

UNITED STATES OF AMERICA92 FERC - 61,112
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: James J. Hoecker, Chairman;
William L. Massey, Linda Breathitt,
and Curt H,bert, Jr.

Morgan Stanley Capital Group Inc.,

Complainant,

v.

Docket No. EL00-91-000

California Independent System Operator
Corporation,

Respondent.

ORDER ON COMPLAINT

(Issued July 28, 2000)

On July 10, 2000, Morgan Stanley Capital Group Inc. (Morgan Stanley) filed a complaint against the California Independent System Operator (ISO) relating to the ISO's recent decision to reduce the maximum purchase prices for imbalance energy and ancillary services. Morgan Stanley requests the Commission to issue a stay of the ISO's maximum purchase price authority, and to direct the ISO to reverse any maximum purchase price reductions. Morgan Stanley requested Fast Track processing pursuant to Rule 206(h). 1/ We grant the request for Fast Track processing because we find that the complaint warrants expeditious action, and address the complaint herein.

Background

On November 12, 1999, the Commission issued an order (November 12 Order) accepting certain tariff revisions (known as Tariff Amendment No. 21) filed by the ISO, which had the effect of extending the ISO's maximum purchase price authority for Imbalance Energy and Ancillary Services through November 15, 2000. 2/ The ISO stated in that filing that, by direction of its Governing Board (ISO Board), the maximum purchase price, (i.e., price levels above which bids will be rejected) in effect were

1/ 18 C.F.R. 385.206(h).

2/ California Independent System Operator, 89 FERC - 61,169 (1999), reh'g pending.

\$750 per MW or MWh (depending on the service), effective September 30, 1999. The ISO stated that it would lower the maximum purchase price to \$500 effective June 1, 2000, if the ISO Governing Board determined that any of three specified conditions were met. The ISO also stated that it would retain discretion to lower the maximum purchase price by an unspecified amount in the event that it determines that the markets were not workably competitive.

The November 12 Order approved tariff revisions to section 28 of the tariff to extend the ISO's maximum purchase price authority "on the facts of this case." The Commission stated that as proposed, the maximum purchase price was not a cap on what the seller may charge to the ISO, but a cap on what the ISO was willing to pay. The Commission's decision was based on the premise that sellers of Ancillary Services and Imbalance Energy who were dissatisfied with the maximum purchase price could choose instead to sell those services into the California Power Exchange or bilateral markets. The Order stated,

If sellers were required to bid into these markets, the ISO's purchase price cap would have the effect of setting the maximum selling price. However, that is not the case here.^{3/}

The order accordingly accepted the tariff revisions for an additional 12 months during which an ongoing market redesign could be completed.

Pursuant to the established criteria, in March 2000, the ISO Board considered the issue of whether the maximum purchase price should be lowered to \$500 for the summer of 2000, but unanimously approved (23-0) a recommendation by the ISO management that the \$750 maximum purchase price be maintained throughout the summer. The ISO management recommendation was based on a March 2000 study prepared by the ISO's Department of Market Analysis (DMA). In addition, the Market Surveillance Committee (MSC) of the ISO also prepared a March 2000 report which was included in the material presented to the ISO Board.

On June 28, 2000, the ISO Board, at a specially-called meeting, approved a motion (June 28 Decision) that, among other things, instructed the ISO management to reduce the maximum purchase price from \$750 to \$500, effective July 1, 2000 through October 15, 2000. The motion stated among other things that it was "in response to market performance indicating that during high load conditions the California Independent System Operator's real-time electricity, day-ahead, and hour-ahead ancillary service markets are not workably competitive." The June 28

3/ Id. at 61,511.

Decision also states, "To the extent permitted by law, regulation and pre-existing contract, Management shall direct generators to bid in all their capacity when system load exceeds 38,000 MW." Further, the resolution directed ISO Management to "work with responsible agencies and the legislature to streamline and accelerate the construction of power plants and transmission lines and to eliminate constraints to hedging opportunities for the UDC's."4/

At another specially-called meeting of the ISO Board held on July 6, 2000, the ISO Board, by a narrow margin, failed to pass a resolution that would have reduced the maximum purchase price to \$250.

Morgan Stanley's Complaint

In its complaint, Morgan Stanley states that it is a power marketer and a participant in the markets operated by the ISO. Morgan Stanley alleges that the June 28 Decision of the ISO Board to reduce the maximum purchase price from \$750 to \$500 is unlawful and violates Commission precedent. In addition, the complaint alleges that the ISO Board's actions in holding an emergency meeting on July 6, 2000, to consider further reducing the maximum purchase price were also impermissible or inappropriate.

Morgan Stanley argues that the June 28 reduction in the maximum purchase price "unfairly amends the market rules midstream, after market participants have invested substantial time and money by responsibly hedging price and market risks under the current \$750/MWh restrictions." It states that the reduction will threaten the stability and integrity of the marketplace. Further, it argues that the ISO Board's exercise of its maximum purchase price authority will distort the market price for electric energy, and therefore is unjust and unreasonable in violation of the Federal Power Act.

Morgan Stanley states that it is unclear at best whether the ISO Board analyzed or justified its maximum purchase price reduction based on the criteria set forth in the August 1999 ISO Board decision establishing the reasons that the \$750 maximum purchase price could be changed. It argues that because the ISO has not sufficiently investigated or demonstrated that the markets are not workably competitive, its action is contrary to ISO's tariffs and market rules and the Commission orders addressing those rules.

4/ In addition, there was recognition by the ISO that constraints on participation by load in demand relief programs should be removed. See Appendix C to ISO's Answer.

Morgan Stanley requests that the Commission issue a stay of the ISO Board's authority regarding the maximum purchase price and an emergency cease and desist order directing the ISO to reinstate the \$750 maximum purchase price. It also asks that the Commission "negate" the ISO's authority to reduce the maximum purchase price after October 15, 2000. Morgan Stanley suggests an emergency technical conference to examine the ISO's justification for the maximum purchase price reduction. Morgan Stanley requested Fast Track processing of its complaint because, it alleged, the reduced maximum purchase price will have a severe and immediate negative impact on consumers and the marketplace.

Pleadings

The Public Utilities Commission of California filed a notice of intervention raising no issues. The following filed motions to intervene raising no issues: the California Electricity Oversight Board, California Department of Water Resources, San Diego Gas & Electric Company, Metropolitan Water District of Southern California, Modesto Irrigation District, Transmission Agency of Northern California, California Municipal Utilities Association, Northern California Power Agency, Duke Energy Trading and Marketing, L.L.C., and jointly, the Cities of Redding, Santa Clara, and Palo Alto and the M-S-R Public Power Agency. The following filed motions to intervene and stated a position in support of the complaint: the Electric Power Supply Association; Southern Energy California, L.L.C., Southern Energy Delta, L.L.C., and Southern Energy Potrero, L.L.C.; Reliant Energy Power Generation, Inc.; Williams Energy Marketing & Trading Company; Duke Energy North America, LLC; Dynegy Power Marketing, Inc.; and Merrill Lynch Capital Services, Inc. The following filed motions to intervene and stated a position in opposition to the complaint: Southern California Edison Company; Pacific Gas & Electric Company; and Sacramento Municipal Utility District. In addition, the ISO filed an answer.

The ISO's Answer

In its answer, the ISO states that the Commission should decline summarily to entertain Morgan Stanley's complaint. It asserts that the ISO Board engaged in a reasoned evaluation before making its June 28 Decision. In making its decision, the ISO Board had before it the March 2000 studies by the ISO's DMA and MSC, a June 21, 2000 Short-term Price Cap Policy Options Paper, correspondence from state regulators and legislators and oral statements. These reports, among other things, expressed concerns about the competitiveness of the ancillary services market, especially during periods of high demand.

The ISO argues, additionally, that the Commission "need not, however, be convinced of the correctness of the ISO Board's judgments," because the exercise of the ISO Board's authority

over its maximum purchase price is not dependent on Commission authorization. Rather, it argues, because the ISO is exercising its discretion as a purchaser to set the price it will purchase at, its authority to establish the maximum prices it will pay is inherent in its position as a purchaser, and is not derived from any grant of authority by the Commission.

The ISO also argues that even if its maximum purchase price authority were derived from the Commission, its authority to change the maximum purchase price pursuant to section 28.2 of the ISO Tariff (which was accepted by the Commission's November 12 Order) is unrestricted. It claims that section 28.2 provides only that the ISO will establish maximum bid price levels for the Imbalance Energy and Ancillary Service markets "in accordance with the criteria adopted by the ISO Governing Board from time to time." The ISO asserts that the price cap criteria adopted by the ISO Board in August 1999 are not permanent limitations on the ISO's on-going exercise of its authority to establish and modify bid price caps. It argues that the Commission recognized that its Amendment No. 21 did not bind the ISO Board to make any particular findings prior to adjusting the price bid cap. The ISO states that even if it had some burden to justify its action, it had ample basis for its action.

Discussion

A. Procedural Matters

Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure,^{5/} the notice of intervention and the timely, unopposed motions to intervene serve to make those who filed them parties to this proceeding.

B. ISO Maximum Purchase Price Authority

For the reasons discussed below, we will deny Morgan Stanley's request for a stay of the ISO Board's maximum purchase price authority and its request that we direct that the \$750 maximum purchase price be reinstated. The November 12 Order granted the ISO's request for temporary authority to change price levels at which bids will be rejected for Imbalance Energy and Ancillary Services. We accepted this tariff amendment, not because it was a cap on sellers' prices but because it would promote order and transparency in the market by clearly telling sellers of the maximum price the ISO was willing to pay and allowing sellers to make informed economic choices on whether to sell in the ISO market or to sell elsewhere and our acceptance was not for the purposes of evaluating the ISO's purchase decisions. We explicitly stated that it was inappropriate to

^{5/} 18 C.F.R. 385.214 (2000).

characterize the ISO's proposal as a price cap on sellers' rates. As explained in the November 12 Order, we did not allow the ISO to establish the prices that sellers may charge, only the price that the ISO is willing to pay. Because sellers are not required to sell to the ISO, the ISO cannot dictate their price.

Currently, notwithstanding the maximum purchase price at what the ISO as purchaser is willing to pay, the ISO has no more or less ability to procure capacity and energy than any other buyer of these services. As noted in the November 12 Order, if the ISO is unable to elicit sufficient supplies at or below its announced purchase price ceiling (because generators are free to sell elsewhere if they choose), it will have to raise its purchase price to the level necessary to meet its needs. Moreover, the ISO's July 6, 2000 presentation to the ISO Board recognizes that lowering the maximum purchase price may result in an insufficient amount of generation in the ISO markets. Therefore, an increase in out-of-market (OOM) calls for generation may be necessary to maintain system reliability. Because the current payment for OOM is not subject to a maximum purchase price, the resulting overall payments may be higher.

To the extent the June 28 ISO Board resolution contemplates implementing a directive that generators must bid their capacity into the ISO markets under any circumstances (e.g., when system load exceeds 38,000 MW), such a requirement is not permitted by our November 12 Order and the ISO tariff. Any requirement to sell to the ISO in conjunction with a maximum purchase price would establish a ceiling on the price that a seller may charge. Future implementation of the ISO Board resolution with regard to a requirement to sell would require significant revisions to the ISO market rules. Such market changes could not become effective absent a corresponding amendment to the ISO tariff which would have to be filed under section 205 of the FPA. Such amendment would require 60 days' advance notice and could not be implemented prior to Commission approval.^{6/} As stated above, our November 12 Order was clearly based on the premise that the proper response to inadequate supply (due to a low maximum purchase price) is to raise the maximum purchase price. As a result, we put the ISO on notice that any amendment to mandate sales must be accompanied by a demonstration that this extreme measure is the proper response to low supplies in the ISO markets.

The complaint questions whether the recent ISO Board decisions adhered to its established criteria set forth in the August 1999 ISO Board decision. The information submitted in the ISO's answer is not sufficient for the Commission to determine

6/ New York Independent System Operator, Inc. 92 FERC - 61,073 (2000).

whether the ISO has complied with its own criteria. It is

crucial to all market participants that any decisions on the appropriate level of the maximum purchase price be based on reasoned decision making. Because the criteria were not used for setting the sellers prices, we need not evaluate the ISO's application of these criteria. If the ISO applies criteria which result in inappropriately low purchase prices, insufficient supplies will respond and the ISO will need to subsequently raise its purchase prices. We noted and relied on this very fact in our November 12 Order. 7/

Finally, the complaint requests an emergency technical conference to examine the ISO markets. We note that the Commission recently issued an Order Directing Staff Investigation.^{8/} Pursuant to this order, staff is directed to institute an investigation of factors affecting competition and market price fluctuations in electric bulk power markets, including the California markets, and report its findings to the Commission. Accordingly, the need for any technical conferences may be considered in conjunction with that investigation .

Conclusion

Because we find that the ISO has no authority to require sellers to bid into the ISO's real-time, ancillary services, and intra-zonal congestion management markets, the ISO cannot dictate the seller's price. Sellers have the option of selling to the ISO at the price it is willing to pay, or sell elsewhere if a higher price is available. To the extent the ISO seeks to impose any requirement to bid into these markets, a tariff amendment would have to be filed with us pursuant to section 205 of the Federal Power Act and approved by us prior to implementation.

The Commission orders:

Morgan Stanley's complaint and requests for relief are hereby denied as discussed in the body of this order.

By the Commission. Commissioners Massey and H,bert concurred with separate
statements attached.

7/ Id. at 61,511.

8/ Order Directing Staff Investigation , Notice Issued July 26, 2000.

Linwood A. Watson, Jr.,
Acting Secretary.

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MASSEY, Commissioner, concurring:

The California ISO's perception of the need for purchase price caps is driven by obvious imperfections in the market. All parties should urgently and diligently address those imperfections. I take particular note of the ISO Management's position that a temporary reduction in the price cap is part of a larger effort to develop the tools and incentives to address market issues, such as using risk management tools, removing constraints on hedging opportunities and participation in demand relief programs, introducing real time pricing through real time metering and other technologies, and expediting approval of new generation and transmission projects in California.^{1/}

I am in strong agreement with the need to take bold steps to achieve these goals. Ensuring that there is a well functioning market will require the combined and forceful efforts of this Commission and California regulatory authorities. The stakes are high, and we must take all necessary steps. Many aspects of demand side responsiveness, hedging at the retail level, and generation and transmission siting can be accomplished through state regulatory processes, and this Commission should offer all assistance that is within our jurisdiction to provide. Implementing a solid program to facilitate a robust and market-based demand side response and expediting the licensing of new generation and new electric and gas transmission facilities are critically important and urgent steps. I strongly urge this Commission and the California Commission to follow through on these

1/ ISO Management Background and Issues for Consideration.
See Appendix C to the ISO's Answer.

and other means of addressing market flaws, and we must work together both formally and informally to solve these problems.

For these reasons, I concur with today's order.

William L. Massey

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H BERT, Commissioner concurring:

The last time FERC ruled on price caps for California the "order trie[d] unsuccessfully, in my opinion to straddle the fence. . . ." California Independent System Operator Corporation (ISO), 89 FERC - 61,169 at 61,507 (1999) (H,bert, Commissioner, dissenting). The majority washed its hands of the particular ceiling, but did not let go completely. Today, the Commission at least starts to lean slightly in the right direction of recognizing that we have a role.

More fundamentally, I find enough in the record to start a proceeding against the ISO under section 206 of the Federal Power Act. This week's order directing the staff to investigate the wholesale bulk power markets, including the California ISO, grants some relief. We are taking a small step indeed, but at least the Commission flexes its collective knee. Therefore, I concur.

I prefer removing the price caps, for the reasons I gave in my ISO dissent. At least, now, we take a small step toward tearing up the blank check we sent to California last fall. The order here hints at a possible remedy if we find a flaw in the ISO's decision making, namely, a failure to follow "established

criteria." Slip op. at 7. The Commission reminds the market that FERC must approve changes in bidding rules, such as a requirement that all generators sell to the ISO. Id.

The majority in ISO and again here uses a theoretical choice of generators not to sell to the ISO as the basis for disclaiming authority over the caps. I still disagree, especially since market rules in California provide no other way to recover capacity costs. ISO at 61,514. Nevertheless, the fact that the ISO seeks to change the rule and we flash a yellow light encourages me.

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Getting to the bottom of the problem, in my view, requires us to begin a proceeding to rescind our approval of the ISO as the operator of the California grid. The record supports such a move. The ISO's response to the data request we issued earlier in this case includes a draft decision from a member of the California Public Utilities Commission asking us to investigate the ISO. A memorandum to the ISO from a stakeholder who resigned from the governing board eloquently brings to our attention repeated attempts to undermine the independence of the ISO. The memorandum also thoughtfully outlines consequences to the market of a return to "command and control."

Because these allegations come from a non-market participant, especially should we take heed. We must also take notice of the public pressure on the ISO Board to compromise its independence. That very attribute, independence, my colleagues have repeatedly and forcefully stated, forms the "bedrock" of restructuring in transmission. The independence of the ISO's governing structure stands threatened. We should "stand up," to quote the resignation letter.

I would open a section 206 proceeding now. I concur in the order because I think it only a matter of time before my colleagues will join me. As we mention here, our staff will begin an inquiry into the bulk power markets, "including the California markets." Slip op. at 7. We pointedly stated in our order directing the staff to institute the investigation if the facts justify it, we will act against institutions. To me, "institutions" includes ISO's.

Curt L. H,bert, Jr.
Commissioner