CALIFORNIA ISO

California Independent
System Operator

Memorandum

To: Grid Reliability / Operations Committee
Market Issues/ADR Committee

From: Zora Lazic, Vice President, Client Services
Anjali Sheffrin, Director of Market Analysis

CC: ISO Board; ISO Officers

Date: March 14, 2000

Re: Summer 2000 Price Cap Policy

EXECUTIVE SUMMARY

This matter requires Board action. Currently, the ISO has price caps of $750/MW in place, for ancillary services (A/S) capacity, imbalance energy, and adjustment bids. In August 1999, the Board voted to raise these price caps from $250/MW(h) to $750/MW(h) effective September 30, 1999 with the provision that the Board would reduce the caps to $500 effective June 1, 2000 if it determined that:

(a) the markets are not workably competitive,

(b) there are not practicable demand side management options in place, or

(c) the IOU Utility Distribution Companies have sought and not obtained practicable options to self-provide Ancillary Services and applicable hedging products in the Power Exchange consistent with the California Public Utilities Commission Preferred Policy Decisions.

In addition, the Board directed Management to report to the Board no later than March 2000 whether these conditions (a), (b), or (c) have been met.

<u>Are markets workably competitive?</u>

Management believes markets are workably competitive in most hours, however the ability to exercise market power exists during very high load hours. During these hours, because supply of those services is limited, individual suppliers can submit high bids with confidence that their bids will be selected. In Summer 1999, due to ISO market reform and the removal of certain regulatory barriers, the impact of market power was less than that experienced during Summer 1998. Another factor that contributed to reduced market power impact was the cooler than usual summer, although average loads were higher. Expected load growth combined with extreme summer weather may pose a new challenge to having a workably competitive market. The ongoing development of demand responsiveness programs and properly designed forward market hedging products will help to mitigate this market power.

Are there practicable demand side management options in place?

Management believes there will be practicable demand side management options in place by June 2000. Both SCE and PG&E have forward market demand responsiveness programs pending CPUC approval. The CPUC is expected to rule on these programs on March 16, 2000. In the interim, the CPUC has issued two draft resolutions approving the programs, subject to some modifications. Additionally, the ISO has developed a trial program for Summer 2000 to develop greater load participation in the ISO's Ancillary Service Markets for Non-Spinning and Replacement Reserve and in the Supplemental Energy Market. Though these programs are small in scale, we believe that, collectively, they provide load providers with significantly more opportunities to protect against high prices than were available last summer.

Are there practicable opportunities for UDC's to self-provide Ancillary Services and hedging products in the Power Exchange?

Management believes there will be practicable opportunities in the CalPX for UDC's to self-provide ancillary services and hedge both energy and ancillary services. Since August 1999, the CalPX has developed several new block forward energy products. The PX has recently filed with FERC for authority to offer ancillary service block forward market products and allow self-provision of ancillary services in the day-ahead market. These hedging products obligate the suppliers to provide future energy or ancillary services at a given price and will help reduce suppliers incentive to exercise market power. Subject to FERC approval, the CalPX expects to have its block forward ancillary service market in place on May 1, 2000. The UDCs will need approval from the CPUC to participate in the CalPX ancillary service block forward market. As of March 8, 2000, they had not filed with the CPUC for such authority. PG&E and SCE currently have CPUC authority to participate in the CalPX Block Forward Market for energy, subject to trading limits, and both have filed with the CPUC for expanded authority for participation in the energy block forward market. The CPUC has recently issued a draft resolution approving the UDC's request for authority to participate in the new energy block forward market products being offered in the CalPX, increasing their trading limits to 100% of their "net-short position", and extending this authority to the end of each UDC's rate freeze.

Other Factors to be Considered.

While the above three criteria are important, Management believes there are also key long-run factors critical to making a decision on price cap levels. When these additional factors are evaluated in combination with the improvements achieved on the first three criteria, we believe they tip the balance in favor of leaving the caps at $750 for summer 2000. These key factors are:

The adequacy of import supply to the ISO system during peak hours of Summer 2000 – Given the likelihood that we will return to normal summer temperatures in 2000, we must consider the possibility of coincident peaks occurring in the southwestern region forcing the ISO to compete with neighboring control areas for a finite supply. In such situations, the $750 cap will be more effective than the $500 cap in attracting supply to the California markets.

A $750 cap will provide a greater incentive for loads to participate in the load responsiveness programs developed for Summer 2000 – Greater participation in these programs will help mitigate price spikes in

Summer 2000 and provide useful information on the extent to which different types of load will respond to market prices. This information is critical to developing future load participation programs and will also help the ISO in developing a market power mitigation policy after Summer 2000.

The need for empirical evidence on market performance at high load levels, in view of the impending expiration of price cap authority on November 15, 2000 – Such evidence will be critical for assessing appropriate ISO policy to pursue after Summer 2000. Unless the Board decides to allow all price cap authority to expire, which we recommend against, we will have to file at FERC for some form of mitigation. To support such a filing, the ISO should have the strongest possible evidence on how the markets will perform in the absence of binding price caps. The $750 cap level will allow more room for demand and supply to reach equilibrium, and thus will provide stronger evidence than the $500 level.

The incentive effect of consistent long-term policy – The level of price caps during Summer 2000 will provide a market a signal about the ISO's long-term policy objective. Management believes it is important to keep the Board's fundamental policy objective in mind; that we should move expediently to a workably competitive market regime in which price caps are no longer needed (except for a very high safety-net cap level). Following this policy, the Board should set the Summer 2000 price cap at a level that facilitates the movement to uncapped market prices. There are good reasons to maintain the cap at the $750 level. Clearly, a $750 price cap level would better facilitate the movement to an uncapped market price regime. Keeping the price cap at $750 would provide strong incentives and signals to the market for new investment in generating capacity, demand price responsiveness, and transmission capacity. This is detailed in the DMA study of March 2000 on price caps (Attachment A).

Based on all of these factors, Management recommends that the Board retain the $750 level of price caps on the ISO markets for Summer 2000.

Management's recommendation is incorporated in the following motion:

MOVED, that:

The ISO Board keep caps in the ancillary services, real-time energy and adjustment bid markets, at their current level of $750 through Nov 15, 2000.

For the long-term, Management recommends that the Board begin to consider various policy options that would be effective in protecting the ISO markets against the exercise of market power beyond November 15, 2000. Some potential options are presented in DMA's report. Given the FERC's 60-day review period, we believe it is imperative to file some type of market power mitigation policy with FERC as part of the comprehensive congestion reform schedule. The Board should consider requesting FERC to extend the ISO's current price cap authority consistent with the ISO's congestion reform proposal schedule that will be filed in October, 2000. The congestion reform proposal would include a long-term market power mitigation policy. We believe this approach makes sense given the inter-relatedness of congestion reform and market power. Management will begin a stakeholder process to discuss this, and other options. We will present a recommendation to the Board on the temporary price cap extension in April, 2000.

MARKET SURVEILLANCE COMMITTEE OPINION

On March 10, 2000, the ISO Market Surveillance Committee (MSC) issued an opinion on workable competition in California's wholesale electricity markets and the merits of leaving the price cap at $750 versus lowering it to $500. Their opinion is included as Attachment B.

The MSC believes that California's energy and ancillary services markets have not been workably competitive during the last two summers. They cite a number of factors that have contributed to this condition, including market design flaws, lack of price-responsive real demand, and limitations on the IOU's ability to enter into forward contracts. The MSC noted there were reduced market power impacts in the summer of 1999.These can be attributed to the improvements due to market reform, the removal of regulatory barriers, and the cooler summer.

The MSC notes that the ISO has implemented most, but not all, of the market design changes they have recommended. However, the effectiveness of these reforms in the supply-limited system conditions expected this summer is unknown. Likewise, the CPUC is currently considering approval of demand-response programs by PG&E and SCE, and may permit expanded IOU participation in the PX block forwards market. Whether these measures will reduce generators' ability to exercise market power, depends upon the scope of the programs the CPUC ultimately authorizes, and their effectiveness during high-demand periods.

The MSC made no recommendation on the level of a price cap. They stated, "This is a policy decision for the ISO Board of Governors, taking into account the potential for extension of the CTC period, greater incentives a higher cap might provide for participation in UDC demand-responsiveness programs, and the likelihood that a test of the ISO's market reforms with a $750 cap will give less ambiguous results than with a $500."

DEPARTMENT OF MARKET ANALYSIS POSITION

A study by the DMA on the appropriate level of the cap is included as Attachment A. The DMA recommends keeping the price cap at $750 for Summer 2000.