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October 15, 2002

The Honorable Magalie Roman Salas
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

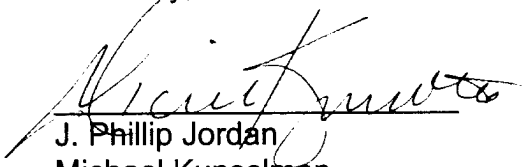
Re: ***San Diego Gas & Electric Co., et al.***
Docket Nos. EL00-95-045, *et al.*

Dear Secretary Salas:

Enclosed for filing are one original and fourteen copies of the Comments of the California Independent System Operator Corporation ("ISO") Concerning the Method for Determining Natural Gas Prices for Purposes of Calculating Refunds, submitted in the above-captioned proceeding. Two courtesy copies of this filing are being provided to Presiding Judge Bruce L. Birchman.

Also enclosed are two extra copies of the filing to be time/date stamped and returned to us by the messenger. Thank you for your assistance. Please contact the undersigned is you have any questions regarding this filing.

Sincerely,



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Independent System Operator Corporation

Enclosures

cc: The Honorable Bruce L. Birchman
Restricted Service List

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

San Diego Gas & Electric Company,	)	
Complainant,	)	
	)	
v.	)	**Docket No. EL00-95-045**
	)	
Sellers of Energy and Ancillary Services	)	
Into Markets Operated by the California	)	
Independent System Operator and the	)	
California Power Exchange,	)	
Respondents.	)	
	)	
Investigation of Practices of the California	)	
Independent System Operator and the	)	**Docket No. EL00-98-042**
California Power Exchange	)	

COMMENTS OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION CONCERNING THE METHOD FOR DETERMINING NATURAL GAS PRICES FOR PURPOSES OF CALCULATING REFUNDS

On August 13, 2002, the Federal Energy Regulatory Commission ("Commission") issued, in the above-referenced dockets, its "Notice Requesting Comment on Method for Determining Natural Gas Prices for Purposes of Calculating Refunds" ("August 13 Notice"). The Commission invited comments and proposals concerning whether it should change the method for determining the cost of natural gas in calculating the mitigated market clearing price ("MMCP") in the ongoing California refund proceeding, and, if so, what alternative method should be used. This notice was issued in response to a report released by Commission Staff ("Staff") on that same day, in which Staff

set forth significant evidence indicating that the spot market gas price indices used in the refund methodology were artificially inflated during the period relevant to the refund proceeding, and recommended an alternative methodology for calculating the cost of natural gas for purposes of determining refunds.[1] In the August 13 Notice, the Commission specifically stated that it wished to obtain comments on whether the substitute method recommended in the Initial Report is appropriate, and if not, what method should be used.

The California Independent System Operator Corporation ("ISO")[2] believes the Commission has appropriately moved promptly to address the serious implications that Staff's findings raise with respect to the calculation of refunds, and is confident that the Commission will take further necessary action to ensure that the issues raised by Staff's findings will be resolved in a manner that ensures appropriate restitution to California consumers and market participants. In an effort to assist in this endeavor, the ISO respectfully submits the following comments.

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[1] Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices, Initial Report on Company-Specific Separate Proceedings and Generic Reevaluations; Published Natural Gas Price Data; and Enron Trading Strategies, Docket No. PA02-2-000, August 2002 ("Initial Report").

[2] Capitalized terms not otherwise defined herein are used in the sense given in the Master Definitions Supplement, Appendix A to the ISO Tariff.

I. INTRODUCTION AND SUMMARY

In an order issued on July 25, 2001, 96 FERC ¶ 61,120 ("July 25 Order"), the Commission recognized that prices in wholesale electricity markets in California during the period from October 2, 2000 to June 20, 2001 (the "Refund Period") were unjust and unreasonably high.[3] The Commission concluded that sellers would be required to refund amounts collected in excess of a single MMCP, which was to be set for each 10-minute interval during the Refund Period pursuant to a methodology based on proxy costs for natural gas, derived from spot gas prices reported by several indices, and the heat rate of the most inefficient unit dispatched by the ISO during an interval. This MMCP approach was designed to approximate pricing that would result in a fully competitive and efficient real time energy market, free from any distortion due to market dysfunctions, the exercise of market power, and manipulation. While this approach was designed to provide generators with a reasonable opportunity to recover their total costs, the Commission recognized the possibility that the MMCP, plus all other sources of revenue (which are not subject to mitigation), may not cover a specific generator's (or specific other seller's) costs. Thus, the Commission provided sellers the option of filing for cost-of-service rates covering all of their units in the area of the Western Systems Coordinating Council ("WSCC") for the duration of the Refund Period.

[3] The Commission clarified and modified certain aspects of the July 25 Order in orders issued on December 19, 2001, 97 FERC ¶ 62,275 ("December 19 Order") and May 15, 2002, 99 FERC ¶ 61,160 ("May 15 Order"). Herein, the July 25, December 19, and May 15 Orders are collectively referred to as the "Refund Orders."

In its Initial Report, Staff recommends modifying the gas inputs to the formula for determining MMCPs established by the Commission in the Refund Orders. Staff bases this recommendation on its uncovering of significant evidence indicating that the spot market gas price indices used in the Commission's refund methodology were artificially inflated during the Refund Period due to both market dysfunction and probable manipulation. Specifically, Staff concludes that there existed "significant incentive on the part of certain market participants to deliberately misreport prices, given that natural gas is the fuel input for the electricity generators that set the market price in California and the rest of the West." Initial Report at 47. Not only does the Initial Report note that the gas price indices currently being used to calculate the MMCP *could* easily have been manipulated; Staff's investigation also suggested that these price indices *were in fact* manipulated, and the Initial Report notes that manipulation of these indices will be the subject of additional investigation. Initial Report at 49-54.

Staff also concludes that even in the absence of an explicit finding of manipulation of spot market gas prices by one or more market participants, the spot market gas price indices for California delivery points are likely to significantly overstate the true price of spot market gas, because various market participants have an incentive to overstate the price they pay for natural gas. The Initial Report also recognizes that the impact on consumers of these irregularities are greatly magnified by the use of spot market gas prices as the basis for determining the MMCP used in mitigating prices in the wholesale

electric markets.

The ISO believes that the evidence uncovered by Staff as to the potential for manipulation, and possible actual manipulation, of California natural gas indices is highly convincing. The ISO also believes that Staff's general approach for modifying the gas cost inputs used in the refund formula represents a reasonable way of limiting the detrimental impact that irregularities in the California spot market for gas will ultimately have on consumers. Nevertheless, while the general principles of Staff's proposal provide a reasonable framework, the ISO recommends that the Commission clarify several specific aspects of this proposal. Specifically, the ISO will address the following areas for clarification and make the following additional points:

- The Initial Report confirms the ISO's longstanding position that spot market gas price indices should not be used in determining refunds, because of the dramatic irregularities in these price indices during the Refund Period.
- While further investigation of spot market gas indices is warranted, the Initial Report correctly concludes that the Commission must adopt a new methodology or benchmark for determining gas prices to be used in calculating the MMCP in order to establish an MMCP that reflects prices that would result from a competitive, efficient wholesale energy market.
- The alternative methodology proposed by Staff for determining gas prices to be used in calculating the MMCP represents a reasonable method of determining refunds based on benchmark prices that would not be

exceeded in a competitive, efficient wholesale energy market.

- The method proposed by Staff is highly preferable to any approach that might be designed to recalculate a spot price for gas based on data for the California market, modified to account for any manipulation or misreporting explicitly identified through the Commission's investigation.
- The transportation costs for gas suggested in the Initial Report may be high, and should be carefully scrutinized.
- Staff's proposal to exclude from calculation of the MMCP any actual gas costs claimed by sellers should be adopted, as the proposal reflects the same principles that the Commission has previously applied in rejecting the use, in calculating the MMCP, of gas or emission cost data provided by generators.
- The Commission should clarify that gas-fired generators should only be allowed to seek recovery of demonstrated gas costs in the event that they opt for cost-based rates over the entire Refund Period, as an alternative to having refunds calculated based on the MMCP.
- The Commission should impose clear, stringent requirements for the calculation and allocation of gas costs before sellers seeking cost-of-service rates are permitted to recover costs in excess of the competitive proxy price for gas proposed by Staff.
- The Commission should not include any additional amounts in the gas proxy price to represent potential scarcity in gas transportation.

II. COMMENTS

A. THE INITIAL STAFF REPORT CONFIRMS THE ISO'S LONGSTANDING POSITION THAT SPOT MARKET GAS PRICE INDICES SHOULD NOT BE USED IN DETERMINING REFUNDS DUE TO THE DRAMATIC IRREGULARITIES IN THESE PRICE INDICES DURING THE REFUND PERIOD.

One of the key concerns with the "soft cap" mitigation approach originally proposed by the Commission in its November 1, 2000 Order, 93 FERC ¶ 61,121 (2000), was that it provided sellers with an incentive to justify higher costs, in order to avoid the potential refund obligation imposed on sales at prices above the "soft cap" (or single price auction "breakpoint"). There were at least two ways in which sellers could be expected to attempt to avoid refund obligations by justifying higher costs:

(1) Sellers could engage in gas transactions with affiliates or non-affiliated entities designed to establish a high cost-basis for any sales from thermal generating units within the ISO system, and

(2) Sellers could export power from the ISO system and engage in a series of electricity transactions, so that power could be offered for sale in the California market as an import for which a high purchase cost could be claimed.

Indeed, trends in exports and imports of power following the implementation of the "soft cap" mechanism indicated that the second of these strategies was, in fact, being employed as a means of "gaming" the cost justification requirements established as part of the Commission's "soft cap"

approach. Recent revelations about the significant volumes of "wash trades" of gas and electricity, and other forms of manipulation of spot market prices for gas and electricity outlined by Staff in the Initial Report, provide further evidence that these strategies were indeed employed by sellers in order to justify high prices based on high purchase costs of gas and electricity.

After the "soft cap" mechanism took effect, virtually all spot market sales by non-utilities were made at prices in excess of the "soft cap" thresholds. Over three-fourths of the approximately $4.3 billion of instructed energy purchased by the ISO to meet the "net short" position of California utilities during the Refund Period were made at prices above the $250 and $150 "soft caps" that were in effect starting in December 2000.[4] The ISO exercised its authority under both the ISO Tariff and its Market Monitoring Information Protocols ("MMIP") to direct suppliers to provide complete cost information for sales over the "soft caps", including data on any gas and electricity purchases being offered as part of the cost justification. However, no major seller provided actual gas or electricity purchase data for examination by the ISO.

When the Commission first proposed the use of spot market gas price indices reported in industry publications as the basis for determining refunds in

[4] While the "soft cap" approach outlined in the November 1 Order was originally scheduled to take effect in January 1, 2001, this same basic approach was implemented on December 8, 2000 as a result of the ISO's emergency filing of Amendment 33 to the ISO Tariff, which established a $250 "soft cap" that was in effect during the last three weeks of December 2000. The information in the text concerning the level at which purchases were made is based on all instructed energy purchases by the ISO (including out-of-market purchases made through CERS) during the Refund Period from sellers other than the state's major investor-owned utilities. The information does not include purchases of Ancillary Services and uninstructed energy in the ISO markets, or purchases in the Day-Ahead and Day-Of markets (PX and, following the closure of the PX, by CERS).

its March 9, 2001 Order,[5] the ISO noted that the Commission's use of these price indices as a proxy for generators' gas procurement costs was unsupported by any explanation or analysis of these indices or of how the use of these indices would result in just and reasonable rates for consumers when used in determining refunds. The ISO's request for rehearing of the March 9 Order asked the Commission to take steps to ensure that generators provided the ISO and California state officials with certain cost data, and to hold evidentiary hearings in which the reasonableness of the rates and cost justifications provided by sellers could be examined. Request for Rehearing at 5. The ISO specifically noted that:

> There is an acute need for an investigation of the generators gas procurement practices. The problem is that the Commission's December 15 Order creates an incentive for suppliers to utilize their most expensive gas since the higher price will provide a greater cost justification for bids above the $150/MWh breakpoint. This is an important issue that should be addressed in the hearings requested below.

Id. at 30.

When the Chief Judge recommended using spot market gas indices as part of the MMCP methodology for determining refunds (a recommendation that was ultimately adopted by the Commission in the July 25 Order), the ISO noted that:

> The problems inherent in using spot market gas prices as the basis for determining *just and reasonable* wholesale electric rates have been well documented by the ISO in these proceedings. Most importantly, perhaps, is the fact that the very spot market gas prices generators propose to use in calculating *just and reasonable rates* for wholesale electricity are the subject of a separate proceeding before the Chief Judge to determine if they are the product of price manipulation in the gas markets. *Any use of these spot*

[5] Order Directing Sellers To Provide Refunds of Excess Amounts Charged for Certain Electric Energy Sales During January 2001 Or, Alternately, To Provide Further Cost or Other Justification for Such Charges, 94 FERC ¶ 61,245 (2001) ("March 9 Order").

> *market gas prices in determining wholesale electric rates may simply pass on and magnify even further for wholesale electricity purchasers the effect of manipulation of spot market gas prices* . . . . Thus, absent a thorough accounting of actual spot market purchases and a thorough investigation of price manipulation in the spot gas markets, the Commission should continue to reject the use of spot market gas prices in any calculation of competitive market rates that might be used as a proxy for just and reasonable rates.

Id. at 10-11 (emphasis added).

The same concern previously identified by the ISO was explicitly recognized by Staff in the Initial Report. Initial Report at 55. In addition, the Initial Report correctly notes that state-level regulations also provide an incentive for many large gas purchasers to overstate purchase prices for gas at the California border. As the Initial Report states, each of California's large natural gas local distribution companies may profit to the extent that it buys gas at prices lower than its reference benchmark price, which is based in part on the California border price indices. Similarly, payments to gas-fired qualifying facilities in California are based on prices reported for Topock, giving another large group of gas purchasers an incentive to report higher natural gas prices. Initial Report at 55.

Therefore, given the susceptibility of spot market gas prices to being artificially inflated, the incentives for various market participants to inflate them, and the anomalous market behavior and price outcomes already observed in the gas markets during the Refund Period, the Commission must eliminate reliance on these price indices as part of the refund proceeding.

B. WHILE FURTHER INVESTIGATION OF SPOT MARKET GAS INDICES IS WARRANTED, THE INITIAL REPORT CORRECTLY CONCLUDES THAT THE COMMISSION MUST ADOPT A NEW METHODOLOGY OR BENCHMARK FOR DETERMINING GAS PRICES TO BE USED IN CALCULATING THE MMCP IN ORDER TO ESTABLISH AN MMCP THAT REFLECTS PRICES THAT WOULD RESULT FROM A COMPETITIVE, EFFICIENT WHOLESALE ENERGY MARKET.

While additional investigation of price manipulation is warranted, the proof necessary to definitively conclude that price manipulation of California spot market gas indices occurred in the context of ongoing legal investigations exceeds the proof that would justify the Commission's adoption of a different approach for determining gas prices to be used in calculating the MMCP. The ISO believes that the evidence and analysis presented in the Initial Report provides all the proof necessary for the Commission to adopt a different approach. In addition, the time constraints of the refund proceeding, in particular the need of both buyers and sellers for a timely resolution, require that the calculation of refunds occur prior to the conclusion of the full investigation and resolution of the issue of price manipulation and other irregularities in the spot market gas indices. Therefore, the Commission should move expeditiously to put in place a reasonable substitute mechanism for determining gas prices for purposes of the refund methodology. As discussed in further detail below, the ISO believes that the mechanism proposed by Staff in the Initial Report represents such a reasonable substitute mechanism.

C. THE ALTERNATIVE METHODOLOGY PROPOSED BY STAFF FOR DETERMINING GAS PRICES TO BE USED IN CALCULATING THE MMCP REPRESENTS A REASONABLE METHOD OF DETERMINING REFUNDS BASED ON BENCHMARK PRICES THAT WOULD NOT BE EXCEEDED IN A COMPETITIVE, EFFICIENT WHOLESALE ENERGY MARKET.

The alternative methodology proposed in the Initial Report for determining gas prices to be used in calculating the MMCP represents a reasonable methodology, given the irregularities surrounding spot market gas price indices and the Commission's overall objective of the Refund Orders: to ensure just and reasonable rates to buyers in California's wholesale electricity markets based on benchmark prices that would have resulted in a competitive, efficiently functioning wholesale market.

Staff's proposal to utilize spot market prices from nearby producing regions (with a cost-based adder for transportation to the California market) ensures that the MMCP will be a reasonable approximation of prices that would result in a competitive, efficient wholesale energy market, and that the impact on consumers of any manipulation or dysfunction in the spot gas markets is not magnified by setting the MMCP for electricity based on uncompetitively high spot market gas price indices. As noted in the Initial Report, "since gas and power markets were closely linked during the Refund Period, it is reasonable to conclude that California spot gas prices were driven to high levels by the same dysfunctions that afflicted the California power market. Therefore, to establish a valid proxy for the competitive power price, gas prices must be independent of

the California market." Initial Report at 62. The proposal by Staff to use prices for producing areas (with a cost-based adder for transportation costs) provides a basis for determining a competitive price of power that is independent of the manipulation and other dysfunctions that inflated the spot market gas prices for California delivery points.

D. THE METHOD PROPOSED BY STAFF IS HIGHLY PREFERABLE TO ANY APPROACH THAT MIGHT BE DESIGNED TO RECALCULATE A SPOT PRICE FOR GAS BASED ON DATA FOR THE CALIFORNIA MARKET, MODIFIED TO ACCOUNT FOR ANY MANIPULATION OR MISREPORTING EXPLICITLY IDENTIFIED THROUGH THE COMMISSION'S INVESTIGATION.

Although the Initial Report provides an example of how the impact of the trading activities of a single market participant on California spot gas price indices might be quantified, Staff's recommended alternative for determining the gas prices to be used in calculating the MMCP recognizes that the Commission should not adopt an approach that attempts to "recalculate" the appropriate spot market price for gas based on such data. First, an approach designed to "recalculate" spot market prices for delivery points in California would be inconsistent with the Commission's previous determination that the MMCP is designed not to represent a detailed re-simulation of the market, but to approximate the result of a competitive, well-functioning market based on a methodology that is not extremely speculative and "could be reasonably implemented." December 19 Order at 62,202.

In addition, Staff's recommended methodology correctly recognizes that any approach that incorporates spot market prices reported (or actually paid) at delivery points in California simply cannot account for the "circular" nature of manipulation or misreporting of spot market prices for those delivery points. As noted in the Initial Report, "the natural tendency is for buyers and sellers to assume that published prices are accurate, so an overstated published index may then affect the actual price buyers pay for the transaction. Thus, misreported prices could become part of the price formation process and adversely affect the true market price." Initial Report at 47.

Elsewhere, the Initial Report indicates that the particular methods used by any reporting firm are "almost irrelevant," due to the dominant role that Enron's Energy On-Line (EOL) played as a source of price discovery and potential manipulation in the natural gas markets. Initial Report at 48-49. Specifically, Staff found that "there is a self-referential or circular nature to the prices being reported by the reporting forms because of how traders relied on EOL." *Id.* at 48. Again, while Staff aptly recognizes that additional investigation of the role of EOL as a means of price discovery and potential price manipulation is warranted, the anomalous nature of the trading activity described in the Initial Report warrants adopting an approach to calculating the MMCP that simply eliminates the need to rely in any way on the tainted spot gas price indices for delivery points in California.

E. THE TRANSPORTATION COSTS FOR GAS SUGGESTED IN THE INITIAL REPORT MAY BE HIGH, AND SHOULD BE CAREFULLY SCRUTINIZED.

Based on a review of the specific gas price formula outlined in the Initial Report, the ISO is concerned that the transportation costs for gas cited by Staff may be high and should be scrutinized in further detail. During the Refund Period, the new price indices proposed by Staff yield prices significantly lower than the prices derived from the indices used in the July 25 Order. However, before and after the refund period, this trend is reversed. For example, as shown in Attachment A, during comparable months of the year before and after the Refund Period, prices calculated pursuant to Staff's proposal for Northern California exceed prices calculated pursuant to the mechanism established in the July 25 Order by an average of $.30 to $.50/MMBtu, or about 9% to 16%. Similarly, prices calculated pursuant to Staff's proposal for Southern California exceed prices calculated consistent with the July 25 Order by an average of $.42 to $.45/MMBtu, or about 12% to 18%. This suggests that the transportation costs specified in the Initial Report may be higher than those that would result under competitive market conditions, and that it may be appropriate to lower the transportation adder used in conjunction with the price index proposed by Staff.

F. STAFF'S PROPOSAL TO EXCLUDE ANY GAS COSTS CLAIMED BY SELLERS FROM CALCULATION OF THE MMCP SHOULD BE ADOPTED, AND REFLECTS THE SAME PRINCIPLES THAT THE COMMISSION HAS PREVIOUSLY APPLIED IN REJECTING THE USE OF GAS OR EMISSION COST DATA PROVIDED BY GENERATORS IN THE CALCULATION OF THE MMCP.

In previously rejecting the use of actual gas costs in calculating the MMCP, the Commission recognized that "use of actual costs is not appropriate because they would not be transparent or readily verifiable." December 19 Order at 62,205. Similarly, in excluding any demonstrated emission costs from the MMCP, the Commission noted that since emission costs have not been demonstrated to be hourly costs, and tend to vary by location, time period and duration, inclusion of these costs would present an insurmountable burden. July 25 Order at 61,519. The Commission also rejected alternative proposals offered by generators for factoring emission costs into the MMCP, explaining that none of the sellers' proposals was workable because these costs are not verifiable, especially for suppliers with portfolios of resources, and that, as a result, "there is no certainty that the expense was incurred for the power purchased." December 19 Order at 62,208. For all of the same reasons, the Commission should adopt Staff's recommendation and continue to reject the consideration of actual gas costs in calculating refunds.

Some sellers may argue that even though spot gas prices may have been artificially inflated by market manipulation or malfunction, the MMCP should continue to be based on the highest price actually paid for gas in the spot market

by sellers eligible to set the MMCP, since these costs were actually incurred by these sellers. However, a closer examination of this argument reveals that any approach that allowed the MMCP to be set based on spot market gas prices that were artificially inflated by market manipulation or malfunction would result in significant windfalls to sellers at the expense of buyers. This is because under the single price auction framework upon which the Commission's MMCP formula is designed, any increases in gas costs directly increase the net revenues received by generators even after the higher cost of gas is taken into consideration. Attachment B provides a series of three scenarios illustrating this basic principle.

- Scenario 1 shows a base case reflecting a competitive, efficient market in which the actual gas cost of all generating units is $10/Mbtu. This results in a MMCP of $199/MWh and net revenues of $78/MWh for generators after subtraction of gas and other variable operating costs from sales revenues.

- Scenario 2 illustrates the impact of an increase in gas costs from $10 to $20/MBtu. Although this increase raises the cost of gas incurred by generators 100%, this also increases the net revenues received by generators by 100%, from $78/MWh to $156/MWh. Thus, under the Commission's MMCP refund methodology, an increase in the gas cost used to set the MMCP directly increases the net revenues received by generators, even if all the generator's gas was procured at these higher spot market gas prices.

- Scenario 3 illustrates another potential scenario, in which 75% of gas is procured at a price of $10, but 25% of gas is procured at a price of $20. As shown by this example, if the MMCP is based on a gas price of $20, the net revenues received by generators are increased by nearly 200% relative to the base case, from $78/MWh to $232/MWh.

These examples illustrate why, given the findings that spot market gas prices were impacted by market manipulation, it would be inequitable from the perspective of buyers for the Commission to adopt an approach that allowed the MMCP to be set based on the price of spot market gas sales, even if it can be demonstrated that these costs were actually incurred as a result of an arms-length transaction by a generator.

G. THE COMMISSION SHOULD CLARIFY THAT GAS-FIRED GENERATORS SHOULD ONLY BE ALLOWED TO SEEK RECOVERY OF DEMONSTRATED GAS COSTS IN THE EVENT THAT THEY OPT FOR COST-BASED RATES OVER THE ENTIRE REFUND PERIOD, AS AN ALTERNATIVE TO HAVING REFUNDS CALCULATED BASED ON THE MMCP.

As noted above, the Commission has allowed sellers, in lieu of paying refunds based on the MMCP, the option of filing for cost-of-service rates covering all of their units in the WSCC for the duration of the Refund Period.

Sellers may continue to argue, as they have in past proceedings, that they should have the opportunity to pick selected elements from the two refund options by first having their refund obligations calculated using the MMCP, and then subtracting from this refund obligation any demonstrated gas costs incurred above the new gas price proxy proposed by Staff. This approach should be rejected. In addition to undermining the basic theoretical foundation of the refund methodology by allowing sellers to selectively pick from the best of both refund options, this approach creates a variety of cost verification problems and

gaming opportunities.

Since gas supplies are typically purchased on a portfolio basis (*i.e.*, for multiple units) and include a mix of long-term and short-term contracts, often there may be no a direct temporal link between specific gas purchases within a generator's portfolio and the fuel burned by a generating unit on any specific day. Thus, allowing generators to seek to subtract a gas uplift on a day-by-day basis from any refund obligation resulting from the application of the MMCP invites a host of gaming opportunities related to how gas procurement costs are allocated to the output of specific plants during specific hours.

In addition, verification of actual gas purchase costs (resulting from arms-length transactions) can be difficult and complicated due to affiliate transactions and wash trades or other agreements with non-affiliated entities, as discussed in the Initial Report and the following section of these comments. The ISO believes the issue of verifying "arms-length" transactions and agreements can be effectively addressed on a portfolio basis for the entire Refund Period, but may be difficult and burdensome to address on a daily basis. Therefore, the ISO recommends that the Commission clarify that gas-fired generators should only be allowed to seek recovery of demonstrated gas costs in the event that they opt for cost-based rates over the entire Refund Period, as an alternative to having refund obligations determined based only on the MMCP.

H. THE COMMISSION SHOULD IMPOSE REQUIREMENTS FOR CLEAR, STRINGENT REPORTING AND ALLOCATION OF GAS COSTS ON ANY GENERATOR SEEKING COST-OF-SERVICE RATES, BEFORE THE GENERATOR IS PERMITTED TO RECOVER COSTS IN EXCESS OF THE PROXY PRICE FOR GAS PROPOSED BY STAFF.

As noted earlier in these comments as well as in the Initial Report, the "soft caps" in effect through most of the Refund Period provided sellers with an incentive to take steps that would enable them to establish a high cost basis for sales. Consequently, it is vital that the Commission establish clear, stringent reporting and allocation requirements for any generator that opts for cost-of-service rates and seeks to recover gas costs in excess of the proxy price for gas recommended by Staff.

For example, the Commission should establish reporting requirements based on a recognition that verification of the actual gas purchase costs that would result from arms-length transactions can be complicated due to affiliate transactions. As noted in the Initial Report, "purchase prices from the generator's gas marketing affiliate are not the result of arms-length negotiations and reflect intra-corporate accounting rather than the true cost of gas." Initial Report at 74.

Similarly, the Commission's reporting requirements also should recognize that verification of the actual gas costs that would result from "arms-length" transactions may be difficult or complicated in many cases due to "wash trades" or other types of trades or arrangements with non-affiliated entities. Although such trades or other arrangements with non-affiliated entities are not specifically cited in the Initial Report in conjunction with the issue of verifying gas purchase

costs, the ISO recommends that the Commission clarify that all such trades or arrangements must be fully disclosed so that they may be scrutinized in order to ensure that gas purchase costs reflect arms-length transactions.

The ISO supports Staff's recommendation that generators should be required to use the average cost over their entire portfolio, but would add the important clarification that where there is no unaffiliated entity in the transaction, Staff's gas index should be used as a cap on gas costs.[6] Without this important clarification, generators utilizing gas procured under long-term contracts through an affiliate at prices lower than the spot gas price index might claim higher costs based on the higher spot gas index. Similarly, the Commission should clarify that sellers opting to recover gas costs through cost-based rates will be required to disclose all gas purchase data, including any and all transactions at prices lower than the spot gas index proposed by Staff.

I. THE COMMISSION SHOULD NOT INCLUDE ANY ADDITIONAL AMOUNTS IN THE GAS PROXY PRICE TO REPRESENT POTENTIAL SCARCITY IN GAS TRANSPORTATION.

In determining whether true scarcity existed, it is important to differentiate between the exercise of market power during tight supply-demand conditions, and true supply scarcity, *i.e.*, a condition in which all potential supply is being fully utilized yet some demand must go unmet. Although the Initial Report suggests that there was a scarcity of gas transportation capacity from producing

[6] In the Initial Report, Staff recommends that "where there is no unaffiliated entity in the transaction, Staff's gas index should be used," but does not indicate that the gas index should

regions to the California market during the Refund Period, Initial Report at 75-76, no specific evidence or explanation of the basis for this conclusion is provided. Such a conclusion would also be inconsistent with the recent decision of the Presiding Judge in the *El Paso* proceeding (RP00-241-006), in which the Presiding Judge found that there existed excess, unutilized gas transportation capacity to California during the Refund Period, and that El Paso Pipeline had "exercised market power by withholding substantial volumes of capacity to its California delivery points which tightened supply and broadened the basis differential." 100 FERC ¶ 63,041 at P 26-32, 61-67.

Nevertheless, even if it could be determined with certainty that true scarcity of gas transportation capacity existed during specific days during the Refund Period, the ISO urges the Commission to avoid efforts to establish some *ex post* "scarcity rent," for a variety of reasons. First, the ISO believes that in most cases it is difficult --- if not impossible --- to empirically determine an appropriate scarcity rent with the suitable level of accuracy, given the data available. Second, even if complete and reliable data on actual supply and demand were available, the elasticity of the demand for gas is severely limited by many of the same factors that limit the elasticity of the demand for electricity (lack of end-use consumer information on retail rates, highly inelastic demand derived from electricity, etc.). Finally, the key economic function served by allowing prices to reflect scarcity rents (*i.e.*, to maximize efficiency by "auctioning off" limited supplies to those end users who place the highest value on limited

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be used as a cap. Initial Report at 74-75.

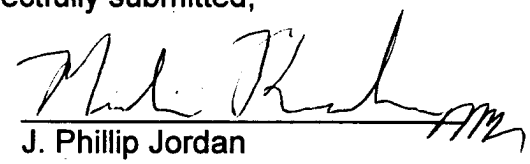
supplies) is not applicable in cases where regulators may seek to include such scarcity rents in an after-the-fact determination of just and reasonable prices.

Thus, while the ISO recognizes that the Staff's proposal represents a "regulatory solution to a market failure," Initial Report at 45, the ISO urges the Commission not to modify the Staff proposal to incorporate additional allowances for any alleged scarcity in the California natural gas market.

III. CONCLUSION

The ISO thanks the Commission for the opportunity to comment and requests that the Commission accept for consideration the comments presented above.

Respectfully submitted,



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Dated: October 15, 2002

Attachment A

Comparison of Spot Gas Price Indexes
During Comparable Months
Before and after Refund Period

Comparison of Average Spot Gas Price Indexes During Comparable Months Before and after Refund Period

Northern California

	Avg. Index Proposed By Staff [1]	Avg. Index in July 25 Order [2]	Avg. Delta ($/MMBtu)	Avg. Delta (%)
Oct 1998 - June 1999	$2.59	$2.29	$ .30	11%
Oct 1999 - June 2000	$3.37	$3.05	$ .32	9%
Oct 2000 - June 2001*	$6.16	$9.41	-$ 3.25	- 53%
Oct 2001 - June 2002	$3.14	$2.64	$ .50	16%

* Refund period

[1] (West Coast Price x 1.0443)+ .9224 (NGI Gas price only)
[2] Average of PG&E Citygate and Malin (NGI Gas price only)

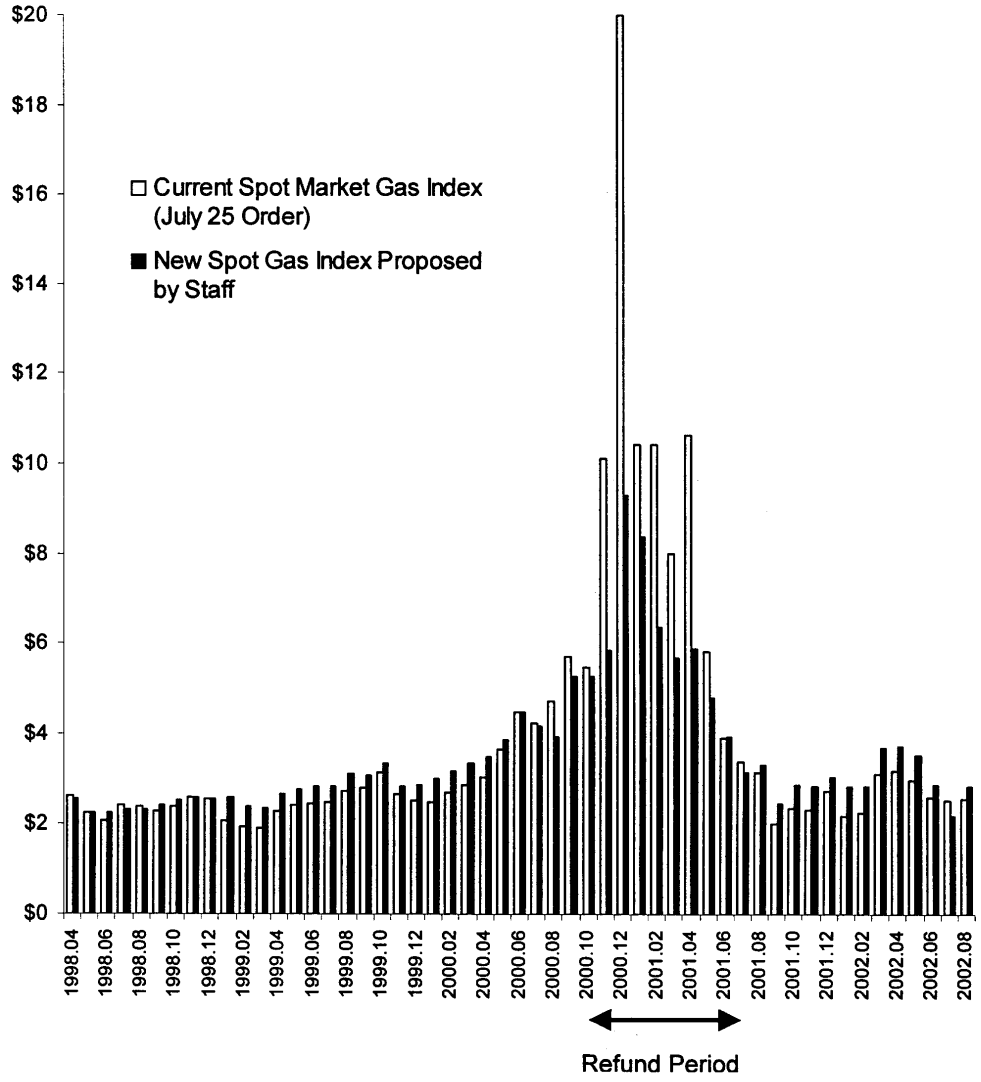
Southern California

	Avg. Index Proposed By Staff [3]	Avg. Index in July 25 Order [4]	Avg. Delta ($/MMBtu)	Avg. Delta (%)
Oct 1998 - June 1999	$2.55	$ 2.10	$ .45	18%
Oct 1999 - June 2000	$3.47	$ 3.05	$ .42	12%
Oct 2000 - June 2001*	$6.32	$13.14	-$ 6.82	-108%
Oct 2001 - June 2002	$3.14	$ 2.70	$ .44	14%

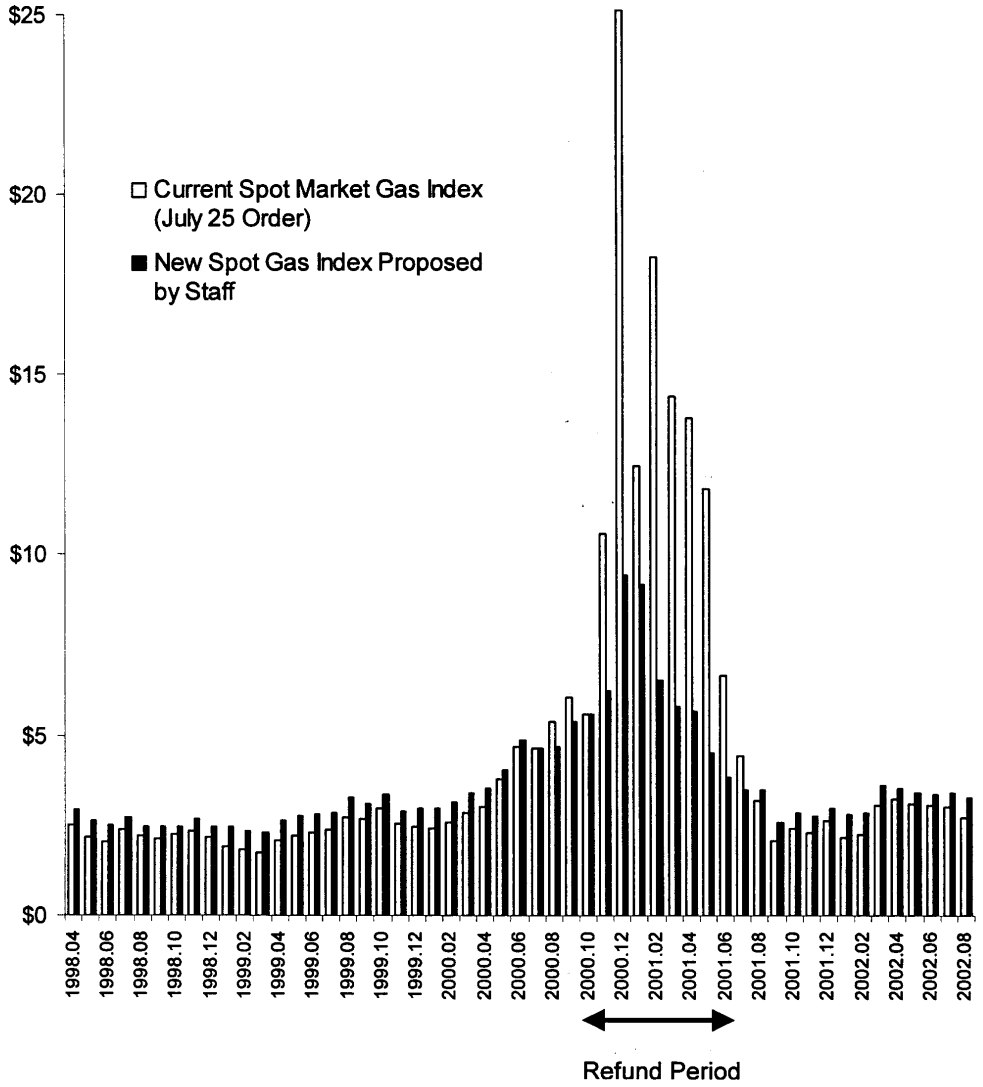
* Refund period

[3] (Average of San Juan and Permian Basin Prices x 1.0374)+ .651 (NGI Gas price only)
[4] SoCal Border (NGI Gas price only)

Comparison of Spot Gas Price Indexes
Average Monthly Price – Northern California



Comparison of Spot Gas Price Indexes
Average Monthly Price – Southern California



Attachment B

Impact of Higher Gas Costs on Net Operating Revenues Received by Generators

Assumptions:

Dispatched Generation:

Quantity (MWh)	Heat Rates (Btu/MWh)
100	8,000
100	10,000
100	12,000
100	18,000
400	

Operating Costs	= (Heat Rate/1,000 x Gas Cost) + $6 O&M
MMCP	= Highest Operating Cost of Units Dispatched + 10% Credit Worthiness Adder
Gross Revenues	= MWH x MMCP
Net Revenues	= MWH x (MMCP – Operating Cost)
Net Revenue ($MWh)	= Net Revenues / Total MWh

Scenario #1: Gas Cost = $10

	MWh	Heat Rate	Gas Cost	Operating Cost	Gross Revenue	Net
	100	8,000	$10	$8,060	$19,866	$11,806
	100	10,000	$10	$10,060	$19,866	$9,806
	100	12,000	$10	$12,060	$19,866	$7,806
	100	18,000	$10	$18,060	$19,866	$1,806
Totals	400			$48,240	$79,464	$31,224

MMCP =	$199	
Net Revenue =	$78	MWh

Scenario #2: Gas Cost = $20

	MWh	Heat Rate	Gas Cost	Operating Cost	Gross Revenue	Net
	100	8,000	$20	$16,120	$39,732	$23,612
	100	10,000	$20	$20,120	$39,732	$19,612
	100	12,000	$20	$24,120	$39,732	$15,612
	100	18,000	$20	$36,120	$39,732	$3,612
Totals	400			$96,480	$158,928	$62,448

MMCP =	$397	
Net Revenue =	$156	MWh

Scenario #3: Gas Cost = $10 for 75% of portolio, $20 for 25% of portfolio

	MWh	Heat Rate	Gas Cost	Operating Cost	Gross Revenue	Net
	100	8,000	$10	$8,060	$39,732	$31,672
	100	10,000	$10	$10,060	$39,732	$29,672
	100	12,000	$10	$12,060	$39,732	$27,672
	100	18,000	$20	$36,120	$39,732	$3,612
Totals	400			$66,300	$158,928	$92,628

MMCP =	$397	
Net Revenue =	$232	MWh

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the restricted service list compiled by the Presiding Administrative Law Judge in this proceeding.

Dated at Washington, DC, this 15th day of October, 2002.

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