**UNITED STATES OF AMERICA**
**BEFORE THE**
**FEDERAL ENERGY REGULATORY COMMISSION**

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| San Diego Gas & Electric Company, Complainant, v. Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and the California Power Exchange, Respondents | ) | Docket No. EL00-95-000 |
| Investigation of Practices of the California Independent System Operator and the California Power Exchange | ) | Docket No. EL00-98-000 |

**THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION'S MOTION TO EXPEDITE CONSIDERATION OF THE REQUIREMENT THAT MARKETERS MUST BID AT $0/MWh AS REQUESTED IN ITS JANUARY 18, 2002 MOTION FOR CLARIFICATION AND REQUEST FOR REHEARING OF THE ORDER ON CLARIFICATION AND REHEARING**

On January 18, 2002, The California Independent System Operator Corporation ("ISO")[1] filed a "Motion For Clarification And Request For Rehearing Of The Order On Clarification And Rehearing," ("Rehearing Request") in the above-captioned dockets in response to the Commission's "Order On Clarification and Rehearing" in the above-captioned dockets, 97 FERC ¶ 61,275 (2001) ("December 19 Order"). Pursuant to Rule 212 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.212, the ISO requests expedited consideration of one aspect of the Rehearing Request. For the reasons explained below, the Commission should act immediately to grant the ISO's

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

request that the Commission remove the requirement for marketers to bid $0/MWh so that the ISO can provide some opportunity for the marketers to earn a price at or near their bid price without having the opportunity to set that price.

## I. BACKGROUND

The Commission has previously concluded in these dockets that the market structures and rules for wholesale sales of electric energy in California are "seriously flawed," and, in conjunction with the imbalance of supply and demand in California, have created the ability of suppliers of electricity in those markets to exercise market power and to charge unjust and unreasonable rates for energy.[2] Through a series of orders, the Commission has adopted a market monitoring and mitigation plan for real-time wholesale energy markets in California. In its June 19, 2001 order,[3] the Commission mandated that all marketers be "price-takers" and not be able to set the Market Clearing Price ("MCP") or be paid as-bid above the mitigated Market Clearing Price.[4] While the Commission's purpose in requiring marketers to be price-takers correctly was to prevent megawatt laundering,[5] ordering that marketers could bid no higher than the MCP was problematic because marketers cannot know what the MCP ultimately will be at the time the marketers bid into the ISO real-time spot markets.

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[2] December 15 Order at 61,998-99.

[3] *San Diego Gas & Electric Co., et al.,* 95 FERC ¶ 61,418 (2001) ("June 19 Order").

[4] Under the June 19 Order, sellers other than marketers continued to have the opportunity to justify bids or prices above the maximum Market Clearing Prices.

[5] Megawatt laundering is the activity wherein power from California generating units first is exported out of California and then imported back into California to escape the price mitigation that is applied specifically to in-state generating units.

In two of its orders issued on December 19, 2001,[6] the Commission directed that marketers must bid at a price of $0/MWh to satisfy their obligation to be price-takers. While the Commission's intent, to prevent megawatt laundering, is again correct, as detailed below, the current provision has serious negative impacts on the reliability of the ISO's operation.

## II. The Problems With Requiring $0/MWh Bids From Marketers

### A. Requiring Bids of $0/MWh Removes Any Ability For Marketers To Assure Themselves That They Will Be Dispatched Only When MCP Is At Or Near Their Actual Costs

As explained in the ISO's Request for Rehearing, the ISO relies on imported Energy to maintain the reliability of the ISO Control Area. Given that the bulk of marketers' Energy is hydroelectric generation outside of California, the ISO, therefore, is dependent upon imported hydroelectric generation from outside the ISO Control Area. The ISO wants to accommodate these critical out-of-state suppliers' reasonable expectations that they earn a price no lower than their bid price. Even if such suppliers are price-takers, the ISO can strive to provide some assurance of price protection by evaluating how much Energy it can import and how much Energy it must Dispatch from the stack of Imbalance Energy bids to provide for assurance that the BEEP price will not go below the price of the highest price import bid dispatched. The ISO cannot make this evaluation, however, if marketers are all required to bid $0/MWh. If all marketers seeking to import Energy into the ISO Control Area are required to bid $0/MWh, the ISO reasonably would be obligated to Dispatch all of those $0/MWh bids first,

[6] December 19 Order and "*Order Accepting In Part and Rejecting In Part Compliance Filings,"* 97 FERC ¶ 61,293 (2001) ("December 19 Compliance Order").

but in so doing, both would depress the BEEP price and thereby discourage out-of-state suppliers from offering supply to the ISO.

The following two examples illustrate the problems with requiring marketers to bid at $0/MWh.

**EXAMPLE 1: June 19 Order Permitting Marketers To Place Non-Zero Bids**

**Assumptions:** Two Marketer Bids at $27/MWh and $35/MWh
Two Bids From Resources Eligible to Set MCP, at $25/MWh and $30/MWh
The Last MCP Set At $20/MWh

**Then:** The ISO inserts the four bids into the BEEP stack in merit order. Upon Dispatching the Eligible Resource's bid of $25/MWh, the new MCP is set at $25/MWh, up from $20/MWh. Should the ISO require additional Energy, the ISO will Dispatch the Marketer bid of $27/MWh. If the last Dispatch in the ten-minute settlement interval is the marketer, then the marketer, as a price-taker, is settled at $25/MWh. However, if the ISO, after Dispatching the marketer, while still within the same ten-minute settlement interval, also Dispatches the next eligible resource at its $30/MWh bid, the MCP is then set at $30/MWh and the marketer will be settled at $30/MWh. If the ISO requires more Energy, while still within the same interval, the ISO will Dispatch the marketer bid at $35/MWH, but all the marketers, along with the eligible resources will be settled at the MCP of $30/MWh.

**The Result:** While marketers can not set the MCP and are price-takers, marketers can "signal" the price at which they are willing to transact in the ISO spot market and will be settled at an MCP that is close to or above their actual bid price.

**EXAMPLE 2: December 19 Order Requiring Marketers To Place Zero Bids**

**Assumptions:** Two Marketers Bid At $0/MWh but have costs of $27/MWh and $35/MWh
Two Bids From Resources Eligible To Set MCP, at $25/MWh and $30/MWh
The Last MCP Set At $20/MWh

**Then:** The ISO Dispatches the two marketer bids at zero and, if no other eligible bids are Dispatched in the ten-minute settlement interval, both marketers will be settled at the prevailing MCP, $20/MWh, which is significantly below their costs. If the ISO does Dispatch the first eligible resource at $25/MWh thus setting a new MCP, but the $25/MWh MCP is still below the costs for both marketers. If the

ISO Dispatches the second eligible resource at $30/MWh, the first marketer will have its costs covered but the second marketer will be settled at $5/MWh less that it's costs.

**The Result:** Marketers are unable to "signal" their price, even approximately, and thus are at risk of Dispatch and Settlement at prices that bear no relationship to the marketers' costs of generation and transactions in ISO spot markets.

The heightened uncertainty caused by $0/MWh bids depressing the settlement price is an unacceptable business risk for the majority of marketers from outside the ISO Control Area. As a result of the bidding requirement in the December 19 Order, marketers have shunned the ISO real-time spot markets.

### B. Other Unintended Consequences Of Requiring $0/MWh Bids

Even if a few marketers are not dissuaded from bidding at $0/MWh into the ISO real time markets, the resulting depression of the BEEP price has encouraged Generators whose operating costs are higher than the artificially low BEEP price to engage in negative uninstructed deviations (*i.e.,* under-generate). Generators do this because, with the depressed BEEP price, it is cheaper to buy from the ISO the supply they need to meet their Load obligations than to generate it themselves. Such an increase in failure to deliver Scheduled Energy directly decreases operational predictability. Artificially low BEEP prices contribute to operational problems for the ISO.

Additionally, when faced with a quantity of $0/MWh bids that exceeds demand, the ISO is forced to make arbitrary decisions as to which units to Dispatch. The lack of ability to distinguish among resources all bid in at $0/MWh has required the ISO to create a process of randomly accepting bids. As a result, marketers now have even less incentives to bid into the ISO markets since there is no way for them to offer bids that distinguish themselves from others and thus be assured of Dispatch.

### C. Since Implementation of The Commission's Requirement That Marketers Bid $0/MWh, External Resources Have Sharply Limited Or Completely Ceased Participation In The ISO Real Time Imbalance Market

As shown in Appendix A, the graphs in the attached report by the ISO's Department of Market Analysis detail the sharp reduction in marketer bids into the ISO spot markets following implementation of the $0/MWh requirement. Appendix B presents charts of ISO data tracing the historic and current reduced levels of marketer participation, again linked to the $0/MWh bid requirement.

The ISO depends upon imported Energy, and the decline will have serious operational impacts as snow melt begins in the next few weeks in California. Peak Demand periods, associated with the daily peak Demand and seasonal Demand for air conditioning will combine to create an operational environment where thermal units will be running to meet Demand and hydroelectric units within the ISO Control Area will be generating as a means to control spill in compliance with environmental spill requirements. The ISO will confront, as it has historically, an over-generation problem in the off-peak period during the spring and summer. Out-of-state hydroelectric bids, reflecting generation that relatively quickly can be "turned off" are essential for the ISO to manage the upcoming over-generation because the marketers' bids can be used as DEC bids to reduce the over-generation.

## III. Market Participants Agree The Requirement Should Be Rescinded As Soon As Possible To Help Assure ISO Grid Reliability In the Coming Spring and Summer

At the Commission's technical conference held in San Francisco, California on April 4 and 5, 2002, there was a lengthy discussion of the reliability problems the ISO will face in the immediate future as Load begins to grow in response to the seasonal hot weather should marketers from outside the ISO Control Area not make their generation available to the ISO. Under peak Demand conditions during the spring and summer, all resources within the ISO Control Area are needed to serve Load and the ISO further depends upon out-of-Control Area resources to assure reliability by meeting operating reserve requirements. As indicated in the graphs in the report in Appendix A, external resources, required to bid at $0/MWh into the ISO spot markets, have reduced bids of imported Energy from some 27% to 30% to less than 1% of the ISO's Imbalance Energy requirement. The reduction is directly linked to the Commission's requirement that marketers must bid at $0/MWh. Also as detailed in the attached report, the ISO has discussed the sharp reduction in marketer bids and has been unequivocally informed that the requirement is a major factor driving away imported Energy from the ISO real time market.

Following a full discussion of the operational problems with the bidding requirement, at the Commission's technical conference on April 4-5, 2002, there was unanimous agreement among the various ISO Market Participants, including representatives from the major out-of-state hydroelectric generating resources that formerly were significant participants in the ISO real time markets and from

the largest ISO Control Area Generators, that the $0/MWh bid requirement should be rescinded immediately to enable significant participation by marketers. The assembled Market Participants made it clear that the present bidding requirement posed an unacceptably high degree of business risk for marketers and as such marketers stated that they would refuse to participate in the ISO Imbalance Market until the requirement was terminated. This agreement among participants is not the end of the collaborative effort. Stakeholders and the ISO, with the Commission's staff's encouragement, will continue to meet to develop additional alternatives that begin with the premise that marketers not be required to bid at $0/MWh.

## IV. CONCLUSION

While the ISO supports the Commission's decision, as a price mitigation provision, to require marketers to be price-takers as a way to prevent megawatt laundering, the ISO requests the Commission remove the requirement for marketers to bid $0/MWh so that the ISO can provide some opportunity for the marketers to earn a price at or near their bid price without having the opportunity to set that price. Specifically, the ISO requests the Commission to re-instate the requirements of its June 19 Order, wherein the ISO may Dispatch marketers' bids in merit order through the BEEP stack, based upon marketers' actual bids, while paying all such bids the applicable MCP but not allowing those bids to set the MCP.

Wherefore, for the reasons discussed above, the ISO respectfully requests that the Commission revoke or otherwise revise the December 19 Order's requirement that marketers must bid at $0/MWh into the ISO's markets.

Respectfully submitted,

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Folsom, California 95630
Tel: (916) 608-7147

Dated: April 10, 2002

Appendix A: ISO Department of Market Analysis Report
Appendix B: ISO Intertie Bid Volumes

# APPENDIX A

**April 1, 2002**

## Investigation of Reduced Volume of Intertie Bids

By The
Department of Market Analysis,
California Independent System Operator Corporation

### Executive Summary

In compliance with the Federal Energy Regulatory Commission's ("Commission") December 19, 2001 "Order on Clarification and Rehearing," 97 FERC ¶ 61,275 (2001) the ISO implemented operating procedures where external resources, i.e., those generating resources outside of the ISO Control Area, biding into the ISO's Imbalance Energy Market are restricted to bids of $0/MWh. Moreover, as previously required by the Commission, such external resources whose bids are accepted are price-takers, and will be paid the relevant market clearing price only.

Since the implementation of the Commission requirement that external resources must bid at $0/MWh, external resources have sharply limited or completely ceased their participation in the ISO's Real Time Imbalance Energy Market. This report details the problems occasioned by the Commission's requirements.

### Statement of the Issue

Through a series of orders over the past year and half, the Commission has sought to inhibit "megawatt laundering," which is the practice when an in-state generator evades a price cap by selling to an out-of-state marketer at a high price. The out-of-state marketer then bids its energy back into the ISO BEEP Stack, and claims that its high resale price is just and reasonable, due to the high cost it paid to the in-state generator.

To address the megawatt laundering problem, the Commission required that marketers who wish to sell into the ISO BEEP Stack must be price-takers; that is, they are limited to bidding Energy at prices no higher than the MCP, and may not be selected as the marginal price-setting unit.[7] The ISO had interpreted this direction by allowing marketers to submit bids into the BEEP Stack in the same manner that in-state generators bid. The bulk of marketers' Energy is hydroelectric generation outside of California and can only be delivered on an hourly basis due to operation constraints associated with transferring power through multiple control areas. As a result of the constraints upon making intra-hour schedule changes, as required under the ISO's current 10-minute Dispatch -interval basis, external resources, once Dispatched in merit order, confront the economic risk of being "reversed" Dispatched later in the operating hour and,

[7] 95 FERC ¶ 61,418, slip op at 36.

being unable to comply with such a subsequent Dispatch, are then settled for the ensuring intervals at the Uninstructed Energy price.

The majority of real-time Energy delivered into the ISO Control Area between June 19 and early December 2001 was procured by the Department of Water Resources' California Energy Resources Scheduling Division ("CERS"). Also, because CERS contracted bilaterally with marketers outside of the BEEP market for real-time energy, marketers seldom bid into the BEEP Stack during this period. As a result, the external resources were able to negotiate prices acceptable to their business and economic strategies and to ensure they would be paid such prices for the entire period over which they delivered Energy.

In compliance with the Commission's November 7 "Order Granting Motion Concerning Creditworthiness Requirements and Rejecting Amendment No. 40," 97 FERC ¶ 61, 151(2001), CERS stopped its bilateral real-time Energy procurement operations on December 12, 2001. At this same time, in response to the problem with external resources not being able to comply with intra-hour schedule changes, the ISO modified its real-time Dispatch operating procedure, M-403, such that once external resources were Dispatched, the ISO would not issue any subsequent within-hour dispatch instructions. Under this modification to the operating procedure, external resources are paid at ten-minute instructed prices throughout the entire hour, even as the ISO continued to pre-dispatch such external resources in economic merit order. This modification to the operating procedure resulted in a dramatic increase in the volume of imported Energy bid into the BEEP Stack, as shown in charts 1 and 2 below.

The M-403 provisions were not extended to generation within the ISO Control Area, because these resources are not subject to the same operational constraints as are resources outside of the ISO Control Area and because resources within the ISO Control Area generally are capable of complying with 10-minute Dispatch instructions. On December 18, 2001 Dynegy, Mirant, and Williams filed a complaint with the Commission against the ISO, alleging that the ISO was acting unlawfully by implementing changes to its operating procedure M-403 that resulted in preferential treatment to marketers of imported energy.

Subsequently, in an order issued on December 19, 2001, the Commission clarified that the mechanism the ISO must employ to classify marketers as price-takers is to require marketers that do not resell in other bilateral markets and choose to participate in the real-time spot market to bid Energy into the BEEP Stack at a price of $0/MWh. A marketer whose Energy is Dispatched would then be paid the MCP, up to the mitigated MCP. This mechanism also applies to load-serving entities that choose to participate in the real-time spot market by reselling excess Energy that they procured, rather than generated. The Commission reiterated its assertion in this Order that it will not consider justification of costs above the mitigated reserve deficiency MCP by marketers. The Commission also specified that marketers that own or control generation and engage in marketing through a portfolio of resources bid as price-takers. By contrast, entities that are able to trace a transaction to a specific generating unit will be treated as generators. This Commission order effectively requires all hydroelectric

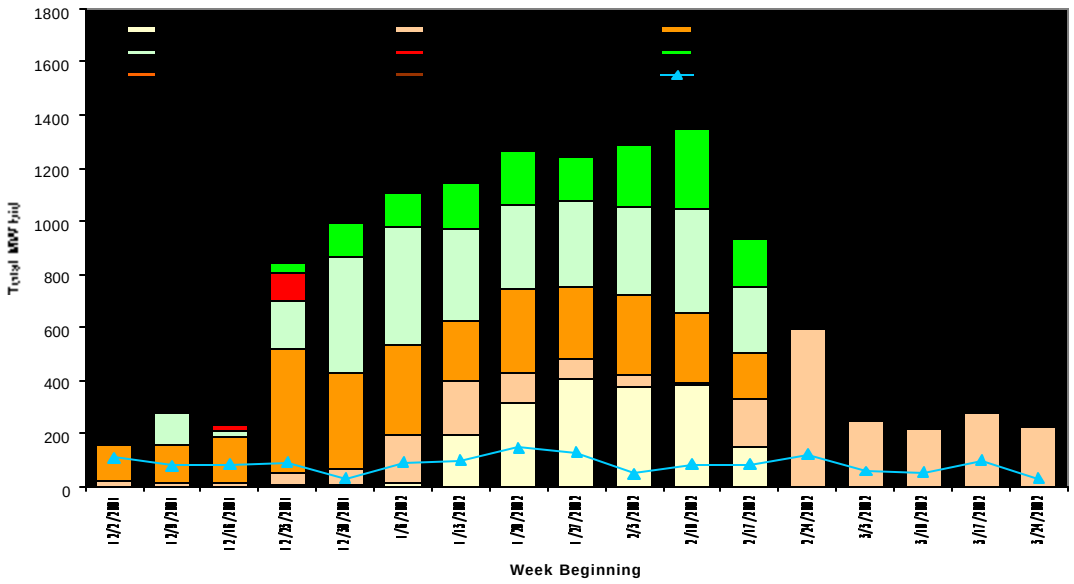
generation potentially coming into the ISO Imbalance Energy Markets from the Pacific Northwest to bid into the ISO BEEP stack at $0/MWh.

The ISO complied with the Commission's Order in its Compliance filing of January 25, 2002; however, in its Request for Clarification and Rehearing on January 18, the ISO expressed serious concern regarding the Commission's zero-bid requirement for marketers. Specifically, the ISO raised the issue that this requirement would likely result in a substantial decrease in the volume of much needed imported Energy offered into the BEEP Stack. The zero-bid restriction was implemented midnight February 22, 2002. Moreover, in response to another Commission order, the ISO rescinded its provisions in M-403 that it had implemented on December 12, which had protected external resources from reverse, or cancelled, Dispatch instructions after the first interval of the operating hour.

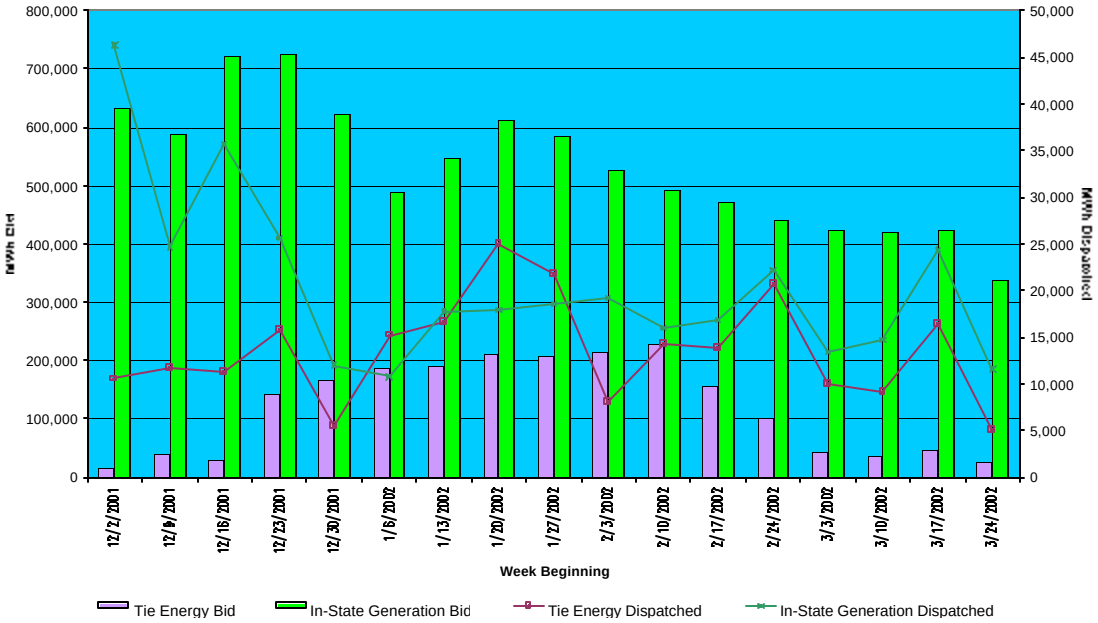
As a result of ISO compliance with these Commission orders, the volume of imports bid into the ISO BEEP Stack fell nearly as sharply as it had risen the month before.

The three charts on the next page show the impact of the changes in the M-403 procedure with respect to the volume of imports bid from December 2001 through early March 2002. The first chart shows the significant decline in supplemental Energy bid volume from out-of-state resources beginning around February 22. The next chart shows the relative decrease in incremental bids from out-of-state resources compared to in-state resources as a result of the February 22 operational changes. As shown in Chart 2, import bids increased significantly in mid-December as importers began bidding real-time Energy previously purchased by CERS into the ISO BEEP stack. However, shortly after the zero-bid requirement was implemented on February 22, import bids into the BEEP stack decreased as quickly as they had increased in December, only now CERS was not purchasing the Energy, thus leaving import Energy all but inaccessible to the ISO for use in balancing system Loads and ensuring adequate operating reserves. The loss of import Energy has led to an increase in prices being bid by generating units within the ISO Control Area and higher market clearing prices. Chart 3 shows the increase in imbalance energy market prices after the imposition of the zero bid restriction on importers.

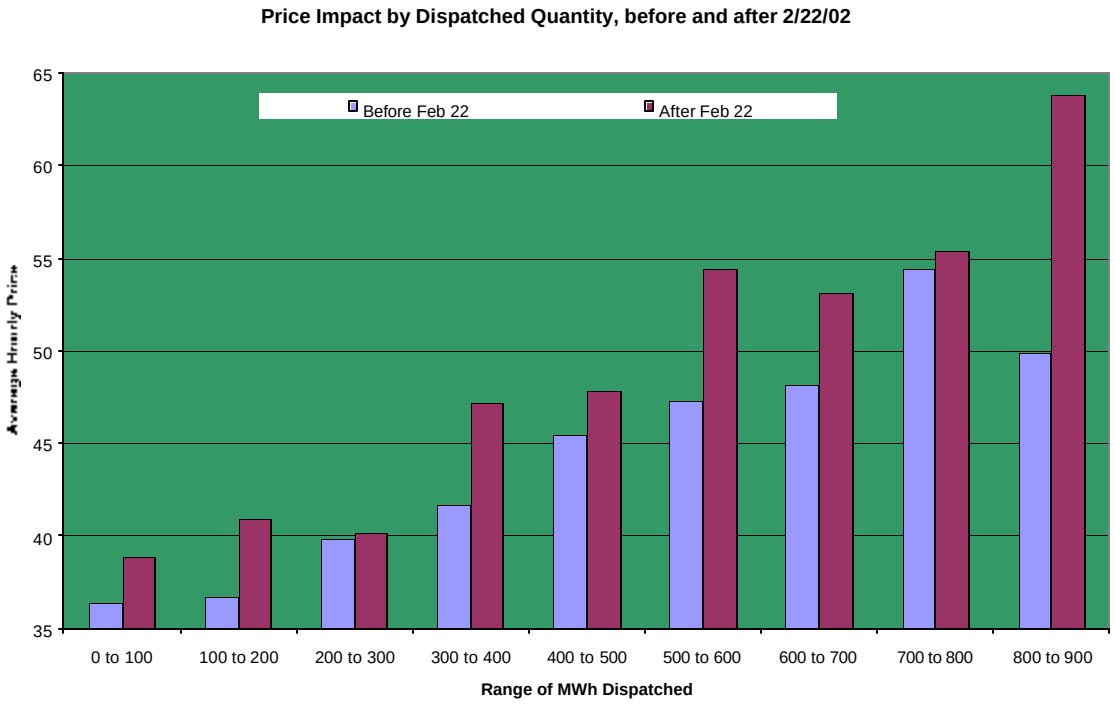
## Chart 1: Average Hourly Supplemental Import Energy Bid into BEEP Stack by Price Bin




## Chart 2: Average Hourly Supplemental INC Energy Bid into BEEP Stack: In-State Generation and Imports below $108/MWh



## Chart 3: Price Impact of Zero Bid Restriction by Dispatch Quantity




The above chart shows a 9% increase in dispatched bid prices after the implementation of zero bid on February 22.

### Summary of Conversations with Marketers on Zero-Bid Requirements

Beginning on March 26 and continuing to date, the ISO initiated separate conference calls with outside ISO Control Area marketers who previously had been active in the ISO Imbalance Energy Markets but whose participation had dropped sharply or been withdrawn completely since implementation the recent Commission orders on bids from marketers and external resources. In conversations with three such entities, who previously accounted for a significant amount of the energy bid into the ISO Imbalance Energy Markets, each of the marketers asserted that the most significant impediment to bidding into the ISO's Imbalance Energy Market was the zero-bid restriction. The marketers acknowledged that they could accept, if necessary, not being eligible to set the market clearing price, but that the zero-bid requirement imposed undue economic risk for transactions with the ISO, since they have no way of asking for a minimum price at which they would be willing to sell Energy into the ISO's Imbalance Energy Market. A common theme expressed by each of the marketers contacted was that they needed price and quantity certainty.

The marketers also expressed some discomfort with ten-minute dispatch and their inability to adjust their schedules mid-hour. However, some of the marketers indicated that they reduce the risk of operation under the 10-minute

Dispatch rules by estimating the risk of being uninstructed during an hour and incorporating it into their bid prices.

## SUMMARY

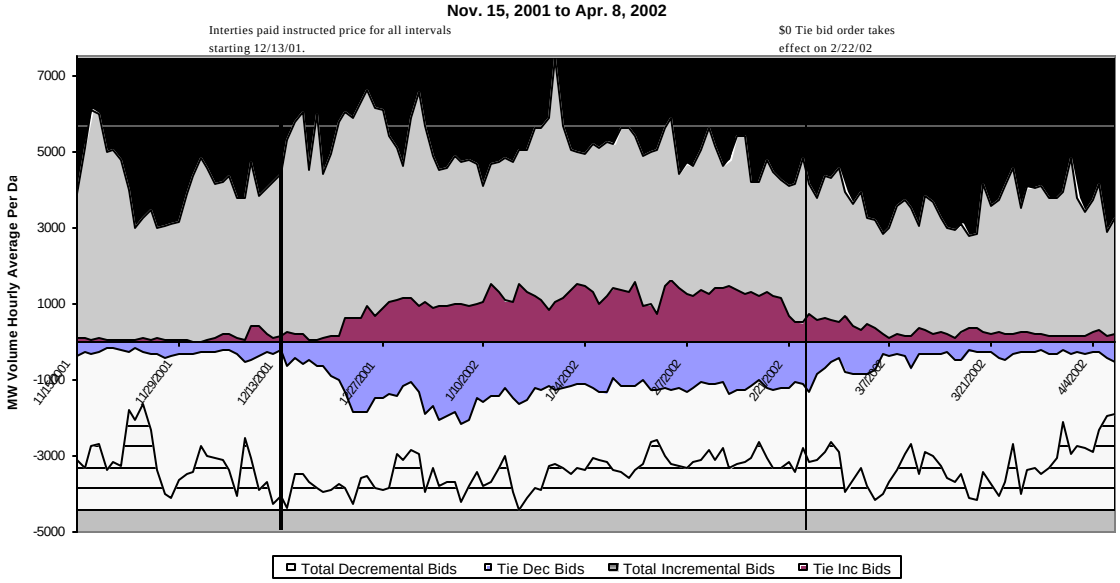
The ISO relies upon import Energy to serve the Imbalance Energy Market and to ensure that operating reserves conform to all applicable requirements and standards. As indicated in the graphs in this report, external resources have reduced bids of imported Energy from some 27% to 30% of the ISO's total Load to less than 1%. The reduction is directly linked to the Commission's requirement that marketers, including those representing outside ISO Control Area hydroelectric and other types of generating resources, unless otherwise eligible to set the ISO market clearing price, must be bid into the ISO Imbalance Energy Markets at $0/MWh. This requirement includes virtually all hydroelectric generation from the Pacific Northwest, a source of import Energy that is critical to meeting California's Loads in the hot weather months of spring and summer.

The loss of import Energy has led to an increase in prices being bid by generating units within the ISO Control Area. Critically, as California moves into the hot spring and summer months of 2002, the lack of import Energy will directly impact reliability of the ISO Controlled Grid when all available generation within the ISO Control Area is required to serve Load and the ISO needs import Energy for balancing the system and to meet operating reserve criteria.

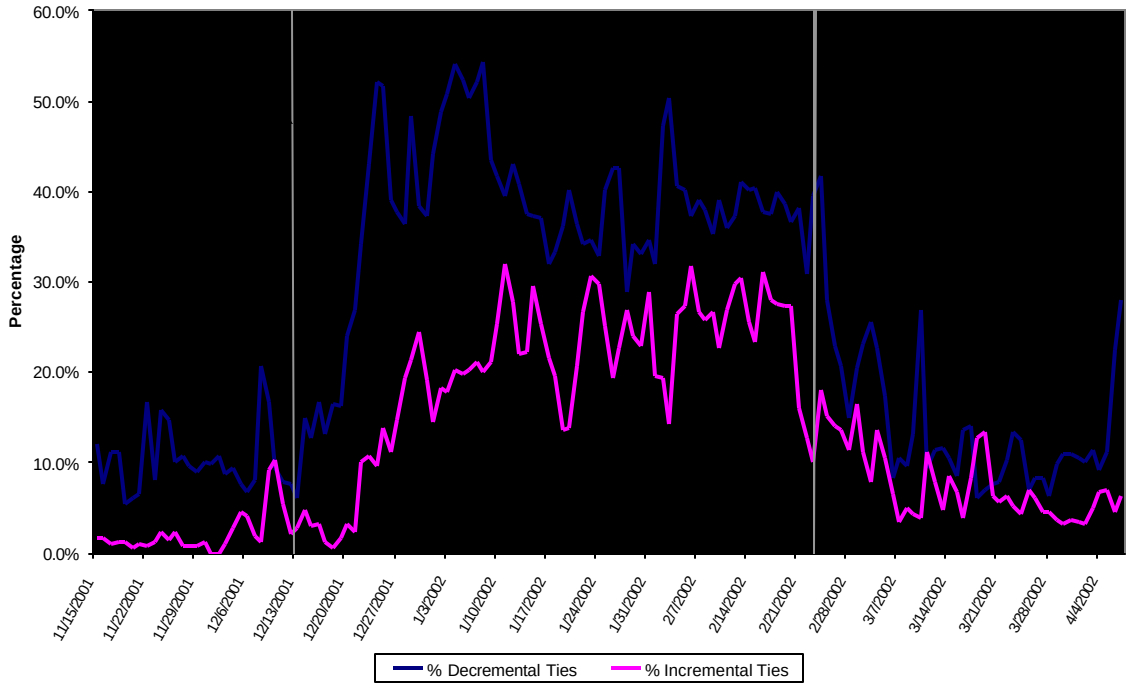
The ISO, once again, urges the Commission to rescind its requirement that external resources, including hydroelectric generating resources, must be bid at $0/MWh into the ISO Imbalance Energy Markets.

# APPENDIX B

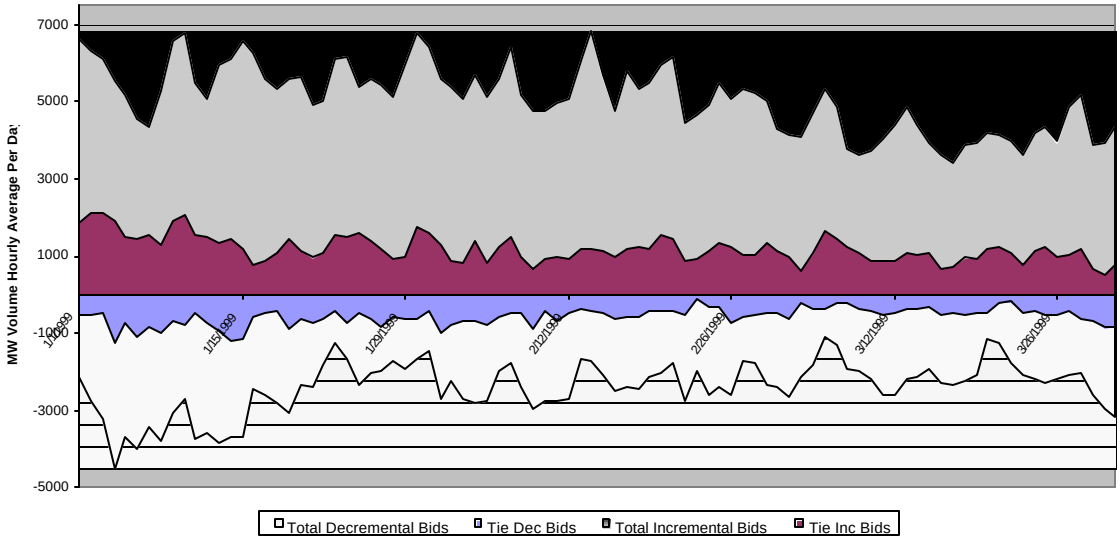
**Total Supplemental Bid Volume vs. Bid Volume on the Interties**
**Nov. 15, 2001 to Apr. 8, 2002**




**Percentage of Total Supplemental Bids Provided by Intertie Resources**
**Nov. 15, 2001 to Apr. 7, 2002**



**Total Supplemental Bid Volume vs. Bid Volume on the Interties**
**Jan. 1, 1999 to Mar. 31, 1999**



April 10, 2002

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

**Re:** ***San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and the California Power Exchange***
**Docket No. EL00-95-000**

***Investigation of Practices of the California Independent System Operator and the California Power Exchange***
**Docket No. EL00-98-000**

Dear Secretary Salas:

Enclosed for electronic filing please find The California Independent System Operator Corporation's Motion to Expedite Consideration of the Requirement that Marketers Must Bid at $0/MWh as Requested in its January 18, 2002 Motion for Clarification and Request for Rehearing of the Order on Clarification and Rehearing.

Thank you for your assistance in this matter.

Respectfully submitted,

Margaret A. Rostker
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(916) 608-7147

## CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in the above-captioned dockets.

Dated at Folsom, California, on this 10th day of April, 2002.

_____

Margaret A. Rostker
Counsel for The California Independent
System Operator Corporation
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Folsom, CA 95630