settlement practices for the provision of imbalance energy are ambiguous. Also, in choosing the reserve supplier to dispatch when energy is to be called upon, the ISO does not have a means of discriminating among reserve suppliers on the basis of relative cost. Thus, suppliers cannot predict whether and to what extent they might be called upon to provide energy and whether the energy price is likely to cover their costs.

A flaw in the allocation of Ancillary Service costs among scheduling coordinators creates an incentive to under-schedule and escape Ancillary Service costs on the unscheduled energy deliveries.

Suppliers from outside of the ISO control area were excluded from supplying Ancillary Services. 18/

Limitations of the ISO's software have exacerbated these problems.

The PX MMC's report focused on the PX market but discussed the ISO markets to the degree they have an impact on the PX market. A fundamental interrelation described in the reports is that "capacity available for the ISO and PX markets comes from the same generating capacity, so that capacity sold in one market means less capacity that can be sold in other markets, thereby driving up prices in the latter." 19/ This led the MMC to expect a close relationship among prices in the different markets.

The MMC concluded that the PX day-ahead and hour-ahead markets are functioning properly, although it noted a steep price increase as market clearing quantities exceeded 30,000 MWh. Examining the behavior of market participants, the MMC found that most did not behave like perfect price takers. The key participants almost never bid their entire generating capacity into the PX market, and they often bid capacity at prices well above their marginal generating cost. The MMC identified five possible explanations for withholding capacity but, due to incomplete data, was not able to draw firm conclusions about participants' motivations. Nevertheless, the MMC concluded that a very small number of firms had the effective ability to determine the prices when demand was high; they saw evidence that, at times, the energy markets are "thin and not fully competitive." 20/

Examining the interactions between the PX and ISO markets, the MMC observed wide price variations among markets and over time. Their analysis did not find support for the hypothesis that price spikes in the Ancillary Services markets were caused by widespread withholding of capacity from Ancillary Services markets to shift capacity to the PX market. The MMC observed much higher prices in the Ancillary Services markets, which are theoretically call options and normally would be priced lower than the underlying commodity (energy). The MMC would have expected prices to equilibrate across markets but significant profit differentials remained, leading it to conclude that the

18/ This has been changed as of August 5, 1998. See California Independent System Operator Corporation, 85 FERC - 61,061 (1998).

19/ PX MMC Report at 3.

20/ Id. at 19.

markets for Ancillary Services are not in equilibrium with the energy market.

The MMC report concludes that structural adjustments to the Ancillary Services markets are called for, the principal solution being the entry of new units and new participants into the markets. In addition, the Report proposes certain demand-side improvements.

The two committees reached very similar recommendations to address the observed market problems. Both proposed that the Commission authorize market-based rates for all suppliers, while continuing in effect the ISO's authority to reject bids that are too high, and both recommended changing the market design to permit more flexible buying practices. This latter, "rational buyer," concept, would permit the ISO to substitute one service for another on the basis of cost where either service would physically satisfy the needs of ISO operations. The MSC added that ISO buying protocols must be transparent to market participants so that they are able to accurately predict revenues from particular bidding strategies. Both committees also thought that revised RMR protocols and rates could eliminate incentives to withhold capacity from the market in order to be called under the RMR Agreement at higher prices. One possible modification proposed by the MSC would be "to treat the RMR contract as a reliability insurance policy." 21/

In addition, the MSC recommended that the ISO always purchase Ancillary Services through a state-wide auction, eliminating the potential for zone-specific, locational market power. If the state-wide market-clearing price produced more services in one zone and less in the other, then the MSC believed that RMR contracts could be used to make up any shortfall. 22/ Finally, the MSC suggested that the ISO revise its scheduling and/or energy imbalance protocols to help reduce the need for Regulation capacity.

Comments in Response to the ISO Market Surveillance Committee's Report and the PX Market Monitoring Committee's Report

The ISO concurs with most of the analysis and recommendations contained in the MSC and MMC reports. The ISO requests that the Commission confirm and extend the ISO's discretion to establish purchase price caps for Ancillary Services until such time as Ancillary Services markets are demonstrably functioning in a workably competitive manner, permit

21/ MSC Report at 44.

22/ Id. at 48.

the ISO to retain its central role as sponsor and facilitator of the Ancillary Services redesign process, and endorse the following objectives:

- * Protecting consumers from excessive prices when markets are not competitive, through means such as the price caps, self-provision of Ancillary Services, contracts for differences, long-term supply contracts, or interruptible contracts;
- * Eliminating the cost-based rate caps on individual generators to encourage sufficient competitive supplies of Ancillary Services;
- * Ensuring that the price caps do not inhibit investments in new capacity;
- * Ensuring that the price caps do not bias market choices, but rather promote equilibration between markets; and
- * Promoting rational purchase of various Ancillary Services products, such that superior services can substitute for inferior services when the prices for inferior services are higher.

The ISO opposes the MSC's recommendations regarding the structure of the RMR Agreements, the MSC's recommendation to use RMR Agreements as local supply in the presence of congestion, and using a statewide auction for all Ancillary Services. The ISO is concerned that the proposal to restructure the RMR Agreements would derail ongoing negotiations, and that the proposal to use the RMR Agreements in the presence of congestion, if implemented, would expand the use of RMR units beyond their stated purpose of ensuring System Reliability and stability, away from a market-first paradigm.

For the most part, the commenters agree with the ISO, endorsing most of the recommendations contained in the MSC and MMC reports for structural changes in the Ancillary Services and Replacement Reserve markets, such as the suggestion that the ISO adopt a "rational buyer" strategy, and that software changes be implemented promptly. 23/ In addition to the MSC and MMC proposals, several parties also recommend that structural reforms also facilitate self-supply options. 24/ BPA recommends that the ISO help increase supplies by lifting the 25% restriction on supplies from outside the control area and that the ISO be

23/ Oversight Board at 2-3; California Commission at 5,9; PG&E at 7; Duke at 5-7; AES/Williams at 8; Bonneville Power Administration (BPA) at 2-3; and Sacramento Municipal Utility District (SMUD) at 3-5.

24/ PG&E at 6 and Enron Power Marketing, Inc. (Enron) at 6-7.

required to provide better information to all market participants. 25/

Most parties believe that market-based rate authority should be maintained and expanded to include all suppliers, to ensure an adequate supply of Ancillary Services. 26/ For example, the Oversight Board supports exploration of mitigation mechanisms, such as an indexed cap, that would allow broad participation in these markets by entities that have thus far been precluded.

However, SoCal Edison continues to argue that market-based rates should be rescinded because the markets are not competitive. 27/ SoCal Edison argues that the Commission should order refunds to the extent that the charges for Ancillary Services and Replacement Reserves under the market-based tariffs exceed just and reasonable levels. 28/ SoCal Edison recommends that a single price cap, based on the opportunity costs of diverting supply to the energy market, apply to all sellers. Metropolitan recommends that the Commission authorize individual entities to sell Ancillary Services at market-based rates only during periods in which markets are demonstrably competitive. 29/ SMUD recommends that any decision to extend market-based rates to all market participants must be supported by a market analysis, together with a market power mitigation plan for any sellers that have market power. In addition, SMUD contends that an appropriate price cap should be maintained if market-based rates are extended. 30/

While the Oversight Board, the California Commission, SDG&E, PG&E, SoCal Edison, and most other parties agree with the reports that the ISO's authority to impose a purchase cap should be maintained in the interim, the ISO's purchase capping authority is opposed by generators such as Duke, AES/Williams, HIPG, El Segundo and Long Beach. The California Commission cautions that such authority should be retained only so long as is necessary and that the price cap should be set at a level that will not

25/ BPA at 2.

26/ See, e.g., Oversight Board at 5; PG&E at 4; AES/Williams at 6-8; Duke at 3-5; El Segundo and Long Beach at 19; and BPA at 2.

27/ SoCal Edison at 8-11. See also, Enron at 8.

28/ SoCal Edison at 15-19.

29/ Metropolitan at 10-11.

30/ SMUD at 7-9.

inhibit market entry. 31/ SMUD contends that the current cap of \$250 is arbitrary and fails to foster competition and has only a limited mitigating effect on market-power abuses, and BPA contends that the price cap should be tied to predetermined and demonstrable undersupply conditions. 32/

Many parties do not support the MSC recommendations regarding changing the use of RMR facilities or reforming the RMR Agreements in the near term. 33/ For example, the Oversight Board believes that RMR protocols and rates should be revised eventually, but that sufficient time should be allowed to ensure that this is done properly. The California Commission agrees with the ISO that the proposals to reform RMR Agreements and to move towards a non-zonal auction should not be adopted at this time. Several other parties noted that changes to the structure of the RMR agreements should not derail ongoing settlement discussions. However, SMUD believes that the MSC recommendations can be taken into account in the ongoing settlement discussions, and Metropolitan agrees with the MSC that RMR contracts require reformation. 34/ Several generators contend that the MSC recommendations were based on incorrect assumptions. 35/

Regarding the MSC's proposal to eliminate the zonal market approach, the Oversight Board is concerned as to how to achieve this design, and PG&E recommends that the Commission encourage the ISO to file a tariff amendment with supporting analysis to demonstrate consistency with reliability criteria, if the ISO wants to procure Ancillary Services and Replacement Reserves on a statewide basis. 36/ Other parties oppose such changes in the near term. 37/

With respect to recommended procedures to further address these issues, the ISO recommends an integrated approach to attaining workable competition in the Ancillary Services and

31/ California Commission at 7-9.

32/ BPA at 5.

33/ See, e.g., Duke at 7-9; El Segundo and Long Beach at 24-26; HIPG at 4, 10; Oversight Board at 4-5; and California Commission at 11.

34/ SMUD at 6-7; Metropolitan at 13.

35/ See, e.g., HIPG at 7-10.

36/ PG&E at 5.

37/ Oversight Board at 6-7; SMUD at 10; California Commission at 10-11; and BPA at 5-6.

Replacement Reserve markets, using a collaborative and

deliberative process that will solicit input from all interested parties and propose solutions by action of the ISO Governing Board. The ISO proposes a work plan to incorporate the MSC and MMC recommendations with initiatives already in progress. Under this plan, the ISO identifies actions currently in progress, which it expects to complete in 1998; short term proposals, which should be implemented within six to nine months; and options for long-term market redesign, with implementation likely to take one year or longer.

The California Commission supports the ISO's procedural proposal. It notes that some of the recommendations by the MSC and the MMC may require further analysis and discussion, and points out that a stakeholder process has already begun to implement most of these changes. 38/ The California Commission recommends continued oversight of these markets and further reports. Enron recommends that the Commission direct the ISO to convene a group of Scheduling Coordinators to submit a report to the Commission within thirty days, recommending solutions to the problems in the Ancillary Services market in California. 39/

Several parties recommend that further investigation be conducted regarding the ISO's actions and practices, such as the ISO's purchases of more Regulation service than has been needed in the past, 40/ ISO practices that limit or discourage participation in the markets, 41/ and the ISO's failure to abide by its Tariff. 42/ SoCal Edison recommends that the Commission investigate the MMC's concerns regarding the functioning of the PX Energy Market during high demand periods prior to removing the price cap on the imbalance energy market.

On October 4, 1998, the ISO filed an update of its progress in integrating the MMC and MSC recommendations with initiatives arising from its ongoing stakeholder process and work plan to improve the Ancillary Services markets. The ISO commits to file another update on the status of its Work Plan following the meeting of its Governing Board on October 22, 1998.

38/ See also, SMUD at 11.

39/ Enron at 9.

40/ Oversight Board at 6-7; California Commission at 10; Enron at 4; HIPG at 6; and SMUD at 11.

41/ Enron at 7-8; El Segundo and Long Beach Response at 5.

42/ Enron at 5; HIPG at 15-16.

Discussion

Procedural Matters

Pursuant to Rule 214 of the Commission's Rules of Practice

and Procedure, 18 C.F.R. 385.214 (1998), the timely, unopposed motions to intervene serve to make the entities listed in Appendix A parties to the proceeding(s) in which they sought intervention, to the extent they were not already parties to any underlying proceeding(s). 43/

We will grant the Oversight Board's and SoCal Edison's motions to intervene out-of-time and accept SoCal Edison's untimely protest in Docket No. ER98-3106-000. Given these parties' earlier involvement in the related proceedings, no party will be prejudiced by allowing the late motions to intervene in this docket. In addition, we will grant the Oversight Board's and the California Commission's untimely motion to intervene and untimely notice of intervention. For good cause shown, we will also accept the late-filed comments on the Committee Reports submitted by the ISO, Metropolitan, the California Commission, and SMUD.

Factors Relating to Rate Treatments

There is a general consensus that Ancillary Service supply is being influenced by the rate treatments afforded different suppliers for Ancillary Services and energy, both of which rely on the same generation resource base. Currently, some suppliers have market-based rates for energy sales, but are restricted to cost-based rates for Ancillary Services. These sellers have no incentive to divert supply to Ancillary Services when the revenues they can earn through market-based energy sales are higher than those they can earn through the cost-based Ancillary Service markets. In turn, this reduces total supply bid into the Ancillary Services markets, potentially causing the market clearing price to be higher than it would be if these disincentives did not exist.

43/ On September 14, 1998, Public Service Resources Corporation (PSRC) filed a motion to intervene in the Duke Energy proceeding, raising no substantive issues. PSRC already was a party to the proceeding by virtue of its timely, unopposed motions to intervene filed on July 7, 1998, as stated in that order. Accordingly, we need not address the second

motion to intervene. In addition, on September 8, 1998, PSRC filed another motion to intervene in the proceedings addressed in the June 30 and July 10 Orders, to which PSRC was already a party of record. Likewise, we need not address this pleading.

This is a phenomenon that we have not seen before. However, there are circumstances presented here that set the stage for this to happen. Traditionally, the transmission provider has been a vertically integrated utility which owns the generating resources that are used to provide both energy and Ancillary Services and which has no option to divert generating resources used to provide Ancillary Services to energy sales, even if the energy sales are more profitable, because the transmission provider must ensure that the Ancillary Service needs of its transmission system are met.

Here, the owners of the generating resources have no obligation to participate in one market over the other and will be guided solely by the economic consequences of their choices. 44/ However, generation owners that are also load-serving entities may have an incentive to bid defensively to supply into Ancillary Service markets under lower cost-based rates in order to minimize the cost of the Ancillary Services that they must purchase. The ISO MSC's report concludes that the three IOUs' bids have been consistent with this defensive bidding strategy. 45/ However, the ability to fully implement a defensive bidding strategy may have been hindered by limited information to predict the periods when the Ancillary Service prices would be high enough to warrant a defensive bidding strategy. With the benefit of hindsight, it is clear that, when evaluating market-based rates where the transmission provider procures its Ancillary Services through a market structure, we must consider the energy markets and Ancillary Service markets in tandem. 46/

Given these conclusions, there is a general consensus among the parties that a return to cost-based rates for all Ancillary Services is not the answer because it simply further reduces the supply. Most parties concede that the remedy for this problem is a mechanism that releases all generators from their cost-based

44/ Certain generators have an obligation to provide Ancillary Services to the ISO by contract. These contracts are referred to as Reliability Must-Run contracts. See June 30 Order, 83 FERC at 62,444.

45/ MSC Report at 24.

46/ In this instance, the initial application seeking market-based rates for Ancillary Services was filed in the same pleading as proposed market-based rates for energy services, but the application failed to include an appropriate market analysis for the Ancillary Service products. See Ocean Vista Power Generation, L.L.C., 82 FERC - 61,114 (1998). When faced with a similar situation in the future, it is our intention to consider market-based rates for energy and

Ancillary Services at the same time.

caps in some way. The parties disagree about how to do this. Some propose that the Commission allow increases above the cost-based rate up to a pre-determined level (e.g., 100 mills/kWh). Others, including the ISO MSC, propose that the Commission grant market-based rates for all Ancillary Services provided to the ISO or sold to ISO customers to satisfy the ISO's self-supply option. 47/ The ISO MSC concedes that there is one supplier, PG&E, that will have market shares for Ancillary Service capacity substantially above 20 percent. 48/ The ISO MSC concludes that two factors will constrain PG&E from using this supply position to raise Ancillary Service prices to above market prices: (1) the continuation of a purchase price cap and (2) the fact that PG&E is the largest consumer of Ancillary Services and, as a result of a retail price cap, PG&E cannot pass through to its customers excessive charges paid for Ancillary Services.

We agree with the ISO MSC's conclusion and have determined that the appropriate remedy here is two-fold. First, all Ancillary Services suppliers that have rate schedules on file under which they are authorized to sell energy at market-based rates to the ISO will be required to amend their rate schedules to add Ancillary Services. Second, we will allow the ISO to continue the purchase price cap which we previously authorized.

While our ultimate goal is to eliminate all reliance on price caps, some form of price constraint is needed until the market design flaws are corrected, as discussed below. Eliminating the low cost caps that have restricted supply will place all resources and suppliers on the same footing. We also agree that, notwithstanding PG&E's control of large amounts of supply for Regulation and Spinning Reserve services, PG&E currently has a greater incentive to depress Ancillary Service prices than to inflate them. Certainly, if PG&E were assured that it could sell more Ancillary Services than it will buy (making it a net seller), it would have an incentive to raise its bids in order to maximize its net Ancillary Service revenues (Ancillary Service revenues for sales to serve the total ISO load less Ancillary Service charges for PG&E's own loads). However,

47/ MSC Report at 45.

48/ The ISO MSC's data show that, even after the divestiture of some of its gas-fired generation capacity, PG&E will control about half of the 10 minute ramping capacity on the ISO system, making it a pivotal supplier for Regulation and Spinning Reserves. MSC Report at 45. Recently, the Commission approved an amendment to the ISO arrangements that allows generation resources with a 30 minute ramp rate to bid into these markets. The ISO MSC's data show that, with respect to these resources, PG&E's maximum market shares are 38 percent.

PG&E has no such assurance. The entity bidding the market clearing price is the last to be called upon to supply Ancillary Services, i.e., after all suppliers that bid lower are accepted. There are currently six other entities that control the other 62 percent of 30 minute ramping supply on the ISO system. 49/ If the other suppliers underbid PG&E's inflated offer, they will supply most of the Ancillary Services and enjoy the above market profits while PG&E, as a net buyer, incurs higher costs that cannot be passed through to its ratepayers.

We do not intend to minimize or oversimplify the concern that PG&E may have opportunities to influence the market clearing price because it controls a significant amount of the supply during some periods. However, we believe that, taken as a whole, there are deterrents and safeguards in place to prevent this, including the presence of six other suppliers that control the remaining half of the on-system supply, PG&E's own need to purchase substantial amounts of Ancillary Services, the continuation of the purchase price cap, and the fact that market redesign will be complete before the next summer peak period, as discussed below.

In addition, constraining the largest supplier to cost-based rates creates the potential for continued short supply and perpetuation of the market distortions we have seen. We expect that the ISO MSC will continue to monitor this situation and, in particular, PG&E's bidding behavior, and we emphasize that we expect the ISO to provide the ISO MSC with any necessary information needed to accomplish this task. 50/

49/ Also, the ISO has procedures in place to obtain up to 25% of its non-Regulation Ancillary Service needs from off-system suppliers. While the ISO's ability to utilize off-system resources to satisfy its Regulation needs may be limited, when the ISO turns to off-system supplies for services other than Regulation, more on-system supply is available to bid in the remaining Ancillary Services markets.

50/ The ISO MSC also suggests that, as a condition of granting market-based rate approval to other generators, we require them to enter into Contracts for Differences (CFDs). CFDs are financial contracts that would require these generation owners to effectively guarantee that the ISO could obtain specific amounts of generation services at specific prices. If the actual prices were higher, the generation owners would make up the difference and if the actual prices were lower, the ISO would pay the generation owners the difference. While CFDs and other financial instruments may become significant elements of competitive markets in the future, we are unwilling to impose such a requirement at a

(continued...)

In order to implement our decision to allow all suppliers of Ancillary Services to the ISO to sell under market-based rates, we shall direct jurisdictional suppliers that have not applied for market-based rates for Ancillary Services to file amendments to the rate schedules under which they sell energy at market-based rates, adding these additional market-based products. 51/ We will grant waiver of notice to permit these amendments to become effective for bids tendered on the Monday following issuance of this order for service to be provided the next day. The proposal to extend market-based rate authority to other suppliers has been before the Commission for more than 60 days, and this provides good cause for waiver of notice with respect to the filings we are directing herein. In order to assure that all market participants are aware of these changes and their timing, we direct the ISO to inform all potential suppliers and market participants through its normal communication procedures and announcements on its web site.

Based on the foregoing, we will deny the requests for rehearing of our underlying decisions to authorize market-based rates for Ancillary Services that were filed by the ISO, SoCal Edison, Metropolitan, and SDG&E. We will not require time-differentiated studies, as the ISO requests; although the Ancillary Services market is an hourly market, the measures discussed in this order should diffuse any participant's ability to influence the market clearing price during certain hours. 52/

Factors Relating to Market Design

The MSC Report identifies numerous factors limiting competition in the Ancillary Services markets that are related to the design of the Ancillary Services markets. All of the parties agree that some design changes are needed. The MSC and MMC Reports, the ISO and the Commenters provided numerous proposals

50/ (...continued)

time when there are remaining market design flaws to be corrected. For example, as the ISO MSC indicates, these types of instruments are useful when demand can be reasonably estimated, but a major market design flaw that has been identified is the reasonableness of the ISO's demand assessments. Our action here does not preclude consideration of CFDs as an element of the comprehensive market redesign.

51/ Of course, these market-based products do not include reactive supply and scheduling services, neither of which has been the subject of any market-based rate applications.

52/ Furthermore, we will dismiss SoCal Edison's complaint for the reasons discussed above.

suggesting ways to restructure these markets to address the deficiencies.

Although the MSC and MMC Reports provide a foundation for a comprehensive solution, we will decline at this time to impose any particular modifications. We believe that the best result will be achieved through the ongoing stakeholder process, as described by the ISO, which incorporates the views of all participants. Therefore, we will direct the ISO to facilitate a comprehensive, stakeholder process, designed to develop structural solutions to the market design problems outlined in the MSC and MMC Reports and any other market design problems identified in the stakeholder process, and to file a comprehensive proposal no later than March 1, 1999. The parties will be permitted to file comments on the proposal within thirty days thereafter.

We adopt this time frame after considering that the ISO and the other participants in the stakeholder process will require sufficient time to design a system that will function properly, that the Commission will need time to review the proposal, and that the ISO will require time to implement the changes before next summer. In addition, while we want to avoid piecemeal changes, we recognize that some proposed changes can and should be implemented sooner. Therefore, it would be appropriate for the ISO to make one interim filing to propose tariff amendments to effectuate short-term actions, such as those described in the ISO's October 2, 1998 Update.

We will reject Enron's recommendation that the Commission direct the ISO to convene a group of Scheduling Coordinators to submit a report to the Commission within thirty days, recommending solutions to the problems in the Ancillary Services market in California. That proposal would limit the process to Scheduling Coordinators. Given the short time frame in which the ISO and the parties must develop a comprehensive solution, we do not see the benefit of excluding other market participants from the process. Of course, Enron and other Scheduling Coordinators will have a full opportunity to participate in the stakeholder process that we order herein, and to comment on any proposal filed as a result of that process.

The Commission commends the MSC and MMC for their excellent reports. We found the reports to provide extremely useful preliminary analyses, particularly given the time constraints under which they were prepared. This is the type of activity we envisioned in our order of October 30, 1997 conditionally authorizing limited operation of the ISO and PX. 53/ Therefore,

53/ Pacific Gas & Electric Company, et al., 81 FERC - 61,122 at (continued...)

these Committees should continue this essential function of independent monitoring and investigation of the relevant markets, informing all stakeholders, the general public, the California Commission, and this Commission.

In addition, we direct the MSC and MMC to prepare final reports to further clarify the causes of the market anomalies identified in their initial reports no later than January 15, 1999. In this effort, the Committees are urged to explore the effectiveness of the existing market institutions at helping market participants choose between participating in the energy versus Ancillary Services markets. To ensure that the final reports are complete, we will direct the ISO and PX to provide their respective Committees with all of the information in their possession that the Committees request. 54/ While the Commission will rely on the stakeholder process to develop comprehensive market solutions, we believe that this process, and our review of the resulting proposal, will benefit from the independent analysis of these Committees.

ISO's Authority to Utilize A Purchase Price Cap

We will deny the requests for rehearing of our July 17, 1998 Order authorizing the ISO to utilize a purchase price cap. Contrary to assertions by El Segundo and Long Beach, the Commission's July 17, 1998 Order neither delegated ratemaking authority to the ISO nor suspended rates that previously had been accepted. The Order simply acknowledged that, as the purchaser of Ancillary Services and Replacement Reserves, the ISO has the discretion to reject excessive bids. Accordingly, while we agree with El Segundo and Long Beach that under the FPA, the ISO may not change the price in another party's rate schedule, that is not what the July 17, 1998 Order allowed the ISO to do.

With respect to El Segundo and Long Beach's contention that the authorization to cap the ISO purchase price is inconsistent with the ISO tariff, the Commission's July 17, 1998 Order authorized the ISO to waive tariff provisions, to the extent necessary, to implement the purchasing price cap. Moreover, the original orders in these proceedings rejecting ISO proposals to cap prices preceded the events that led the Commission to believe that urgent action was required.

53/ (...continued)

pp. 61,549 and 61,553 (1997) (noting the compliance divisions' discretion to submit reports directly to regulatory agencies).

54/ In the meantime, we encourage the MMC and MSC to share their views with the ISO and the market participants to facilitate the stakeholder process to redesign these markets.

We agree with El Segundo and Long Beach that the ISO's purchase cap is not an ideal approach to operating a competitive market. For that reason, we do not expect it to remain in place on a long-term basis. Although the California Commission had early in these proceedings requested that the Commission allow one year of experience to examine the net impact of pricing peaks and valleys, the California Commission's recent comments state, "since the market for Ancillary Services is clearly not yet competitive, the CPUC can support 'damage-control' caps on a short term basis." 55/

We also find that our July 17, 1998 Order is fully consistent with the Commission's holding in Duke Energy Moss Landing directing certain owners to recover their acquisition premium from the market. 56/ In that proceeding, the Commission, among other things, determined that Duke's incentive to purchase these plants relied on market-based rates in California and that Duke can recover its acquisition premium through the market-based rates that it will receive. There is no inconsistency between the orders. As discussed above, the ISO's purchase price cap is based on the discretion that the ISO has as a purchaser.

We take seriously the process requirements under the FPA and the APA, and agree that in ordinary circumstances the Commission would have allowed those affected to respond or comment to the ISO motion before acting. However, the Commission was faced with serious concerns that the markets for Regulation, Spinning Reserve, Non-Spinning Reserve, and Replacement Reserve were not well functioning, and the causes of these market malfunctions were not clear. In these circumstances, providing an opportunity to comment prior to allowing the ISO to implement its purchase price cap was not a reasonable option.

We will grant AES/Williams' request for clarification that the Commission's July 17, 1998 Order authorized the ISO to reject bids that are above its purchase cap for these services, rather than to accept bids that are above the cap, but to pay no more than the stated level of the purchase cap. As the Commission stated in the July 17, 1998 Order, "In the interim, the ISO's rejection of bids in excess of whatever price levels it believes are appropriate for Regulation, Spinning Reserve, Non-Spinning Reserve, and Replacement Reserve are authorized." 57/ Thus, the ISO, as a purchaser, has the discretion to reject bids that are excessive; it does not have the unilateral authority to set rates or to reduce bids. However, the Commission does not perceive

55/ California Commission at 8.

56/ See Duke Moss Landing, 83 FERC at 62,303-305.

57/ July 17, 1998 Order, 84 FERC at 61,199.

that this should occur very often. It is unclear why generators would bid at levels above the ISO's purchasing cap when the ISO is required to provide advance notice to all market participants of any adjustments in the price at which it will accept bids for these services.

We do not at this time consider it appropriate to direct the ISO to remove the purchase price cap. While we agree with many parties that using purchase caps, or any intervention measures, is not ideal, the MSC and MMC reports have addressed numerous structural changes that should be considered to improve the workings of the Ancillary Services and Replacement Reserves markets. Therefore, we have concluded that these changes would best be determined through an integrated, collaborative process, facilitated by the ISO. These proposed changes will take time to implement. Until such proposed changes are developed and implemented, and until we are assured that the markets are well functioning, we believe that the best course is to allow the ISO to maintain a purchase cap. Furthermore, we are in this order allowing all suppliers to bid into the Ancillary Services market at market-based rates. The temporary purchase price cap will mitigate any potential exercise of market power by these entities.

We are mindful of the concerns raised by some parties that the ISO's discretion to use a purchase price cap should not be in place any longer than is absolutely necessary. For this reason, we will direct the ISO in its March 1st filing to indicate whether it intends to continue or to eliminate its discretion to use a purchase price cap. If the ISO proposes to retain such discretion, it must in its filing propose objective criteria that it will use to exercise this discretion. Moreover, the ISO must propose a formula or specific level for any cap. The Commission at that time will evaluate the ISO's proposed market structure, including any proposal to retain the use of a purchase price cap.

The Commission recognizes the importance of monitoring any market structure that is put in place. Accordingly, we will direct the MSC and the PX MMC to monitor the Ancillary Services and Replacement Reserve markets with respect to the implementation of the ISO's restructuring reforms and to file reports directly with this Commission by October 15, 1999. Furthermore, we will direct the MSC and the PX MMC to file comments on the ISO's March 1, 1999 revised market structure proposal, independently advising this Commission on the viability of the revised market structure and whether the continuation or elimination of purchase price caps is appropriate. Finally, we will direct the ISO and PX to provide any data requested by the Committees, as discussed above.

Remaining Issues

Numerous parties object to our determination that Replacement Reserve is not an Ancillary Service and thus does not require separate authorization to bid at market-based rates. The ISO and SoCal Edison argue that in past orders the Commission characterized Replacement Reserve as an Ancillary Service. Moreover, regardless how the service is categorized, they argue that a separate market power analysis is needed in order to allow sales of Replacement Reserves at market-based rates. The ISO asserts that Replacement Reserve, as defined in its tariff, is analogous to the "Supplemental Reserve" provided for in Order No. 888. The ISO argues further that even if Replacement Reserve is not among the services enumerated in Order No. 888, the nature of the service that it represents is the same as those listed in Order No. 888. SoCal Edison points out that a finding that energy and capacity markets are workably competitive is insufficient to support a finding that there is a workably competitive market for Replacement Reserve because not all suppliers are capable of providing Replacement Reserve service.

Supplemental Reserve Service (Schedule 6) under our pro forma tariff is available in a short period of time (generally 10 minutes) for the purpose of continuing to meet load in the event of a system contingency such as the loss of a generator. Replacement Reserve service, on the other hand, is available in 60 minutes and is intended to support the real time energy market administered by the ISO, particularly when the day ahead schedules fall short of the actual load. That said, the analyses presented in these applications and the data provided by the ISO MSC show that the market shares for this product are lower than the market shares that each supplier holds for Ancillary Services and, in fact, are generally analogous to the market shares that these suppliers hold with respect to the hourly energy market administered by the PX. This is not surprising because resources used to supply short-term energy are the same resources that are capable of supplying Replacement Reserves.

According to the ISO, subsequent to our June 30 and July 10 Orders, all bidders were under the assumption that they would be entitled to recover the market clearing price for Replacement Reserve service. The ISO requested clarification that that was our intent. We clarify that the underlying orders permit all bidders to sell Replacement Reserves at market-based rates. To implement this formally, we shall direct public utility suppliers to file amendments to their rate schedules under which they sell energy at market-based rates to include Replacement Reserves as a separate product. These amendments should be included with the filing ordered above.

The Commission orders:

(A) The late motions to intervene by the Oversight Board and SoCal Edison in Docket No. ER98-3106-000 are hereby granted.

(B) SoCal Edison's Complaint in Docket No. EL98-62-000 is hereby dismissed.

(C) The requests for rehearing of the Commission's orders accepting market-based rates for Ancillary Services are hereby denied, as discussed in the body of this order.

(D) Jurisdictional suppliers that have not applied for market-based rates for sales of Ancillary Services are hereby directed to file, within 15 days of the date of this order, amendments to their rate schedules under which they sell energy at market-based rates to add Ancillary Services, to become effective for bids tendered on the Monday following the date of this order, as discussed in the body of this order.

(E) Jurisdictional suppliers are hereby directed to file, within 15 days of the date of this order, amendments to their rate schedules under which they sell energy at market-based rates to add Replacement Reserves, to become effective for bids tendered on the Monday following the date of this order, as discussed in the body of this order.

(F) The ISO is hereby directed to post this order on its web page to inform all potential suppliers and market participants.

(G) The ISO is hereby directed to conduct a stakeholder process to redesign the Ancillary Services market, as discussed in the body of this order, and to file a comprehensive proposal for structural modifications to the Ancillary Services market no later than March 1, 1999.

(H) The ISO MSC and the PX MMC are hereby directed to file reports and comments with the Commission, as discussed in the body of this order .

(I) El Segundo and Long Beach's request for rehearing and HIPG's request for reconsideration of the Commission's July 17, 1998 Order are hereby denied.

(J) AES/Williams' request for clarification of the Commission's July 17, 1998 Order is hereby granted as discussed in the body of this order.

(K) The ISO's request to continue to use a purchase price cap until improved market mechanisms are in place is hereby granted.

By the Commission.

(S E A L)

David P. Boergers,
Secretary.

Appendix A

Interventions and Protests

- ** AES Alamitos, L.L.C.
- ** AES Huntington Beach, L.L.C.
- ** AES Redondo Beach, L.L.C.
- * ** Bonneville Power Administration
- * ** California Department of Water Resources
- California Electricity Oversight Board
- California Independent System Operator Corporation
- * ** Cogeneration Association of California
- * Duke Energy Morro Bay LLC
- * Duke Energy Moss Landing LLC
- * Duke Energy Oakland LLC
- * ** El Segundo Power, LLC
- * ** Enron Power Marketing, Inc.
- Energy Producers and Users Coalition
- ** Houston Industries Power Generation, Inc.
- * ** Imperial Irrigation District
- * ** Long Beach Generation, LLC
- Metropolitan Water District of Southern California
- * ** Northern California Power Agency
- * Pacific Gas and Electric Company
- Public Utilities Commission of the State of California
- * Public Service Resources Corporation
- * ** Redondo Beach, City of 58/
- * ** San Diego Gas & Electric
- Southern California Edison
- * Sacramento Municipal Utility District
- * ** Turlock Irrigation District
- ** Williams Energy Services Company

- * Party did not intervene in Williams

- ** Party did not intervene in Duke Energy