UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Morgan Stanley Capital Group Inc.,	)	
	)	
Complainant,	)	
	)	
v.	)	**Docket No. EL00-91-000**
	)	
California Independent System Operator Corporation,	)	
	)	
	)	
Respondent.	)	

ANSWER OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION TO COMPLAINT AND REQUEST FOR FAST TRACK PROCESSING AND EMERGENCY MOTIONS REQUESTING A STAY, CEASE AND DESIST ORDER AND TECHNICAL CONFERENCE

Pursuant to Rule 213 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213, and the Commission's July 12, 2000, Notice of Complaint and Directing Respondent to File Certain Information, the California Independent System Operator Corporation ("ISO") [1] hereby files its Answer to the Complaint and Request for Fast Track Processing and Emergency Motions Requesting a Stay, Cease and Desist Order and Technical Conference of the Morgan Stanley Capital Group Inc. ("MSCG").

[1] Capitalized terms not otherwise defined herein are defined in the Master Definitions Supplement, ISO Tariff, Appendix A, as filed August 15, 1997, and subsequently revised.

1. Introduction and Summary

On July 10, 2000, MSCG filed a complaint and request for emergency action addressed to the June 28th decision of the ISO's Governing Board ("Board") to reduce from $750/MW to $500/MW the price that the ISO, as the *purchaser* of Ancillary Services and Imbalance Energy, will pay in the markets for those products conducted by the ISO between July 1st and October 15, 2000. MSCG "requests that the Commission issue a stay of the Board's authority regarding price caps"; that the ISO be directed "to reinstate the $750 price cap level"; and that the Commission "negate Cal ISO's authority to further reduce price caps after the sunset date of the current resolution, October 15, 2000." Complaint at 13.

MSCG's complaint and request for emergency relief are critically dependent on a faulty premise: that the Federal Power Act restricts the exercise of discretion by purchasers in deciding what they will pay. As the Commission has affirmed in the context of purchase price caps established by the ISO, there is no such limitation. This alone is a sufficient answer to MSCG's claims of discrimination and reliance. However, even if the law were otherwise, there can be no such well-founded claims: the ISO's purchase price caps are uniformly applied, contemporaneously, to all sellers similarly situated, and the ISO's authority, recognized by the Commission and explicitly acknowledged by MSCG in its complaint, to adjust its purchase price caps from time-to-time, defeats any claim of reliance.

For these and other reasons developed in this Answer – including the fact that the ISO Board, dealing with what admittedly was a politically charged and difficult issue, reached a reasoned result – the Commission should decline summarily to entertain MSCG's Complaint and request for emergency relief.[2]

2. The ISO Governing Board Dealt Reasonably With A Difficult, Contentious Issue

In its Notice of the MSCG complaint, the Commission directed the ISO to submit with its answer "(1) transcripts and minutes from the June 28, 2000 and July 6, 2000 Board of Governors meetings; (2) any and all analysis, reports, studies, workpapers, and/or supporting documentation concerning the competitiveness of the ISO's energy and ancillary service markets, or any other correspondence, presented to or considered by members of the Board of Governors at or before the June 28, 2000 and July 6, 2000 meetings regarding the motions to reduce the bid price cap." Notice at 2.

[2] The Commission has stated that expedited processing should be employed in only limited circumstances and only in most unusual cases. *See, e.g., Amoco Energy Trading Corporation, et al., v. El Paso Natural Gas Company*, 89 FERC ¶ 61,165 (1999), *reh'g denied*, 90 FERC ¶ 61,354 (2000). MSCG has made no showing that such treatment is justified. Moreover, Rule 206(b)(7) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.206(b)(7), requires that requests for preliminary relief include a detailed justification for the relief addressing (i) the likelihood of success on the merits, (ii) the nature and extent of the harm if preliminary relief is denied; (iii) the balance of relevant interests; and (iv) the effect on the public interest. MSCG provided no such justification; it has not even addressed the immediate impact on consumers of the price spikes that prompted the Board's action. The complaint also appears to violate the requirement of Rule 206(b)(6), 18 C.F.R. § 385.206(b)(6), that it state whether the issues are pending in another Commission proceeding. The issue of the ISO's price cap authority is clearly pending in rehearing requests in Docket No. ER99-4462-001. Because MSCG's request raises arguments substantially similar to those raised by Williams Energy Marketing & Trading Company in its "Requests for Expedited Hearing and Immediate Stay" filed in Docket Nos. ER99-4462-000, EC96-19-000 and ER96-1663-000, much of the substance of this Answer parallels the Answer filed by the ISO in response to the Williams' filing.

The pertinent documents are included in an Appendix as Attachments A through V.[3] They must be read in context, however. The issue of the competitiveness of the ISO Energy and Ancillary Service markets has been at the center of ISO Board and management activities dating well before commercial operation on April 1, 1998. The ISO has been and remains committed to elimination of the obstacles to a workably competitive market so that, at the earliest practical date, price caps can be eliminated. Accordingly, while the Appendix of materials supplied with this answer is limited to those that were directly before the Board at its June 28th and July 6th sessions, it is fair to conclude that the monthly analyses of market performance prepared by the Department of Market Analysis ("DMA"), as well as the reports periodically prepared by DMA and the independent Market Surveillance Committee ("MSC") (typically filed with the Commission), and by other ISO staff were an inherent part of the Board's deliberations and informed its exercise of judgment.[4]

The ISO respectfully submits that review of the requested materials leads to but one conclusion: while honestly motivated individuals surely can differ in their judgment as to the price cap action counseled by those materials, the

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[3] The Notice directed the filing of transcripts and of minutes. It is not the Board's practice to make and keep a transcription of its meetings. It is the case that over the past few Board meetings, the discussions were taped solely for the announced purpose of facilitating the preparation of minutes. The transcriptions attached as A and B were made from those tapes. We regret, therefore, that they contain significant gaps and other departures from what one would expect from a more formal transcription process. As to minutes, they have not yet been prepared or approved by the Board. ISO management intends to request Board consideration of the minutes when it next meets on August 1st and, once they are approved, will forward copies of the minutes to the Commission.

[4] *See*, *e.g.*, the MSC's "Report on Redesign of California Real-Time Energy and Ancillary Services Markets", filed in Docket Nos. ER98-2843, et al., and available on the ISO's home page at http://www.caiso.com/docs/1999/10/20/199910201045345098.pdf. A list of some of these other reports and analyses is included in the Appendix as Attachment W.

decision to reduce price caps in the ISO Energy and Ancillary Service markets to $500/MW between July 1st and October 15, 2000, was a reasoned one.

Unquestionably, unusually high prices experienced very early in the peak season gave rise to political demands that the ISO reevaluate its extant $750/MW bid cap. That is precisely, and appropriately, what ISO management and its Board did – engage in a reasoned reevaluation. When it first established the $750/MW bid cap applicable September 30, 1999, the ISO Board had explicitly signaled that it would review the propriety of a reduction in bid cap levels – specifically to $500/MW – if it found evidence that the market was not workably competitive or if the programs intended to facilitate demand responsiveness were not in place.[5] It would not have been in keeping with that commitment had the Board declined to undertake the requested reevaluation.

At its June 28th session, the Board had available to it, in addition to correspondence from those with principal regulatory and legislative responsibility for the State's electricity industry and oral statements calling for a reduction in bid caps to $250/MW, reports prepared by DMA and by the MSC in March. Those reports continued to express concerns about competitive conditions in the ISO's markets.

The DMA March 14th memorandum to the Board (Attachment G), while then supportive of continuing the bid cap at $750/MW, nevertheless noted signs that the market may not yet be workably competitive. It expressed particular concern about the immaturity of demand responsiveness programs and the blunting effect of the continued application of rate freezes covering most of the

State's consumers through the year 2000 and beyond. These concerns were developed in some detail in the appended DMA report. As that report emphasized:

> While the markets are workably competitive during most hours, there is clearly market power during hours in which system loads are highest.

"Price Cap Policy for Summer 2000," March 2000, (Attachment G) at 2. Specifically, DMA found that market power is a concern when load reaches 40,000 MW, which occurred during 121 hours in 1998, but only during 57 hours in 1999 or less than 1% of the time. *Id.* at 10. DMA's report concluded that demand responsiveness, that is, the ability of consumers to respond to high prices, is critical to a workably competitive market, a signal denied by the existence of rate freezes applicable to most consumers. *Id.* at 31.

The MSC, in its Report of March 9, 2000, expressed similar concerns, finding:

> . . . that California's energy and ancillary services markets were not workably competitive during the Summers of 1998 and 1999. Despite the market design and other changes made since last summer, under current market rules we cannot conclude that the ISO's energy and ancillary services markets will be workably competitive during periods of peak demand in the Summer of 2000. *That assessment must await actual experience with the reconfigured markets under conditions of high demand*.

MSC, "The Competitiveness of the California Energy and Ancillary Services Markets," March 2000 (Attachment G) at 1-2 (emphasis added).

The MSC was specifically concerned about the absence of meaningful demand responsiveness:

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[5] The Board's Motion is attached. S*ee* Attachment O.

> The regulatory barriers to price-responsive final demand and the limits on UDC forward contracting are two of the major reasons for our uncertainty as to whether the California energy and ancillary services markets will be workably competitive in summer 2000. If both of these barriers were eliminated, a case could be made in favor of the real-time energy and ancillary services markets being workably competitive. However, unless and until a significant fraction of retail load has the financial incentive to respond to hourly wholesale prices, it is very possible that even a high price cap on the energy and ancillary services markets will be hit a number of times during the summer of 2000, even if the summer as a whole involves relatively mild weather conditions.

Id. at 7 (footnote omitted). It is noteworthy that the MSC's concerns were expressed in the context of an assumption that energy growth in the ISO-controlled area would be between 4% and 5% between 1999 and 2000. Report at 5. Despite the concerns of the DMA and MSC about the competitiveness of the market and the ability of demand to mitigate high prices, the Board in March retained the bid cap at $750/MW.

Within two months, critical facts had changed. At its June 28th session, the Board received an updated demand forecast: DMA reported its estimate that energy growth from 1999 to 2000 would be at the rate of 10.9%, and peak growth at 6.2%. Tr., June 28th at 64. Moreover, it now anticipated that during 2000, load would exceed 40,000 MW, the level at which both the MSC and DMA had expressed concerns about market competitiveness, "anywhere between 142 and 241 hours . . . ." Tr., June 28th at 65. The Board also saw evidence of the effect of high demand on prices.

Nevertheless, the Board did not act precipitously. It heard concerns about how supply reliability could be affected were the bid cap to be lowered. But it also heard about market imperfections, including the underscheduling of both

supply and demand in the forward markets operated by the California Power Exchange, Tr., June 28th at 44-47, and about significant price increases in the San Diego area, by as much as 59% of total electric bills, Tr., June 28th at 51. The Board explored what could be done to increase supply availability and to moderate demand or, at a minimum, to moderate price spikes through greater use of hedging options. And, it concluded that it should, for the period of peak demand only, reduce the bid cap to $500/MW as it had signaled it would, in August of 1999, if the markets were not yet workably competitive.

The requests that the ISO do more did not abate and the Board met again on July 6th for consideration of a possible further reduction of the bid cap to $250/MW. It declined to take that step, notwithstanding indications of even greater consumer impact in the San Diego area than previously had been assumed. Tr., July 6th at 19. The Board did, however, direct ISO management expeditiously to develop a plan of short- and longer-term actions designed to increase supply availability and demand responsiveness. Tr., July 6th at 54, 62.

The ISO Board, as its Chairman indicated, was called upon to make "a very difficult decision." Tr., June 28th at 112. It was sure to disappoint many, however it decided. It engaged the issues and ventilated fully the pertinent considerations and it reached a reasoned result. No more can be expected of any entity that is called upon to deal with difficult, contentious issues in a very public setting.

3. MSCG's Claims Are Legally Unfounded

The Commission need not, however, be convinced of the correctness of the Board's judgments. MSCG's claims, and its request that the Commission invoke emergency authority to rescind or stay the ability of the ISO to limit the prices it will pay for Ancillary Services and Imbalance Energy, necessarily presumes that the exercise of that authority is dependent upon Commission authorization. It is not. Section 205 of the Federal Power Act ("FPA"), the sole authority offered by MSCG, by its express terms imposes limitations on *sellers* – "all rates and charges made, *demanded*, *or received* . . . and all rules and regulations affecting or pertaining to *such* rates or charges . . . ." FPA, 16 U.S.C. § 824d(a) (emphasis added). It neither expressly nor implicitly limits a *purchaser's* ability to decide whether to purchase and at what rate.

The Commission recognized explicitly this inherent purchaser's prerogative when it confirmed the authority of the ISO to limit what it would pay.[6] As a purchaser, "the ISO has no more, or less, discretion than any other buyer of services" to specify the maximum prices it is willing to pay and to adjust those prices from time-to-time, as it sees fit.[7] The Amendment No. 21 Order was not a necessary grant of authority to the ISO to establish or adjust price caps in its markets but, instead, an acknowledgement that the ISO, in its capacity as a

[6] *California Independent System Operator Corporation*, 89 FERC ¶ 61,169 (1999) ("Amendment No. 21 Order").

[7] *Id.* at 61,511.

purchaser of Ancillary Services and Imbalance Energy, *inherently* possessed that authority.[8]

The implications of the Commission's rationale are dispositive of the present requests. Since the ISO's ability to establish the maximum prices it will pay is inherent in its position as a purchaser, it does not derive from any grant of authority by the Commission, and therefore there is nothing for the Commission to stay. [9]

In characterizing the ISO's specification of bid price caps as an exercise of a standard buyer's prerogative, the Commission noted that sellers who are dissatisfied with the ISO's ceiling price can choose instead to sell Ancillary Services and Imbalance Energy in bilateral transactions or in the markets operated by the California Power Exchange.[10] This fact, which remains true, further undermines MSCG's claim that Commission intervention is necessary to prevent prejudice, assuming that relief otherwise were available.

4. MSCG's Claims of Reliance Are Unfounded

MSCG's reliance argument is on no firmer footing, even assuming that the ISO's ability to set for itself purchase price caps were dependent on Commission authorization or that the Board's actions in adjusting the cap to $500/MW were not based on a reasoned consideration of market conditions. The argument

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[8] Under the ISO Tariff amendment approved in the Amendment No. 21 Order, if the ISO intends to exercise this authority after November 15, 2000, it will make an appropriate filing prior to that date.

[9] As the Commission has acknowledged, a motion for a stay necessarily asks the Commission to grant "a stay *of its orders,*" i.e., of authorizations that the Commission has given to a jurisdictional entity. *ANR Pipeline Company v. Transcontinental Gas Pipe Line Corporation*, 91 FERC ¶ 61,252, at 61,887 (2000) (emphasis added).

presumes, incorrectly, that the ISO was precluded from modifying downward the $750/MW cap absent a determination "that the markets are not workably competitive." Complaint at 3. Moreover, even assuming *arguendo* that the ISO's authority is conditioned, the Board made the requisite finding.

a. Section 28.2 of the ISO Tariff, as modified by Amendment No. 21, provides only that the ISO will establish maximum bid price levels for the Imbalance Energy and Ancillary Service markets "in accordance with criteria adopted by the ISO Governing Board from time to time." MSCG attempts to convert the set of price cap criteria adopted by the ISO Board in September 1999 into permanent limitations on the ISO's ongoing exercise of its authority to establish and modify bid price caps. Section 28.2 of the ISO Tariff is clear, however, that the ISO Board may adopt criteria to govern price cap levels "*from time to time*" (emphasis added). A plain reading of the Tariff language presented and approved in Amendment No. 21 thus recognizes that the ISO Board could modify its price cap criteria and establishes no prerequisites for such a decision. MSCG's attempt to read the limitations of the September 1999 ISO Board price cap resolution into the ISO Tariff also ignores the Commission's January 27, 1999, decision on an earlier amendment to the ISO Tariff, where the Commission confirmed the ISO's authority to cap bids in its markets, but rejected limitations on that authority. Instead, the Commission made it clear that the ISO should have the flexibility necessary to establish price caps "at whatever level it deems necessary and appropriate" to respond to conditions in those markets, as they

[10] Amendment No. 21 Order at 61,511.

change over time.[11] Indeed, the Commission confirmed the broad scope of the ISO's discretion in the Amendment No. 21 Order, where it noted that it had previously authorized the ISO "to reject bids in excess of *whatever price levels it believed were appropriate*" for Ancillary Services and Imbalance Energy.[12] The Commission thus recognized that Amendment No. 21 did not bind the ISO Board to make any particular findings prior to adjusting the bid price cap.

In light of the unambiguous, unrestricted tariff language, and the Commission's reaffirmations of ISO authority, MSCG, a sophisticated market participant, surely was on notice that the purchase price cap was subject to change. There is no basis for a claim of reliance. Indeed, any such claim would render meaningless the tariff language and Commission endorsements.

b. Moreover, although not a necessary precondition to action on its bid cap, the Motion adopted by the Board at its June 28th session states in its opening paragraph:

> In response to market performance indicating that during high load conditions the California Independent System Operator's real-time electricity, day-ahead and hour-ahead ancillary service markets are not workably competitive, the Board instructs ISO management to . . . .

If MSCG's point is that the Board failed to carry some burden, its contention is not advanced. First, as shown in section 3, *supra*, there is no such obligation. Second, as shown in section 2, *supra*, the Board surely had ample basis for its action.

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[11] *See California Independent System Operator Corporation*, 86 FERC ¶ 61,059 at 61,202 & n.16 (1999).

[12] Amendment No. 21 Order at 61,507 (citing *AES Redondo Beach, L.L.C., et al.*, 84 FERC ¶ 61,046 (1998)) (emphasis added).

5. Communications

Communications regarding this docket should be sent to the following individuals, whose names should be entered on the official service list established by the Secretary for this proceeding:

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6. Conclusion

The ISO Board did not ignore the concerns raised by MSCG and others who share its views, but took those concerns into account in deciding how to respond to high prices in the California electricity markets and their consequences for the customers who rely on those markets and lack adequate mitigation options. It acted well within its authority as a buyer of Ancillary Services and Imbalance Energy to specify the maximum prices it is willing to pay for those services and, where circumstances warrant, to adjust those maximum prices.

For the reasons set forth above, the ISO urges the Commission to decline summarily to entertain MSCG's Complaint and request for emergency relief.

Respectfully submitted,

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