

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

**California Independent System            )  
Operator Corporation                        )**       **Docket No. ER02-1656-026**

**MOTION FOR LEAVE TO FILE ANSWER AND ANSWER OF  
THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION TO  
COMMENTS, PROTESTS, MOTIONS TO REJECT AND  
REQUEST FOR EVIDENTIARY HEARING**

**I.       INTRODUCTION**

On May 13, 2005, the California Independent System Operator Corporation (“CAISO”)<sup>1</sup> filed its Further Amendments to the California Independent System Operator Corporation’s Amended Comprehensive Market Redesign Proposal” (the “MRTU Amendments”) in the captioned proceeding (“May 13 Filing”).<sup>2</sup> The MRTU Amendments consist of amendments to certain elements of the conceptual Market Redesign and Technology Upgrade (“MRTU”) proposal that the CAISO submitted in the captioned proceeding on July 22, 2003 (“July 2003 Filing”). Specifically, in the May 13 Filing, the CAISO requested that the Commission grant conceptual approval of the following elements of its comprehensive market redesign: (1) the clearing of demand bids at the load aggregation point (“LAP”) level; (2) a revised Hour-Ahead Scheduling Process (“HASP”) (as opposed to a financially binding Hour-Ahead market); and (3) a

---

<sup>1</sup> Capitalized terms not otherwise defined herein shall have the meaning set forth in the Master Definitions Supplement, Appendix A to the CAISO Tariff.

<sup>2</sup> In this answer, citations to the transmittal letter for the May 13 Filing will be to pages of “Transmittal Letter,” and citations to the other lettered attachments to the May 13 Filing will be to those particular attachments.

package of market power mitigation measures that will become effective upon implementation of MRTU. The CAISO emphasized that the purpose of the May 13 Filing was to obtain conceptual approval of these three design proposals so that the CAISO will be able to: (1) proceed with development of the software and systems needed to accommodate such design elements, and (2) maintain the MRTU project development and implementation schedule. The CAISO requested that the Commission conceptually approve these design proposals, without significant modification, by July 31, 2005, so that the CAISO can remain on track for a February 2007 implementation of MRTU. The CAISO stressed that changes to the fundamental design proposed by the CAISO are likely to result in deferral of the February 2007 implementation date and therefore a delay in fixing the flaws with the existing market structure, potentially beyond summer 2007. As explained in greater detail in the Answer below, the February 2007 implementation date is critical in order to provide the CAISO and market participants with real-world experience under the new market structure before the peak demand summer season in 2007. In addition, the deferral of certain market design elements until after day one of MRTU implementation is consistent with the Commission's long-standing precedent of permitting staged implementation of comprehensive market design changes.

A number of parties have submitted comments, protests, motions to reject, and a request for evidentiary hearing concerning the MRTU Amendments.<sup>3</sup>

---

<sup>3</sup> Comments, protests, and/or motions to reject were submitted by the following entities: California Department of Water Resources ("DWR"); California Electricity Oversight Board ("EOB"); California Public Utilities Commission ("CPUC"); Calpine Corporation ("Calpine"); Cities of Anaheim, Azusa, Banning, Colton and Riverside, California ("So. Cities"); City of Santa Clara,

Although many parties support some or all of the specific design elements contained in the May 13 Filing, the parties intervening in this proceeding also raise concerns and criticisms with regard to certain proposed design elements or request changes to the CAISO's existing market structure that go beyond the conceptual proposals set forth in the MRTU Amendments. Pursuant to Rules 212 and 213 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §§ 385.212, 385.213, the CAISO hereby requests leave to file an answer, and files its answer, to the motions to reject, comments, request for evidentiary hearing, and protests submitted in this proceeding.<sup>4</sup>

For the reasons set forth below and in the May 13 Filing, the Commission should: (1) approve without modification the MRTU Amendments proposed in the May 13 Filing, and (2) approve the process proposed in the May 13 Filing to address specified unresolved issues and the details of the market design, so that the CAISO can finalize the MRTU tariff language and file such tariff language by November 30, 2005.

---

California, Silicon Valley Power ("SVP"); City and County of San Francisco ("CCSF"); Coral Power ("Coral"); Duke Energy North America, *et al.* ("Duke"); Independent Energy Producers/Western Power Trading Forum (joined by Dynegy and Williams) ("IEP/WPTF"); Metropolitan Water District ("MWD"); Powerex Corporation ("Powerex"); Pacific Gas & Electric Company ("PG&E"); Sacramento Municipal Utility District ("SMUD"); Sempra Energy Trading ("Sempra"); and Southern California Edison Company ("SCE").

<sup>4</sup> To the extent this answer is deemed an answer to protests, the CAISO 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 because the answer will aid the Commission in understanding the issues in the proceeding, provide additional information to assist the Commission in the decision-making process, and help to ensure a complete and accurate record in this case. See, e.g., *Entergy Services, Inc.*, 101 FERC ¶ 61,289, at 62,163 (2002); *Duke Energy Corporation*, 100 FERC ¶ 61,251, at 61,886 (2002); *Delmarva Power & Light Company*, 93 FERC ¶ 61,098, at 61,259 (2000).

## II. EXECUTIVE SUMMARY

The MRTU Amendments represent a critical milestone on the road to developing and ultimately implementing a new market design for California. The market design elements set forth in the MRTU Amendments have been crafted based on the guidance provided in the Commission's orders in this proceeding and have benefited from additional refinements developed in response to comments from Commission Staff and through the extensive stakeholder process preceding the May 13 Filing. The CAISO believes this stakeholder process has been successful in addressing many of the questions and concerns raised in response to the CAISO's previous conceptual market design filings. One measure of that success is the general support for the elements of the MRTU Amendments offered by many parties commenting on the May 13 Filing.<sup>5</sup> Notwithstanding that support, some parties argue for significant modifications to the design elements proposed in the MRTU Amendments, while others claim that the Commission cannot or should not act on the May 13 Filing until other elements of the CAISO's redesigned markets are finalized. Parties also suggest that the Commission should direct modifications to the CAISO's existing market

---

<sup>5</sup> See, e.g., PG&E at 2 ("PG&E commends the CAISO on the extensive efforts of its staff in developing the proposals contained in the CAISO's May 2005 Filing, and supports much within the three proposals"); Sempra at 2 ("the MRTU proposal follows the sound and proven core design elements that have been deployed by the relatively successful eastern ISOs"); SCE at 2 ("SCE strongly supports the CAISO's PJM-style local market power mitigation proposal"); CPUC at 1 ("the CPUC supports the vast majority of the CAISO's Conceptual Proposal and urges the Commission to approve many of its key elements in a timely manner"); EOB at 2 ("The CEOB requests that the Commission approve the CAISO Proposal"); CCSF at 1 ("In summary, San Francisco is generally supportive of the CAISO's May 13 filing on Market Power Mitigation as a much more effective collection of mechanisms than what was originally proposed in its July 2003 MRTU filing").

structure and market power mitigation measures that go beyond the scope of the MRTU proposals set forth in the May 13 Filing.

The CAISO responds to these comments in detail in Section III of this Answer, explaining the reasons why the Commission should approve the MRTU Amendments now and why the market design modifications desired by various parties either are not justified or should be addressed through a subsequent stakeholder process considering market design features that cannot be implemented on day one of the new market structure.

As the Commission prepares to act on the May 13 Filing, however, the CAISO believes it is important to consider three overarching reasons why the MRTU Amendments should be approved without modification. First, the MRTU Amendments represent a just and reasonable package of market design elements that will provide a solid foundation for California's new wholesale electricity markets, incorporating successful market design features from ISOs in the eastern United States that are appropriate for implementation in California. Second, the MRTU Amendments represent an appropriate balancing of various interests that will ensure a smooth transition to a new market structure without sustained periods of high prices and/or price volatility associated with low hydroelectric and import availability until new generation and transmission infrastructure is in place. Such a period of high prices and/or price volatility could undermine the region's confidence in wholesale markets. Third, the MRTU Amendments reflect the very real need to prioritize market redesign elements so that the critical features of the new markets will be in place for the February 2007

MRTU implementation date, several months in advance of the critical summer season, while allowing other design elements to be developed through an ongoing stakeholder process and staged implementation of new market design features.

The MRTU Amendments are designed to facilitate the transition to Locational Marginal Pricing (“LMP”) in California and incorporate market design elements approved by the Commission and successfully implemented in the eastern ISOs that are already administering LMP-based markets. It is true that certain characteristics of the California electricity system – in particular, California’s dependence on imports and hydroelectric power – are quite different from the systems operated by eastern ISOs. These differences affect the ability of suppliers to exercise market power on a system-wide basis during periods of low hydro and import availability and therefore justify the CAISO’s proposal to retain a lower Damage Control Bid Cap on day one of MRTU implementation.

In other respects, including the potential for market participants to exercise local market power, California is very much like the systems operated by eastern ISOs. Like the eastern ISOs, local market power in California primarily arises because of local transmission constraints, which generally occur along transmission paths entering population centers with high load conditions. As in the eastern ISOs, the CAISO Control Area is also subject to contingencies, such as unanticipated transmission line outages, which create short-term opportunities for the exercise of local market power. Two different approaches have been implemented in eastern ISOs to address local market power concerns, and both

have been found to be just and reasonable. The CAISO and the CAISO's Market Surveillance Committee ("MSC") strongly favor the approach being utilized in PJM and have significant concerns with a Conduct and Impact ("C & I") bid evaluation approach as is used in other eastern ISOs. Thus, the CAISO has sought, to the greatest extent possible, to adopt local market power mitigation measures consistent with the PJM approach. The Commission should disregard comments suggesting that these mitigation measures and related market design elements already found to be just and reasonable elsewhere in the country should be rejected or substantially modified in California.

For example, IEP/WPTF and other parties contend that the CAISO should not adopt the design of local market power mitigation ("LMPM") used in PJM. These commenters provide no justification as to why local market power mitigation measures that the Commission has accepted for PJM are not just and reasonable as proposed by the CAISO. Indeed, these parties are clear that their objections to the MRTU Amendments are based on their opposition to the Commission-approved local market power mitigation measures as applied in PJM.

Some parties also argue that the CAISO should be compelled to abandon the PJM LMPM model in favor of a C & I bid evaluation system like that employed by the NYISO. The CAISO believes that PJM-style LMPM is superior to a C & I bid evaluation model for a number of reasons explained in the May 13 Filing and the Answer below. In considering the CAISO's filing under Section 205 of the Federal Power Act ("FPA"), however, the Commission should not even

reach the question of comparing the PJM-style mitigation to the C & I model. Once the Commission determines (again) that PJM-style market LMPM is just and reasonable, there is no legal basis under Section 205 for the Commission to consider alternatives to the measures proposed by the CAISO. Other alternatives are simply irrelevant.

For the same reason, the Commission should reject calls to require the CAISO to replace its proposed Hour-Ahead Scheduling Process with a financially binding Hour-Ahead settlement market. The markets administered by eastern ISOs have functioned effectively under LMP without a financially binding Hour-Ahead settlement market. The absence of such an Hour-Ahead settlement market has not rendered the market designs in those regions unjust and unreasonable. Address import and variable climate concerns. The CAISO has demonstrated in its filing that it can appropriately address these issues with HASP. Indeed, the Commission has approved the Balancing Market Evaluation (“BME”) currently in operation in the NYISO, which served as the model for the design of the CAISO’s HASP proposal. As in the eastern ISOs, there is no reason to impose a financially binding Hour-Ahead settlement market in California, especially in light of the modifications the CAISO has made to incorporate into the MRTU design those features of today’s Hour-Ahead Market that will still be appropriate under the LMP design, including provisions to facilitate import energy and Ancillary Service (“A/S”) scheduling and self-scheduling of internal supply resources, and to limit load exposure to additional unit commitment costs.



As a second general consideration, the Commission should recognize that the MRTU Amendments represent an appropriate balancing of the interests of various affected parties. Among other things, the CAISO believes it has attained the right balance between the need to ensure that the CAISO's redesigned markets will not facilitate the exercise of market power and the need to provide sufficient compensation to dispatched resources and to promote investment in the new generation needed to address load growth in California, along with the programs administered by the CPUC.

A number of commenters express concerns that the proposed market power mitigation measures will prevent the CAISO's redesigned markets from providing sufficient compensation to resources participating in the CAISO markets or will not promote sufficient investment in generation infrastructure. The CAISO recognizes that an effective market must provide sufficient opportunities for suppliers that are critical to meeting reliability needs to recover their costs, both fixed and variable. Sufficient opportunities for cost recovery are needed not only to ensure "revenue adequacy" for existing resources, but also to provide financial incentives for investment in new generation and other infrastructure that will ensure continued reliability and competitive markets.

These needs will be addressed by the CPUC's ongoing procurement proceedings – including the resource adequacy framework being developed by the CPUC – working in concert with other elements of MRTU "Release 1."<sup>6</sup> The

---

<sup>6</sup> As explained in the May 13 Filing, Release 1 includes all the features and elements of the market design that will be implemented on day one of the new LMP-based markets, because they are necessary to: (1) ensure reliable operation of the grid, (2) ensure that the market design

CPUC has made substantial progress in developing a year-round resource adequacy framework, which will be implemented starting in June of 2006. The CAISO has been actively working with the CPUC and stakeholders on the development of this resource adequacy framework. The CPUC has recently released its report on the “Phase 2” resource adequacy workshops, building on the CPUC orders issued on January 26 and October 28, 2004. The CPUC’s resource adequacy framework will implement a year-round planning reserve margin that must be satisfied by as much as a year in advance of the critical summer months. The CPUC is also committed to implementing detailed deliverability requirements, including local capacity requirements that are currently under development.

The CPUC’s Resource Adequacy Requirements are only one component of the CPUC’s “procurement proceedings” addressing the long-term energy needs of California consumers. These procurement proceedings also include CPUC review and authorization of long-term (*i.e.*, five to ten-year) procurement plans developed by investor-owned utilities in California. The CPUC’s resource adequacy and procurement requirements will ensure that load-serving entities (“LSEs”) enter into appropriate long-term arrangements with resources on both a regional and local level, thereby promoting revenue adequacy. In addition, the design of MRTU Release 1 includes many features that will provide market revenue opportunities to resources. These features of the MRTU Release 1, coupled with the CPUC’s resource adequacy and long-term procurement

---

works properly, *i.e.*, does not have a “fatal flaw”, or (3) satisfy a regulatory requirement. May 13 Filing, Transmittal Letter (“Transmittal Letter”) at 17 n.14.

requirements, will provide for resource revenue adequacy and incentives for infrastructure investment.

Thus, concerns about revenue adequacy are being addressed in the new market structure (which will include the MRTU Release 1 market elements as well as the CPUC resource adequacy and procurement requirements), and there are compelling reasons why the Commission should not modify the market power mitigation measures set forth in the MRTU Amendments. Public confidence in wholesale electricity markets in California was shaken as a result of the energy crisis. A smooth transition to LMP-based markets is a critical step in restoring the region's faith in wholesale markets. If insufficient market power mitigation measures are in place when MRTU is implemented, especially through the premature increase of damage control price caps, sustained periods of high prices and/or price volatility associated with low hydroelectric and import availability could occur until new generation and transmission infrastructure is in place. Such a period of high prices or price volatility could permanently undermine the region's confidence in wholesale markets. In order to prevent this from occurring, the CAISO strongly believes that the entire package of market power mitigation measures set forth in the MRTU Amendments must be in place on day one of the new markets.

As the region gains experience with the new markets, and the appropriate infrastructure is developed, system-wide market power mitigation measures can be modified and relaxed, including a measured increase of the level of damage control price caps. In the meantime, however, features of the MRTU Release 1

design, coupled with the CPUC's resource adequacy and procurement requirements, will provide for resource adequacy and incentives for infrastructure investment, while protecting against the type of sustained exercise of market power experienced during the California energy crisis.

As a final general consideration, the Commission should recognize the pragmatic concerns that have led the CAISO to decide how to prioritize elements of the MRTU market design. The development, integration, testing and ultimate implementation of the software and equipment needed to effectuate the new LMP-based markets in California is a monumental undertaking. The interaction of various elements of the new market design requires a strict schedule for software development and testing. In order to maintain such a schedule, the CAISO Board in June of last year identified the need to finalize and "freeze" critical market design elements as soon as possible, with virtually no flexibility on critical elements after mid-2005.

The MRTU Amendments include critical market design elements that are part of the frozen design for inclusion in MRTU "Release 1" for implementation in February 2007. In order to determine which items would be included in Release 1, an internal CAISO team undertook a review of the proposed market design in late 2004 and identified the design elements necessary to assure the safe and reliable operation of the grid as well as those that provided the infrastructure for a functional wholesale energy market. Further, the CAISO undertook a third-party review of the MRTU design to determine if any critical elements were missing or if there were items that required modification. To assure internal consistency of

the design, some modifications for Release 1 were identified and incorporated into the overall MRTU implementation plan.

All other design elements under consideration, including many the CAISO believes are desirable but not critical for initial implementation, have been slated for consideration as part of MRTU Release 2. Although some parties may disagree with the CAISO's assignment of certain design elements to Release 2 rather than Release 1, the CAISO has taken great pains to ensure that Release 1 includes all design elements that are necessary to ensure reliable grid operation, successful performance of the new LMP-based markets, and a comprehensive package of market rules and provisions that are just and reasonable.

Based on the CAISO's prioritization of design elements, and consistent with the Commission's prior orders in this proceeding, the CAISO's vendors have already begun development of many key elements of the MRTU software. These software development efforts have been documented in the monthly status reports filed with the Commission in compliance with the Commission's November 27, 2002 "Order Clarifying The California Market Redesign Implementation Schedule," 101 FERC ¶ 61,266 (2002) ("November 27 Order").

The CAISO emphasizes that the February 2007 MRTU implementation date is essential because it will provide the CAISO and market participants with several months of real-world experience under the new market design before the peak demand summer season in California. As the 2000-2001 energy crisis demonstrated, the summer months are particularly challenging for California's wholesale electricity markets because of the region's dependence on

hydroelectric power and imports to meet peak demand. Prudence therefore requires a “shakedown” period of several months to identify any unintended consequences of the new market design before the start of the summer season.

Even without changes to the MRTU Amendments, the February 2007 implementation date is an ambitious target which is by no means guaranteed. Significant changes or additions to these design elements surely will prevent the CAISO from achieving the objective of a February 2007 MRTU implementation date, potentially delaying MRTU implementation beyond summer 2007 and perhaps even later.

Some commenters question why certain MRTU design elements must be finalized expeditiously while other Release 1 elements are still undergoing development. As an initial matter, the CAISO notes that the Commission has already decided that it is appropriate to act on conceptual market design filings in this proceeding while details of the final MRTU Release 1 design and implementing Tariff language continue to be developed.<sup>7</sup> Moreover, such an approach is appropriate because a project of the scope and magnitude of MRTU necessarily will have a logical sequence or hierarchy that requires certain design decisions to be made early in order to maintain the implementation schedule, while other decisions can be held open for further deliberation and made later. The CAISO has designed flexibility into the MRTU software and systems being

---

<sup>7</sup> *California Independent System Operator Corp.*, 105 FERC ¶ 61,140 at P 203 (2003) (“October 28 Order”) (“It is the Commission’s view that by considering the CAISO’s conceptual filing as a complete package at this time, notwithstanding that parts of it are not yet fully developed, or that there may be related matters presently under consideration before the Commission, the public will benefit by having further direction and guidance for the ongoing development of the California electricity market.”).

developed in order to ensure that decisions held open at one point in time are not foreclosed by decisions made earlier. This principle applies to the design elements presently before the Commission for conceptual approval, and therefore the Commission should grant such approval now rather than delay a decision based on the fact that some design details and issues remain open. Withholding a decision on those design elements currently before the Commission until all MRTU Release 1 details are finalized would add significant risk to the implementation schedule, potentially delaying the implementation of a consistent and transparent market design that addresses the shortcomings of the current market designs in California post 2007. Given the widespread recognition that the current market design is fatally flawed, such a delay is simply unacceptable. In particular, two fundamental flaws in the existing market design are the lack of a mechanism to enforce schedule feasibility in the Day-Ahead time frame and the lack of resource adequacy requirements. The lack of these key features in the market forces the CAISO to rely on necessary but sub-optimal and inefficient mechanisms, such as the Commission-imposed Must-Offer obligation and related processes, Reliability Must-Run Generation, the real-time re-dispatch of resources (to manage Intra-Zonal Congestion), and other mechanisms that result in indirect market costs that fail to send meaningful price signals to market participants. MRTU Release 1 will address the first flaw through the implementation of the Integrated Forward Market (“IFM”) and Full Network Model, while the CPUC’s Resource Adequacy Requirements will

address the second flaw by providing a framework for supplier revenue adequacy and encouraging new investment.

The treatment of virtual bidding provides a snapshot of the overall MRTU prioritization process. In order for the CAISO to have included virtual bidding in MRTU Release 1, the CAISO and stakeholders would have needed to finalize important design and rule requirements late last year. Virtual bidding proved to be highly contentious, however, with a number of stakeholders raising concerns about the potential for gaming and price distortions. Rules and limitations to address these concerns could not be finalized in time for inclusion of virtual bidding in MRTU Release 1. In addition, the CAISO concluded that virtual bidding was not necessary to ensure reliable grid operation or to prevent a fatal flaw in the new LMP markets. While the CAISO is committed to consider a virtual bidding feature as part of MRTU Release 2, adding it to MRTU Release 1 now would delay the implementation of LMP-based markets in California, potentially beyond the summer of 2007.

Some parties contend that the CAISO's timing and implementation concerns are an attempt to limit or eliminate the Commission's role in reviewing and approving the new market design for California.<sup>8</sup> This is simply not the case. The CAISO recognizes that the Commission has the critical role of determining whether the MRTU Amendments are just and reasonable. For all the reasons set forth in the May 13 Filing and this Answer, the CAISO believes it has more than met the burden of demonstrating that the MRTU Amendments, without modification or the addition of new market design elements, satisfy the Section

---

<sup>8</sup> See Coral at 12-13.



205 standard. The discussion of the implementation issues, however, is important for the Commission to make an informed decision on the CAISO's filing.

As the name implies, Release 1 is simply the first step in MRTU implementation. Every ISO that has moved to an LMP-based market design has done so through an evolutionary process, allowing essential features to be implemented on day one of a new market design and enhancements to be added through a deliberative process. The Commission has approved staged implementation not only of the original market design in California<sup>9</sup> but also of LMP-based market designs in the eastern ISOs.<sup>10</sup> There is no reason to depart from this practice now or to delay implementation of a just and reasonable market design that will fix the flaws in the CAISO's existing market structure.

While changing significant features of the MRTU Amendments now will surely delay MRTU implementation, approval of the MRTU Amendments will allow the CAISO to proceed expeditiously to resolve the remaining open policy and design issues related to the essential Release 1 elements, to complete and file the MRTU tariff, and then to initiate a process to consider enhancements to the MRTU design for a future release. A stakeholder process is already in place

---

<sup>9</sup> See, e.g., *Pacific Gas and Electric Company, et al.*, 81 FERC ¶ 61,122, at 61,443 (1997) ("We agree that staging implementation of the California Restructuring is necessary to ensure that start-up of operations can proceed on schedule. However, many of the elements of the staging plan are essential to the development of a well-structured market. Accordingly, we accept the proposed staging plan subject to the condition that the ISO and PX each provide quarterly status reports, as outlined below. As the ISO/PX has acknowledged, the start-up of ISO and PX operations is an extremely complicated endeavor and staging elements of the proposal has become a procedural necessity given the timeframes adopted in the California Restructuring.")

<sup>10</sup> See, e.g., *New England Power Pool, et al.*, 105 FERC ¶ 61,211 at P 22 (2003) ("The Commission is cognizant of the numerous market improvements under development in the next several years and the need to implement these improvements in a logically phased process").

to address the outstanding Release 1 issues and, in the process to identify potential post-Release 1 enhancements, and the Commission should allow this process to move forward. Both consumers and market participants in California will suffer if MRTU implementation is delayed. The Commission should not allow the perfect to be the enemy of the good. To prevent such a delay, the CAISO urges the Commission to accept the MRTU Amendments without modification by July 31, 2005.

### **III. ANSWER**

#### **A. The CAISO's Proposed MRTU Market Power Mitigation Measures Are Just And Reasonable And Should Be Approved Without Modification**

The revised set of market power mitigation measures included in the MRTU Amendments is designed to satisfy the following fundamental objectives:

- (1) To provide strong and effective measures against the exercise of local market power;
- (2) To provide an explicit mechanism within the MRTU design for addressing revenue adequacy of Frequently Mitigated Units not under long-term contracts; and
- (3) To provide a definitive transition plan for relaxing CAISO-imposed system market power mitigation so that system market power concerns can be more effectively addressed through greater demand response and long-term energy contracting, the latter of which will provide protection against spot market price volatility and reduce supplier incentives to exercise market power.

The market power mitigation measures in the MRTU Amendments include a number of significant modifications to the market power mitigation proposal included in the CAISO's July 2003 Filing. These modifications were made in response to the guidance provided in the Commission's October 28 Order.

These modifications also benefited from the Commission Staff's January 18, 2005, letter providing comments on the development of market power mitigation measures ("Staff Guidance Letter"). The revised market power mitigation measures are described in detail in the May 13 Filing.<sup>11</sup> Many commenters support the CAISO's proposed market power mitigation measures or request only minor clarifications or refinements to those measures.<sup>12</sup>

Other parties object to core elements of the proposed market power mitigation measures. The most significant objections focus on two categories of issues. First, some parties claim that the CAISO has not adequately addressed concerns raised in the Commission's October 28, 2003, order that "market power mitigation should address market power concerns without undermining incentives for new entry and long-term resource adequacy." October 28 Order at P 274 (footnote omitted). These parties disregard the features of the MRTU market design that, in concert with the CPUC's resource adequacy and procurement requirements, will provide sufficient revenues for resources participating in the CAISO's markets and will therefore provide incentives for investment in California's generation infrastructure. These parties also underestimate the threat to the long-term viability of wholesale markets in California if the transition to LMP-based markets is accompanied by sustained periods of high prices and/or price volatility comparable to those experienced during the California energy crisis of 2000-2001. The CAISO believes that the overall California market design, including the market power mitigation measures proposed in the

---

<sup>11</sup> See pp. 32-57 of the May 13 Filing and Attachment B to that filing, the CAISO White Paper on Proposed MRTU Market Power Mitigation Provisions.

<sup>12</sup> See the comments of PG&E, SCE, CCSF, CPUC, and EOB.

May 13 Filing, will provide a sustainable and stable design that can reliably and efficiently meet California's ever-growing demand for electricity.

Second, some parties object to the CAISO's adoption of PJM-style local market power mitigation structure. They propose that the CAISO adopt mitigation features from other ISOs, and in particular the C & I bid evaluation mechanism utilized by the NYISO. Such comments fail to take into account the concerns that the Commission Staff raised in the Staff Guidance Letter that the CAISO's original market power mitigation proposal inappropriately combined elements of different market power mitigation packages approved for use in different ISOs. Based on this guidance, and the CAISO's concerns with adopting a C & I approach to local market power mitigation, the CAISO has striven to develop a mitigation package that closely resembles the local market power mitigation measures in effect in PJM.<sup>13</sup> The parties objecting to adoption of this PJM-style mitigation package in California are essentially arguing that the existing PJM local market power mitigation structure is unjust and unreasonable. The Commission should disregard such objections and permit the CAISO to adopt local market power mitigation measures that have been implemented successfully in PJM.

---

<sup>13</sup> The CAISO acknowledges that the day one MRTU market power mitigation measures will depart from the PJM measures in one significant respect – the CAISO does not propose to adopt a \$1,000 energy bid cap on day one of MRTU implementation. The CAISO has developed a transition plan for moving to such a \$1,000 cap through a deliberate transition process. As explained below, California's history of market volatility and its dependence on imports and hydroelectric resources that are susceptible to large shifts in supply margins justify the decision not to raise the damage control bid caps on day one of MRTU implementation.

For all the reasons explained below, the overall package of revised market power mitigation measures set forth in the MRTU Amendments is just and reasonable. Requests to modify those measures should be rejected.

**1. Revenue Adequacy and Generation Infrastructure Issues Are Already Being Addressed and Do Not Justify Modifications to the MRTU Market Power Mitigation Measures**

A number of parties argue that core elements of the market power mitigation measures set forth in the MRTU Amendments should be modified or rejected because the new California market design will not address the need for resource revenue adequacy or incentives for the development of new resources. IEP/WPTF contends that the CAISO has not satisfied the directives of the October 28 Order that “market power mitigation should address market power concerns without undermining incentives for new entry and long-term resource adequacy” and that “the resource adequacy measures adopted by the region must work together with the region’s market power mitigation measures to ensure that there are appropriate incentives to invest in sufficient infrastructure to maintain reliable and reasonably priced service to customers in the region.” October 28 Order at P 274 (footnote omitted). Calpine and Coral base their objections to elements of the MRTU market power mitigation package on similar concerns, claiming that the CAISO has not demonstrated that the MRTU market design “will provide reasonable opportunities for generators to recover the fixed costs of their investments” and that the mitigation measures will “depress

incentives for developers to invest in California markets.” Calpine at 5; Coral at 13.

Claims that the new California market design will not address revenue adequacy or investment incentive issues are incorrect. The CPUC’s Resource Adequacy Requirements, which will be implemented in June 2006, are an integral component of the new California market design. As the CPUC notes in its own comments on the May 13 Filing, the Commission should consider the MRTU Amendments “in light of the CPUC’s resource adequacy framework.”<sup>14</sup> These Resource Adequacy Requirements are designed to provide: (1) sufficient incentives for infrastructure investment in California, and (2) sufficient opportunities for suppliers to recover their going forward fixed costs (by entering into both short and long- term supply arrangements with LSEs). The market power mitigation measures set forth in the MRTU Amendments are consistent with and complementary to those Resource Adequacy Requirements and include features designed to provide additional revenues to promote investment. Because these issues have been addressed in the new market design, there is no need to eliminate or modify core elements of the mitigation structure, especially since these measures are needed to address the very real concerns that hydro conditions and reduced availability of imports can create the potential for system-wide market power under any market structure in California, at least until additional infrastructure is added over the first few years of MRTU implementation.

---

<sup>14</sup> CPUC at 9; see *also* PG&E at 6-9.

Claims of Calpine and others that the CPUC's resource adequacy framework is not sufficiently developed to address their concerns fail to take into account the substantial progress that has been made on the development of Resource Adequacy Requirements. On October 28, 2004, the CPUC issued its *Interim Order Regarding Resource Adequacy* ("Interim RA Order"). In the Interim RA Order, the CPUC ruled, *inter alia*, that the 15-17% planning reserve margin it had previously approved in its January 2004 order applied for the entire year. The CPUC further ruled that load serving entities have the obligation to satisfy: (1) 90% of their capacity requirements (load plus a 15-17% planning reserve margin) one year in advance for the summer peak season of May-September, and (2) 100% of their capacity requirements one month in advance throughout the year. The CPUC adopted this latter requirement, in part, for the express purpose of promoting revenue adequacy. Interim RA Order at 37.

Additional issues relating to the CPUC's resource adequacy framework – including the key issue of deliverability – have been discussed at length through the Phase 2 stakeholder workshops conducted between November 2004 and April 2005. The CAISO has been actively involved in the CPUC's resource adequacy proceeding. In particular, the CAISO has played an active role in developing local deliverability requirements. On June 13, 2005, the CPUC's advisory staff issued the Phase 2 Resource Adequacy Requirements Workshop Report ("Phase 2 Workshop Report").<sup>15</sup> Issuance of the Phase 2 Workshop Report represents another significant milestone in the development of the

---

<sup>15</sup> The Workshop Report may be obtained at the following link:  
<http://www.cpuc.ca.gov/PUBLISHED/REPORT/46914.PDF>.

CPUC's Resource Adequacy Requirements. The final Resource Adequacy Requirements that will go into effect in June 2006 will establish a clear framework and impetus for forward capacity contracting by LSEs.

The development of CPUC's Resource Adequacy Requirements is only one component of the CPUC's more comprehensive regulatory proceedings addressing the need of LSEs in California to procure both capacity and energy on a long-term basis. These proceedings were initiated, in part, in response to Assembly Bill 57, a California state statute that resulted in the CPUC substantially broadening the ability of LSEs to enter into forward contracts. As part of its procurement proceedings, the CPUC has directed California investor-owned utilities ("IOUs") to file long-term procurement plans. Through the review and adoption of these long-term procurement plans, the CPUC will provide the three largest California LSEs with authorization to plan for and procure the resources necessary to provide reliable service to their customers for a ten-year planning period. These procurement requirements will provide the framework for forward contracting by LSEs (including, *e.g.*, forward energy contracts and forward A/S contracts).

The CPUC's resource adequacy and procurement requirements will ensure that resources have an appropriate opportunity to recover their fixed costs and return on and of capital, thereby providing a vehicle for addressing revenue adequacy of existing generation and creating appropriate incentives for investment in new generation.



In addition, MRTU Release 1 will include many features designed to address revenue adequacy concerns. As a result of the elimination of System AMP, per the Commission Staff's proposal in the January 2005 Staff Guidance Letter, the new market design will allow prices to rise during shortage periods without any constraints other than the Damage Control Bid Caps<sup>16</sup>. The CAISO's spot markets will also allow resources to recover their incremental costs and will provide opportunities for receiving revenues above these incremental costs, which will contribute to the recovery of a resource's going forward fixed costs. In addition to receiving the nodal market clearing price, resources participating in the MRTU markets will also have an opportunity to be compensated for start-up and minimum load costs.<sup>17</sup>

Under the MRTU market design, suppliers participating in the A/S markets may submit market-based capacity bids and receive capacity payments that reflect the opportunity cost of reserving that capacity. Suppliers providing A/S thus have the potential to earn additional revenues that can be credited toward fixed cost recovery. The CAISO is one of the few ISOs that provides markets for four types of Ancillary Services, *i.e.*, Spinning Reserve, Non-Spinning Reserve, Regulation Up and Regulation Down. California market participants received

---

<sup>16</sup> Some have suggested that the CAISO's proposed local market power mitigation provisions would preclude prices from rising during system scarcity conditions. This is incorrect. The LMPM procedure works through two Pre-Market runs of the market, one in which only "competitive" transmission constraints are enforced and a second in which all transmission constraints are enforced. Non-RMR units that are dispatched up in the second pass will be subject to LMPM. However, the local market power procedures will not mitigate a resource below its highest accepted bid in the previous market pass in which only competitive transmission constraints are enforced. To the extent system scarcity conditions result in higher accepted bids at a broad region/system level, such bids will not be mitigated below those levels in the subsequent LMPM pass.

<sup>17</sup> See Attachment A to the May 13 Filing, the Market Design White Paper at 13-14.

approximately \$87 million in capacity payments for these services in 2004. Under MRTU, the CAISO will continue to provide capacity payments to A/S suppliers. Moreover, non-Resource Adequacy units will be eligible to receive a Residual Unit Commitment (“RUC”) Availability Payment for their provision of RUC capacity, which will be paid in addition to the guaranteed recovery of start-up and minimum load costs. Lastly, as discussed in Section III.A.4.c below, the CAISO has committed to put in place a “backstop” mechanism to ensure revenue adequacy for frequently mitigated units (“FMUs”).

In the longer term (*e.g.*, after the first year of MRTU operation), the CAISO is considering the development of a monthly local capacity market such as that being proposed by ISO-New England (and being considered in other eastern markets). The CPUC is also considering the viability of some form of capacity market, and the CAISO has committed to coordinate with the CPUC on the development of a capacity market structure. Such a market would complement the CPUC’s Resource Adequacy Requirements and would not be a replacement for those requirements. Indeed, one of the primary benefits of such a capacity market is that, once the Resource Adequacy Requirements are finalized, an organized capacity market will provide one mechanism through which an LSE can satisfy those requirements.

Calpine contends that the redesigned California markets will not provide sufficient opportunities for return of and on capital. Calpine at 10-11. The CAISO notes that the MRTU features described above provide resources with many opportunities to earn revenues above their variable costs that can

contribute to providing returns of and on their capital. In addition, the forward contracts promoted by the CPUC's Resource Adequacy Requirements and approval of long-term procurement plans will allow a resource owner to lock in a return on capital. As LECG noted in its comments on the MRTU market design, such forward contracts may reduce the costs of financing new generation by locking in return to capital.<sup>18</sup>

Calpine suggests that the discussion of Net Revenue Analysis and Revenue Adequacy for New Generation in the Annual Report on Market Issues and Performance prepared by the CAISO's Department of Market Analysis ("DMA") demonstrates that spot markets will not provide sufficient revenue opportunities for new generation. Calpine at 11-13. This argument ignores the fact that the MRTU spot markets will work in concert with the state's Resource Adequacy Requirements and procurement requirements to provide such opportunities. The DMA stated as much in its analysis, when it noted that its examination of spot markets serves to "highlight the key role that forward contracts and/or capacity markets must play in stimulating investment in new supply."<sup>19</sup>

Calpine and other parties claim that potential concerns about resource adequacy during the Summer of 2005 undercut the CAISO's reliance on the Resource Adequacy Requirements to address resource revenue concerns. This is simply a case of comparing apples to oranges. The CPUC's year-round

---

<sup>18</sup> See Attachment C to the May 13 Filing at 139.

<sup>19</sup> *Annual Report on Market Issues and Performance*, issued in April 2005, at 2-29. This report is available on the CAISO's web site at: <http://www.caiso.com/docs/2005/04/28/2005042814343415812.html>.

Resource Adequacy Requirements do not go into effect until June 2006, and the MRTU Amendments that are the subject of the May 13 Filing will not become effective until early 2007. Any issues that might arise with the market design in place during this summer will not and cannot reflect adversely on market elements that will not be in place until next year or later.

Lastly, Calpine urges the expedited implementation of an organized installed capacity market in California in order to provide revenue opportunities for new investment. As noted above, the CAISO is considering the development of a monthly local capacity market similar to those under development in New England and has committed to work with the CPUC to explore an appropriate design for a capacity market in California after day one of MRTU implementation. Prior to development of such markets, the state Resource Adequacy Requirements and other market mechanisms described above will more than address the revenue needs of new generation. Indeed, it would be premature to develop a capacity market until the Resource Adequacy Requirements are finalized. Only after those requirements are finalized will the CAISO and the CPUC know the details of the product that LSEs will be seeking to obtain through a capacity market.

Because resource revenue needs will be adequately addressed by day one of MRTU implementation, the Commission should not require the development of capacity markets on an excessively hasty schedule that would compromise the CAISO's ability to meet its February 2007 MRTU implementation date. As LECG points out in its comments on the MRTU market design,

traditional installed capacity markets, such as those employed in Eastern markets, “have several potential limitations as a solution to the resource adequacy problem that should be kept in mind in designing California’s resource adequacy system.”<sup>20</sup> Designing capacity markets can be a complex and contentious undertaking, as evidenced by the controversy surrounding the proposed New England capacity markets. The Commission should permit the CAISO and CPUC to consider capacity market issues in an appropriate time frame for consideration and implementation after day one of the MRTU markets.

## **2. Damage Control Bid Caps**

Commenters expressed a wide range of views regarding the CAISO’s proposed transition plan for raising the energy bid caps and differed substantially on the initial level of the bid cap, the timing of any transition plan and the standards by which the cap should be increased.

PG&E states that the CAISO and the Commission must make an affirmative finding, subject to public scrutiny, that fundamental market conditions support such an increase before raising the bid cap. The CPUC supports the proposal to raise the bid cap because it recognizes the long-term efficiencies to be gained by such an increase, but cautions that the bid caps should only be raised once there is certainty that the LMP system is working properly. The EOB supports a three-step process for raising the soft bid cap as described in the May 13 Filing, but seeks clarification that the three-year schedule suggested by the

---

<sup>20</sup> Attachment C to the May 13 Filing at 123 (also noting that the CPUC has generally recognized these limitations in its own resource adequacy orders).

CAISO's filing is not hard-wired and that the cap will not necessarily be increased if non-competitive conditions continue to exist.

CCSF believes that raising system-wide bid caps after the first year of MRTU implementation is inappropriate. CCSF states that California is still recovering from the financial disaster of the energy crisis and believes that more than a year's experience with forward supply margins under MRTU is needed before the Commission should consider relaxing the current \$250 bid cap.

Sempra supports the CAISO's commitment to raise the level of the energy bid cap, but states that the proposed three-year time frame for transition to higher bid caps is overly deliberate given the possible adverse effects that may flow from suppressing California spot market prices in times of scarcity. Sempra at 12.

Other entities (*e.g.*, IEP/WPTF, Calpine, and Coral) contend that the bid cap should be raised to \$1,000/MWh immediately (consistent with the eastern ISOs) upon day one of MRTU implementation. Duke argues that a \$1,000/MWh safety net cap should be implemented prior to day one of MRTU implementation, on October 1, 2005.

A number of the parties seeking a more immediate increase to the bid caps express concerns that the existing bid caps do not provide sufficient revenues for resources to promote infrastructure development, and that the CPUC's resource adequacy framework may not address this need. IEP/WPTF at 15-16; Duke at 7-8; Calpine at 15-16; and Sempra at 5-7. IEP/WPTF and Duke both contend that market conditions have changed since the Commission

approved the existing \$250 soft bid cap and that these changed market conditions justify a more immediate increase in the caps. IEP/WPTF at 8-10; Duke at 7.

IEP/WPTF raises a number of concerns with the CAISO's proposal for transitioning to higher bid caps. Specifically, IEP/WPTF claims that the proposal grants the CAISO too much discretion to determine when and for what reasons to raise the bid caps and that the criteria for determining whether markets are "sufficiently competitive" to raise the caps are needlessly subjective. IEP/WPTF at 16-17. Sempra opposes the CAISO's proposal to increase the bid caps only upon a finding that there is a regional supply margin of unspecified magnitude. Sempra at 12.

IEP/WPTF also expresses concerns that, unless bid caps in California are tied to regional caps, California is at risk of suppressing the price of real-time energy in California and exporting needed resources, especially when supply conditions are tight. IEP/WPTF at 12-13. Lastly, IEP/WPTF and Calpine express concern that the existing bid caps will impede the development of demand response. IEP/WPTF at 15; Calpine at 16.

**a. The Proposed Treatment of the Damage Control Bid Caps Adequately Balances Competing Interests**

In considering comments on the Damage Control Bid Cap, the Commission faces an extremely delicate balancing act. On the one hand, an early increase in the bid cap may provide benefits in terms of facilitating greater demand participation and through promoting investment in new infrastructure by

creating greater incentives for LSEs to forward contract. On the other hand, there is a need to set the cap at a level that will address the potential for sustained periods of high prices and/or price volatility associated with low hydroelectric and import availability, until adequate generation and transmission infrastructure is developed. Setting the cap too low for too long could impede the development of demand response and new investment through long-term forward energy contracting, but setting the cap too high too quickly could result in unjust and unreasonable prices resulting from the exercise of market power. The CAISO believes that its proposal for transitioning to a \$1,000/MWh bid cap achieves the appropriate balance.

As indicated in the May 13 Filing, the CAISO believes that there are benefits associated with a higher bid cap and that such benefits should not be delayed beyond a reasonable period. However, contrary to the claims of certain commenters, the Commission does not need to raise the bid cap to \$1,000/MWh (or some other level higher than \$250/MWh) on day one of MRTU implementation in order to promote infrastructure development in California.

The level of the energy bid caps is not the sole – or even primary – driver of decisions to invest in new generation. As described above, the CPUC’s resource adequacy program, which will be implemented in June 2006 (prior to MRTU day one), is specifically designed to facilitate generation investment and to encourage LSEs to enter into forward capacity contracts.<sup>21</sup> As the Commission has recognized in this docket, “Market power mitigation measures

---

<sup>21</sup> As discussed above, the long-term procurement plans approved by the CPUC also will encourage LSEs to enter into forward contracts.



should rely principally on mitigating market power in the spot market, and rely on a separate resource requirement to provide revenues to support long-term resource adequacy.” *California Independent System Operator Corporation*, 100 FERC ¶ 61,060 at P 44 (2002) (“July 17, 2002 Order”).

The experience of eastern ISOs confirms that high bid caps are insufficient to promote new generation investment. Even though PJM, New York and New England have \$1,000 Damage Control Bid Caps, these regions have also needed to implement some form of capacity requirement in order to provide sufficient incentives for investment in generation infrastructure. In the eastern markets, these capacity requirements are the primary driver of generation investment, while the spot markets provide a supplemental revenue source that contributes to resource revenue recovery.

This will also be true under California’s new market design. CPUC resource adequacy and procurement requirements will be the primary mechanism for ensuring a resource’s ability to recover fixed costs and return of and on capital, while the spot markets will provide a supplement revenue stream for recovery of such costs. The other elements of the MRTU market structure designed to promote revenue adequacy, including the elimination of System AMP and the provisions ensuring revenue adequacy for FMUs, will provide further sources of revenue that will promote generation investment. The anticipated increase in the energy bid cap under the timeframes described in the CAISO’s May 13 Filing will provide a further incentive for generation investment,

because that schedule will result in an energy bid cap of \$1,000/MWh for most of the operational life of new generation in California.

While an ill-advised rush to raise the energy bid cap will not result in the accelerated construction of new resources in California, raising the cap on day one of MRTU implementation could have serious adverse consequences. As the Commission is well aware, California is currently dependent on hydro-electric power from the Northwest and imports from throughout the Western Interconnection during periods of peak demand. If the energy bid cap were increased and California were to face a dry hydro season or significantly reduced imports (or if market fundamentals – such as a reasonable reserve margin – are not in place to support such an increased bid cap), the CAISO markets could be subject to the exercise of system market power on a sustained basis with prices pushing the limits of any higher bid cap. This scenario would be all the more likely if the Commission were to approve the CAISO's proposal to eliminate System AMP. Such periods of high prices or volatility in the first year of LMP-based markets in California could permanently undermine the region's confidence in wholesale electricity markets. Over the following three years, the CAISO expects that additional generation and transmission will be constructed in response to the state resource adequacy and procurement requirements. This additional generation will reduce the susceptibility of California's markets to hydro conditions or a reduced availability of imports. This is the primary justification for the measured increase to the bid caps proposed by the CAISO.

In addition, a measured increase in the Damage Control Bid Caps will allow the CAISO to respond to any unforeseen problems in the MRTU design. Although the MRTU design will be thoroughly tested prior to going live, in a market redesign as comprehensive and complex as MRTU, actual market operation may reveal problems that were not identified during the testing period. To the extent such problems do arise and result in higher market prices, having a higher energy bid cap would only compound the impacts to Californian consumers.

The CAISO is sympathetic to comments suggesting that a more accelerated increase of energy bid caps will facilitate the development of demand response. The CAISO is committed to promoting demand response options and is cognizant of concerns raised by the CAISO's MSC about the importance of demand response under the new California market design. More specifically, the CAISO recognizes that a higher bid cap may be more effective in promoting demand response, particularly under Real-Time pricing programs. However, the CAISO does not believe that raising the energy bid cap on day one implementation of MRTU is appropriate for the reasons discussed above. The CAISO also believes that other measures, including the forward contracting resulting from the state's Resource Adequacy Requirements and approval of long-term procurement plans, will help to promote demand response prior to the eventual increase in energy bid caps. The CAISO notes that, notwithstanding its concerns about promoting demand response, the MSC supports the CAISO's

proposal for a transition plan to raise the energy bid cap, but emphasizes the need to maintain significant levels of forward contracting for energy and A/S.<sup>22</sup>

The CAISO's proposal for transitioning to a \$1,000/MWh bid cap strikes the proper balance between the need to promote infrastructure development and the need to provide adequate protection against the exercise of market power and price volatility before additional generation is placed in service. By signaling its intent to review the level of the price cap on an annual basis and to raise the bid cap in the future (based upon the results of such review), the Commission will help to promote the development of necessary infrastructure. More importantly the CPUC's resource adequacy and procurement requirements, coupled with increased LSE forward contracting, will serve as the primary vehicle for new investment. In summary, the CAISO's proposal allows for the bid cap to be raised in a rational and prudent manner.

**b. Parties Requesting an Immediate Increase in the Bid Caps Have Not Demonstrated That the Increase Is Justified**

It is important to recall that the CAISO is proposing, at least during the first year of MRTU implementation, to retain a \$250/MWh soft energy cap that the Commission itself has already determined to be just and reasonable. The CAISO recognizes that it is appropriate to revisit the appropriateness of the \$250 cap in the context of the new market structure being implemented in February 2007. This consideration of the cap, however, must be made against the backdrop of the Commission's orders recognizing that a \$250 soft cap is appropriate to mitigate the potential for market power abuse in California's

---

<sup>22</sup> MSC MRTU Opinion, Attachment F at 11-13.

wholesale electricity markets. Parties arguing for increases to the existing \$250/MWh bid cap bear the burden of demonstrating that: (1) the CAISO's proposed retention of the \$250 bid cap (at least for the first year of the new markets) is not just and reasonable, and (2) the higher bid cap they propose is just and reasonable.<sup>23</sup>

The CAISO notes that one commenter, Duke, raises a bid cap issue that goes beyond the scope of the CAISO's May 13 Filing. Duke requests that the Commission increase the existing energy bid cap to \$1,000/MWh by October of this year – fifteen months in advance of the February 2007 MRTU implementation date. This request is not a comment on the CAISO's proposed market power mitigation measures, but is instead an impermissible collateral attack on the CAISO's existing market power mitigation measures, wholly separate from the MRTU issues raised by the CAISO's May 13 filing pursuant to Section 205 of the FPA. Duke's request to increase the energy bid cap prior to MRTU implementation must be rejected.<sup>24</sup>

In its January 17, 2002 Order setting the bid cap at \$250/MWh, the Commission stated that a "\$250/MWh bid cap is needed at this time to mitigate the potential for market power abuse." January 17, 2002 Order at P 47. The

---

<sup>23</sup> See *New England Power Company*, 52 FERC ¶ 61,090 at 61,336 (1990), *reh'g denied*, 54 FERC ¶ 61,055 (1991), *aff'd*, *Town of Norwood v. FERC*, 962 F.2d 20 (D.C. Cir. 1992), citing *City of Bethany v. FERC*, 727 F.2d 1131, 1136 (D.C. Cir. 1984) (a utility need only establish that its jurisdictional tariff or rate schedule is reasonable, not that it is superior to alternatives); see also, e.g., *Tarpon Transmission Company*, 57 FERC ¶ 61,371 at 62,235 (1991) (noting that the burden is on parties challenging an existing rate to prove that that rate is unjust and unreasonable and that the lower rate that they seek is just and reasonable); *Vermont Yankee Nuclear Power Company*, 40 FERC ¶ 63,006 at 65,043 (1987) (same).

<sup>24</sup> The CAISO notes that the only appropriate way for Duke to request that the Commission increase the existing energy bid caps would be through a complaint under Section 206 of the FPA.

Commission recognized that the \$250/MWh bid cap reflected a “careful balance of the need to provide incentive for market entry by new generation investment with the need to protect markets from the potential of market power abuse.” *Id.* at P 51. The Commission added that it would “consider increasing the bid cap to reflect market conditions.” *Id.* at P 48.

In the July 17, 2002, Order the Commission stated that market design flaws needed to be corrected and additional generation and transmission infrastructure needed to be built in order to make the California markets competitive. While the MRTU proposal addresses the former problem, the latter problem has not been adequately addressed at this time. The CAISO believes that the CPUC’s resource adequacy program and a renewed focus on transmission in California will result in the development of adequate infrastructure in the future. For example, the CAISO Board recently approved a new 500 kV transmission line between Arizona and California (Palo Verde 2) that is expected to increase California’s import capability from Arizona by at least 1,200 MW. This new transmission line is expected to be operational by 2009.<sup>25</sup> However, California is not there yet, and there is not adequate infrastructure in place to support increasing the bid cap at this time.

Most of the commenters seeking an increase in the energy bid cap do not even attempt to identify changed market conditions since July 2002 that would justify increasing the bid cap above \$250/MWh on day one of MRTU implementation. IEP/WPTF points to the following four changes in market

---

<sup>25</sup> See Memorandum to CAISO Board of Governors on Palo-Verde-Devers No. 2 500KV Transmission Project (Feb. 18, 2005), available on the CAISO’s Home Page at <http://www.caiso.com/docs/09003a6080/34/cf/09003a608034cf20.pdf>.

conditions that they believe justify an increase on MRTU day one: 1) unlike Summer 2000, California utilities can now make forward energy purchases; 2) market participants operate under more vigorous oversight under the Commission's recently adopted Market Behavior Rules; 3) the CAISO's Nov. 2005 MRTU filing will create a completely revised wholesale market structure related to the one that existed when the current "price caps" [sic] were imposed; and 4) Path 15 has been improved, allowing for more efficient balancing of supply and demand in California. IEP/WPTF at 8-10.

This argument is unconvincing because the factors identified by IEP/WPTF are either unrelated to or fail to fully address the infrastructure needs in the region that create the potential for the exercise of market power. The factors identified by IEP/WPTF have not led to sufficient generation investment to reduce California's dependence on hydroelectric power and imports. The generation capacity that has been added has largely been offset by load growth and unit retirements in the region.<sup>26</sup> The CAISO acknowledges that the addition of new capacity on Path 15 addresses a significant transmission constraint in California, but without still further infrastructure improvements, the potential for the exercise of system market power remains. Although California has been fortunate to have access to sufficient hydroelectric power over the past few summers, a dry hydro season could still replicate many of the conditions experienced during the energy crisis, causing the region to rely on the Damage

---

<sup>26</sup> See CAISO 2005 Summer Operations Assessment Report , available on the CAISO's Home Page at <http://www.caiso.com/docs/09003a6080/35/46/09003a60803546fd.pdf>.

Control Bid Cap as the primary measure to mitigate system-wide market power. Thus the need for the \$250 Damage Control Bid Cap remains.

The CAISO submits that the level of the bid cap should reflect market conditions in the particular region where the bid cap will apply. In the CAISO's opinion, to the extent that either structural or market deficiencies enable suppliers to exert market power on a sustained basis or otherwise engage in market power abuse, the bid cap must be set at a level low enough to provide adequate protection to consumers, but not so low as to dull price signals for long-term energy contracting and demand response. In the July 17, 2002 Order, the Commission found that the \$250/MWh Damage Control Bid Cap achieved these objectives given market and infrastructure conditions at the time. These conditions have not changed sufficiently to justify a higher bid cap at this time.

The reserve margins in California are still significantly lower than the reserve margins in PJM.<sup>27</sup> In particular, projected reserve margins for 2005 are razor thin in Southern California (6.6% for a "1-in-2" forecast and -0.7% for a "1-in-10" forecast). It is much easier to justify higher bid caps in a market such as PJM's because the exercise of market power is less of a concern given the existence of a robust supply-demand balance. That is not the case in California. California needs to develop additional infrastructure to justify implementing the same bid cap level as PJM. Also, as indicated in the 2005 Summer Assessment, the CAISO is still reliant on imports to meet approximately 20% of its peak day needs. However, there are tight supply conditions in Southern California due to

---

<sup>27</sup> Compare CAISO 2005 Summer Operations Assessment with PJM's 2004 *State of the Market Report*.



deliverability constraints that limit the amount of imported energy. Moreover, as the Commission has recognized, demand in neighboring states is increasing and the CAISO cannot continue to rely on imports to ensure reliability and low electricity prices. *California Independent System Operator Corporation*, 100 FERC ¶ 61,060 at P 32 (2002). Until additional in-state generation is built, the CAISO will not be able to avoid its reliance on imports.

Further, there is a greater reliance on hydro-electric resources in California than in the eastern markets. When there is an adequate supply of hydro-electric resources, prices can remain competitive; however, as California learned first hand during the energy crisis, when hydro-electric reserves are low, suppliers have increased opportunities to exercise market power. In the last couple of years, California has been the beneficiary of good hydro-electric conditions, and that has helped to moderate prices. However, the fact remains that there is still a supply-demand imbalance in California and, until additional generation is built, a lower bid cap may be necessary to protect against the exercise of market power in the event of a dry-hydro year.

IEP/WPTF contends that, due to the interaction of Western markets, the \$250 bid cap could lead to shortfalls in supply in California during periods of high gas prices or capacity shortages resulting from low hydro conditions. IEP/WPTF at 12-13. As the CAISO explained in the May 13 filing, LECG raised a similar concern. Transmittal Letter at 36-37. Although, in theory, the West-wide application of the soft cap should prevent other Western states from enjoying a competitive advantage in shortage conditions, in practice California may be

disadvantaged vis-à-vis the rest of the West if spot bilateral transactions outside of California occur above \$250/MWh and are not reported to FERC and/or bilateral purchases outside of California are priced at \$250/MWh over a block of hours (*i.e.*, a peak hour purchase above the cap is amortized at the cap over a block of hours to avoid FERC reporting requirements).

It should be noted that this is not a change in market conditions that justifies an increase in the energy bid caps. The CAISO and California consumers have been living with the risks associated with a \$250/MWh soft cap for the past four years ever since the West-wide soft-cap was first implemented in June 2001. Ultimately, this risk must be weighed against the potential customer harm that could result under a higher bid cap if there are sustained market power problems at a West-wide level and insufficient forward energy contracts by LSEs to hedge against such high prices. The CAISO believes that on balance, the prudent course is to maintain the \$250/MWh energy bid cap until there is some proven and positive experience under both MRTU and the CPUC resource adequacy program.

None of the commenters proffered credible evidence that the supply-demand conditions in California have permanently and significantly changed to support increasing the Damage Control Bid Cap on day one of MRTU implementation – nor can they. Thus, it is appropriate that the bid cap remain at \$250/MWh on day one of MRTU implementation.

**c. The CAISO's Proposal to Transition To a Higher Damage Control Bid Cap is Reasonable**

As noted above, comments on the CAISO's proposed process for implementing a measured increase of the energy bid caps express a wide range of views. On the one hand, CCSF claims that raising the bid cap after even a year of MRTU implementation would be premature given the potential for a repeat of the energy crisis. CCSF urges that the CAISO gain additional experience with the new markets before proposing an increase in the cap. On the other hand, Sempra suggests that the three-year transition proposed in the May 13 Filing is overly cautious. IEP/WPTF contends that the CAISO's bid cap transition proposal would provide the CAISO with excessive discretion to raise the caps based on subjective criteria.

As an initial matter, the CAISO notes that one of IEP/WPTF's objections to the transition approach proposed by the CAISO is based on a misunderstanding of the CAISO's proposal. They state that, "there is no guarantee or requirement in the CAISO proposal that the CAISO ever make such a filing with the Commission to review the CAISO's actions." In the May 13 Filing, however, the CAISO explained that:

Under the CAISO's proposal, the CAISO will obligate itself to file its analysis and bid cap recommendation with the Commission annually even if the CAISO does not recommend raising the energy bid cap. This will provide market participants with an opportunity to respond to the CAISO's analysis and recommendation and provide their own analysis if they desire. Importantly, it will provide the Commission with a "record" upon which to base its own determination as to whether the energy bid cap should or should not be raised. Thus, CAISO will be providing the Commission and stakeholders both with a forum to address this issue and a detailed record of market performance and prognosis, as well as other

considerations upon which the Commission can make a reasoned decision, supported by substantial evidence, whether to raise the bid cap.

Transmittal Letter at 35-36. Thus IEP/WPTF is incorrect in suggesting that future bid cap determinations will not be subject to Commission review. Regular Commission review of the bid caps is a key feature of the CAISO's proposal. The specific criteria for this annual consideration of bid cap increases will be discussed with stakeholders over the course of the summer and will be included in the MRTU Tariff filing to be filed with the Commission in November of this year.

The EOB requests confirmation that the CAISO is not proposing a hard-wired schedule for increasing the bid caps and specifically that the three-year timetable suggested in the May 13 Filing is not binding on the CAISO in the event that market conditions do not justify an increase in the cap. The CAISO agrees with the EOB that increases to the energy bid caps should not be hard-wired. The three year schedule described in the May 13 Filing is contingent upon a finding that market conditions support an increase to the bid cap and that the specific criteria laid out in the November 2005 Tariff filing have been satisfied.

In an effort to respond to opponents of the current bid cap, the Commission may be tempted to hard-wire a timeline for automatically raising the bid cap. The CAISO urges the Commission to recognize such a directive would be unjustified and premature. Under the CAISO's proposal, beginning 16 months after MRTU implementation, the Commission will have an annual opportunity to consider whether the bid cap should be increased. The Commission's annual

consideration of the bid cap will have the benefit of analyses of market conditions under the new LMP-based markets in California. The CAISO's bid cap transition proposal will provide the Commission with the necessary forum, mechanism and record to make reasoned decisions, supported by substantial evidence as to whether actual market conditions justify an increase to the bid cap. Moreover, the phased-in approach contemplated by the CAISO's proposal will permit additional generation to be constructed before the bid cap reaches \$1,000/MWh, thereby protecting consumers from system market power and price spikes during dry hydro seasons.

Conversely, a decision to increase bid caps at this time would essentially constitute an arbitrary projection that market conditions at some future date will be favorable so as to support increasing the bid cap at that time. Such a decision would be contrary to the Commission's finding in the January 17, 2002 Order that the existing bid cap should be raised only if market conditions change. For the reasons discussed above, these market conditions will only change once the infrastructure problems that create the potential for abuse of market power have been addressed. If the Commission expresses an intent to raise the bid cap in the future, that would be supportive of the investment in new infrastructure, which will permit a future increase in the bid cap based on real evidence of competition in California's markets.

IEP/WPTF has one comment on the criteria the CAISO should consider in making its annual determination and FERC filing concerning bid cap increases. IEP/WPTF argues that allowing the CAISO to consider forward contracting and

actual hedging practices of LSEs in determining whether to raise the caps will create distortions in bilateral markets and the CPUC's resource adequacy program. IEP/WPTF at 18. As noted above, the specific criteria for annual assessments of the bid caps will be discussed with stakeholders and included in the November 2005 MRTU Tariff filing. The CAISO notes, however, that the ability of LSEs to enter into forward contracts is a critical measure for determining the ability of suppliers to exercise market power. Indeed, in the CAISO's May 2002 and July 2003 MRTU filings, the CAISO identified forward contracting by LSEs as the first tier of market power mitigation measures that must be satisfied to have truly competitive markets.<sup>28</sup> The CAISO expects that the need to comply with CPUC's Resource Adequacy Requirements, which will include deliverability tests and local area requirements, and the CPUC-approved long-term procurement plans will drive the bulk of forward contracting in California starting in 2006. The CAISO's consideration of forward contracting issues (*e.g.*, the extent to which the state's regulatory framework provides an appropriate opportunity and impetus for forward contracting) as part of its annual bid cap assessments is therefore unlikely to create distortions in bilateral markets.

### **3. Bid Caps for Ancillary Services and Residual Unit Commitment Availability Bids**

IEP/WPTF opposes the CAISO's proposal to reduce A/S bid caps in lock-step with increases to the damage control energy bid caps, arguing that the CAISO is incorrect that the cost of providing A/S is close to zero, and that lowering the A/S cap is inconsistent with creating the proper incentives to

---

<sup>28</sup> See Attachment B to the May 13 Filing at 4-5.

address A/S bid insufficiency. IEP/WPTF at 18-19. These arguments are without merit.

Once MRTU is fully implemented and the energy bid cap has been increased to \$1,000/MWh, there is no justification for an A/S cap of higher than \$100/MW. Eastern ISOs have lower A/S caps. For example, PJM currently has a \$100/MW cap on regulation bids and a \$7/MW cap on spinning reserve bids. Also, it is important to note that under MRTU, A/S prices will automatically reflect the opportunity cost of providing reserves and, therefore, unlike today's market design, it will not be necessary for market participants to incorporate opportunity costs into their A/S capacity bids. As a result of this A/S pricing design, the prices paid for A/S may exceed the level of the capacity bid cap. This change largely eliminates the need for a high capacity bid for ancillary services. Lastly, nothing in IEP/WPTF's comments counters the conclusions of the MSC that A/S markets are "far more susceptible to the exercise of unilateral market power than the energy market" due to the relative thinness of the A/S markets. MSC MRTU Opinion, Attachment F at 13.

IEP/WPTF also opposes the CAISO's proposal to reduce the RUC Availability Payment bid cap in lockstep with the A/S bid caps. IEP/WPTF at 19-20. IEP/WPTF suggests that this proposal is inconsistent with the Commission orders approving the RUC Availability bid cap. This argument ignores the fact that the Commission's rationale for requiring a \$250/MWh RUC Availability Payment bid cap is because RUC capacity procurement is comparable to A/S procurement and the RUC Availability Payment should be subject to the same

bid cap as A/S. For example, in the October 28 Order, the Commission found that the procurement of capacity under RUC was similar to the procurement of capacity in the ancillary services market, and directed the CAISO to replace the proposed \$100/MWh RUC availability bid cap to reflect the \$250/MWh ancillary services capacity bid cap. October 28 Order at P 123; see also *California Independent System Operator Corp.*, 110 FERC ¶ 61,041 at P 10 (2005).

SCE raises concerns regarding A/S mitigation in the event that the CAISO procures A/S on a locational basis. SCE at 6. SCE is concerned that the price of such A/S will be high as a result of suppliers exercising market power due to a lack of competitive alternatives within a procurement area. If the CAISO is committed to procuring A/S on a level more granular than the current zones in MRTU Release 1, then SCE urges the CAISO to conduct a separate stakeholder process on the issue of A/S market definition, which will consider appropriate A/S market power mitigation based on that definition. *Id.* at 7.

SCE's concerns are premature. As explained in the CAISO's MRTU White Paper, the CAISO is initiating a stakeholder process over the next several months to better define potential procurement regions for A/S under MRTU and to examine the potential competitiveness of these regions.<sup>29</sup> One of the issues the CAISO will address as part of that stakeholder process is whether there is a need for more stringent A/S market power mitigation measures than the proposed reduction in A/S bid caps described above. The CAISO will address the procurement regions for A/S under MRTU and any further market power

---

<sup>29</sup> May 13 Filing, Attachment A at 26-27.



mitigation measures that might be justified by locational A/S procurement as part of its November 2005 MRTU Tariff filing.

#### **4. Local Market Power Mitigation (“LMPM”)**

##### **a. It Is Imperative That the CAISO Have an Effective LMPM Structure in Place When It Implements LMP-Based Markets**

SCE, PG&E, CCSF, the CPUC and the EOB all support the need for effective LMPM. SCE at 2; PG&E at 11-12; CCSF at 3; CPUC at 12; EOB at 4. Two parties, Duke and Coral, however, assert that the CAISO has not met its burden of demonstrating a need for LMPM. Duke also contends that the CAISO has not made any showing in its filing that its existing local market power mitigation measures are inadequate to mitigate local market power because of the transition to a LMP-based market structure. Duke at 11. None of these arguments is convincing, and additionally, Duke’s argument is not relevant to the CAISO’s burden to demonstrate that its proposed LMPM measures are just and reasonable. Nevertheless, in the May 13 Filing, the CAISO included a lengthy and comprehensive explanation of why LMPM was necessary under an LMP congestion pricing model, and why the CAISO’s existing protections against locational market power are inadequate under an LMP regime. With respect to the need for LMPM in conjunction with LMP, the CAISO cited to the MSC’s *Opinion on the Necessity of Effective Local Market Power Mitigation for a Workably Competitive Wholesale Market*, dated May 29, 2003,<sup>30</sup> in which the

---

<sup>30</sup> This opinion was included in the CAISO’s July 2003 Filing as Attachment D.

MSC undertook a detailed examination of the need for LMPM measures under the CAISO's market redesign process, and concluded that such measures were critically necessary under an LMP system in order to prevent units with local market power from being able to "extract substantial, practically unlimited profits from the market for the output of those units." July 2003 Filing, Attachment D at 2.

With respect to the adequacy of existing LMPM measures, the CAISO provided several convincing reasons why existing LMPM measures would prove inadequate and would result in unjust and unreasonable rates when the CAISO implements LMP. First, citing the MSC's opinion on the CAISO's most current proposed mitigation measures,<sup>31</sup> as well as its May 29, 2003 opinion, the CAISO explained why existing AMP thresholds are inadequate and inappropriate to effectively mitigate the exercise of locational market power. Transmittal Letter at 42. The CAISO also explained that the limits on bidding flexibility approved by the Commission in the July 17 Order are significantly less protective of consumers than those which the Commission has approved for PJM. Transmittal Letter at 43.

Duke's argument that the CAISO's LMPM proposal constitutes a collateral attack on the Commission's previous orders with respect to the justness and reasonableness of existing market mitigation measures is also without merit. Duke suggests that the Commission, in its July 17, 2002 Order, found that the solution to local market power was for the CAISO to use AMP along with a day-

---

<sup>31</sup> Attachment F to the May 13 Filing.

ahead market and nodal pricing. Thus, the CAISO's proposal to use a PJM-style mitigation package is inconsistent with the July 17, 2002 Order. Duke at 11. Duke's argument, however, is undercut by the Commission's discussion of the CAISO's proposal to employ a PJM-style regime for mitigation of local market power in the October 28 Order. Significantly, in that order, the Commission did not conclude that the CAISO's proposal was unjust and unreasonable, or direct the CAISO to adopt an AMP methodology for local market power mitigation instead of the PJM methodology. Rather, the Commission noted that it was not certain that the CAISO's mitigation proposal would "achieve an appropriate balance with other market design elements," and therefore set this issue for discussion in a Commission Staff-led technical conference. October 28 Order at P 275. Moreover, in his concurrence to the October 28 Order, Chairman Wood specifically noted that he would be "comfortable" accepting the CAISO's proposal to adopt a PJM-style local market power mitigation regime. *Id.* at Wood Concurrence, p 2. Thus, Duke's assertion that the Commission has already determined that the CAISO should employ an AMP methodology for local market power mitigation rather than a PJM-style methodology is incorrect.

Finally, Coral argues that the CAISO has not adequately demonstrated that its markets are not workably competitive such that *any* mitigation measures would be appropriate. Coral at 17. This argument is directly contradicted by the performance of California wholesale energy markets over the past five years. During this period, the CAISO, as well as a variety of other entities and commentators, have detailed the ability of suppliers to exercise locational market

power under certain conditions, and the Commission has recognized the ability of suppliers to do so in numerous orders, most notably its series of orders addressing the need for mitigation measures in the CAISO markets as a result of the energy crisis of 2000-2001.<sup>32</sup>

**b. The CAISO's Proposed LMPM Measures Are Based on the Just and Reasonable Measures Employed in PJM**

In addition to the explanation regarding the need for an effective LMPM if the CAISO is to implement LMP, the CAISO laid out the particulars of its proposed LMPM process in the May 13 Filing. Under this "PJM-like" approach, a unit owner may choose among three default bid options: (1) variable cost plus 10%, including adjustment for fuel price changes; (2) a weighted average LMP at the same location during the dispatches in the preceding 90 days, where the resource was dispatched for energy in economic merit order; or (3) an amount negotiated with the Independent Entity responsible for determining Default Bids. Transmittal Letter at 45. The CAISO explained that this proposal reflects several modifications made to the CAISO's earlier LMPM proposal in order to more closely mirror the PJM approach, in response to the concerns articulated by Commission Staff in the Staff Guidance Letter that certain elements of the CAISO's earlier LMPM proposal diverged from PJM's local market power mitigation process. Transmittal Letter at 44-45.

---

<sup>32</sup> See, e.g., *San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Services, et al.*, 93 FERC ¶ 61,121 at 61,350 (2000) (finding that "there is clear evidence that the California market structure and rules provide the opportunity for sellers to exercise market power when supply is tight, and can result in unjust and unreasonable rates under the FPA")

SCE, PG&E, CCSF, the CPUC and the EOB all support the CAISO's recommendation to establish PJM-style LMPM measures. SCE at 2; PG&E at 11-12; CCSF at 3; CPUC at 12; EOB at 4. IEP/WPTF, joined by Dynegy/Williams and Coral, opposes the adoption of a PJM-style LMPM, instead recommending the NYISO-style C & I approach, stating that the PJM-style measures may result in over-mitigation. IEP/WPTF at 27-29.

No party has raised any legitimate arguments that warrant rejection of the CAISO's proposed PJM-style LMPM measures. Rather opponents of the PJM-style LMPM measures merely claim -- without any underlying support -- that the PJM-style mitigation measures will result in over-mitigation and the suppression of price signals, and that NYISO-style C & I measures are better suited for the CAISO than the PJM-style LMPM measures.<sup>33</sup> As discussed below, the CAISO believes that the opponents of the PJM-style mitigation are incorrect in their assertion that these measures are somehow inferior to the NYISO-style C & I approach. Even assuming for the sake of argument, however, that the Commission was to accept the notion that the NYISO-style C & I measures were better suited for the CAISO than the PJM-style measures, this in and of itself does not warrant rejection of the CAISO's proposal. Rather, the standard that the Commission must apply is whether the CAISO's proposal is just and reasonable in and of itself. The CAISO is not required to demonstrate that it

---

<sup>33</sup> IEP/WPTF also suggest that the CAISO's decision to propose a PJM-style LMPM approach was motivated by the desire to "pursue the path of least resistance," based on the CAISO's statement in the May 13 Filing that a PJM-style approach would be "simpler to implement." IEP/WPTF at 3-4. This argument, however, takes the CAISO's statement out of context. In full, the CAISO stated that it "prefers the PJM-like approach to local market power mitigation because it *provides greater protection against local market power* and is simpler to implement." May 13 Filing, Attachment B at 19 (emphasis added).

has filed the best possible alternative; it is only required to file a proposal that is just and reasonable. See *New England Power Company*, 52 FERC ¶ 61,090 at 61,055 (1991), *reh'g denied*, 54 FERC ¶ 6,055, *aff'd*, *Town of Norwood v. FERC*, 962 F.2d 20 (D.C. Cir. 1992), citing *City of Bethany v. FERC*, 727 F.2d 1131, 1136 (D.C. Cir. 1984) (utility need only establish that its proposed rate design is reasonable, not that it is superior to alternatives); *OXY USA, Inc. v. FERC*, 64 F.3d 679, 692 (D.C. Cir. 1995) (“[T]he Commission may approve the methodology proposed in the settlement agreement if it is ‘just and reasonable’; it need not be the only reasonable methodology or even the most accurate”). Thus, if the CAISO files a proposal that is just and reasonable, the Commission must approve it; the Commission cannot reject that proposal and instead substitute another just and reasonable proposal that it believes is superior. Stated another way, the sole test of whether the Commission should approve the CAISO’s proposal is whether that proposal is just and reasonable. The existence of other just and reasonable alternatives, even if it can be demonstrated that those alternatives are superior (which the CAISO, the MSC, and many parties do not believe to be true) is irrelevant in any event.

Although IEP/WPTF makes several conclusory claims regarding the “problems” with the PJM-style mitigation measures, and attempts to denigrate, without explanation, the PJM approach by referring to it as “dated,” they do not present any credible evidence actually demonstrating that the PJM approach is unjust and unreasonable. IEP/WPTF ignores the fact that the Commission has approved (and consistently reaffirmed) the justness and reasonableness of

PJM's LMPM measures in a number of orders. See *PJM Interconnection, LLC.*, 96 FERC ¶ 61,233 (2001); *Atlantic City Electric Company, et al.*, 86 FERC ¶ 61,248 at 61,899 (1999); *PJM Interconnection, LLC*, 110 FERC ¶ 61,053 at P 113 (2005). More recently, the Commission concluded that PJM's market design package, which provides generators with three options, including a cost-plus-10-percent offer cap, worked effectively to mitigate market power "in a manner that is fair to most generating units." *PJM Interconnection, LLC*, 107 FERC ¶ 61,112 (2004) at P 36.<sup>34</sup> It is axiomatic that an agency must conform to its prior practice, policy or decisions or explain the reasons for its departure from precedent. *United Municipal Distributors Group v. FERC*, 732 F.2d 202, 210 (D.C. Cir. 1984); *Greater Boston Television Corporation v. FCC*, 444 F.2d. 841, 852 (D.C. Cir. 1970), *cert. denied*, 403 U.S. 923 (1971) (agency must give reasoned analysis for departure from prior agency practice). Accordingly, there is no rational basis to reject the CAISO's proposed PJM-style LMPM measures.

Moreover, despite IEP/WPTF's unjustified claims to the contrary, IEP/WPTF at 23-24, the PJM-style mitigation measures are appropriately applied to the CAISO. In PJM, the Commission recognized that PJM's LMPM measures apply when there is a transmission constraint and PJM must dispatch a unit out of merit order for reliability purposes. *PJM*, 110 FERC at P 54. Thus, the LMPM measures operate in load pockets and the LMPM rules mitigate local market power in load pockets when transmission constraints arise. *Id.* That is

---

<sup>34</sup> In this order, the Commission expressed concern with respect to PJM's compensation of frequently mitigated generators. As explained below, the CAISO is proposing to adopt several measures approved with respect to PJM to address concerns regarding compensation for frequently mitigated units.

essentially the same circumstances under which the CAISO's LMPM measures will apply. The Commission recognized that the fact that a generator is dispatched out of economic order due to transmission constraints means that there are few competitive options and the market is unlikely to be competitive. *Id.* at P 58. The same logic applies in the CAISO markets as it does in PJM's markets.

The CAISO wishes to make it clear that just because a transmission path is listed as non-competitive, that does not mean that LMPM will be applied automatically; rather, the CAISO will only apply its LMPM in instances where there is an actual opportunity for a supplier to exercise local market power on a non-competitive path. Thus, the "competitive" versus "non-competitive path" designation is intended solely as a "screen" to specify the paths on which bids might be subject to LMPM. Whether any bids on "non-competitive paths" will actually be mitigated under the LMPM will depend on the results of the LMPM runs performed prior to the IFM in the Day-Ahead timeframe and the HASP in Real-Time (the "LMPM pre-Market runs"), and application of the specified criteria. If a resource is dispatched to resolve Congestion on a non-competitive path in the second LMPM pre-Market run and has a market bid that is equal to its accepted bid in the first LMPM pre-Market run, its bid will not be mitigated. This fact, coupled with the fact that the CAISO is also proposing a PJM-style bid adder for frequently mitigated units (discussed further below), supports a finding that the CAISO's proposed LMPM measures are just and reasonable. Given that the Commission did not find that PJM's LMPM measures result in over-



mitigation, it is difficult to see how one can claim that such measures result in over-mitigation in the CAISO's markets.<sup>35</sup>

Further reinforcing the justness and reasonableness of the CAISO's LMPM proposal is the fact that the CAISO's proposal comports with the guidance on market power mitigation measures offered by Commission Staff in the Staff Guidance Letter. As indicated in the May 13 Filing, the CAISO made various changes to its proposed LMPM measures in order to ensure that they more closely resemble PJM's measures. Also, in response to Commission Staff's concerns with respect to the differences between the CAISO's AMP proposal and the use of AMP by other ISOs, the CAISO, in the May 13 Filing, proposed to eliminate system-wide AMP for day one MRTU implementation, thus further conforming the CAISO's mitigation proposal to the measures that the Commission has already found to be just and reasonable for PJM. It is also significant to note that nowhere in the Staff Guidance Letter did Commission Staff suggest that a PJM-style mitigation package would be inappropriate for the CAISO. Indeed, Staff's numerous citations to the PJM market mitigation provisions and the Commission orders approving those provisions, and Staff's

---

<sup>35</sup> The CAISO's proposed LMPM measures provide suppliers the opportunity to elect one of three Default Energy Bids all of which are designed to ensure that a supplier adequately covers its marginal operating costs. Further, units that are mitigated are not precluded from earning the locational marginal price. Thus, to the extent units are infra-marginal, there will be opportunities for additional fixed cost recovery, even during mitigated periods. Moreover, resources will be able to earn revenues in excess of variable costs when prices are set by non-mitigated bids during unconstrained periods. As the Commission has recognized, in a competitive market, generators should submit bids based on their short-run marginal costs, but will receive revenues based on the market clearing price. *PJM*, 110 FERC at n. 97. The CAISO's proposed LMPM measures -- just like PJM's LMPM measures -- are consistent with this principle.

requests for the CAISO to reconcile differences between its proposal and the existing PJM measures strongly points to the opposite conclusion.

IEP/WPTF also takes issue with the rationales presented by the CAISO and the MSC for preferring the PJM-style LMPM methodology over the NYISO-type C & I methodology. However, rather than directly addressing and rebutting any of the concerns articulated by the CAISO and MSC with respect to the use of a C & I methodology, IEP/WPTF waxes philosophical about how these criticisms reflect a failure to consider meaningful price signals, and the CAISO's belief that the appropriate bid is always a unit's short-run marginal costs, without consideration to any type of scarcity pricing or the ability of a unit to recover investment costs. IEP/WPTF at 28-29. The CAISO first notes that with the proposal to eliminate system-wide AMP, the CAISO's LMPM approach focuses mitigation on the least competitive aspects of its markets, rather than the market as a whole.<sup>36</sup> With respect to the appropriate level of bids, the CAISO shares the MSC's view that in a competitive spot market, in the absence of physical scarcity, locational marginal prices should reflect the incremental cost (*i.e.* short-run marginal cost) of providing power. As the MSC explained, "In the absence of shortages, prices that deviate from incremental costs cause inefficient consumption and inefficient production." *Id.* at 6. The MSC further explained, "[t]he general idea of local market power mitigation is to induce an offer price from a generation unit with local market power equal to the one that would obtain

---

<sup>36</sup> See May 13 Filing, Attachment F at 13 (noting that the CAISO's move to eliminate system-wide AMP is "consistent with the general approach of focusing mitigation on the least-competitive aspects of the markets and reduces reliance on an ineffective and potentially intrusive mitigation tool.")

if that unit faced sufficient competition. A unit that faces substantial competition would offer a price equal to its variable cost of supplying additional energy.” *Id.*

The CAISO’s position on the appropriate level of bids, however, does not mean that the CAISO has not considered the need for price scarcity, recovery of investment costs, and meaningful price signals. As the CAISO explained in its May 13 Filing, the current MRTU design already provides for scarcity pricing in the forward market when there is insufficient supply to clear against self-scheduled load, and it also provides for scarcity pricing in Real-Time in circumstances where a deficiency in Real-Time supplemental energy bids results in having to dispatch contingency operating reserves. Transmittal Letter at 51-52. If a generator is mitigated under LMPM but is at a location that is subject to the aforementioned scarcity conditions, the LMP for that generator will be set at the Damage Control Bid Cap.

With respect to the recovery of investment costs, the CAISO points out that mitigating a unit to its variable costs does not imply that the unit owner cannot recover sufficient costs to remain in the market. As the MSC explained:

In fact, if this supplier is required to meet a local energy need during a number of hours of the year, then the local LSE will have a strong incentive to enter into a long-term contract with this local supplier that recovers its going-forward fixed costs.

May 13 Filing, Attachment F at 9.

Such an incentive exists because absent such a payment stream, the unit owner may exit the industry or mothball its unit. Moreover, LSEs will be obligated to

enter into such local contracts under the CPUC local resource adequacy requirements.

Finally, with respect to the issue of price signals, the CAISO disagrees with the position that locational prices will be a significant factor in providing incentives for new merchant generation investment, because the addition of new generation into a locally constrained area is apt to significantly reduce LMPs and, therefore, the expected benefits from the investment. Instead, new infrastructure investment (generation and transmission) in a constrained area is more likely to be pursued by the LSEs within that area. In which case, new generation investment in a constrained area is most likely to be the result of a long-term contract between the investor and the applicable LSE.

Moreover, a NYISO-style C & I approach to local market power mitigation of the sort recommended by IEP/WPTF is problematic in the following respects:

- Depending on the specific conduct and impact threshold levels for triggering mitigation, a substantial amount of local market power could go unmitigated.<sup>37</sup>
- Basing dispatch and LMP determination on bids that do not reflect a unit's short-run variable cost will result in inefficient dispatch and distorted price signals.

---

<sup>37</sup> As the MSC pointed out in its November 23, 2004 Opinion, even the conduct threshold of \$10/MWh or 20% of a unit's Default Energy Bid, which was originally proposed as a less-preferred alternative to the PJM-Approach in the CAISO's July 2003 Filing, could result in significant market power, particularly in chronic load pockets where mitigation is apt to be very frequent. A copy of the November 23, 2004 MSC Opinion is available on the CAISO's Home Page at <http://www.caiso.com/docs/2004/11/23/2004112316123829554.pdf>.

- Under a C&I approach, the question of whether a supplier's bidding behavior has an impact on price(s) depends on the bidding behavior of others. If other suppliers are exercising market power (*i.e.*, bidding high but not so high as to trigger a conduct violation) then a supplier being subject to an impact test is unlikely to violate the test.
- A C & I approach is often coupled with bid-based reference prices. The MSC and the CAISO have expressed concern that using bid-based reference prices for LMPM will create a strong incentive for suppliers that are frequently subject to LMPM to strategically manipulate their reference price. This could be accomplished by increasing their bids in hours when they are not subject to LMPM, a phenomenon referred to as "Reference Price Creep." The CAISO has seen empirical evidence of this type of behavior under its current System Conduct and Impact market power mitigation scheme.<sup>38</sup>

In summary, contrary to IEP/WPTF's assertions, the CAISO believes that its proposed PJM-style approach to LMPM is most consistent with competitive pricing outcomes, is superior to a NYISO-style C & I approach for purposes of addressing local market power, and therefore is surely just and reasonable for California.

---

<sup>38</sup> See 2004 Annual Report on Market Issues and Performance (April 2005) at p. 2-32. This document is available on the CAISO's Home Page at <http://www.caiso.com/docs/2005/04/28/2005042814343415812.html>. See also, Comments of the CAISO on Establishing Reference Prices for Mitigation in Markets Operated by Regional Transmission Organizations and Independent System Operators, Docket No. PL05-6-000 (May 2, 2005).

**c. The CAISO's Proposed LMPM Measures Already Provide for Sufficient Revenue Adequacy for Frequently Mitigated Units**

In the May 13 Filing, the CAISO recognized the concerns articulated by Commission Staff in the Staff Guidance Letter with respect to adequate compensation for frequently mitigated units (“FMUs”). In response, the CAISO noted that it believes that revenue adequacy for units that are critical to grid reliability should be met first and foremost through long-term contracting with LSEs and that the CAISO is currently in the process of developing locational procurement requirements to be used in the CPUC resource adequacy program to ensure that LSEs have an obligation to procure sufficient capacity in local areas to meet the reliability needs of the grid. Transmittal Letter at 46. The CAISO also noted its willingness to offer RMR contracts (or a similar alternative) to units which are needed for local reliability but do not have a long-term contract. *Id.* However, in response to the Commission’s expressed preference for administratively simpler and more market-oriented approaches to addressing revenue adequacy, and to ensure that the CAISO would be able to implement appropriate measures along with Release 1 of MRTU, the CAISO proposed an evolutionary process consisting of three measures to address concerns regarding FMUs<sup>39</sup>: (1) a bid adder set at a level similar to what was recently approved for PJM for units not under an RMR or resource adequacy contract, which would most likely be the primary backstop mechanism for ensuring FMU revenue adequacy on day one of MRTU; (2) a CAISO-administered local

---

<sup>39</sup> Under the CAISO’s proposal, FMUs are defined as those units mitigated in 80% or more of their run hours over a rolling 12-month period. Transmittal Letter at 46.

capacity contract for FMUs not under an RMR or resource adequacy contract to replace or serve as an option to the bid adder, which the CAISO plans to develop and implement as rapidly as possible, potentially on day one of MRTU; and (3) possible development of a monthly local capacity market, such as that proposed by ISO-NE, which will be considered after the details of the CPUC resource adequacy requirements are finalized. *Id.* at 46-47.

A number of parties provide comments on the issue of revenue adequacy for FMUs, and the CAISO's proposed approaches to ensuring revenue adequacy for FMUs. Many of these parties take issue with the CAISO's bid adder proposal. DWR contends that such a program could frustrate cost causation principles. DWR at 22-24. PG&E believes that the proposed fixed cost bid adder for frequently mitigated units would be detrimental to, and has not been justified for, the California market. PG&E at 12. SCE maintains that a \$40/MWh bid adder for FMUs would simply legitimize the exercise of local market power without any assurance of a reasonable result, and that exercise of market power will be allowed to set a node's market clearing price, which would impact prices of neighboring nodes. SCE supports the CAISO entering into RMR or RMR-like contracts with specific resources to ensure cost recovery. SCE at 2-4. CPUC states that it shares the concerns with the bid adder approach described by the CAISO and echoed by the MSC, and requests that the Commission reject this aspect of the CAISO's proposal in favor of going forward with development of a backstop local capacity contract to be available prior to implementation of MRTU. CPUC at 12-13. IEP/WPTF opines that the concepts of FMUs, bid adders and

CAISO backstop agreements do not advance the CAISO's market design towards an end-state market-based approach such as a capacity market, and therefore place the CAISO in an unnecessary position. IEP/WPTF at 29. Finally, CCSF argues that the bid adder is inappropriate and unnecessary, and contends that if a generator is mitigated frequently and faces the threat of uneconomic operation, the CAISO should identify such a unit as RMR or provide the unit with a reliability contract as anticipated under the new resource adequacy program. CCSF at 4-5.

At the outset, it bears reiterating that the CAISO has not committed to any specific level of bid adder, but rather noted in the May 13 Filing that it would be set at a level similar to what was recently approved by PJM. Transmittal Letter at 47. As stated in the May 13 Filing, the CAISO has initiated a stakeholder process in order to develop a methodology for determining the appropriate bid adder for FMUs. *Id.* Given the ongoing nature of this stakeholder process, the CAISO submits that it is premature to address issues concerning the specific level of the bid adder at this stage of the proceeding.

With respect to the comments opposing the bid adder in concept, as discussed in the May 13 Filing, the CAISO recognizes that there are drawbacks to the bid adder approach, namely, the possible distortion of spot market performance by allowing units within local reliability areas to bid significantly in excess of their marginal costs, and a wide range of uncertainty or variance in a unit's actual fixed cost recovery over the course of a year. *Id.* at 47-48. However, as explained in the CAISO's April 29, 2005 White Paper on market



mitigation measures, because the CAISO's proposal would only apply bid adders to FMUs without a capacity contract, the likelihood that the undesirable outcomes identified with respect to bid adders will occur largely depends on the extent to which FMUs are not covered by such contracts. May 13 Filing, Attachment B at 23. If relatively few FMUs are in the position of not having a capacity contract, then the potential adverse consequences resulting from bid adders are significantly reduced.

Use of a bid adder also satisfies the concerns articulated by Commission Staff that the CAISO address how FMUs would be able to recover their costs, and that the CAISO reduce its reliance on RMR contracts. Staff Guidance Letter at 4, 6. The CAISO adopted the bid adder approach to address the revenue adequacy issue of FMUs in a manner similar to PJM. Moreover, as noted above, the use of a bid adder mechanism to ensure revenue adequacy for FMUs was recently approved by the Commission for use in the PJM markets. *PJM Interconnection, LLC*, 110 FERC at P 113.

Calpine and IEP/WPTF both object to use of the 80 percent threshold, but neither provides any convincing reason why the 80 percent threshold is unreasonable or offers an alternative proposal. Calpine at 17; IEP/WPTF at 24-25. As the Commission has previously recognized, "the 80 percent test is a useful administrative benchmark for determining what units should be eligible for higher bid caps." *PJM Interconnection LLC*, 110 FERC at P 106. The Commission also found that the "80 percent level is a reasonable cutoff level as the more a unit is mitigated, the less revenue it can recover through participation

in the market.” *Id.* Further, the Commission noted that the 80 percent threshold provides certainty and clarity to market participants. *Id.* at P 105. Moreover, there is no basis to IEP/WPTF’s suggestion that the Commission’s logic for approving an 80 percent threshold in PJM might not apply in California.

IEP/WPTF at 25-26. The Commission approved that threshold to address the situation where units are used a high percentage of the time to support reliability and are not dispatched in merit order most of the time. *PJM Interconnection LLC*, 107 FERC ¶ 61,112 at P 37 (2004). That is exactly the situation in California. FMUs are units that are needed for reliability purposes due to transmission constraints (especially in Southern California) and are generally called out-of-sequence by the CAISO.

IEP/WPTF also argues that the CAISO’s own data demonstrate that the 80 percent threshold is infeasible. IEP/WPTF bases its argument on a presentation given by the CAISO at a stakeholder meeting in May of 2005 which showed that the maximum percentage of run hours where non-RMR units were dispatched out-of-sequence during the period May 2004 through April 2005 was 50 percent.<sup>40</sup> IEP/WPTF at 24. The flaw in IEP/WPTF’s argument is that the presentation they rely upon explicitly excluded RMR units, which are generally the units that are most critical to ensuring local reliability, and thus, absent appropriate mitigation measures, have the greatest opportunity to exercise locational market power. In the CAISO’s June 15, 2005 Working Paper on market mitigation issues, the CAISO included data showing that, in fact, many

---

<sup>40</sup> A copy of this presentation is attached to IEP/WPTF’s filing as Attachment A.

RMR units were dispatched out-of-sequence for 80 percent or more of their run hours during the May 2004 through April 2005 period.<sup>41</sup> Moreover, even with respect to those units that do not satisfy the 80 percent threshold for FMU designation, it is important to understand that, as with PJM,<sup>42</sup> such units will be permitted to demonstrate to the CAISO (or another independent entity that the CAISO may hire to administer the Default Energy Bids) that they are needed for reliability and do not have a reasonable opportunity to recover their costs through the market, and negotiate a Default Energy bid directly with the CAISO (or alternative independent entity), pursuant to option three of the CAISO's base LMPM package. See Transmittal Letter at 45. For these reasons, IEP/WPTF's suggestion that the 80 percent threshold is infeasible is without merit.

In conclusion, as no party has stated a valid basis why the 80 percent threshold -- which was just and reasonable for PJM -- is not just and reasonable for the CAISO, the Commission should reject these arguments and permit the CAISO to implement this mechanism.

IEP/WPTF also takes issue with the CAISO's proposal to implement a backstop capacity contract prior to implementing a capacity market, arguing that the CAISO should focus its efforts on developing a monthly local capacity market, which the CAISO noted in the May 13 Filing it would consider developing on a longer-term basis (e.g., after the first year of MRTU operation). IEP/WPTF at 30. IEP/WPTF contends that the CAISO should address the issue of

---

<sup>41</sup> This Working Paper is available on the CAISO's Home Page at <http://www.caiso.com/docs/2005/06/15/2005061515240422146.pdf>

<sup>42</sup> *PJM Interconnection, LLC*, 110 FERC at P 108.

developing a local capacity market as soon as possible – either contemporaneous with Release 1 or as soon as it can thereafter -- and argues that rejecting the CAISO’s proposal to develop a local capacity contract will “encourage development of a capacity market sooner.” *Id.*

Although the CAISO does not oppose the principle of establishing a local capacity market as a long-term goal, IEP/WPTF’s arguments concerning the timeframe for implementing such a market are unrealistic. As the CAISO stated in the May 13 Filing, it is most appropriate to address the development of a CAISO-administered local capacity market in concert with the ongoing resource adequacy activities at the CPUC. May 13 Filing, Attachment B at 22. Failure to do so would very likely result in a proposal that is not in harmony with the resource adequacy requirements and provisions ultimately adopted by the CPUC, thus undermining the entire rationale for establishing such a market in the first place. Even setting aside the need to coordinate with the CPUC resource adequacy process, the development of a new CAISO-administered market for local capacity would require a significant investment of time and resources on the part of the CAISO, as well as a lengthy and comprehensive stakeholder process. Indeed, IEP/WPTF admits that “creation of a centralized capacity market in California would require due deliberation, and the lead time associated with the creation of such a market is uncertain.” IEP/WPTF at 33. IEP/WPTF then comes full circle by proposing that if a capacity market cannot be immediately developed, then the Commission should adopt a Reliability Capacity Services Tariff (“RCST”), with the features set forth by IEP/WPTF. *Id.* at 34.

Interestingly, the RCST proposed by IEP/WPTF appears to share many of the features of the backstop local capacity contract as it is currently envisioned by the CAISO. IEP/WPTF nevertheless argues that its proposed RCST is superior to the CAISO's proposed backstop capacity contract because the "tariffed reliability payments" provided for in the RCST will increase certainty for the market due to the existence of a tariff price, as opposed to "haggling" over a contract price. IEP/WPTF at 35-36. IEP/WPTF also suggests that because the CAISO's proposed local capacity contract will be based on unit-specific costs, it will not encourage forward contracting by LSEs. As a preliminary matter, it should be understood that these arguments are premature in that none of these issues has yet been addressed in a CAISO stakeholder process, much less presented to the Commission for approval. IEP/WPTF's arguments are nonetheless flawed because they are premised on a fundamental misunderstanding of the anticipated structure of the CAISO's backstop capacity contract. In its April 29, 2005 White Paper on market mitigation, the CAISO explained that payments under a local capacity contract should be made based on pre-set limits, and that such limits could be established by using a demand curve approach, such as the one proposed by ISO-NE. May 13 Filing, Attachment B at 23. Therefore, under this set of assumptions, there would be no "haggling" over contract prices, because such prices would be fixed in advance, and because these prices would be established based on a demand curve, forward contracting by LSEs would not be discouraged. Given that IEP/WPTF has not shown any pressing need to develop a RCST in lieu of the CAISO's

proposed backstop local capacity contract, the Commission should reject IEP/WPTF's request to adopt the proposed RCST. In any event, to the extent that there are any differences between the backstop contract proposed by the CAISO and the RCST as envisioned by IEP/WPTF, these are details that should be discussed in a stakeholder process prior to the filing of a local backstop mechanism (be it through a contract or tariff).

**5. Elimination of System AMP Is Consistent With the Commission's Guidance, and Is Unopposed by Any Party**

As noted above, the CAISO proposes, in the May 13 Filing, to eliminate system-wide AMP. Eliminating system-wide AMP is justified given the Commission's concern that the use of system-wide AMP by the CAISO would be inconsistent with the AMP provisions of other ISOs. Staff Guidance Letter at 5-6. Moreover, this proposal is supported by the MSC, as well as several of the parties commenting on the May 13 Filing. May 13 Filing, Attachment D at 13; IEP/WPTF at 20; CPUC at 10. Finally, no party raises any objection to elimination of system-wide AMP.<sup>43</sup> For these reasons, the CAISO submits that the Commission should approve the CAISO's proposal to eliminate system-wide AMP from its market mitigation design.

---

<sup>43</sup> The CPUC supports the elimination of system-wide AMP, but recommends retaining system AMP functionality in the MRTU software development in the event it is required in the future as the bid caps rise. CPUC at 10. As the CAISO pointed out in footnote 11 of its Market Power Mitigation White Paper (Attachment B to the May 13 Filing), the CAISO will be retaining this functionality in the MRTU Release 1 software.

## 6. Scarcity Pricing

As discussed in the May 13 Filing, the CAISO's current MRTU design provides for a form of scarcity pricing in both the Day-Ahead and Real-Time energy markets. Transmittal Letter at 51-52. In the longer run, the CAISO intends to consider developing a more extensive scarcity pricing design at a system level that could be implemented as a MRTU Release 2 item. *Id.* at 52.

In its comments, the CPUC questions the value of scarcity pricing, including the theory that scarcity pricing encourages new investment. According to the CPUC, scarcity pricing, at best, appears only to send short-term price signals that can only be met with short-term responses. Long-term investment is best encouraged through long-term contracting and the types of resource adequacy programs currently being implemented by the CPUC. CPUC at 16. The CPUC also expresses concern that the CAISO's proposed scarcity pricing mechanisms will not be able to differentiate between the exercise of market power and legitimate scarcity pricing, and notes that unless properly implemented, scarcity pricing can create opportunities for suppliers to create "artificial scarcity" through physical or economic withholding. *Id.*

In response, the CAISO notes that a limited scarcity pricing policy is consistent with the Commission's conclusion that allowing prices for energy and reserves to rise during shortage periods encourages reductions in demand and additional investment in supply, and reinforces contracting. Staff Guidance Letter at 5. Moreover, the MSC generally supports the concept of scarcity pricing. May 13 Filing, Attachment F at 10.

With respect to the CPUC's concerns relating to the CAISO's limited scarcity pricing mechanisms, and the danger that scarcity pricing can create opportunities for withholding, the CAISO is sensitive to these concerns, and believes that this issue would benefit from further discussion with the CPUC and other stakeholders before there is any extension of scarcity pricing in the CAISO's markets. Nevertheless, the CAISO urges the Commission not to require the CAISO to revise or remove the limited scarcity pricing mechanisms currently in its MRTU design, because doing so would require significant modifications to the CAISO's MRTU software, which would, in turn, compromise the February 2007 MRTU Release 1 implementation date. Furthermore, the CAISO believes that these limited scarcity pricing mechanisms are just and reasonable, because they will help to provide incentives for new investment and encourage demand response.

**B. The Concerns Regarding the CAISO's HASP Proposal Are Without Merit or Will Be Addressed by the CAISO In Subsequent Phases of the MRTU Implementation Process**

A number of parties commented on the CAISO's HASP proposal. CPUC, CDWR, EOB, MWD, PG&E, and SCE all state their support for the HASP concept,<sup>44</sup> although several of these parties express concerns regarding the implementation of HASP.

Only two parties, Powerex and Coral, appear to actually oppose the principle of the HASP design. Both of these parties contend that the CAISO has not shown that its HASP proposal is just and reasonable as opposed to

---

<sup>44</sup> SCE at 7; MWD at 6; CPUC at 4-6; PG&E at 4; EOB at 3; CDWR at 17-18.



implementing a financially binding full Hour-Ahead market. Powerex at 5-6; Coral at 8-12. These comments are without merit. In fact, the May 13 Filing contained substantial discussion detailing why the HASP proposal is just and reasonable, and the numerous benefits that HASP offers over a financially binding Hour-Ahead settlement market. Therein, the CAISO explained that the HASP proposal meets the following objectives: (1) reducing design complexity; (2) reducing implementation costs for the CAISO and market participants; (3) reducing ongoing operating costs for the CAISO and market participants; and (4) meeting, to the maximum extent possible, the primary operation and business requirements of the CAISO and market participants. Transmittal Letter at 25. Moreover, the May 13 Filing contained a detailed analysis of the HASP design performed by Hogan & Harvey, including a comparison of the advantages of implementing a HASP versus the advantages of implementing a financially binding Hour-Ahead market. Therein, Hogan & Harvey concluded that the HASP “would achieve most of the purposes of an hour-ahead market, so there would be few if any benefits from the implementation of a full Hour-Ahead market.” May 13 Filing, Attachment D at 3. Hogan & Harvey also addressed three broad areas of concern that have been identified with respect to reliance on an Hour-Ahead scheduling process that is not accompanied by an hour-ahead market, and concluded that all of these concerns could be addressed within the structure of HASP without the need to incur the costs, time lags, and market design complications associated with the implementation of a full Hour-Ahead market. *Id.* at 9.

Echoing the comments of Hogan & Harvey, the CAISO also pointed out that two of the eastern ISOs, PJM and the NYISO, have successfully operated ISO coordinated day-ahead markets based on security-constrained unit commitment for nearly five years without the need for a full Hour-Ahead settlement process. Transmittal Letter at 26; May 13 Filing, Attachment D at 2. Coral argues, however, that the Commission, in the September 20 Order, rejected the notion that because PJM and NYISO do not operate an Hour-Ahead market such a market should not be required in California. Coral at 11. This argument ignores the fact that the Hogan & Harvey analysis specifically addressed the unique aspects of California that, according to the Commission, might make it more important that the CAISO have a full Hour-Ahead market, and concluded that a full Hour-Ahead market would not offer any advantages over the HASP proposal with respect to these issues. May 13 Filing, Attachment D at 9-11. Moreover, as the CAISO noted in the Transmittal Letter, several modifications were made to the HASP proposal in order to address the import-related concerns enunciated by the Commission in its September 20 Order. Transmittal Letter at 26. Thus, as Hogan & Harvey conclude, absent some identification of important irreversible decisions that CAISO market participants would make in such an Hour-Ahead market but that do not confront market participants in PJM or NYISO, there is no reason to require the CAISO to increase the administrative and design complexities of its MRTU implementation task by requiring it to implement a financially binding Hour-Ahead settlement

process that has not proven to be necessary to other ISOs operating under very similar market designs. May 13 Filing, Attachment D at 2-3.

Coral also argues that the CAISO did not satisfy the Commission's requirement in the September 20 Order that the CAISO quantify the costs and benefits of implementing HASP versus a full Hour-Ahead market. Coral at 10-11. Coral is incorrect. Where it was possible to perform a quantitative assessment of the relative costs and benefits of the two approaches, the CAISO did so. For instance, in the May 13 Filing, the CAISO indicated that incorporating a financially binding Hour-Ahead market into the initial release of MRTU would cost in the range of \$150,000 to \$300,000 above the current budget for system development and testing. Where such detailed quantitative results were not available, the CAISO provided a qualitative assessment of the relative costs and benefits of the two approaches. What is significant is that the CAISO's assessments were not based merely on its own analysis, but also on the third-party analysis performed by Hogan and Harvey, which the CAISO solicited in a good-faith effort to obtain a neutral and exhaustive review of the costs and benefits of HASP versus a binding Hour-Ahead market. Given that Coral presents no reason to dispute the conclusions reached by Hogan and Harvey, the Commission should reject Coral's argument that the CAISO did not meet the Commission's requirements with respect to quantifying the benefits of HASP versus a binding Hour-Ahead market.

The remainder of the concerns expressed by the various parties commenting on this issue relate to the implementation of HASP, rather than to

the essential principle of HASP. For instance, IEP/WPTF expresses concern that the CAISO's HASP proposal, as currently designed, does not offer a second explicit settlement, which would include the re-optimization of energy and A/S after the Day-Ahead market and the opportunity for market participants to buy back their A/S after the Day-Ahead market. According to IEP/WPTF, failure to include these features creates inconsistent and ambiguous settlements and prevents full bilateral transactions after the Day-Ahead market. IEP/WPTF at 43-49.

In response to IEP/WPTF's concerns, the CAISO emphasizes, as explained in the May 13 Filing, that the issues raised by IEP/WPTF are separate from the issue which the CAISO has presented for conceptual approval. Namely, whether the CAISO should retain in the MRTU design the cumbersome three-settlement market system (*i.e.* a full Hour-Ahead settlement market in addition to the Day-Ahead and Real-Time markets) or move to a two-settlement system as employed by all other ISOs. Transmittal Letter at 28. The ISO understands the concerns expressed by IEP/WPTF, and appreciates parties' arguments that there may indeed be benefits to adopting a second complete settlement market for A/S, including a re-optimization process and opportunity for A/S buy-back. As noted in the Revised MRTU White Paper included with the May 13 Filing as Attachment A, the CAISO recognizes that there are outstanding issues regarding pricing of A/S procured in HASP and in Real-Time that must be addressed in the ongoing MRTU stakeholder process. May 13 Filing, Attachment A at 9. At the time of the filing the CAISO had intended to consider the possibility of creating a

full re-optimization of A/S in conjunction with these pricing issues, but has since determined that it would be impossible to implement such a process as part of the HASP or the Real-Time Market in Release 1 and still meet the February, 2007 implementation target.

The CAISO submits that there is no reason that the implementation deadline should be jeopardized, or that conceptual approval of HASP should be delayed, because of this issue. There is nothing about the HASP design that would prevent the CAISO from implementing a second A/S settlement process with re-optimization of energy and A/S as a post-Release 1 element if this is determined to be a valuable enhancement. IEP/WPTF's concern that energy and A/S procured in the HASP process would be "more expensive than need be," does not suggest that it would be unjust and unreasonable to implement HASP without the inclusion of an A/S re-optimization process. This conclusion is supported by the fact that although the LECG Report noted the efficiency benefits of re-optimizing A/S after the Day-Ahead market (either within the HASP or in Real-Time), Hogan & Harvey still support the adoption of the HASP rather than a complete Hour-Ahead settlement market. May 13 Filing, Attachment D at 3.

With respect to the buy-back of A/S in the Hour-Ahead time frame, IEP/WPTF contends that this is an important feature that supports the convergence of A/S prices between Day-Ahead and Real-Time. IEP/WPTF at 47-48. However, the CAISO notes that price convergence between Day-Ahead and Real-Time would be a relevant concern only if the CAISO was actually to

implement a full multi-settlement process for A/S. Under the MRTU design, the CAISO's Day-Ahead A/S demand will be determined by its forecast A/S requirements, and the CAISO will procure A/S in the IFM to meet 100 percent of this demand. Based on this Day-Ahead procurement process, the CAISO's HASP/Real-Time A/S demand will, in general, be minimal. Moreover, this demand will be random, based on demand forecast errors and unforeseen events such as plant outages and contingencies. Hence, Real-Time A/S prices will be random, and it makes no sense to try to converge them with Day-Ahead A/S prices. Therefore, although the CAISO recognizes that price convergence is an issue that would need to be addressed in the context of considering a full multi-settlement market for A/S, it is not an issue that is germane to the CAISO's proposed HASP design.

Several parties comment on the relationship between HASP and the recent problems with respect to settling intertie bids under MRTU Phase 1B, which are currently being addressed in the Amendment No. 66 proceeding. PG&E at 5-6; CPUC at 4-6<sup>45</sup>; Powerex at 6-8. For instance, PG&E states that it is concerned that it would be imprudent to implement HASP measures for pre-dispatching import bids prior to having arrived at an appropriate permanent solution to the problems with respect to pre-dispatching intertie bids under Phase 1B. PG&E at 5. Powerex maintains that the CAISO's conceptual proposal fails

---

<sup>45</sup> The CPUC requests that the CAISO provide regular updates in the MRTU process regarding how resolution of Amendment No. 66 issues will ensure consistency between treatment of interties under the current market design and MRTU. CPUC at 4-6. Because, as noted below, the CAISO has concluded the Amendment No. 66 stakeholder process, and will be filing, in the immediate future, its proposed solution to the intertie bid issue to be effective until implementation of MRTU, the CAISO believes that the CPUC's request is no longer relevant.

to consider including a pre-dispatch market clearing price solution, which it alleges would be superior to the current pay-as-bid system. Powerex at 6.<sup>46</sup> As discussed below, however, the CAISO believes that it would be inappropriate for the Commission to delay conceptual approval of the HASP design because of this issue.

Pursuant to the provisions of Amendment No. 66, the CAISO put into place an interim solution to the problems relating to the settlement of intertie bids under Phase 1B,<sup>47</sup> and, as noted in the April 29, 2005 White Paper, the CAISO has initiated a stakeholder process to further review these issues and to determine what additional action might be appropriate in terms of a longer-term pre-LMP solution. That stakeholder process has concluded, and the CAISO is preparing to file in the immediate future its proposed longer-term solution, to be effective for the remainder of the pre-LMP period. In addition, in the context of the ongoing MRTU stakeholder process, the CAISO will begin discussions with stakeholders regarding the preferred solution for resolving this issue in the context of the LMP market design to be implemented in February 2007.<sup>48</sup> Thus,

---

<sup>46</sup> Powerex also devotes a significant number of pages to addressing what it alleges to be “false statements” made by the CAISO in its weekly reports to the Commission on the implementation of Amendment No. 66. Powerex at 9-14. The CAISO believes that Powerex’s allegations are unfounded, but in any event, submits that the Amendment No. 66 proceeding is clearly the more appropriate forum for Powerex to raise such concerns, and that such allegations should have no bearing on the Commission’s consideration of the CAISO’s HASP proposal in this proceeding. The CAISO will fully address Powerex’s allegations and suggestions in its next filing in the Amendment 66 proceeding.

<sup>47</sup> As noted in the CAISO DMA’s weekly reports to the Commission on the implementation of Amendment No. 66, the interim “pay as bid” solution has been, so far, working well to curb the excessive costs associated with the clearing of intertie bids prior to Amendment No. 66, with little impact in bid volume and liquidity.

<sup>48</sup> In this regard it is important to clarify a mistaken assertion by Powerex that was noted above. Contrary to Powerex’s assertion, the HASP design does not preclude calculation of pre-dispatch market-clearing prices for settling pre-dispatched intertie schedules. Therefore, this

although the issue of the appropriate manner of settling pre-dispatched inertia bids has yet to be resolved with respect to MRTU Release 1, this uncertainty should not stand in the way of obtaining Commission conceptual approval of the HASP design in preference to a full Hour-Ahead settlement market, which is needed to ensure continuity and timely completion of the MRTU implementation process.

Duke alleges that the HASP proposal unfairly discriminates against in-state generators vis-à-vis imports because, according to Duke, it would provide imports with the option of either being pre-dispatched for an entire hour at an Hour-Ahead clearing price, or participating in the five-minute imbalance market, but would only allow in-state resources to participate in the five-minute market. Duke at 2-4. Duke's argument is flawed. The HASP proposal does not discriminate against in-state suppliers vis-à-vis imports because, contrary to Duke's assumption, imports cannot choose between being pre-dispatched or participating in the five-minute imbalance market. Differential treatment of imports and internal generators with regard to their supply of Real-Time energy is necessitated by a long-standing seams issue. That is, because of current practices for scheduling hourly interchanges between the CAISO and neighboring control areas, imports cannot be dispatched on a five-minute basis except as needed to respond to a contingency. Thus, imports do not have the option of choosing between hourly pre-dispatch and participating in the five-minute imbalance market. Instead, they must be pre-dispatched for an entire

---

option can be considered as a possible solution to the issue of how to settle inertia schedules under MRTU.



hour. The Commission recognized this fact in its decision concerning mitigation of imports in the California refund proceeding.<sup>49</sup>

The CAISO agrees with Duke that the five-minute dispatch capability of in-state CAISO instructed imbalance energy is superior to pre-dispatched energy in its ability to follow load. Nevertheless, import energy does play a valuable role in the CAISO's ability to meet demand in the CAISO Control Area, and thus, participation of imports in the CAISO's markets should be encouraged. Given that in-state energy is superior in its load-following ability, and the fact that imports are constrained from being dispatched in this manner, the CAISO submits that it is most appropriate to adopt a system that encourages the greatest amount of participation in the five-minute markets, rather than one that gives the CAISO less flexibility in meeting demand in Real-Time. Finally, with respect to Duke's concerns that the CAISO's five-minute dispatch process exposes in-state generators to mechanical stress, the CAISO would expect that any costs that Duke believes it has incurred as a result of CAISO dispatch instructions would be reflected in the bid price for energy from its units

Finally, SVP notes that it continues to be concerned regarding the details of how the CAISO will integrate MSS contracts with the HASP proposal. SVP at 6. Although the CAISO does not believe that any conflicts exist between its HASP proposal and the MSS proposal, the CAISO agrees with SVP that MSS contracts should be honored in conjunction with HASP, and the CAISO commits

---

<sup>49</sup> See *San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Services, et al.*, 105 FERC ¶ 61,066 (2003) at P 54 (noting that unlike other types of energy, imports must be dispatched for a minimum of one hour).

to continue to work with MSS participants to ensure a successful integration of established MSS concepts into the MRTU design.

**C. Intervenor Fail To Raise Any Arguments That Require Modification or Rejection of the CAISO's Demand Clearing Proposal**

Several parties submitted comments on the CAISO's revised demand clearing proposal, which would clear LAP-level load bids based on LAP prices, rather than distributing load bids to individual nodes and then re-aggregating the nodal loads cleared in the forward market back up to the LAP level. Most of these parties express support for the proposed revision. SCE at 6-7; SVP at 2-4; CPUC at 4. In fact, none of the parties that comment on this issue actually appears to oppose the CAISO's proposed revision, although several parties challenge elements of the CAISO LAP design already considered and approved by the Commission.

DWR, for instance, takes issue with the fundamental principle of scheduling, bidding, and settling load at the LAP level, rather than the nodal level. DWR argues that aggregating prices for load defeats the objective of LMP in sending efficient price signals, specifically price signals to load. DWR at 9-14. Specifically, DWR contends that load aggregation cannot be reconciled with prior guidance from the Commission. *Id.* DWR's arguments should be rejected, first and foremost, because they are irrelevant to the specific revision to the CAISO's LAP proposal raised in the May 13 Filing. Rather, DWR challenges an element of the CAISO's MRTU design that has already been considered and approved by the Commission. In the October 28 Order the Commission specifically approved

the underlying principle of aggregating load to the LAP level, stating that the CAISO's proposal to aggregate load prices on the basis of the three IOU service territories "provides a reasonable and simplified approach to introduce LMP pricing, while minimizing its impact on load." October 28 Order at P 65. Thus, DWR's argument is nothing more than a collateral attack on the Commission's October 28 Order, and should be rejected as such.

Moreover, DWR's contention that the aggregation of load at the LAP level is inconsistent with guidance from the Commission is simply incorrect. DWR cites to the Staff Guidance Letter. Specifically, DWR references Commission Staff's discussion therein of a 2004 ISO-NE order<sup>50</sup> in which the Commission approved the use of LICAP<sup>51</sup> requirements to help resolve reliability compensation issues, but expressed a concern regarding the appropriate configuration of the LICAP regions to ensure investment and retention of infrastructure in import-constrained areas, and required the ISO-NE to re-evaluate its treatment of the Southwest Connecticut load pocket. The Commission also required ISO-NE to consider a scarcity pricing mechanism to provide locational signals. In the Guidance Letter, Staff noted that this order is particularly relevant to the CAISO market design because similar types of locational constraints may exist within the CAISO service territory. Contrary to DWR's argument, however, nothing in the Staff Guidance Letter, or the

---

<sup>50</sup> *ISO New England*, 107 FERC ¶ 61,240 (2004).

<sup>51</sup> According to the Commission, the ISO-NE's Installed Capacity (ICAP)/LICAP requirement ensures that ISO-NE has sufficient resources available to meet the region's reliability needs. LSEs are obligated to procure their load-weighted share of system capacity resources, and generation resources that supply ICAP/LICAP are compensated for the obligation to participate in the applicable ISO-NE day-ahead market. Staff Guidance Letter at 4, n. 9.

referenced ISO-NE order, suggests that the aggregation of load at the LAP level is inappropriate. Indeed, neither the Staff Guidance Letter nor the ISO-NE order even makes reference to the issue of pricing load based on aggregation points. More to the point, the price signals needed to retain existing generation and incent generation investment in import-constrained areas are the prices used to settle supply resources, which will be the nodal LMPs and will not be affected by the CAISO's load aggregation scheme. For these reasons, the Commission should reject DWR's unsupported attempt to re-cast a broad concern expressed by the Commission with respect to the need to provide locational price signals into a specific finding that the CAISO's Commission-approved load aggregation approach is somehow flawed.

Indeed, a close reading of DWR's discussion of this issue suggests that its real concern is not the overall principle of load aggregation, but rather a subsidiary issue concerning the appropriate number and size of the LAPs employed by the CAISO. This is a concern that is raised by several commenters, especially insofar as this issue impacts the CAISO's development and allocation of Congestion Revenue Rights ("CRRs"). MWD at 3-5; Southern Cities at 3-6; Sempra at 9-10. Generally speaking, these parties express concern that the size of the CAISO's LAP areas will limit the availability of CRRs due to internal constraints within the area covered by the LAP, and suggest that the CAISO should disaggregate the three LAP zones into a number of smaller zones. Again, it is important to note that the Commission has already approved the CAISO's proposal to aggregate prices for load over the three existing IOU

service territories. That being said, the CAISO points out that it is presently conducting, with the assistance of LECG, a detailed CRR study whose results will be reported to stakeholders at the end of July, 2005. This study will provide quantitative evidence concerning the impact of using LAPs corresponding to the service territories of the three existing IOUs on the availability of CRRs. After the release of this study, the CAISO will present the evidence detailed therein to stakeholders and will respond to and discuss any concerns raised by stakeholders that the impact is sufficiently material to warrant changing the granularity of the LAP zones. At present, however, the fact remains that this issue is not relevant to the specific revision to the demand clearing proposal submitted by the CAISO for Commission approval in the May 13 Filing. As noted by LECG in their February 23, 2005 report on the MRTU market design, the demand clearing proposal being considered by the Commission at this time is a necessary feature under any load aggregation scheme, no matter how granular or aggregated the specific LAP zones are. Therefore, the CAISO submits that it would be procedurally inappropriate as well as premature for the Commission to address this issue in connection with its review of the May 13 Filing.

**D. The Commission Should Approve the CAISO's Process For Resolving Open Market Design Issues**

In the May 13 Filing, the CAISO explained in detail its phased approach to resolving open market design issues and implementing MRTU. Pursuant to this approach, the CAISO has identified February 2007 as the target date for implementation of MRTU. However, because of the enormous amount of effort

involved in designing and implementing the various elements of MRTU, the CAISO has been forced to distinguish between the design elements and features that by necessity must be included in the design as implemented on February 2007 (“Release 1”), and those elements that, while they may be desirable, will by necessity have to be implemented some time after February 2007 (“Release 2”). Moreover, given the length of time needed to ensure that individually stable components of the overall software can be carried into the software integration effort<sup>52</sup> that is scheduled to begin in January 2006, the CAISO must finalize or “freeze” the design of the MRTU elements slated to be implemented in Release 1. Starting in April 2005, the CAISO has been following an established cycle of White Paper releases, meetings with stakeholders, written stakeholder comments, and White Paper revisions to resolve these issues and to develop the MRTU tariff language. The CAISO intends to file its MRTU tariff language with the Commission by November 30, 2005.

Several parties take issue with the CAISO’s phased approach. SMUD contends that the CAISO has not shown that immediate approval of the primary elements of MRTU is either necessary or reasonable, and maintains that the Commission should not be driven to try to facilitate a February 2007 MRTU implementation date by forcing premature and needlessly expedited reviews of essential market designs. SMUD at 5-10. Sempra urges the Commission to direct the CAISO to address the second-tier LECG recommendations in the initial

---

<sup>52</sup> Prior to Integration, the various systems (IFM, Settlements, CRRs etc.) need to complete Factory Acceptance Testing and Site Acceptance Testing to give a reasonable assurance that any variances that arise during the integration effort are due to bringing the pieces together rather than inherent problems with the pieces themselves.

implementation of MRTU, or establish a date certain for implementation of the recommendations, explaining why the market design weaknesses identified by LECG are not likely to become a significant cause for concern upon initial MRTU implementation. Sempra at 10-11.

With respect to SMUD's arguments, the CAISO once again emphasizes that adopting a serial approach which involves finalizing design issues prior to proceeding with any aspect of implementation would necessarily result in a very lengthy design through implementation schedule. Such a lengthy schedule would mean that the current market design, which virtually all market participants have acknowledged is fatally flawed, would likely persist far beyond February 2007. The CAISO has been working since early 2002 to correct this situation by implementing an LMP-based market design based on one that is currently working in all of the eastern ISOs, and is endorsed by the Commission. Given the amount of time that has already passed, and the magnitude of the existing design flaws, the CAISO submits that further delay would be patently unjust and unreasonable, and thus, the Commission's consideration and conceptual approval of the Release 1 MRTU design elements at this time is anything but premature and needless. This is especially true given the fact that, as the CAISO explained in the May 13 Filing, freezing the design for MRTU Release 1 does not preclude the CAISO from modifying the MRTU design after February 2007. Transmittal Letter at 59.

With respect to Sempra's arguments concerning the implementation of the second-tier LECG recommendations that the CAISO has not slated for Release

1, the CAISO appreciates the need to address these recommendations in the ongoing stakeholder process, and indeed, believes that those recommendations can be successfully addressed, resolved, and to the extent necessary, implemented in future phases of MRTU implementation. The CAISO has carefully considered the potential impacts on the project of incorporating these recommendations now, versus the potential market performance impacts of not having them as part of the February 2007 implementation, and has concluded that the greater risk would be to attempt to resolve them in time for inclusion in Release 1. Again, it is important to understand that freezing the design for MRTU Release 1 does not preclude the CAISO from modifying the MRTU design after February 2007. Nevertheless, in order to ensure the implementation of MRTU in a reasonable time frame, the CAISO is compelled to adopt the phased approach to MRTU design and implementation. Failure to adhere to the CAISO's implementation schedule in order to address and incorporate additional design elements will inevitably result in a slippery-slope process, characterized by a continuing series of implementation delays that will only serve to prolong and exacerbate existing market design flaws.

**E. The Commission Should Deny Requests for Significant Modifications to the MRTU Design**

**1. The CAISO Cannot Implement Virtual Bidding on Day One of MRTU Implementation**

A couple commenters argue that convergence bidding or “virtual bidding” should be included in MRTU Release 1. IEP/WPTF and Duke point to the



Commission's statement in the June, 17, 2004, order that the CAISO should file "either tariff sheets to implement virtual bidding simultaneously with the implementation of the day-ahead market, or a full explanation of why this should not be done, and the date when it would be implemented." *California Independent System Operator Corp.*, 107 FERC ¶ 61,274 at P 159 (2004) ("June 17 Order"). They contend that the CAISO has provided insufficient justification for deferring development and implementation of virtual bidding until after day one of the new LMP markets in California. IEP/WPTF at 49-54; Duke at 12.

One other commenter – Sempra – does not request that virtual bidding be implemented on day one of the new markets, but states that virtual bidding is an essential feature of a well-designed electricity market, and that the Commission should direct the CAISO to provide a time certain for incorporating virtual bidding into the new market software. Sempra at 13.

The CAISO recognizes that virtual bidding is an important feature to many market participants and that it could offer another tool for addressing the potential abuse of market power. As explained in the MRTU White Paper,<sup>53</sup> in response to the Commission's June 17 Order, the CAISO began to explore a design for incorporating virtual bidding into MRTU and considered adopting NYISO-style explicit virtual bidding into the MRTU market design.

Virtual bidding proved to be highly contentious, however, with a number of stakeholders raising concerns about the potential for gaming and price distortions. Rules and limitations to address these concerns could not be finalized in time to include virtual bidding in MRTU Release 1. In addition, the

---

<sup>53</sup> May 13 Filing, Attachment A at 21.

CAISO concluded that virtual bidding did not satisfy the criteria for inclusion as a Release 1 market design element, *i.e.*, it was not necessary to ensure reliable grid operation or to prevent a fatal flaw in the new LMP markets. As explained in the May 13 Filing, pragmatic considerations associated with the development, integration, testing and ultimate implementation of the software needed to effectuate the new markets forced the CAISO to defer certain, potentially beneficial market features, including virtual bidding, until MRTU Release 2.

The commenters seeking an earlier implementation of virtual bidding substantially underestimate the complexity associated with incorporating virtual bidding into the MRTU software. For example Duke suggests that MRTU implementation could be “delayed by a few months” so that virtual bidding can be incorporated in Release 1, while IEP/WPTF claims that virtual bidding should be implemented by no later than April 2007. Duke at 12; IEP/WPTF at 54. Contrary to the claims of these commenters, integration of virtual bidding will not delay MRTU implementation by only a few months. Even assuming all virtual bidding design elements were finalized, integrating virtual bidding into MRTU Release 1 at this point would certainly delay the February 2007 implementation date. Because of the need for real-world experience with the new market design before the crucial summer peak demand season, such a delay would likely defer MRTU implementation until late 2007 at the earliest.

Moreover, before the changes to the MRTU software could be made, the CAISO would have to hold additional stakeholder meetings to discuss open and contentious issues concerning the design of virtual bidding. Subsequent to

resolution of these open and contentious issues, the CAISO would have to engage the primary system vendors to develop and incorporate change orders to effectuate the functionality. This effort by itself, development and testing notwithstanding, is likely to take several months. This would also imperil the overall schedule for MRTU implementation, as both CAISO and stakeholder resources are already strained to the limits with the work needed to finalize those elements of MRTU Release 1 undergoing stakeholder review prior to the November 30, 2005 Tariff filing, including important issues related to CRRs.

In short, a directive to implement virtual bidding on day one of MRTU implementation could deprive customers and market participants of the benefits of the new market system for an extended period. The CAISO urges the Commission to recognize that the benefits of having virtual bidding in place on day one of the new markets do not outweigh the substantial costs associated with failing to fix the fundamental flaws in the existing market design by the earliest date possible.

Moreover, while the CAISO recognizes the keen interest of stakeholders and the Commission itself in establishing a “date certain” for virtual bidding, the many variables associated with the overall MRTU project, as well as the need to develop the details of a virtual bidding feature, make it impossible for the CAISO to provide a firm estimate for implementing virtual bidding at this time. By November of this year, the CAISO will submit to the Commission the final design elements of MRTU Release 1, along with implementing Tariff language. After the Commission acts on that filing, the CAISO can begin the process of considering

the market features that have been suggested for MRTU Release 2. In particular, the CAISO commits to initiate a stakeholder process in 2006 to consider whether virtual bidding should be adopted as a Release 2 design element and to address a number of critical open issues associated with the virtual bidding feature, including: (1) defining, monitoring and enforcing credit requirements on virtual bidders, and (2) determining the need for limits on virtual positions, to prevent the use of virtual bidding for inefficient market manipulation.

The CAISO therefore respectfully requests that the Commission permit the CAISO to make a filing after this stakeholder process is completed and the MRTU tariff is filed, that will address the virtual bidding issues identified in the Commission's June 17 Order.

## **2. The Commission Need Not Act on Comments That Go Beyond the Scope of the May 13 MRTU Filing**

Several parties raise issues that go beyond the scope of the May 13 Filing. For instance, Powerex contends that the CAISO should adopt and implement a pre-dispatch market clearing price solution as soon as possible, even before the planned implementation of MRTU. Powerex at 6-7. Duke contends that the Commission should direct the CAISO to implement a \$1,000/MWh bid cap as of October 1, 2005. Duke at 9. Calpine contends that generation that the CAISO does not deem critical to system or local reliability and does not have a long-term capacity contract with an LSE should not remain subject to the existing price caps, AMP, or the must-offer obligation. Calpine at 15. SMUD raises the issue of the feasibility of granting CRR options to ETC holders who convert their rights to CRRs. SMUD at 22-23. SMUD also requests

clarification on whether the CAISO's proposal to allow "scheduling coordinators" to self-supply A/S is limited to "Scheduling Coordinators" as defined under the CAISO Tariff, or is meant to be extended to "scheduling coordinators" that "serve the same function as CAISO Tariff defined 'Scheduling Coordinators.'" SMUD at 24.

Because these comments are not directly related to the CAISO's request for conceptual approval of certain MRTU elements to be implemented in February, 2007, this proceeding is not the appropriate vehicle for resolving these concerns, and thus the Commission should decline to address these comments. If certain parties believe that certain provisions of the current CAISO Tariff, as approved by the Commission, are unjust and unreasonable, then the appropriate mechanism for relief is for those parties to file with the Commission a complaint pursuant to Section 206 of the Federal Power Act. Attempting to resolve such issues in this proceeding would be procedurally inappropriate, a waste of Commission resources, and constitute a further, unwarranted, risk to the CAISO's February 2007 implementation deadline.

### **3. There Is No Justification For An Evidentiary Hearing on the May 13 Filing**

One commenter – SMUD – requests that the Commission set the CAISO's May 13 Filing for an evidentiary hearing "because it raises material issues of disputed fact." SMUD at 1. SMUD does not identify what those material issues of disputed fact might be or offer any support for this request other than a single conclusory sentence in the first page of their motion. There are no significant

disputed issues of fact in this proceeding, nor is there any reason to believe that hearing procedures would provide the Commission with useful information in resolving the disputes concerning the MRTU Amendments. The conceptual market design issues raised in the CAISO's filing are issues of policy that are ripe for Commission action. Moreover, as explained above, if the Commission does not act on the MRTU Amendments by July 31, the overall schedule for MRTU implementation is at risk. The delay that would be created by an administrative hearing on these market design issues would almost surely delay the implementation of the new LMP markets in California until 2008 or later. For all these reasons, SMUD's request for an evidentiary hearing should be denied.

**4. The Commission Has Already Approved of the CAISO's Approach of Submitting its MRTU Design Elements for Conceptual Approval**

Two parties, SMUD and PG&E, raise issues with respect to the conceptual nature of the May 13 Filing. SMUD argues that the CAISO's filing is not a full and complete rate schedule under Section 205 of the Federal Power Act, and thus, the Commission lacks sufficient information to ascertain the proposal's impact, and should reject the filing as deficient. SMUD at 4-5. SMUD's argument is nothing more than an inappropriate attempt to advance a theory that has already been considered and rejected by the Commission in the context of the CAISO's July 2003 Filing, which was also conceptual in nature. In its October 28 Order, the Commission noted that the purpose of the July 2003 Filing was to "solicit the Commission's guidance so that the CAISO can either

proceed as planned or modify its proposal as necessary.” October 28 Order at P 23. Denying requests to reject the July 2003 Filing because it did not include specific tariff language, the Commission explained that “considering this filing in its present state will benefit customers as our approval in principle of these design elements will provide further assurance to the CAISO that the general design is acceptable to the Commission.” *Id.* at P 24. The Commission’s logic in the October 28 order applies with equal force to the May 13 Filing. Thus, SMUD’s argument must be rejected.

PG&E does not take issue with the Commission approving, conditionally, the MRTU design elements in the May 13 Filing that the Commission finds to be just and reasonable, but maintains that the Commission should reserve definitive approval of any given element until it can complete a review of the full, integrated market design and its implementing tariff language. PG&E at 3. The CAISO understands that definitive Commission approval of the particulars of the MRTU elements presented in the May 13 Filing must wait until the CAISO files the associated tariff language. Moreover, the CAISO appreciates that the MRTU design elements, including those submitted for approval in the May 13 Filing, may benefit from revisions during future phases of the MRTU process. However, the CAISO urges the Commission not to condition its approval of the MRTU concepts presented in the May 13 Filing. Doing so would undermine much of the point of submitting those design elements for conceptual approval in the first place, and interject a high degree of uncertainty into the process, which could in turn jeopardize the February 2007 Release 1 implementation schedule.

**5. The CAISO's May 13 Filing is Not Deficient Because it Does not Provide for Long-Term Firm Transmission Rights**

SMUD argues that the May 13 Filing should be rejected because it does not provide for long-term firm transmission rights. SMUD at 13-16. SMUD's argument is without merit. The fact that the CAISO's market design does not currently include long-term firm transmission rights is not a basis upon which the Commission should reject that design. First, the CAISO notes that the eastern ISO markets do not offer long-term firm transmission rights.<sup>54</sup> Moreover, including such rights in the CAISO's current MRTU design would be premature, given that the Commission is currently addressing this issue generically in a rulemaking proceeding.<sup>55</sup> As part of the ongoing MRTU process, the CAISO plans to consider these issues with guidance from the Commission. However, even if the Commission concludes its rulemaking on this issue prior to the February 2007 MRTU Release 1 implementation date, it would be impossible for the CAISO to design, test, and implement long-term firm transmission rights in time for MRTU Release 1. For these reasons, the CAISO urges the Commission to reject SMUD's argument.

---

<sup>54</sup> A description of the long-term firm transmission rights offered by other ISOs was recently prepared by LECG and is set forth on pages 12 to 13 in the CAISO's June 14, 2005 White Paper on CRR allocation rules. This document is available on the CAISO's Home Page at <http://www.caiso.com/docs/2005/06/14/2005061414291518999.pdf>.

<sup>55</sup> See *Notice Inviting Comments on Establishing Long Term Transmission Rights In Markets With Locational Pricing*, Docket AD05-7-000 (May 11, 2005).



#### IV. CONCLUSION

Wherefore, for the foregoing reasons, the CAISO respectfully requests that the Commission conceptually approve the MRTU Amendments proposed in the May 13 Filing without modification. The CAISO urges the Commission to act on the May 13 Filing by July 31, 2005, so that the CAISO can maintain the current MRTU implementation schedule.

Respectfully submitted,

Charles F. Robinson  
Anthony J. Ivancovich  
Sidney Mannheim Davies  
The California Independent System  
Operator Corporation  
151 Blue Ravine Road  
Folsom, CA 95630  
Tel: (916) 608-7049  
Fax: (916) 608-7296

/s/ Sean A. Atkins  
Sean A. Atkins  
Michael Kunselman  
Swidler Berlin LLP  
3000 K Street, NW, Suite 300  
Washington, DC 20007  
Tel: (202) 424-7500  
Fax: (202) 424-7643

Dated: June 23, 2005

## CERTIFICATE OF SERVICE

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

Dated this 23<sup>rd</sup> day of June, 2005 at Folsom in the State of California.

/s/ Sidney Mannheim Davies

Sidney Mannheim Davies  
(916) 608-7144