MORGAN STANLEY

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June 28, 2000

VIA FACSIMILLE TRANSMISSION

Jan Smutney Jones
Chairman
California Independent System Operator Corporation
151 Blue Ravine Road
Folsom, CA 95630

Terry M. Winter
President and Chief Executive Officer
California Independent System Operator Corporation
151 Blue Ravine Road
Folsom, CA 95630

Re: Proposed Change to Energy Bid Caps

Gentlemen:

We are writing to express our strong opposition to the proposal being considered by the California Independent System Operator ("Cal ISO") Governing Board at its June 28, 2000 emergency meeting to reduce the price cap in the Cal ISO market. This hastily considered change of direction could have severe negative consequences on the liquidity and development of the California energy markets.

As a matter of principle, we oppose price caps in any form because they inhibit the development of truly competitive markets. However, participants in California markets at least were able to consider the effect of the Cal ISO's existing price cap when devising and implementing their overall market strategies. The present proposal would unfairly amend the rules of the market midstream, after market participants who responsibly hedged some of their price and market risks have invested substantial amounts of time and money under the premise that the artificial restrictions would be capped at $750/MWh. Furthermore, since the market design flaws that were the impetus for the institution of the price cap have, by most accounts, been remedied, there is no compelling need for reduction of the cap at this time.

It is obvious that this change in the rules will significantly benefit market participants that are buyers and significantly disadvantage those that are sellers. Not surprisingly, those entities that will benefit financially from a change to this artificial imposition are the ones that are advocating the change. If these entities are successful in influencing the reduction of this price cap, then the Cal ISO market can reasonably be characterized as a "rigged market". Under those circumstances, we will have no choice but to consider pursuing appropriate remedies to protect its rights and the integrity of the marketplace.

Additionally, and importantly, the Governing Board may be under the mistaken impression that reducing the price cap will automatically benefit California's consumers. In fact, the very opposite may occur.

Entities such as Morgan Stanley Capital Group, Inc. ("MSCGI") utilize their investment capital in electricity markets, either by entering into forward purchases or sales from producers or consumers or by investing, through subsidiaries, in generation assets. Through these efforts MSCGI provides a *long-term, stable* source of capital and liquidity which, when grouped with other such providers of capital, is essential to the trading of power and the development of new power generation in California and throughout the country. Buyers of electricity, such as cooperatives and other net users of power, directly benefit from these actions because this capital is utilized to provide users with energy purchases which more closely match their needs and risk parameters than the types of sales which are oftentimes directly offered by producers, who face different risks and needs.

At the same time, producers of electricity rely upon significant investments of outside capital from various private sources and the capital markets themselves and the willingness on the part of these investors to take long-term positions in the competitive market. This is particularly the case in the current marketplace where the long-term all output power purchase agreement that enabled project financing is quickly disappearing. However, investors' positions are premised on long-term predictability in the regulatory regime that governs the buying and selling of power. When predictability does not exist, investment capital, such as that provided by MSCGI, will quickly move on to invest in other regions or markets where more certainty exists. This reaction is increasingly true given the acute need for investment in the development of electrical generation and the marketing of power across the nation and worldwide. What results is a reduction in the overall liquidity in the markets and an increase in the cost of investment in additional generation.

The mere fact that the Governing Board is hastily considering such a drastic action has a chilling effect on future capital investment. The Governing Board should very carefully consider the short-term and long-term ramifications that a reduction of the price cap will have on the developing, but already complex, competitive California power market. We believe that power consumers in the state of California can ill afford any reduction in the development of new generation, a point which we believe is being borne out in recent elevated prices. As a final note, while prices in California have been higher than in the past, they are not high in comparison to prices seen in others areas of the country, particularly when viewed in light of the lower supply of hydroelectricity in the West and the unusually high temperatures.

For the above reasons, we strongly urge the Governing Board to reject any and all proposals to reduce the price cap from its current level.

Very truly yours,

Simon T.W. Greenshields
Vice-President

CALIFORNIA
MANUFACTURERS
& TECHNOLOGY
ASSOCIATION

June 28, 2000

Jan Smutney-Jones
Chairman, California ISO Board of Governors
1112 I Street, Suite 380
Sacramento, CA 95814

Terry Winter
Chief Executive Officer
California ISO Board of Governors
151 Blue Ravine Road
Folsom, CA 95630

Dear Mr. Smutney-Jones and Mr. Winter:

Today the independent system operator will consider lowering the energy price caps in order to address the high prices recently experienced in the energy markets. California Manufacturers and Technology Association does not support lowering the price cap.

On the contrary, the recent supply shortages argue for maintaining the higher cap in order to encourage suppliers to make financial investments to serve growing loads in California. Reducing the market cap in this precipitous manner will also add uncertainty and confusion to the market, creating even less enthusiasm for making long term commitments in the state.

Energy suppliers will find and invest in markets where prices and policies support economic success over the long term. The change in the price cap under consideration today does not promote such a market in California.

Respectfully,

Jack Stewart
President

cc: Governor Gray Davis
Members, Cal ISO Board of Governors

CALIFORNIA ENERGY COMMISSION
OFFICE OF THE COMMISSIONERS
16 NINTH STREET
SACRAMENTO, CALIFORNIA 95814-5512

June 28, 2000

The Honorable Jan Smutny-Jones, Chairman
California Independent System Operator
151 Blue Ravine Road
Folsom, CA 95630

Dear Chairman Smutny-Jones:

We understand the Board will be convening in special session today to consider a request to adjust the existing real time energy price cap back to its previous level of $250 per Mw hour.

Current price levels have exceeded common expectations about market response, even in light of the temperature extremes of recent weeks. The temperature fluctuations, coupled with consumer-related demands, are predictable and can be expected to reappear at unknown intervals during the summer months. In a fully-functioning, demand-responsive market, price caps would typically only exist for damage control, to mitigate prices generated by truly extraordinary combinations of events (such as multiple plants idle combined with peak demands or major transmission line failures). In such a regime with open competition and transparent pricing, average prices will approach long-run average costs. The consumer is then at risk only for the real cost of energy and can make individual choices regarding time of day use or choice of load.

These conditions do not exist today, as recent evidence and prices reaching the $750 per Mwh level illustrate. While we do not have current evidence that would suggest the most market-friendly price cap to set, the $750 per Mwh level appears too high. The only other figure with any market history is $250 per Mwh; we suggest that you return to that figure temporarily until other complementary market issues, such as congestion management reform, demand responsiveness, reliability must-run, and ancillary service markets, are resolved. A corollary benefit will be a limit to the de facto exercises of market power, by generators, when tight market conditions prevail.

We recognize that this will be a temporary measure to avoid sending potential new generators the signal that our market will always be capped at this level. Nevertheless, at this time, imposing a lower cap to enhance market stability, seems to be the most prudent public policy.

The optimal situation would be one where there is sufficient demand elasticity in the future to make this type of regulatory action unnecessary. To assist in demonstrating methods that can achieve this outcome, the Energy Commission has initiated pilot programs with two municipal utilities that allow building managers to program their space conditioning systems to respond appropriately to ISO real time prices. As we gain experience with these programs, the Energy Commission will examine whether the Commission's authority under Public Resources Code section 25403.5 to adopt load management standards might be helpful in accelerating the maturation of our market.

Sincerely,

Art Rosenfeld

MICHAL C. MOORE, Ph.D.
Commissioner

ROBERT PERNELL
Commissioner

ARTHUR ROSENFELD, Ph.D.
Commissioner

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SCOTT R. BAUGH
ASSEMBLY REPUBLICAN LEADER

June 28, 2000

Jan Smutny-Jones
Chairman, California ISO Board of Governors
1112 I Street, Suite 380
Sacramento, CA 95814

Terry Winter
Chief Executive Officer
California ISO Board of Governors
151 Blue Ravine Road
Folsom, CA 95630

Dear Mr. Smutny-Jones and Mr. Winter:

My letter to you on June 27, 2000 was written prior to my being briefed on all of the facts surrounding the issue of price caps. Therefore, I am now taking a neutral position on this issue and urge the ISO Board of Governors to take the action they feel best serves the consumers of the state of California.

Please distribute this letter to anyone to whom you furnished my June 27 letter. Please contact Jeff Sauls in my office at (916) 319-2067 to acknowledge receipt of this letter.

Sincerely,

Scott Baugh

Scott Baugh
Assembly Republican Leader

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California State Assembly

BILL LEONARD

ASSEMBLYMEMBER, SIXTY-THIRD DISTRICT

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RULES (VICE CHAIR)
BUDGET
BUDGET SUBCOMMITTEE ON EDUCATION FINANCE
SELECT COMMITTEES:
TRANSPORTATION CONGESTION RELIEF
SCHOOL FACILITIES FINANCE
COMPTON UNIFIED SCHOOL DISTRICT

June 28, 2000

Mr. Jan Smutny-Jones, Chairman
California ISO Board of Governors
1112 I Street, Suite 380
Sacramento, CA 95814

Dear Mr. Smutny-Jones:

As a member of the AB-1890 Conference Committee, I believed that the restructuring of California's electric industry would result in a reduction in the high electricity prices throughout the state. Although I continue to believe such is possible, the recent and continuing extremely high electricity prices, at times exceeding $1.00/kWh, is a clear indication something is not functioning properly. Until corrections are identified and made, and some reasonable level of demand responsiveness exists, I believe the ISO must reduce the market cap to those levels that worked last summer.

Based on last year's experience, a $250/MWH cap on the ISO markets did not appear to discourage the interest of developers in pursuing new electric generation. However, today's prices for electricity with the higher cap and the market imperfections are producing a price for electricity more than ten-fold the rate utilities had prior to restructuring. I am very concerned of the significant detrimental impacts this will have on California's businesses and residents. There has to be some control over the market until the obvious flaws are corrected, and last summers cap of $250/MWH has proven itself.

Please contact me if you have any questions regarding my position.

Sincerely,

BILL LEONARD

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SCOTT R. BAUGH
ASSEMBLY REPUBLICAN LEADER

June 27, 2000

Jan Smutny-Jones
Chairman, California ISO Board of Governors
1112 I Street, Suite 380
Sacramento, CA 95814

Terry Winter
Chief Executive Officer
California ISO Board of Governors
151 Blue Ravine Road
Folsom, CA 95630

Dear Mr. Smutny-Jones and Mr. Winter:

It has come to my attention that on June 28, 2000, the Board of Governors of the California Independent System Operator (ISO) will be considering a request to reduce the current price caps. I must voice my concern over taking any action to alter the price caps before a study has been completed on the power outages that occurred in the San Francisco Bay Area during the week of June 13-16, 2000. As you are aware, Governor Davis has requested just such an investigation by the California Public Utilities Commission (CPUC) and the Electricity Oversight Board (EOB). I feel that any action taken prior to the completion of this study would be premature.

The surest way to discourage investment in California's electrical infrastructure is to create uncertainty in the electricity marketplace. I am sure the ISO recognizes that its decision on price caps will effect the generation and delivery of electricity in California not just over the next several months, but over several years.

I urge your caution on taking any action relating to price caps before the completion of the investigation by the CPUC and the EOB.

Sincerely,

Scott Baugh

Scott Baugh
Assembly Republican Leader

INDEPENDENT ENERGY PRODUCERS

June 27, 2000

The Honorable Gray Davis
Governor
State of California
State Capitol
Sacramento, CA 95814

Re: Response to Bay Area Electricity Outage

Dear Governor Davis:

The Independent Energy Producers Association (IEP) shares your grave concern about the recent electricity outages in the San Francisco Bay Area. Our industry's single most important goal is to provide reliable, competitively priced, clean electricity to California. To that end, IEP and its members pledge to cooperate with the outage investigations you requested of the California Public Utilities Commission (CPUC) and the Electricity Oversight Board (EOB).

Key to a successful policy response is the understanding that reliable service requires reliable policy. Nothing will discourage power plant investments in California faster than regulatory and market instability, and these are investments that are essential to improved reliability and the future of California's electricity – dependent economy.

Based on contacts with major Bay Area generators, IEP is confident that your investigation will document that they did everything physically possible to supply the region's extraordinary and unexpected electricity demand during the week of June 12th-16th. Other factors, of course, also warrant consideration in your investigation.

Today's electricity supply shortage and reliability problems are the result of a complex combination of past decisions and current conditions. For example, the federal government's preemption of a state power plant development program in the mid-nineties deprived this market of generation that would otherwise be in service today. In addition, weather, market, and environmental conditions in neighboring states contribute significantly to the California's ability to meet unexpected demand, as documented by the California Energy Commission. Other issues specific to the Bay Area outage and prices include the availability and sufficiency of transmission capacity into load centers, whether retail providers, including certain utilities, scheduled their purchases in a way that exacerbated the supply shortage and price effects, and the effectiveness of load reduction programs.

(916) 448-9499 / Office
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California independent power producers are responding in the best way they can to improve the reliability of California's electric system. As a result of electric industry restructuring, they have improved the availability of existing generation and they have submitted proposals to the California Energy Commission that literally rebuild the state's electricity infrastructure. In the Bay Area alone IEP members are proposing to invest $2-3 billion in 3,500 MW of generation facilities. Three are already under construction – two in Contra Costa County and one in Sutter County. Four more, located in San Francisco, Contra Costa, Santa Clara and Monterey counties, are maneuvering through the permit process at the California Energy Commission. In addition to significantly improving electric service reliability, these new Bay Area facilities will provide new union jobs and improve air quality.

The ultimate success of these projects depends on regulatory reliability. Since the service outage, certain policy makers have called for significant, fundamental and retroactive changes to ISO and PX pricing policies. Nothing is a bigger threat to electric service reliability than the instability that these proposals would cause in the regulatory and market environments. This is not to say that the market is flawless and must remain unchanged. IEP is working with the ISO and the PX to identify anomalies in the market and to identify appropriate adjustments. IEP will share its conclusions with the CPUC and the EOB as soon as they are finalized.

In closing, IEP would like to reiterate its commitment to work with you, your appointees, and the Legislature to develop a strong and appropriate public policy response to the state's critical need for improved electric service reliability. Reliable policy is key to reliable service. IEP is joined on this letter by representatives of many of its members, including several serving the northern California market. Together and singly we urge you to maintain California's stable regulatory environment as you address the state's critical electricity reliability needs.

Sincerely yours,

JAN SMUTNY-JONES
Executive Director

Jonathan M. Weisgall
Vice President
Legislative & Regulatory Affairs
CalENERGY Company, Inc.

Joseph E. Ronan, Jr
Vice President
Governmental Regulatory Affairs
Calpine Corporation

David Parquet
Vice President
Enron North American Corporation

William F. Hall, III
Vice President & General Manager
California Operations
Duke Energy North America

Nick Wallace
Senior Vice President
Dynegy

Michael Leighton
Vice President
FPL Energy, LLC

Duane H. Nelsen
GWF Power Systems Company, Inc.

John Stout
Reliant Energy

Rob Lamkin
Vice President
Southern Energy

President
Power Resources
Thermo Ecotek Corporation

William H. Carlson
Vice President & General Manager
Alternative Energy Group
Wheelabrator Environmental Systems, Inc.

Roger Pelote
Williams Energy Services

cc: Loretta Lynch, President
California Public Utilities Commission

Michael Kahn, Chairman
Electricity Oversight Board

William Keese, Chairman
California Energy Commission

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Southern Energy California

SOUTHERN COMPANY
Energy to Serve Your World

June 27, 2000

Mr. Jan Smutney-Jones
Chairman, ISO Governing Board
1112 "I" Street, Suite 380
Sacramento, CA 95814

Subject: Price Caps

I am sure it is no surprise that Southern Energy does not support the proposal to lower the current price caps at the ISO. There certainly remains no limit to the number of letters or opinions on this subject, but I still wanted to highlight a few of our concerns.

Of significant relevance is the fact that the ISO Board has already discussed and addressed this issue of summer 2000 price caps at its meeting several months ago. All of the usual issues and debates occurred at the meeting along with an ISO staff recommendation to continue with the $750 cap. The Board made no finding that the market was not "workably competitive" and determined to maintain the current cap. Also, at that time, we all were aware of the supply and demand conditions for the upcoming summer.

Since the Board decision a number of events have occurred. First, a number of market participants relied on this Board action and made commercial arrangements to buy/sell energy at set prices for the summer months. The prices were established based on a number of parameters including, most importantly, price caps. To administratively change the rules at this point after numerous contracts have been executed would severely damage our faith in the California marketplace. Second, the ISO has implemented a number of market design changes to, as argued by the ISO, improve market operations. These include the Automated Dispatch System, Predispatch of RMR units, Target Price, and (soon) 10-minute dispatch. In short, each market participant assessed its supply/demand situation, given all of the above, and hedged its financial position accordingly.

So, where are we today? Certain parties apparently are not happy with the outcome of their current financial positions and they seek to find a fix through regulatory fiat. Terry Winter (ISO CEO) reported at the Board meeting last week that he believed the markets are working well and, if anything, the price cap may need to be equivalent to the PX cap of $2500. Furthermore, neither the ISO nor any other party, has demonstrated that the markets are not "workably competitive". It is no surprise that the electric demand is high

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this summer and there is insufficient generation supply in California. Though some have argued that the energy shortage indicates the market is not working, the real problem, however, is that very few new generation plants or transmission lines have been constructed in the last ten years. Unfortunately, continued intervention by the ISO in the marketplace will further discourage new plant investments. New plant construction is desperately needed to support the economic growth in California.

Southern Energy believes that the ISO Board should not lower the price cap given the reasons listed above and also iterated in letters from WPTF and IEP. Also, we believe the California marketplace needs some regulatory certainty. Nothing could damage the marketplace more effectively than unforeseeable and drastic actions by the ISO. Lastly, the ISO should focus on the real problem of meeting increased electric demand. We have an immediate and serious problem to face regarding electric reliability for this summer and the next few years! This very real problem is not being addressed or fixed, and is exacerbated, by addressing the cap.

Sincerely,

Rob Lamkin
Vice President

Rl/ab

Cc: ISO Governing Board
Loretta Lynch, President CPUC
Michael Kahn, Chairman EOB
William Keese, Chairman CEC

June 27, 2000

The Honorable Gray Davis
Governor, State of California
State Capitol
Sacramento, CA 95814

RE: California Electric Markets

Dear Governor Davis:

On June 28, 2000, the Board of Governors of the California Independent System Operator ("CAISO") will be considering a request to substantially reduce their price caps. The California electric market has labored under price caps for far too long. While Williams would support the total removal of all price caps, we are extremely concerned that anyone would recommend to the CAISO that they should consider a substantial reduction during the middle of the summer. This is particularly the case since a large portion of the summer's business has already been done in forward markets in reliance on the existence of the existing price caps.

Price caps do not equate to reliability in a competitive market. Although recent events evidence the need for additional generation, a reduction of the price caps will only serve to chill enthusiasm for constructing those projects. While the price volatility that can accompany free markets may be dramatic, intervention to control that market will ultimately cause even greater concerns. Effective competitive markets can only develop and then thrive if they operate in a world of stability and certainty. Wildly changing price caps during the middle of the summer presents a world of chaos. Such chaos will not only reduce participation in the existing power market and erode confidence in the CAISO, it will delay any market expansion. Further, reduced price caps will create a low priced island in the greater nation-wide electric grid. This will discourage imports and encourage exports thereby providing precisely the opposite result needed for reliability.

Williams understands the need to investigate the circumstances of the week of June 12-16, 2000. We will cooperate with any investigation to the greatest reasonable extent. However, to the extent such investigation yields the expected result that there was insufficient generation for such peak periods and that forward markets were not utilized to the extent necessary to mitigate prices, Williams argues that reducing price caps is exactly the wrong solution at the wrong time. Instead, the CAISO should be allowed to work with its stakeholders to find constructive solutions that encourage additional generation and enhance market flexibility.

For California, expansion of the total generating capacity and power markets is vital. The existing infrastructure can not continue to support a growing populace and economy. If power is exported, and imports reduced, then matters are even worse. To date, California ratepayers have not suffered to any significant extent from an unreliable power supply, or from high prices for power. California has not experienced extended black-outs, and regardless of power acquisition practices by utilities that may have lead to high purchased power costs during peak periods, most customers have been protected by a rate freeze. Prices for power in California are also not out of line with other states, and at many times are in fact lower. Williams is confident that additional generation will be built, power will be imported, not exported, and reliability will be enhanced not degraded, provided the market is allowed to operate free of existing, or even greater distorting regulatory constraints. All else being equal, additional supply will also have the effect of reducing prices to the benefit of consumers. Forward and bilateral markets will also continue to develop and provide buyers the opportunity to purchase power at reasonable prices.

The CAISO is showing signs that it understands these basic realities. At a meeting last week, when it was suggested that price caps be lowered, the CAISO staff appeared ready to hold firm. The CAISO staff should be applauded for the courage they have shown to date to withstand the pressure of advocates of a cap reduction and instead advance the California power markets. However, at this week's meeting, a vote of the board will be held to determine the immediate outcome of this debate.

Williams, for one, will attend the meeting and will present information to the Board regarding its behavior during the week of June 12-16, 2000. Virtually all of the generation that Williams controls that was capable of producing power during that week did in fact operate. At no time during the week did Williams have generation under its control that was "held back" until the real time markets in order to influence prices. In fact, Williams will discuss how during most of the week it entered the day ahead market with more commitments to provide power than it had power available to provide and was forced to become a power buyer in order to meet its commitments.

All of the tools are in place for the renaissance of the California power industry that is needed to support California's growing economy. While some sharpening of these tools may still be needed, there are forces that seek to hold them to the grinding stone too long, such that their points become weak and break off. Others, like Williams, are ready to put those tools to good use right now and to be part of, and encourage, the growth.

Please consider these views as you review these important issues. The opportunity to develop power in California, for California, exists today. Williams looks forward to working with you to fulfill that promise.

Very truly yours,

Steven Malcolm,
President and Chief Executive Officer

cc: Members of the California ISO Governing Board

Grid Services, Inc.

June 27, 2000 VIA EMAIL

Board of Governors of the California Independent System Operator
c/o Terry Winter, CEO, California Independent System Operator
151 Blue Ravine Road
Folsom, CA 95630

Dear Board of Governors

Subject: **Decision on Price Caps**

Grid Services, represents ESPs, infrastructure providers, energy marketers, and independent power producers. I can speak passionately on either side of the price cap issue.

I am also a native Californian. My home and business are located within the service territory of Southern California Edison. Thanks to the State legislature and AB1890, energy price fluctuations will not impact me until some time in 2002.

What does concern me is the availability of energy.

In the event of a warmer than normal summer, there is insufficient energy in the western United States to supply consumer needs.

Demand continues to grow. New generation resources, both approved and planned, are not sufficient to meet this growing demand.

The California utilities have divested themselves of the many of their power plants, reducing the volume of available 'native generation' to serve 'native load'.

In August, the ISO plans to implement 10-minute dispatch-settlement protocols, forcing some real time energy providers into other markets.

The California ISO's mottos is "Reliability through Markets". Markets entail competition. This summer the competition may come from our neighbors.

I recommend the Board settle on a price cap that will allow the ISO staff to compete in a marketplace the encompasses the entire western U.S.

Sincerely

Michele Wynne

STATE OF CALIFORNIA
ELECTRICITY OVERSIGHT BOARD

Gray Davis, Governor

June 27, 2000

Jan Smutny-Jones
Chairman of the Board of Governors
California Independent System Operator
151 Blue Ravine Road
Folsom, CA 95630

Dear Mr. Smutny-Jones:

As you are aware, the California Independent System Operator Corporation (CAISO) was created under State charter to operate in the public interest as a public benefit corporation. The Electricity Oversight Board (EOB) is charged with conducting diligent oversight of the CAISO's operations to ensure that the public interests are being well served. The EOB can only fulfill this mandate if it has access to the information and processes of the CAISO. This access would include access to all decision making of the CAISO on matters significantly affecting public interest. The matter on which your Governing Board is convening a meeting tomorrow clearly falls within this category. Specifically, in addition to the General Session, the Executive Session discussion on the market data related to the bid price cap is clearly a matter of public interest. I request that the EOB, its officers and staff have access to this Executive Session as well as future Executive Sessions where decisions and/or discussions occur that affect public interests.

Your timely response to this matter will be greatly appreciated.

Sincerely,

~~GARY~~ C. HEATH
Executive Director

cc: Electricity Oversight Board Members
Mr. Charles Robinson, CAISO General Counsel

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June 27, 2000

DYNEGY

Mr. Jan Smutny-Jones
Chairman
California Independent System Operator
151 Blue Ravine Road
Folsom, CA 95630

Dear Mr. Smutny-Jones,

Events in California's electric market during the last few weeks have prompted the Board of Directors of the California Independent System Operator (CAISO) to schedule a special meeting on June 27, 2000. The unusual weather conditions and high electric demand that occurred on June 13-15, have caused both public and industry officials to ask for a review of the circumstances that led to increased prices in the California electric markets during these days.

So far, two general theories have been advanced as explanations of events over the last several weeks. The first theory is that dramatic increases in the costs of reliable electric service has occurred as a result of significant underscheduling of load in the California PX. This underscheduling could be the result of a deliberate bidding strategy which uses the CAISO's purchase cap as a means of establishing a cap on the costs of electricity to purchasers, or could be the result of the failure by purchasers to adequately hedge their power purchase costs through the forward markets thus leaving a substantial portion of load at risk in the real-time market. The second theory is that electric generators in California have withheld generation capacity in order to create scarcity of supply and thereby drive up electric prices.

Dynegy Power Corp., with its partner NRG Energy, Inc., owns approximately 2,700 MW of generation capacity in southern California. This generation capacity consists of 36 generation units located at 10 sites. As a major generator we are able to shed some light on the basis for claims of withholding by generators. In short, Dynegy and NRG see no evidence to support the withholding theory

As the CAISO Board considers its response to recent events, it should consider the following facts for the week of June 12th:

- 35 of Dynegy's 36 generation units were available for operation in the electric markets. The 36th unit, a 335 MW, 1965 vintage steam-fired generator was unavailable until June 16th because of a forced outage (which began on June 9th) to make repairs to the LP turbine.

2. During the peak demand hours Dynegy sold over 1,800 MW of electricity and capacity in the bilateral, PX Day Ahead, PX Day-Of, and ISO Ancillary Services markets
3. During peak days Dynegy had at least 250 MW of uncalled bids in the PX Day Ahead market
4. On each day Dynegy sold additional energy in the real-time market; the exact amount was dependent on the condition of our generation units and the dynamics of the markets.

It should be noted that, as a matter of prudent business risk management (especially in light of the age of our generation fleet), Dynegy does not commit all of its generation capacity in the forward markets. Although we do our best to make all units available at all times, we are subject to forced outages. If Dynegy were to enter into forward commitments for all of our generation capacity and then suffer a forced outage, the cost of replacement power for the outage event could be substantial. We essentially maintain a kind of operating reserve as protection against the financial consequences of a forced outage. As operational and market conditions allow, this reserve can be sold in the real-time market.

While I do not have specific data for other generators, I do know that they face the same economic incentives. These economic incentives clearly dictate that all possible generation should be made available to the market during peak demand periods.

The fact that California has not added significant new generation resources in the last decade, while load growth has been strong dictates that prices should increase during peak demand periods. Further, given the uncertainties of weather, unit availability (for older units), market rules (including price caps), and load procurement habits, it is not surprising that prices increase during periods of high demand as generators try to recover their operating costs in relatively few hours. It is not necessary to attribute high prices to "gaming" by generators. The fundamental elements of the market lead to high prices during peak periods. Recent price trends in the Palo Verde and Mid-Columbia market (where prices have frequently traded above California SP15 prices and have even traded at greater than $750/MWh) confirm that prices will rise in a market during times of peak demand for a commodity.

Dynegy and NRG are committed to working with the CAISO and other market participants to create a successful electric market place in California. I hope the information contained in this letter has helped shed some light on the issues at hand.

Sincerely,

Lynn A. Lednicky
Sr. Vice President

STATE OF CALIFORNIA
ELECTRICITY OVERSIGHT BOARD

Gray Davis, Governor

June 27, 2000

Jan Smutny-Jones
Chairman of the Board of Governors
California Independent System Operator
151 Blue Ravine Road
Folsom, CA 95630

Dear Mr. Smutny-Jones:

We are writing to urge the Independent System Operator to lower price caps from $750 per megawatt to $250 per megawatt in the electricity markets subject to your control for the Summer 2000 period. In so doing we are joining Senators Peace and Bowen and Assemblyman Rod Wright, the Legislative leaders in the utility regulation arena, who have previously written to you. While reducing price caps may need to be reevaluated once we reach a fully functioning market, California has not yet reached that point in its electricity markets.

We are concerned that the level of electricity prices in the preceding several weeks poses a serious threat to the California economy and a serious threat to the well-being of California residents. During the week of June 12th alone, skyrocketing market process for electricity cost California customers as much as $1billion even though power capacity was reportedly adequate. In five days, Californians spent one eighth of the total amount that they spent on electricity for the entire year. The electric supply and demand behavior and the experience of electric prices in the forward and real-time markets demonstrate that unacceptable levels of market power persist under high load conditions.

This is an issue of extreme importance to the people of the State of California. It should be discussed and decided in public, not in executive session or other non-public process. We urge you to consider the impact on California customers and on the California economy and to reduce price caps to their original levels.

Sincerely,

Loretta Lynch / 6-III

Loretta Lynch
President
California Public Utilities Commission

Michael Kahn
Chairman
California Electricity Oversight Board

cc: ISO Governors
Senator Bowen
Senator Peace
Assemblyman Rod Wright

Reliant Energy™

Joe Bob Perkins
President
Chief Operating Officer
Wholesale Group

June 26, 2000

The Honorable Gray Davis
Governor, State of California
State Capitol
Sacramento, CA 95814

Subject: California Electricity Market

Dear Governor Davis:

In recent weeks, California's electricity system has been stressed to its limits by extreme weather conditions and other unexpected events. These conditions caused short-term electricity prices to rise sharply and required rotating service interruptions of customers in the San Francisco area. Overall, however, it appears that the markets functioned as designed during these periods and that the required load interruptions were well coordinated and managed, averting what could have been a serious crisis for California and surrounding western states.

I understand that you have called for an investigation of these events by the CPUC and the Electricity Oversight Board, and I want to assure you that Reliant Energy stands ready to assist you and the state agencies in this review. Through separate correspondence, we have provided CPUC President Lynch with information about the availability of our power plants during these periods and some of the extra-ordinary actions we took in this regard. A copy of that letter is attached.

As you may recall, Reliant Energy is an international energy services and delivery company serving nearly 4 million electricity and natural gas customers in six states. In the past several years, Reliant Energy has invested over $500 million in generation assets that serve California consumers.

While these recent events are serious and deserve thorough examination, they appear to be fundamentally related to the scarcity conditions that have developed in California and other western states. Intervening in the market precipitously, however, and lowering the existing price caps from $750 per megawatt-hour to $250/MWh, as some have proposed, would be a serious mistake. Far from protecting consumers, such intervention would:

- Undermine developing forward markets;
- Eliminate demand responsiveness incentives;
- Signal instability and uncertainty; and

- Threaten reliability by delaying or reducing needed investment in new generation.

California consumers would be better served if the proponents of market intervention directed their efforts toward utilizing available market mechanisms, such as forward contracts, rather than seeking to use lower price caps as a way of addressing energy cost concerns.

Like many regions across the U.S., the phenomenal growth of California's economy over the past eight years, and the lack of any new power plant construction in the past decade, have caused the state's surplus electricity reserves to decline substantially. The obvious result is the need for significant new investment in energy infrastructure. Reliant Energy agrees with the California ISO that a combination of new generation and transmission facilities, and a vibrant demand-responsive market, are needed to meet the state's future energy requirements.

The current market, although certainly not perfect, is developing rapidly. Buyers and sellers are beginning to enter into long-term forward contracts that will ensure delivery of energy in a future period at a price certain. For example, the California Power Exchange recently announced that participants in its forward markets have already begun to execute hedging contracts for the summer of 2001. Moreover, demand responsiveness, which all experts agree is critical to the development of fully competitive electricity markets, is just now beginning to take hold, as customers recognize the economic incentives of curtailing usage during peak periods, effectively using their loads as a source of supply. Also, for the first time since the opening of the California market, price signals are making it more likely that the state will be able to attract the capital investment necessary to build new generation.

But recent market conditions have also prompted calls for intervening in the market and lowering existing price caps, which are already among the lowest in any major market in the country. Imposing these restrictive price controls in the face of existing supply shortages would be ill-advised, however, as they would only exacerbate the shortage condition and further threaten long-term reliability. California's need for new energy infrastructure has already arrived, as recent events have demonstrated, and intervening in the market now would create the risk that needed investments will not be forthcoming in the amounts required and in the time frame necessary to ensure a reliable electric system.

Building new energy infrastructure is a costly and time-consuming process. In California, it takes 2-3 years to license and construct a new generation plant, and a major new transmission project can take as long as 5-7 years to complete. In other parts of the country where price caps do not exist or are less restrictive, price signals in one summer have resulted in new supplies being constructed in time for the following summer.

I urge you not to be persuaded by the claims of a persistent few that the market is broken and that the utilities are somehow unable to protect themselves or their customers from high prices. To the contrary, the utilities are highly sophisticated participants in these markets, leveraging and optimizing their positions as both large buyers and sellers of energy. Bear in mind that while the hypothetical total market value of energy transactions can rise significantly during extreme conditions, as occurred last week when gross transaction values in the California market reached $1.2 billion, the underlying market positions of buyers and sellers have probably reduced the true impact to substantially lower amounts.

The utilities, for example, continue to own or control more than 40% of the state's generation capacity, a larger ownership share than any other entity in the market, and as sellers they benefit when prices rise. The utilities also have been aggressive, and appropriately so, in developing new hedging products that allow them to manage price risk, and in gaining the regulatory approvals necessary to use these products to manage their energy costs. In fact, a buyer who had purchased energy for June prior to the beginning of the second quarter could easily have locked in prices of $38/MWh, only 5% of the price levels reached during the week of June 12.

It's also important to note that most California consumers are still under the rate freeze (SDG&E customers excepted) enacted in January 1998, and as a result any short-term price increases mainly impact the recovery of utility stranded costs. Thus, the real issue is not whether the markets are competitive, surely they are, but rather whether intervention in the market at this critical juncture is an appropriate response to concerns regarding the impact of energy cost on stranded cost recovery mechanisms.

In closing, let me say that although important refinements are still needed, California has successfully created one of the largest and most sophisticated competitive electricity markets in the world. Ultimately, though, the reforms will be judged by their ability to attract the capital investment needed to build new energy infrastructure. I urge you to support the continued development of California's competitive electricity markets, and hope you will encourage the proponents of market intervention to identify alternative ways of mitigating energy cost concerns.

I appreciate your consideration of these views and invite you to contact me if I can be of assistance in any way.

Respectfully and sincerely,

Joe Bob Perkins

c. Loretta Lynch, President, California Public Utilities Commission
Michael Kahn, Chairman, Electricity Oversight Board
Members of the California ISO Governing Board

Reliant Energy™
Wholesale Group

John H. Stout
Vice President
Southwest Region Asset Commercialization
P O Box 286
Houston, Texas 77001-0286
713/207-2023

June 26, 2000

The Honorable Loretta Lynch
President
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Dear President Lynch:

It was recently brought to our attention that the CPUC staff has started preparation of a report on the circumstances surrounding the supply shortfalls that occurred during the week of June 12th in California. We also understand that CPUC staff has visited selected plant sites to personally inspect the generating facilities that were not operational during the shortfall period. While it is certainly appropriate to focus on factors that contributed to the problem, it is very easy to overlook successful efforts that helped to prevent the problem from being any worse than it actually was. For this reason I wish to bring your attention to some of the successes which occurred during the recent crisis and to request that whatever reports are issued by the CPUC include a perspective on how much worse the circumstances *might have been* if it had not been for those successes.

Reliant Energy owns and operates nearly 4,000 megawatts of generation in the California ISO marketplace. Most of this generation was acquired from the divestiture of assets by Southern California Edison. Specifically, our facilities include Ormond Beach, Mandalay, Ellwood, Etiwanda, Coolwater and El Dorado. El Dorado is the newest source of generation in the California market, completed and put into commercial operation in May 2000. It represents 500 megawatts of additional supply that was online and which helped keep the lights on during the crisis.

As two examples of successful efforts to keep the lights on, let me mention the circumstances surrounding our Coolwater and Ormond Beach facilities. Coolwater consists of four units, two of which are 250 megawatt combined cycle facilities. Just a few weeks ago, as we were returning one of those 250 megawatt units to service, we experienced the failure of a critical component, the generator exciter. It was determined that a replacement exciter would not be available until after the summer peak despite extensive efforts to find a temporary replacement. Once this was recognized, Reliant Energy immediately began modifying of this facility to enable

President Loretta Lynch
California Public Utilities Commission
Page Two

the unit to operate in a simple-cycle mode, without the steam turbine, so that it could still contribute to the peak demand needs of its California customers. During the June 12th -16th crisis those modifications were completed and this unit was successfully started in the revised mode of operation. Many traditional players in this industry would probably have simply concluded that the unit was unavailable for the summer. However, because of this success, the California market had another 140 megawatts to help keep the lights on.

Our Ormond Beach facility experienced significantly greater problems. While completing the annual maintenance outage on Ormond 1 during the early spring, defects were discovered in critical retaining rings. The do-it-by-the-book solution would have been to simply order new castings for these rings, have them machined, and sometime in early fall have the unit back in service. Instead of taking this approach, Reliant Energy brought in experts to do a detailed structural analysis of the defects in the retaining rings. From that analysis concluded that it was possible to continue operation of the generator through this summer's peak season before having to replace the rings. A decision was made to go ahead and put the unit back in service, but as we continued to restore the unit to operational status, another problem was discovered. This time it involved insulation failures in the rotor of the generator. Once again, the status quo response would have been to have the rotors sent out for repairs, in which case it would have been early fall before the unit would have been back in service. Instead, Reliant Energy worked around the clock to remove the damaged insulation and to temporarily secure it in a way that the unit could be put back in service for this summer's peak season. Both of these efforts have proven successful thus far and during the June 12th -16th emergency, Ormond Beach Unit 1 provided a solid 750 megawatts of energy and ancillary services.

In these two simple examples you can see nearly 900 megawatts of capacity that could have easily not been there when California needed it. These are not the only examples and we would be happy to spend time visiting with CPUC staff to highlight other efforts that have been made which contributed to minimizing the power crisis which existed during the week of June 12th. We would welcome on-site visits by your staff to inspect our facilities and to learn more about the efforts we make to help keep the lights on in California. Please feel free to contact Aldie Warnock, Reliant Energy's Director of State and Federal Regulatory Relations, or me, if you or your staff wish to follow-up on this offer. Mr. Warnock can be reached at 1-800-462-4547 ext. 77318 or on his cellular phone at 713-822-7005.

Very truly yours,

John H. Stout
Vice President, Southwest Region Asset Commercialization

JHS/if

WPTF
Western Power Trading Forum

June 26, 2000

Mr. Jan Smutny-Jones
Chairman, ISO Governing Board
IEP Independent Energy Producers
1112 I Street Ste 380
Sacramento CA 95814

RE: ISO Price Cap

The Western Power Trading Forum (WPTF) submits for your consideration our position on the ISO price cap. WPTF does not believe a price cap is necessary for the California electricity markets, and we certainly are against lowering the price cap from its current level. Lowering the price cap works contrary to all of your reliability and economic interests.

Price caps distort market signals, lead to bidding behavior which depress forward markets, and threaten reliability in the real-time market. These outcomes are only observable when either the weather boosts demand, plants are unavailable, or the cap is so low that even nominal weather and operating conditions cause the distortions which we believe break markets rather than repair them.

Two weeks ago, California buyers were caught in a dilemma of hot weather before the summer began, and thousands of megawatts of in-state resources were unavailable either due to "pre-summer readiness" maintenance, or unscheduled outages. Many buyers accepted the exposure of price spikes in that they didn't hedge their positions to the maximum extent possible, but instead, rolled the dice and lost.

Default customers of Southern California Edison didn't feel the financial pain of the events which occurred two weeks ago. Those customers received service under SCE's frozen retail rates. Their bills didn't change one iota. SCE, of course was upset because the price spikes delayed their stranded cost recovery, and maybe extended their transition period by some undefined amount of time. The outrage alluded to in public comment by SCE's representatives at your meeting last week was very real. They were outraged at their lack of prudence, and sudden financial loss.

Rolling back the price cap will not reduce exposure to market price volatility. Prudent procurement practices on the part of buyers, and increased use of hedging instruments will solve their problem. Rolling back the price cap will exacerbate the situation you so desperately wish to avoid. It will increase the frequency of utilities entering short forward schedules because buying unscheduled energy in real time will be less risky. It will send power sales outside of California every time the market price in the Northwest or Southwest exceeds the cap. It will increase the number of times the ISO operators will face gut-wrenching decisions to let the market self correct in the operating hour, or force the ISO to intervene, thereby crashing the real-time price.

The utilities who are buying electricity for the majority of California consumers want you to believe that the opportunities for hedging price risk are gone, it is too late, and the summer is now upon us. Nothing could be further from the truth. The Cal PX block forward market provides monthly positions, and even today, the utilities or any PX participant can substantially increase their hedged position for this coming July, August, or any month.

And most dangerously, if you decide the lower the price cap , then you will stunt the fledgling Cal PX block forward market, and other commercial hedging instruments which are the very mechanisms you seek to expand. The events of the last few weeks have witnessed a sudden increase in the Cal PX block forward volume. Buyers' forward demand is growing at an unprecedented level, and as the block forward price moves up, more supply comes forward to greet it.

Therefore, resist the urge to lower the existing price cap. It may seem like an attractive alternative at the moment, and politically correct. Yet, reliability is effected by the instability in our regulatory and market environments As we have witnessed time and time again, lower price caps cripple markets, chase away much-needed investments, and place an unnecessary burden on ISO operators.

Sincerely,

Gary B. Ackerman
Executive Director
Western Power Trading Forum

ISO Governing Board

Duke Energy North America.
A Duke Energy Company

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JUN 28 2000
OFFICE OF THE CEO
TERRY M. WINTER

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June 26, 2000

Mr. Jan Smutny-Jones
Chairman
California Independent System Operator
151 Blue Ravine Road
Folsom, CA 95630

Re: California Electricity Market

Dear Mr. Smutny-Jones:

Recent interruptions of electricity in the San Francisco Bay area coupled with elevated electric market prices have created legitimate concerns among state leaders. These concerns are well founded and action by all stakeholders is fundamental to solving the impending energy shortfall in this State.

The situation that exists today was created by a lack of energy infrastructure build-up in the State over the last two decades. California's electrical energy infrastructure has simply not kept pace with a rapidly expanding economy and population. Additionally, California has always been a net importer of electricity. However, the State can no longer rely on imports as other regions in the West are experiencing the same rapid economic growth as California, thus available import energy from these regions will diminish over time.

Duke Energy North America (DENA) is a new entrant into the State and currently owns in excess of 3,300 megawatts (MW) of generation capacity. In addition, DENA has under development over 1,500 MW of new highly efficient and clean generation. DENA has a long-term commitment to the State and intends to be part of the solution to the State's energy needs. The reliability of our assets continues to be very high, however because the State has little margin during periods of hot weather any forced outage of a generating unit immediately impacts the ability of the California Independent System Operator (ISO) to meet system demand. In a competitive market environment this shortfall of supply drives the market price of energy upward until supply and demand begin to equalize. This response is normal and sends price signals to the industry that spur development to meet the growing demand.

During the week of June 12, as temperatures reached record levels, the State experienced a shortfall of electricity supply and for periods of time the price of available electricity reached the market cap of $750/mwhr. Since then there have been outcries to lower price caps, this is a mistake. Lower price caps will not facilitate the development of new generation. In addition, because California is a net importer of electricity it must compete with market prices in other regions of the West. Lowering price caps in California will result in lower available imports as marketers take their power elsewhere. Price increases are simply the market sending signals of an imbalance between supply and demand, this will stimulate the correct response from the market, proposed new generation which this State so desperately needs. It should be noted that Palo Verde has been selling at similar levels to the California markets, which is indicative of a capacity short supply system throughout the West.

On June 15, the Governor requested the Public Utilities Commission (CPUC) and the Electricity Oversight Board (EOSB) conduct an investigation of the events during the week of June 12. DENA supports this initiative and will cooperate in the investigation. Recently, I spoke with EOSB executive director, Mr. Gary Heath, to discuss DENA's actions during this period. Among other things I wanted to ensure the EOSB fully understood that a recent forced outage at DENA's Moss Landing Power Plant resulted in negative financial consequences for DENA, at no time was DENA purposely controlling the output of this unit to manipulate market prices. I might add that during the power interruptions in the San Francisco area on June 14 all of DENA's generating units were in service with the exception of one small peaking unit at our Oakland facility. I believe the ISO's records can confirm these details.

DENA has also expressed its expectation that a full review of all participants in the market be conducted to ensure an accurate assessment of the situation and recommendations that send the correct signals to the energy industry to step up and solve the energy crisis in California.

DENA has begun the process of permitting new generation projects in the State, and stands ready to assist in developing timely and effective solutions to the State's energy needs. I am available to meet with you to discuss our future plans and commitment to California.

Respectfully yours,

Bill Hall

Bill Hall
Vice President – California Operations

cc: Members of the ISO Board of Governors cc CAL...

CAROLYN VEAL-HUNTER
CHIEF CONSULTANT
JOSEPH LYONS
SENIOR CONSULTANT
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Assembly
California Legislature

Committee on Utilities and Commerce
RODERICK D. WRIGHT, Chair

RECEIVED
JUN 27 2000
OFFICE OF THE CEO
TERRY M. WINTER

June 23, 2000

Mr. Terry Winter
California ISO
151 Blue Ravine Road
Folsom, CA 95630

Dear Mr. Winter:

Last year I wrote you to urge you not to raise the price cap from $250 to $750. I did so because of my concern regarding the proposed doubling or quadrupling of costs this summer. Based on last week's market performance, my worst fears have been confirmed. Electricity prices during a single one-week period were greater than one-tenth of the energy costs for the entire year of 1999. Based on numerous reports I have received, it is my understanding that these significant increases were not related to an inadequate energy supply but instead the conduct of the market in conjunction with ISO policies regarding prices paid for replacement power.

I expressed concern last year that raising or eliminating price controls could result in hundred of millions of dollars of increased energy costs for Californians. I reiterate that concern and believe it is now clear that California's electricity market is not workably competitive. I therefore urge you to reduce the price cap back to its original level of $250.

The ISO has been charged by the Legislature with responsibility to protect California's electric customers. A price cap of $250 would provide needed protection for consumers, and should remain in place until it is clear that the market is functioning in a manner that insulates California's consumers from these severe price spikes.

I would welcome the opportunity to discuss this matter further with you. Please do not hesitate to contact me directly at (916) 319-2048.

Sincerely,

R Wright

RODERICK D. WRIGHT, Chair
Assembly Committee on Utilities and Commerce

cc: Members of the ISO Board of Governors

SDGE®

A Sempra Energy company

Edwin A. Guiles
President

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June 23, 2000

Chairman Jan Smutney-Jones and Members of the Governing Board
California Independent System Operator
151 Blue Ravine Road
Folsom, CA 95630

Dear Jan,

We are extremely concerned with recent electricity prices and the impact that they are having on our customers. For example, the bills we are sending to our bundled service customers today include an electric energy charge of 6.5 cents per kWh, the highest commodity charge we have billed customers since the opening of the market. This compares to last year's average of 3.3 cents per kWh, creating about a 30% bill increase for an average SDG&E residential electric customer. Based on the current prices and forecasts, the bill impact for our customers will get even more severe in the weeks ahead. In fact, we expect that the electric energy charge used for bills that will be mailed the week of June 25 will be over 9 cents per kWh.

Some of the measures that we are taking to mitigate the situation include:

- Increasing energy efficiency communications to customers, including information about ways to conserve electricity and available incentive programs.
- Increasing communications to customers about the changes in the marketplace, and the current price volatility.
- Increasing promotion of SDG&E's level bill payment plan, which can help mitigate monthly bill swings.
- Increasing outreach communications to the low income, senior citizen and non-English speaking communities about the market, and actions they can take to mitigate the bill impact.
- Participation in the forward electricity commodity markets.

However, these efforts will not be enough if this price trend continues throughout the summer. We request your immediate focus on this issue and expeditious inquiry into the current workings of California's electricity market. Specifically, we understand from the CAL ISO report that the major market issue on June 13, 14, and 15 was caused by the gross under-scheduling of load by Scheduling Coordinators. We support a complete and thorough investigation of this behavior and appropriate sanctions for any irresponsible gaming that is identified.

We offer any assistance in this inquiry and our full cooperation as you look at possible alternatives to the current untenable situation.

Sincerely,

Edwin A. Guiles

Edwin A. Guiles

cc: Senator Steve Peace
Assemblyman Rod Wright
Loretta Lynch, President, California Public Utilities Commission
Michael Kahn, Chairman, Electricity Oversight Board

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California Legislature
Senate Energy, Utilities and Communications Committee

DEBRA BOWEN, Chairwoman

June 22, 2000

Mr. Jan Smutney-Jones, Chairman
ISO Governing Board, Members
California Independent System Operator
151 Blue Ravine Road
Folsom, CA 95630

via facsimile – (916) 351-4436

Dear Chairman Jones & Board Members:

For the deregulation of California's electric industry to truly be deemed a success, we have to ensure that consumers benefit from an open marketplace. It's with that goal in mind that I urge you to consider temporarily reducing the bid price caps from $750 to $250.

As you know, electricity market prices were at or near record levels during last week's heat wave despite the fact that consumer demand for energy was well below the peak demand forecast for the year. For those customers out of the AB 1890-mandated rate freeze, last week's spike means they'll soon be hit with astronomically high electric bills. For those people still under the rate freeze, the impact will be delayed, but in all likelihood they'll end up with higher – not lower – prices when the rate freeze ends.

If these high prices continue, individual generators and their stockholders will undoubtedly benefit in the short run, but in the long run, that benefit will hurt the credibility of those companies who argue that a competitive marketplace benefits the average ratepayer. It will be very hard for anyone to make the case that competition benefits California's residential and small business customers if those customer get hit with electric bills that are higher than they were prior to the electric market being restructured.

Given the behavior of the electric market last week, combined with the short-term generation shortage and transmission restrictions California faces, the ISO must evaluate whether the market is working competitively for the benefit of the ratepayers. If you determine, as I believe you will, that it's not, I would urge you to strongly consider lowering the price cap to $250 until such time as the ISO and the California Public Utilities Commission jointly determine that California has sufficient generation capacity, an adequate transmission system, and a truly competitive marketplace. At that point, ratepayers will benefit from a competitive market that includes both a reliable and a reliably-priced supply of electricity.

Thank you for your attention to this matter. If you have any questions or would like to discuss this issue further, please feel free to call me at (916) 445-5953

Sincerely,

Debra Bowen

Debra Bowen, Chairwoman
Senate Energy, Utilities & Communications Committee
(Redondo Beach)

California State Senate

SENATOR
STEVE PEACE
FORTIETH SENATORIAL DISTRICT

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CHAIRMAN OF:
COMMITTEE ON BUDGET AND FISCAL REVIEW
JOINT LEGISLATIVE BUDGET COMMITTEE
BUDGET AND FISCAL REVIEW SUBCOMMITTEE #5 ON ENERGY AND OFF-BUDGET FISCAL ISSUES

MEMBER OF:
AGRICULTURE AND WATER RESOURCES
ENERGY, UTILITIES AND COMMUNICATION
JOINT COMMITTEE ON LEGISLATIVE AUDIT
JUDICIARY

June 22, 2000

Chairman Jan Smutney-Jones and Members of the Governing Board
California Independent System Operator
151 Blue Ravine Road
Folsom, CA 95630

Dear Mr. Jones and Board Members:

Last year I appeared before you and urged you not to raise your price cap from $250 to $750. I did so because I believed that the state's electricity market was not workably competitive because customers could not exercise any timely ability to say no. Despite my urgings, however, this board raised the caps to $750.

Sadly, lasts week's market performance confirmed my worst fears. Electricity prices and electricity costs reached grossly unreasonable levels considering that, from a statewide perspective, there were ample supplies. Instead, the performance of the market demonstrated that the conduct of power suppliers was unconnected to any public or private commitment they had made.

It is clear that, for now, California's electricity market is not workably competitive.. I, therefore, urge you to reduce the price cap to its original $250 level, retroactive to May 1, 2000. The California Independent System Operator was created by AB 1890 to serve the interests of the people of California. This board and its individual members have a responsibility to ensure that those interests are protected. Until the California electricity market is repaired, this board must reinstate the original $250 price cap.

Sincerely,

STEVE PEACE

cc: Governor Gray Davis
Loretta Lynch, President, California Public Utilities Commission
Michael Kahn, Chairman, Electricity Oversight Board

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TERRY M. WINTER

cc

STATE OF CALIFORNIA
ELECTRICITY OVERSIGHT BOARD

770 "L" Street, Suite 1250
Sacramento, CA 95814
916.322.8601
916.322.8591 (fax)

MEMORANDUM

Date: June 22, 2000

PAT DORINSON

To: Electricity Oversight Board Members:

Mr. Michael Kahn, Chairman
Mr. Bruce Willison, Member
Senator Debra Bowen, Member
Assemblyman Roderick D. Wright, Member

Via: Gary Heath, Executive Director

From: Pat McAuliffe, Market Analyst

Subject: Electricity Prices and Costs for June 12 to June 16, 2000

I am providing you with the following price and costs data related to last week's events. My data are preliminary; however, because price and cost numbers are being thrown around, I thought I should provide you with the numbers.

As you are aware, a significant heat wave hit Northern California during the week of June 12th, bringing record temperatures to the Bay Area and sending prices for electricity into the stratosphere. Record prices were recorded in the California Power Exchange (CalPX), the California Independent Operator (CAISO) prices hit the current cap of $750 per MWh or MW on many occasions, and large quantities of replacement reserves were purchased by the CAISO. As a result, California experienced its first **BILLION DOLLAR** week since the inception of the restructured market in April 1998. The resulting costs are significant and warrant thorough examination.

Market costs for the period of June 12 to June 16 were $ 940 million for energy[1] and $ 206 million for ancillary services, including replacement reserves which totaled $ 120 million. Total cost was $ 1.145 billion for this five day period.

Table 1 provides additional details on costs by day as well as daily peak demand and daily total energy consumed in the ISO grid.

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[1] Energy costs are calculated by multiplying day-ahead CalPX unconstrained prices by hour-ahead schedule and adding to this the real time volumes (actual load less hour ahead schedules) multiplied by the average real time price in Northern and Southern California. Due to a number of factors consumers are not necessarily paying these prices at retail.

Table 1 – Electricity Costs for Week of June 12 to June 16, 2000[2]

Date	Daily Peak Load	Actual MWh for Day	Total Energy Cost	Total AS costs	Total Costs
June 12	37,132	714,728	$58,033,300	$2,217,544	$60,251,844
June 13	42,288	792,353	$103,370,206	$56,147,842	$159,518,048
June 14	43,447	836,377	$269,625,590	$68,195,670	$337,821,260
June 15	43,146	824,880	$296,411,338	$64,822,909	$361,234,247
June 16	39,823	775,875	$212,095,788	$14,449,736	$226,545,524
5 Day Totals		3,944,213	$939,536,422	$205,833,701	$1,145,370,123

To provide perspective, total market costs for the twelve month period from June 1, 1999 to May 31, 2000 was $ 8.7 billion, divided between energy costs of $ 8.33 billion and ancillary service costs of $ 355 million. Prior to this week, the single most expensive day totaled $ 195 million on May 23, 2000. Table 2 provides additional details on costs.

Table 2 – Electricity Costs for Days Prior to June 12, 2000

Date	Daily Peak Load	Actual MWh for Day	Total Energy Cost	Total AS costs	Total Costs
May 23, 2000	37,677	743,493	$180,342,250	$14,993,448	$195,335,698
May 22, 2000	39,521	763,839	$99,829,975	$15,715,688	$115,545,663
May 24, 2000	34,719	702,137	$75,550,326	$8,076,204	$83,626,530
August 27, 1999	42,687	802,551	$72,890,424	$6,289,250	$79,179,674
July 12, 1999	45,574	863,691	$59,444,240	$7,301,228	$66,745,468
July 13, 1999	44,511	855,870	$55,525,233	$8,757,677	$64,282,910
September 28, 1999	36,415	702,053	$58,025,656	$2,440,659	$60,466,315
July 14, 1999	41,248	787,982	$54,020,263	$4,461,564	$58,481,827
August 26, 1999	41,334	799,858	$49,114,506	$6,783,714	$55,898,220
October 13, 1999	36,357	702,665	$53,002,071	$1,465,301	$54,467,372
November 1, 1999	32,452	633,388	$50,779,655	$1,060,384	$51,840,039

The seven most expensive days yet recorded have all occurred in 2000 and we are just into the beginning of the summer. Although all factors have not yet been evaluated, it appears obvious that the raising of the price caps from $ 250 to $ 750 accounts, in significant part, for the expensive prices seen in May and June of this year. Caps of $ 250 were increased to $ 750 in CAISO markets beginning in October 1999. Recent events indicate that prices would likely go beyond $ 750 if such a cap were not in place. The extension of the $ 750 price cap will be discussed at the June 29 Board meeting

"Underscheduling" has been a part of this market almost since its inception. At times of expected high load levels and high prices, we have often seen day-ahead schedules, as well as hour-ahead schedules, that are thousands of megawatts less that the CAISO's

[2] Natural Gas prices during this time period also have been more expensive than expected for this time of the year.

forecast of load. However, the magnitude of this feature of the market increased by about 3,000 MW for trades on during the peak hours on June 13, 14 and 15 from what had occurred previously. Faced with shortfalls[3] of 7,500 MW on June 13, 9000 MW on June 14, and 7,700 MW on June 15, the CAISO apparently decided to alter its practices regarding purchases of Replacement Reserves. Previously, the CAISO had purchased limited amounts of replacement reserves with the maximum quantity of 1,200 MW[4] in any one hour. During the week of June 12, the ISO at times bought in excess of 7,000 MW in an hour at a price at or near $ 750 per MW. As mentioned earlier, the CAISO's replacement reserve purchases cost $ 120 million over just a five day period. Prior to the week of June 12, the supplemental energy market in conjunction with uninstructed deviations from generators (chasing the high prices), rather than the replacement reserves, provided sufficient energy to cover the scheduling shortfalls.

I will of course keep you apprised of my continuing assessment regarding prices and costs of electricity in the California markets.

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[3] - Shortfalls are defined as how much less the hour-ahead schedules are than the actual loads forecasts.
[4] - Due to the ISO's rational buyer process, other ancillary services can at times be substituted for replacement reserves. Our data does not readily indicate when such substitution has occurred. In addition, we have limited our assessment to the time period after June 1, 1999.

EXECUTIVE SUMMARY

Fellow Board Members;

The following is an Executive Summary of the attached detailed letter that I am sending urging you to maintain the status quo regarding the upcoming proposal to lower the current price cap.

- Significant underscheduling of load that occurred during the week of June 12th caused operational problems for the ISO.
- Price Cap arbitrage between the PX day-ahead cap and the ISO real-time cap creates an incentive for SCE to let thousands of MWs ride into the real-time market.
- The cost of a grid-wide outage which results from operational problems caused by underscheduling far outweighs any cost savings by the short term "strategic bidding" of load.
- Yet another piece-meal change in the market will further erode credibility and confidence in the ISO by the market participants and FERC.
- No generation has been built with price caps in place and applications at the CEC have not increased appreciably.
- True issue here is CTC collection and the effect higher prices have on that effort. Despite hedging tools to protect themselves against high prices SCE appears to have been caught short.
- Under CPUC and FERC approved PX Block Forward participation SCE can hedge 2,200 MWs with an increase on July 1st to 5,200 MWs.
- SCE has approximately 5,000 MWs of QF supply that is not subject to market volatility and still owns approximately 6,000 MWs of generation and this cost needs to be netted out of any alleged harm to them.
- Many market participants have already hedged their risk for this summer based on the $750 cap. Changing the cap will render these tools useless.
- Lowering price caps will increase likelihood of energy moving out of state at critical times.
- Neither PG&E nor SDG&E openly support SCE on this.
- The event that provoked this debate was a 100-year weather event in the Bay Area.

Longer term "safety net" cap is warranted

Fellow Board Members;

I am writing this letter to urge you to maintain the status quo regarding the upcoming proposal to lower the current price cap. Unfortunately, despite the long debates that has led to the current price cap policy, Southern California Edison (SCE) has once again requested that the price caps be lowered. Lowering the price cap would be a mistake because, this action:

- Will further undermine the credibility of the ISO in the minds of market participants and the FERC;
- Will jeopardize the long-term reliability of the electric industry in California;
- Is unneeded because suitable tools are available to address the issues raised by SCE;
- Is an inappropriate regulatory intervention in response to an abnormal weather condition (for which there is no regulatory fix);
- Will inhibit full load participation in the California electric market at a time when load is just beginning to take a more active role in the market;

One of the major components contributing to the system emergency that occurred two weeks ago was the underscheduling of load that was taking place. I agree with the San Diego Gas & Electric letter dated June 23 where they state, "Specifically, we understand from the CAL ISO report that the major market issue on June 13, 14, and 15 was caused by the gross underscheduling of load by Scheduling Coordinators." Analysis of data from the last few weeks indicates that the day-ahead market is generally one of the lower-priced markets during times of high demand. As reported at last week's Board meeting, the high demand periods in mid-June were also times when underscheduling of load was significant. On numerous occasions, the ISO staff has pointed out that chronic underscheduling of load presents operational reliability problems to the grid operator. By letting thousands of MWs go into the real-time market SCE forced the ISO to purchase larger amounts of Replacement Reserves with this cost being passed on to SCE and other market participants.

There are two reasons SCE might choose to underschedule load. One is due to the price cap arbitrage between the PX and the ISO's markets. Under the current price caps the total maximum charge for real-time balancing is $1,500 (Maximum energy plus maximum congestion). When the real-time market (including incs and decs) is capped at $750 and the forward market (day-ahead and day-of) market are capped at $2,500 the UDCs cannot rationally mitigate the congestion cost if they purchase energy in the forward market at more than $750. The second reason has to do with the current market structure utilizing the Market Clearing Price methodology. As explained at last week's Board meeting, the combination of the ISO's $750 price cap and the PX's market clearing price methodology provides an incentive for SCE to lower overall cost by buying only a portion of its load in the PX market. This is a rational market behavior to save money given the market conditions, but a behavior that potentially jeopardizes grid reliability. Notably, the solution to this perverse incentive is to raise, not lower the price caps to the same level as the PX.

Irrespective of the money saved letting thousands of MWs of load ride to real time, this behavior causes significant operational problems to the ISO. The cost of a grid wide outage far outweighs any savings derived by the short-term so-called strategic bidding by the load.

Just the fact that we are discussing yet another spur-of-the-moment, piece-meal change to the market should be of great concern to all of us. Constant changes to the market have the effect of eroding the credibility of the California ISO and reducing the attractiveness of generation investments in the California market relative to other markets. Over the past two and a half years we have made several significant changes to the design of the California market and we are still making significant changes. We like to take pride in the fact the California is a pioneer in electric restructuring activities but after 29 tariff amendments, it appears that we are pioneers in "not getting it right." Our credibility is certainly in debate – at FERC, at other ISO's, and within the industry in general.

It has been stated by more than one of the companies in the generator class that while they understand the need for new electric generation in California, they are reluctant to invest in California because of price caps and constant rule changes. Short-term price spikes occurred in the Mid-west in 1998 and 1999. As a result, numerous new peaking generation plants have been sited and built in the last two years and are available to meet peak demand in 2000. Price spikes in California also occurred in 1998. The result was price caps. Not only has no new generation been added in California, the number of applications at the CEC has not appreciably increased and less than 2,000 MW of additional capacity seems to be moving forward without delay. When given the choice of investing in generation in California and investing in generation in other parts of the country, it is clear that more and more companies are choosing to invest in other parts of the country. This pattern combined with California's strong economy and load growth, mean that California can expect many more years of short supply of electricity. If this trend continues, it will sooner, rather than later become a serious threat to reliability. To ensure long-term reliability, the ISO should be doing everything it can to encourage the addition of new generation, participation of load in the market, and strengthening of the transmission system. Price caps do not achieve any of these goals.

The true issue here is not the price cap but SCE's continued collection of CTC and the effect that higher prices have on that collection. Despite having been provided with tools to protect against price spikes, SCE appears to have nonetheless been caught short. In place of careful attention to, and execution of, its business, SCE advocates more changes to the price cap. At this time, I fail to see why SCE or other purchasers of electricity need lower price caps. So far, SCE has only offered vague references to costs. SCE has not provided a detailed analysis of those costs reflecting the relevant factors such as SCE's QF generation (which is not materially affected by market prices) and its own generation (Nuclear, Hydro and Coal) that is netted out of its cost. The burden of proof for damages that can only be remedied by changes to the price cap falls to SCE. SCE has not met this burden.

Further, consider the tools that SCE has to avoid the impacts of price spikes. First, SCE has FERC-approved and CPUC-approved ability to hedge a portion of their load (currently 2,200 MWs increasing to 5,200 MWs July 1st) to mitigate their price exposure by participating in the PX Block Forward Markets. SCE has offered no evidence that they have taken full advantage of this program. Perhaps most importantly on July 11th the PX will begin its daily block forward program. This will virtually eliminate the incentive to underschedule in the day ahead market due to the fact that the block forward market is a matched bid market rather that a market clearing price market.

If, SCE had fully participate in the Block Forward Market, used the Real-Time market as it was designed for (balancing only) instead of a major market for it's underscheduled load, and utilized all of the other hedging tools available, I would argue that SCE's problems were not of its own making. Again, SCE has not made a case that its problems can only be resolved through changes to price caps. It is noteworthy that many parties in this market, including load, ESP's, generators, and even some utilities, have already hedged their risk this summer based on the $750 cap. To change the price caps now will render those tools useless. It seems ridiculous to punish those who used the hedging tools available for the benefit of those who did not.

Lowering the price caps will also increase the likelihood that energy will move out of state during critical periods. In today's forward markets for energy in Q3, Palo Verde is trading at a premium to SP15 even though Arizona exports power to California for most of the hours of the year. The issues of what generators get paid when they do sell out of state and their schedule is cut due to California emergency (See my e-mail memo dated June 19) is still outstanding and with a lower cap becomes a more significant issue.

In today's price cap debate, carried out with the usual religious fervor, it is important to remember that the event which provoked the current debate was a result of a 100-year weather event in the Bay Area accompanied by true shortage of supply and transmission transfer capability. It is interesting to note that PG&E's statements at the Board meeting indicated their main concern to be reliability and not market volatility or pricing. Likewise, SDG&E, whose customers are actually exposed to the impacts of price volatility, did not support SCE's position. It should be noted that one of the ancillary effects of SCE's proposal is to further shield load from the true cost of reliable power in California. We cannot expect to have active load participation in the California electric markets if we refuse to let load pay the true costs of reliable electricity.

In summary with the increased amounts of hedging capability to 5,200 MWs on July 1st and the commencement of the PX daily block forward market on July 11th SCE has all the tools it needs to protect their consumers. Once again I urge you to resist political pressures and to do the right thing for the long term good of the California market and maintain the status quo regarding any lowering of the current cap. I do believe that for the longer term we need a safety net cap, which aligns real-time markets with the PX day-ahead cap and would eliminate the price cap arbitrage that I discussed earlier.

Greg Blue
ISO Governing Board