CALIFORNIA ISO

California Independent
System Operator

Memo

To: Market Issues/ADR Committee

From: N. Beth Emery, Vice President & General Counsel

CC: ISO Board of Governors, ISO Executives

Date: June 16, 1999

Re: ***Board Action on Price Caps***

EXECUTIVE SUMMARY

The Board deferred action on a price cap policy until the June meeting to allow Management time to analyze the May 26 Federal Energy Regulatory Commission ("FERC") order, consult with the Market Surveillance Committee ("MSC"), and make any changes it deemed appropriate to our May recommendation on price caps. Based on this analysis, and consultations with the MSC and our Washington counsel, management recommends a three-step process described in the proposed motion below. This approach would send desired long-term price signals to the market. It would rely on mechanisms in use in other functioning markets rather than price caps (see accompanying memo describing proposed price volatility limit mechanism or PVLM). It would meet FERC's order to eliminate caps. (We recognize that FERC would need to confirm the appropriateness of using a PVLM typical of other markets). Of equal importance is that it allows us to support a filing for long-term PVLM authority based on the MSC's and our own analysis of summer 1999 experience. That support would not be available if we attempted to seek final resolution in a rehearing application or if we sought to file Tariff changes to be effective before the November 15 termination date. Finally, given the novelty and possible complexity of the PVLM option, we believe it prudent to take the time until August to finalize the PVLM design.

Thus, management proposes the following motion:

Moved, that the Committee recommends that the Board

- ***eliminate price caps immediately upon completion of a four week "shake-out period" after Phase I Ancillary Service redesign software is in full operational with the following conditions:***
  - ***immediate implementation of a circuit breaker (Price Volatility Limit Mechanism or PVLM) and***
  - ***the "floor" for the PVLM will be $250 pending effectiveness of the "netting out" provisions for RMR contracts, thereafter it would be $1000;***

- ***direct management to develop implementation details for the PVLM (including timing and amount of incremental moves), with stakeholder and Market Surveillance Committee (MSC) input, for Board approval in August; and***

- ***direct management to seek limited rehearing of FERC's termination of the Board's cap authority to extend the November 15 date to February 15, thereby allowing any filing for continuing authority to incorporate the results of the October 15 reports FERC has requested of the MSC.***

ISSUES FOR DECISION

In May, the Board was scheduled to address its policy on price caps. The Federal Energy Regulatory Commission (FERC) order on Ancillary Services (A/S) redesign was issued the day of this Committee's meeting. That order limited the Board's continuing authority to impose price caps. Given the order, it was the sense of the Board that the policy discussion should be deferred to the June meeting to allow sufficient time to understand the FERC order and develop policy options consistent with the order, or a defensible position for seeking rehearing. This memorandum sets forth management's recommendation for a three-step process to address the price cap issue. Attached is a separate memorandum (***Attachment A***) from the policy team providing the substantive details of the proposed policy, as well as alternatives considered.

The current Board policy on price caps, adopted at the November 19, 1998, meeting established a $250 cap on Ancillary Services and Imbalance Energy.[1] The policy specified that caps would be raised to $750 upon implementation of the Phase I Ancillary Services redesign and revision of the Reliability Must-Run (RMR) *pro forma* contract. It also provided that unless an additional Tariff change was approved by the Board, caps would rise on October 1, 1999 to $2500. This authority was filed in Amendment No. 12. FERC rejected the amendment on caps in its January 27, 1999 order,[2] but left discretion with the ISO to impose caps while dealing with A/S redesign. In its May 26 order on Amendment No. 14, in which A/S redesign mechanisms were accepted, FERC terminated ISO authority to set caps effective November 15, 1999, absent a filing by the ISO to continue cap authority.

The Board is faced with several decisions:

- Should the Board act now or at some later date?
- What policy should the ISO adopt? (Covered in ***Attachment A.***)
- When should the ISO implement the new policy? (Covered in ***Attachment A.***)
- What should be addressed in the rehearing request on the May 26 order?
- What, if anything, should be addressed in a Tariff amendment and when?

CRITERIA FOR DECISION

The following are the key criteria for decision: (1) how can we meet the Board's desire to send appropriate long-term price signals, and (2) what is the best strategy for complying with FERC's order or presenting a compelling case for change?

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[1] The cap is, to be precise, $250/MW for Ancillary Service capacity and both a positive and negative cap (± $250/MWh) for Imbalance Energy.

[2] <u>California Independent System Operator Corporation</u>, 86 FERC ¶ 61,059 (1999).

OPTIONS CONSIDERED AND *PROS* AND *CONS*

Should the Board act now or at some later date?

The Board in November stressed its commitment to lifting caps and relying on markets as soon as possible, and its desire to send appropriate long-term price signals. Clarifying policy now would signal that continuing commitment to the market. Moreover, the "do nothing" option in reliance on the current policy is not feasible since there is uncertainty about how to apply the conditions to raising the caps to $750.

Specifically, the Board needs to clarify whether last November it was implicitly agreeing to a "shake-out" in a non-peak month given the stated assumption of May-June effectiveness of A/S redesign. Likewise, the Board needs to confirm whether the netting-out provision for RMR contracts is a necessary element of RMR reform.

What policy should the ISO adopt?

The Board has several options for its policy decision:

- first, what mechanism(s) it wishes to use in its discretion between now and November 15;[3]
- second, what mechanism to use thereafter.

The two approaches (price caps *vs.* a PVLM or circuit-breaker) are detailed in ***Attachment A.***

When should the ISO implement the new policy?

The timing of implementation is also treated in ***Attachment A.***

What should be addressed in the rehearing request on the May 26 order?

The ISO's rehearing request on the May 26 order is due Friday, June 25. We considered these options:

- not seek rehearing;
- assert that FERC erred in its order in terminating the ISO's cap authority and seek *via* the rehearing FERC approval for the mechanism the Board selects, *i.e.*
  - continuing authority to use price caps through a full summer of operation (2000) with the A/S redesign, or
  - confirmation that the ISO may continue using the Price Volatility Limit Mechanism beyond November 15; or
- seek limited rehearing to extend the November 15 deadline.

Getting the Commission to reverse itself on rehearing is difficult, at best. On the other hand, not seeking rehearing at all would leave the ISO in the position of losing all authority November 15, or filing by September 15 to extend

[3] FERC's May 26, 1999 Order left discretion with the ISO to determine appropriate caps, but terminated this authority effective November 15, 1999 unless the ISO files and obtains further authority.

authority (but without good data on operations in the summer), or filing after the MSC report due to FERC October 15, but having to rely on emergency action by FERC or face at least a temporary gap between November 15 and FERC action.

The limited rehearing (coupled with information on the Board's policy direction) affords FERC time to consider the MSC's report on the partial experience to be gained this summer before ruling on continuing authority for the ISO to impose some limits on the market.

What, if anything, should be addressed in a Tariff amendment and when?

Implementing PVLM would require substantial additional analysis and consultation with Market Participants to arrive at a solution that is most workable and effective. Moreover, we believe it will require a Tariff change to specify the mechanism. Filing a Tariff change to continue price caps beyond November 15 will also take considerable time. In either case, we believe having the MSC report before final decisions are made is preferable. On the other hand, since FERC need not act on the substance of our rehearing, there is a risk that in August we will have to agree to details for a Tariff amendment, to enable us to file by September 15 to ensure a remedy by November 15.

Because either the cap or PVLM requires substantial work, management needs a Board policy decision on which option to pursue. We will work on a schedule that assumes approval of details in August; although if we seek limited rehearing for an extension and FERC acts by its July 28 meeting, we can slow down the process for filing documents (but not the process of developing the details, presuming a September 15 implementation under our interim authority).

MANAGEMENT'S RECOMMENDATION

After further analysis of the FERC order, consultation with the Market Surveillance Committee, and with the advice of our Washington counsel, management recommends a three step process described in the proposed motion above. This approach would send desired long-term price signals to the market and establish Board policy to rely on mechanisms in use in other functioning markets rather than price caps. It would meet FERC's order to eliminate caps. Of equal importance is that it allows us to support a filing for long-term PVLM authority based on the MSC's and our own analysis of summer 1999 experience. That support would not be available if we attempted to seek final resolution in a rehearing application or if we sought to file Tariff changes to be effective before the November 15 termination date. Finally, given the novelty and possible complexity of the PVLM options available, we believe it prudent to take the time until August to finalize the PVLM design.