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May 9, 2005

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

Re: ISO Plan for Addressing Issues Identified in Amendment No. 66 Order
Docket No. ER05-718

Dear Secretary Salas:

Pursuant to Paragraph 21 of the Commission's "Order on Tariff Filing" issued in this docket on April 7, 2005, 111 FERC ¶ 61,008 (2005), the California Independent System Operator Corporation ("ISO") respectfully submits an original and fourteen copies of its "Plan for Addressing Issues Identified in Amendment No. 66 Order." Two additional copies of this filing are enclosed to be date-stamped and returned to our messenger. If there are any questions concerning this filing please contact the undersigned.

Respectfully Submitted,

Michael Kunselman

Counsel for the California Independent System Operator Corporation

CAISO Plan for Addressing Issues Identified in Amendment No.66 Order
May 9, 2005

Background

In Amendment No. 66, the California Independent System Operator ("CAISO") proposed to modify the CAISO Tariff so that bids for incremental and decremental energy on inter-ties with neighboring control areas that are pre-dispatched by the CAISO are settled under a "pay as bid" rule. With this modification, bids would be paid (or pay the CAISO) their original bid price, rather than "bid or better," in effect since the implementation of Phase 1B of the CAISO's Market Redesign and Technology Upgrade ("MRTU") on October 1, 2004. [1]

In its April 7, 2005 order on Amendment No. 66, [2] the Federal Regulatory Energy Commission ("Commission") approved the move to a "pay as bid" settlement rule effective as of March 24, 2005. The Commission indicated that its approval of Amendment No. 66 was on an interim basis, until the earlier of September 30, 2005 or the effective date of a long-term solution filed by the CAISO and accepted by FERC. The Commission also ordered the CAISO to monitor and report on the market impacts and effectiveness of the "as-bid" settlement rule, and to file a "plan (including milestones) for addressing the problems identified in this order."

Finally, the Commission indicated that options considered as part of the stakeholder process to develop a longer-term solution should specifically include a " financially binding hour-ahead market for inc/dec bids from System Resources at the interties under which bids would be settled at the predicted market clearing price rather than the higher of bid or real-time market clearing price." Amendment No. 66 Order at P 22. This option appears to correspond to the "single pre-dispatch price auction" option already under consideration by the CAISO, under which all incremental and decremental inter-tie bids dispatched by the CAISO would be settled at a single pre-dispatch market clearing price.

Process in Developing Recommendation

Since the issuance of the Amendment No. 66 Order, the CAISO has monitored and filed weekly reports on market performance under the "as-bid" settlement rule, and has continued to assess various options that might be implemented on a longer-term basis.

On Apri 28, the CAISO held a stakeholder meeting to discuss various pre-dispatch settlement options under review, update participants on market performance under the "as-bid" settlement rule, and outline potential modifications to settlement provisions relating to how pre-dispatch costs are allocated.

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[1] Pursuant to the Amendment No. 66 Order, if no proposed tariff amendment has been filed to become effective by September 30, 2005, then on October 1. 2005, the provisions of Amendment No. 66 will sunset, and the Tariff will revert to the prior "bid or better" settlement provisions.

[2] *California Independent System Operator Corporation*, 111 FERC ¶ 61,008 (2005) ("Amendment No. 66 Order")

As a result of the April 28, Stakeholder meeting, stakeholders requested additional written information in the form of a whitepaper on four topics:

1. How pre-dispatch prices are determined.
2. How the "deviation credit" (projecting the amount of uninstructed deviations during the next operating hour) is determined within the CAISO's RTMA software.
3. An explanation of uplift allocation issues and proposals.
4. A mathematical proof or explanation of how one of the options for a longer-term solution ("Option 1a") would produce prices that ensure that any pre-dispatched bid will recover its full bid price.

The CAISO is currently developing written information on these topics and expects to release them by May 13, 2005, prior to the next Stakeholder conference call on May 20, 2005.

The CAISO has also discussed the problem and various options with members of the Market Surveillance Committee ("MSC"). Options being developed and assessed will be further discussed at a May 24th meeting of the MSC. Informal feedback and/or a formal option may be provided by the MSC members by late May/early June, prior to development of a final recommendation to the CAISO Board.

Finally, it should be noted that key milestones may be subject to change depending on the Commission's response to the CAISO's Request for Clarification and Rehearing on Amendment 66. filed on today's date.

Update on Assessment of Option 1 (Pre-Dispatch Clearing Price)

As noted above, the Commission's Order indicated that options considered as part of the stakeholder process should specifically include a " financially binding hour-ahead market for inc/dec bids from System Resources at the interties under which bids would be settled at the predicted market clearing price rather than the higher of bid or real-time market clearing price" Amendment No. 66 Order at P 22. This solution appears to correspond to Option 1 of the several options under consideration in the current CAISO stakeholder process.

The CAISO continues to assess the feasibility of and issues with respect to implementing this option with the current RTMA software, as well as in the context of the proposed Hour Ahead Scheduling Protocol ("HASP") that will replace the RTMA pre-dispatch process under MRTU in February 2007. As part of this assessment, several additional issues and options have been identified which may add significant complexity and the risk of additional problems if this options is to be implemented using the existing RTMA software.

As part of the current process for pre-dispatching intertie bids, the RTMA software produces, but does not publish for settlement[3], three sets of four 15-minute prices prior to each

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[3] When first assessing Option 1, the scope of work estimated was based on the assumption that the prices that were already produced by the RTMA software during the pre-dispatch process could be published for settlement purposes. Upon further review, an additional RTMA pricing run appears to be necessary, as explained below.

operating hour. The first set of prices results from a "multi-step" optimization process which identifies the least cost mix of inter-tie bids and bids from internal resources. A second set of prices is generated through a "single step" optimization, in which inter-tie bids selected for pre-dispatch in the multi-step stage run are treated as "fixed" for the entire operating hour, and internal resources are optimized to meet projected demand for each 15-minute interval, subject to various operating and dispatch constraints. In cases of congestion or other binding constraints that cannot be resolved using the available economic bids during these first two optimization runs, the resulting prices would not reflect an economic solution based solely on submitted bids, but rather would reflect dollar amounts that are used by the optimization software to prioritize how those constraints should be relaxed in order to arrive at a solution when economic bids have been exhausted. These soft constraints that are relaxed in order to obtain a solution are called "slack variables". The dollar amounts used by the software when these slack variable constraints are relaxed are called "penalty prices". Finally, a third set of prices is generated through a single step "pricing run", which produces prices reflecting the marginal prices that are based on actual bid prices with no "soft-cap[4]" price constraints enforced. Because inter-tie bids are not allowed to set prices within the ISO System, however, prices produced in this final single step pricing run do not reflect the price of inter-tie bids that will be pre-dispatched at each inter-tie based on this optimization.

Thus, while prices produced during the initial multi-step optimization process determine the price of inter-tie bids that will be pre-dispatched at each inter-tie, if it proves necessary to relax "slack variables," as described above, then these multi-step prices may reflect "penalty prices" in cases of congestion or other constraints, rather than an economic solution based solely on submitted bids. In order to ensure that these multi-step prices are appropriate for settlement of bids pre-dispatched at the inter-ties they must reflect an economic solution rather than "penalty prices,". As a result some alternative method would need to be implemented that replaces these slack variable penalty prices with prices appropriate for use in settlement. Ideally, these prices should be determined through a separate multi-step pricing run that effectively excludes the penalty prices from setting the price, and constrains the prices within the allowable soft-cap economic range (-$30 to $250). However modifying the RTMA software to include a multi-step "pricing run" would require significant additional cost, development time, and potential complexity.[5]

Alternative options for determining settlement prices for hours (and individual branch groups) when RTMA multi-step prices reflect slack variable penalty prices may include settlement on an "as-bid" basis or based on a "hard cap" (e.g. $250/MWh). While the ISO continues to assess such options, the need to incorporate such features may add significant complexity and risk of additional problems if Option 1 is to be implemented using the RTMA software.

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[4] The "soft-cap" constraint ensures that prices remain between –$30 and $250 based on the marginal resource that is at or below the "soft-cap" limits.

[5] The current HASP proposal makes allowance for both the software and time needed to perform a pricing run for pre-dispatch prices, since the current HASP design contemplates the use of such pre-dispatch prices during hours of congestion.

Development Milestones

April 28, 2005	Stakeholder Meeting
May 2-5, 2005	Written Comments from Stakeholders
May 6, 2005	CAISO Board Update
May 6, 2005	File Request for Clarification and Rehearing and Milestones
May 16, 2005	Issue white papers
May 20, 2005	Stakeholder Conference Call (tentative date)
May 24, 2005	Market Surveillance Committee Meeting
June 6, 2005	Recommendation and materials for June 15 CAISO Board meeting due to CAISO management (tentative)
June 15, 2005	Present recommendation for longer-term solution for approval at CAISO Board Meeting (tentative)
June 22, 2005	FERC filing (tentative)

Certificate of Service

I hereby certify that I have this day served a copy of this document upon all parties listed on the official service list compiled by the Secretary in the above-captioned proceedings, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated this 9th day of May, 2005 at Folsom in the State of California.

Sidney Mannheim Jubien (MNK)

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