UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

California Independent System Operator Corporation	**)**	**Docket No. ER03-1046-___**

MOTION FOR CLARIFICATION OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION

Pursuant to Rule 212 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.212, the California Independent System Operator Corporation ("CAISO")[1] hereby requests that the Commission clarify its "Order on Rehearing and Compliance on Proposed Tariff Amendment No. 54" issued on August 5, 2004 in the captioned proceeding ("Amendment No. 54 Rehearing Order").[2]

In support here, the CAISO respectfully states as follows:

I. BACKGROUND

On December 19, 2001, the Commission issued an Order on Clarification and Rehearing of four prior orders.[3] The Commission granted rehearing that "generators subject to the must offer requirement can recover their actual costs for complying with the ISO's instructions to keep their units on-line at minimum load status to be available for dispatch instructions." 97 FERC at 62,241. On January 25, 2002, the ISO submitted

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[1] Capitalized terms not otherwise defined herein are defined in the Master Definitions Supplement, ISO Tariff Appendix A, as filed on August 15, 1997, and subsequently revised.

[2] *California Independent System Operator Corporation*, 107 FERC ¶ 61,274 (2004).

[3] *San Diego Gas & Electric Company, et al.*, 97 FERC ¶ 61,275. The four prior orders had been issued on August 23, 2000, November 1, 2000, and two on December 8, 2000.

a filing to comply with the Commission's December 19, 2001 Order. In that filing, the ISO proposed to net profits from sales of Imbalance Energy in one hour against Minimum Load Costs in other hours over a 24-hour period. On May 15, 2002, the Commission issued an order rejecting the ISO's proposal to net Minimum Load Costs over a 24-hour period. *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*, 99 FERC ¶ 61,158 (2002).

On July 8, 2003, the ISO submitted Amendment No. 54 to the ISO Tariff ("Amendment No. 54"). Amendment No. 54 provided details for the implementation of certain of the market redesign elements initially proposed in the May 1, 2002 filing (the Phase 1-B redesigns). More specifically, Amendment No. 54 proposed to treat the minimum operating level Energy of a Generating Unit operating during a Waiver Denial Period in accordance with the must-offer obligation as Instructed Imbalance Energy and provide an uplift to ensure that Energy was paid its full Minimum Load Costs. This would eliminate making two separate payments for that minimum operating level Energy – one for the Minimum Load Costs and one at the Uninstructed Imbalance Energy price.

On October 21, 2003, Dynegy and Williams filed untimely protests of Amendment No. 54 alleging that the ISO's proposed treatment of Minimum Load Costs in Amendment No. 54 violated the Commission's May 15, 2002 order prohibiting the ISO to net Minimum Load Costs.

On October 22, 2003, the Commission issued an order accepting much of Amendment No. 54 and directing the ISO to file complying tariff language within 30 days. *California Independent System Operator Corporation*, 105 FERC ¶ 61,091 (2003)

("Amendment No. 54 Order"). The ISO submitted its compliance filing on November 21, 2003 ("A-54 Compliance Filing").

On August 5, 2004, the Commission issued an order on rehearing of Amendment No. 54. *California Independent System Operator Corporation*, 108 FERC ¶ 61,142 (2004) ("Amendment No. 54 Rehearing Order"). In its description of the procedural history provided in that order, the Commission indicated it "did not reach a determination on the revision to ISO Tariff Section 5.11.6.1.1" in the Amendment No. 54 Order and rejected the treatment of Minimum Load Costs the ISO proposed in Amendment No. 54. Amendment No. 54 Rehearing Order at P 76.

II. MOTION FOR CLARIFICATION

In their protests on Amendment No. 54, Duke, Reliant and the California Generators complained about the CAISO's proposal to offset Minimum Load Cost payments for Instructed Imbalance Energy payments during the same operating hour. In the Amendment No. 54 Rehearing Order, the Commission rejected "the provision to net ex-post revenues against [M]inimum [L]oad [C]osts." The Order states, "[w]e agree with intervenors that the proposed tariff language is contrary to the representations made by the CAISO in its transmittal letter. We reject the provision to net ex-post revenues against minimum load costs." Amendment No. 54 Rehearing Order at P 78.

In Amendment No. 54, the ISO proposed to use profits from Imbalance Energy sales <u>above</u> the minimum operating level to help pay <u>bid cost recovery</u> in other hours over a 24-hour period – a proposal the Commission appeared to accept. *See* Amendment No. 54 Order at P 90-94. The CAISO did not propose in Amendment No. 54 to use profits from Imbalance Energy sales above a unit's minimum operating

level to pay Minimum Load Costs in another hour. Thus, if the Commission intends that "ex-post revenues" are revenues for Imbalance Energy sales above the minimum operating level, then the Commission would be rejecting something that the CAISO did not propose.

Conversely, the term "ex-post revenues" could be interpreted to mean all market revenues paid to a Generating Unit, including the Uninstructed Imbalance Energy payment that is currently paid for the minimum operating level Energy in addition to separately paying for the Minimum Load Costs.[4] It was this latter interpretation that Amendment No. 54 was meant to address by eliminating a double payment. The double payment occurs because the ISO pays the Minimum Load Costs for the minimum operating level Energy and, because the minimum operating level Energy is not treated as Instructed Imbalance Energy or Scheduled in a forward market, also pays the Uninstructed Imbalance Energy price for the same quantity of minimum operating level Energy. Amendment No. 54 would have eliminated the double payment by treating the minimum operating level Energy as Instructed Imbalance Energy, but Amendment No. 54 would still have guaranteed full Minimum Load Cost payment by paying an uplift when the Instructed Imbalance Energy price would not have covered the Minimum Load Costs for Energy delivered at the Generating Unit's minimum operating level. Additionally, in those intervals in which the Instructed Imbalance Energy exceeded the equivalent $/MWh Minimum Load Cost price, the supplier would keep the revenues above its Minimum Load Costs. What Amendment No. 54 proposed

[4] As the CAISO explains below, this Uninstructed Imbalance Energy payment is a by-product of the CAISO treating minimum operating level Energy as unscheduled Energy so that the CAISO can clearly identify that Energy as being eligible to be paid its Minimum Load Costs.

was to eliminate a double payment, not to compromise full payment of Minimum Load Costs.[5]

The CAISO has historically paid twice for the minimum operating level Energy for a simple reason - because this Energy is not scheduled in the forward markets. The minimum operating level Energy is not Scheduled so the CAISO can clearly identify it as being eligible to be paid its Minimum Load Costs as directed by the Commission in the December 19 Order. As the CAISO has previously explained to the Commission,[6] if this minimum operating level Energy was Scheduled in a bilateral transaction, the CAISO would have no way to distinguish this minimum operating level Energy that is eligible to be paid its Minimum Load Costs from Energy Scheduled in a bilateral transaction that is not eligible for recovery of Minimum Load Costs by Commission order.[7] Because this minimum operating level Energy is not Scheduled, the ISO's market settlements system recognizes and treats it as Uninstructed Imbalance Energy and pays it the Uninstructed Imbalance Energy Price.

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[5] An example will illustrate the ISO's proposal in Amendment No. 54. Assume a Generating Unit has a minimum operating level of 30 MW. The Minimum Load Costs at that minimum operating level equate to a price of $50/MWh. The Instructed Imbalance Energy Price is $45/MWh and the Uninstructed Imbalance Energy Price is $40/MWh. Prior to Amendment No. 54, if the ISO required this Generating Unit to be on line at its minimum operating level under the must-offer obligation, then the ISO would pay the Uninstructed Instructed Imbalance Energy price of $40/MWh for 30 MWh of minimum operating level Energy, plus pay the Minimum Load Costs of $50/MWh for the same minimum operating level Energy. In Amendment No. 54, the ISO proposed that it would treat the minimum operating level Energy as Instructed Imbalance Energy and pay that Energy the price of $45/MWh. Because the Instructed Imbalance Energy price of $45/MWh is less than the Generating Unit's equivalent $50/MWh Minimum Load Costs, the ISO would also pay an uplift of $5/MWh on the 30 MWh minimum operating level Energy, thereby providing full compensation for the Generating Unit's Minimum Load Costs. By rejecting the changes proposed to Section 5.11.6.1.1 in Amendment No. 54, the ISO interprets the Commission's directive in the Amendment No. 54 Rehearing Order to return to the pre-Amendment No. 54 treatment and pay both the Minimum Load Costs and the Uninstructed Imbalance Energy payment for the same minimum operating level Energy.

[6] *See, e.g.*, the December 15, 2003 Motion For Clarification, Request for Rehearing, Motion For Stay And Motion For Expedited Consideration Of The California Independent System Operator Corporation at 4-6.

[7] *San Diego Gas & Electric Company, et al*., 97 FERC ¶61,293 at 62,363 (2001).

It is axiomatic that the Commission should provide a reasoned basis for its determinations.[8] In the Amendment No. 54 Rehearing Order, however, the Commission rejects the CAISO's proposal with no discussion as to the reason why the additional payments to the generators are warranted. One potential rationale for the Commission's rejection of the CAISO's proposal in Section 5.11.6.1.1 in the Amendment No. 54 Rehearing Order, though not stated in that order, is to provide an additional measure of fixed cost recovery for Generators. The Uninstructed Imbalance Energy payment, however, has no relationship to a Generating Unit's capacity costs. This payment was never designed or intended to be an explicit source of fixed cost

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[8] The court will overturn an agency decision as arbitrary and capricious if the agency failed to base its decision on a consideration of relevant factors or committed a clear error of judgment. 5 U.S.C. § 706(2)(A) (2000); *California Dep't of Water Resources v. FERC*, 341 F.3d 906, 910 (9th Cir. 2003) (*"DWR"*). Furthermore, as this Court has stated, "for a court to fulfill its function under the appropriate standard of review," it:

> [M]ust be able to ascertain the reasons for an agency's decision. [It] cannot determine whether an agency has acted correctly unless [it is] told what factors are important and why they are relevant. Therefore, an agency must provide a reasoned explanation for its actions and articulate with some clarity the standards that governed its decision.

Northwest Resource Info. Ctr., Inc. v. Northwest Power Planning Council, 35 F.3d 1371, 1385 (9th Cir. 1994) (quoting *Moon v. United States Dep't of Labor*, 727 F.2d 1315, 1318 (D.C. Cir. 1984)). Thus, in determining whether the agency committed a clear error of judgment, "the question is whether the agency '. . . articulated a rational connection between the facts found and the choice made.'" *Northcoast Envtl. Ctr. v. Glickman*, 136 F.3d 660, 666 (9th Cir. 1998) (quoting *Pyramid Lake Paiute Tribe v. United States Dep't of Navy*, 898 F.2d 1410, 1414 (9th Cir. 1990)). "Normally, an agency rule would be arbitrary and capricious if the agency . . . entirely failed to consider an important aspect of the problem, [or] offered an explanation for its decision that runs counter to the evidence before the agency . . . ." *National Wildlife Fed'n v. FERC*, 801 F.2d 1505, 1511-12 (9th Cir. 1986) (quoting *Motor Vehicle Mfrs. Ass'n of United States v. State Farm Mut. Auto. Ins. Co*., 463 U.S. 29, 43, (1983)). In this regard, this Court has further explained:

> Although we "may uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned," we cannot infer an agency's reasoning from mere silence or where the agency failed to address significant objections and alternative proposals. Rather, "an agency's action must be upheld, if at all, on the basis articulated by the agency itself."

Beno v. Shalala, 30 F.3d 1057, 1073-74 (9th Cir. 1994) (citations omitted) (quoting *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43, 50)

recovery or a surrogate capacity payment; rather, it is only an artifact of how minimum operating level Energy is handled by the CAISO's market settlement systems to comply with the Commission's orders to pay Minimum Load Costs. In 2003, the Minimum Load Costs totaled $125 million. The Uninstructed Imbalance Energy payments made for the same minimum operating level Energy totaled $53.9 million. There is no evidence to show that this $53.9 million payment accurately or adequately provided fixed cost recovery beyond all the other sources of fixed cost recovery currently in place, including existing bilateral contracts, Ancillary Services sales, sales at the Market Clearing Price above the minimum operating level in the Imbalance Energy market, and out-of-sequence dispatch instructions above the minimum operating level that are paid as-bid.

Nevertheless, if it is the Commission's intent to provide an additional stream of fixed cost recovery at this time, the ISO respectfully requests that the Commission not make this payment permanent but reconsider this position at the appropriate time in the future. The Commission has recognized that "bilateral contracts should be the principal means by which generators recover their total costs."[9] The Uninstructed Imbalance Energy price is the price for decremental Energy in the CAISO's Imbalance Energy market. It is a price for buying Energy from the CAISO, not a price for the CAISO to buy Energy from Market Participants. There is no evidence for how this Uninstructed Imbalance Energy payment constitutes a just and reasonable source of fixed cost recovery for Generators. At best it amounts to an arbitrary additional source of revenue for suppliers whose Generating Units happen to be denied waivers of the must-offer

[9] *See Midwest Independent System Operator*, 102 FERC ¶ 61,280 at P 47 (2003); *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services in Markets Operated by the California Independent System Operator Corporation and the California Power Exchange*, 95 FERC ¶ 61,1156 at 61,364 (2001).

obligation rather than a rational, targeted approach that provides necessary funds for any and all Generators with genuine revenue adequacy requirements.[10]

The CAISO recognizes that revenue adequacy for Participating Generators is a critically important issue. It is too important to leave to the spot market or to the Uninstructed Imbalance Energy payment. The ISO is currently engaged with stakeholders to explore bilateral contracts as a far more rational and effective means to address revenue adequacy issues. The CAISO is committed to developing a short-term bilateral contract as an effective interim measure to provide revenue adequacy. The CAISO expects to file a *pro forma* contract at or around the same time it responds, in accordance with the Commission's direction, to the upcoming California Public Utilities Commission decision on resource adequacy.

Eliminating the double payment will be important to create proper incentives as the CAISO moves to a more rational, stable market. If suppliers believe that they may earn more money through the Uninstructed Imbalance Energy payment than they would through a bilateral contract or other market opportunities, it is reasonable to believe they will not seek a bilateral contract, or will use the expected revenue stream of the Uninstructed Imbalance Energy payments (if they are willing to gamble on those payments continuing in a reliable way) as the negotiating floor for a bilateral contract. Such suppliers may be faced with a decision between the certainty of a fixed revenue stream and maximizing profits through spot market sales. They may choose the certainty of a bilateral contract, but they may not. If they do not, then this Uninstructed

[10] To illustrate the arbitrary nature of the Uninstructed Imbalance Energy payment as a proxy for a capacity payment, consider the following example. Assume Unit 1 is a 300 MW unit with a 40 MW minimum operating level, and Unit 2 is a 100 MW unit with the same 40 MW minimum operating level. The unloaded capacity made available by Unit 1 is 260 MW, compared to only 60 MW of capacity made available by Unit 2, yet the Uninstructed Imbalance Energy payments to Unit 1 and 2 are the same.

Imbalance Energy payment will have interfered with what should be, by the Commission's own words, the preferred method for recovering total costs. This game of "wait and see", which creates an improper incentive for suppliers to withhold from markets if they believe that doing so will maximize their revenue through additional extra-market payments, is what prompted the abandonment of the original "A" form of RMR Contract, which provided fixed cost recovery on an as-called basis. If suppliers, faced with the choice between a bilateral contract or other market opportunities and continuing to collect the additional Uninstructed Imbalance Energy payment, choose the Uninstructed Imbalance Energy payment, then this payment would ironically interfere with the intent of the must-offer obligation – to get suppliers participating in the preferred longer-term markets.

Thus, while the CAISO will not challenge the Commission's rejection of Section 5.11.6.1.1 at this time, the CAISO respectfully requests that the Commission should be explicit that it intends that there be a double payment of the minimum operating level Energy to assist generators in the recovery of fixed costs in the absence of other mechanisms to do so. The ISO also requests that the Commission properly identify the conditions whereby the double payment should be eliminated, such as either: (1) the adoption of a short-term bilateral contract product by the CAISO or (2) implementation of a resource adequacy requirement in California.

Accordingly, the CAISO respectfully requests that the Commission to clarify:

(1) whether "ex-post revenues" are those revenues that are for CAISO energy market sales above the minimum operating level, or whether "ex-post revenues" also include the Uninstructed Imbalance Energy payment for the Energy produced by a Generating Units at its minimum operating level so that the Commission intends that the CAISO make two payments – one payment for the Minimum Load Costs and a second payment for

Uninstructed Imbalance Energy - for the same minimum operating level Energy; and

(2) whether the justification for this double payment is to provide suppliers with an additional measure of fixed cost recovery.

Respectfully Submitted,

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CERTIFICATE OF SERVICE

I hereby certify I have this day served the foregoing document on each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Folsom, CA, on this 7th day of September, 2004.

/s/ Brian D. Theaker
Brian D. Theaker