UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

California Independent System Operator Corporation	))	**Docket Nos. ER08-73-000**

MOTION FOR LEAVE TO FILE ANSWER AND ANSWER OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION

Pursuant to Rules 212 and 213 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §§ 385.212 and 385.213 (2006), the California Independent System Operator Corporation ("CAISO") respectfully submits this Motion for Leave to File Answer and Answer to comments and protests addressing the CAISO's Amendment to the MRTU Tariff[1] to Implement Caps on Start-Up and Minimum Load Costs ("SU-ML Cap Amendment"), as filed on October 19, 2007 in the above-captioned docket. Several parties have submitted comments and protests concerning the SU-ML Cap Amendment.[2]

Although an answer is permitted in response to comments, the CAISO recognizes that, unless authorized by the Commission, the Commission's Rules of Practice and Procedures precludes an answer to protests. However, the Commission has accepted

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[1] The Commission has addressed the provisions of the MRTU Tariff in several major orders over the course of the past year: Order Conditionally Accepting the CAISO's MRTU Tariff, *Cal. Indep. Sys. Operator Corp.*, 116 FERC ¶ 61,274 (2006) ("September 21 Order"); Order Granting in Part and Denying in Part Requests for Clarification and Rehearing, *Cal. Indep. Sys. Operator Corp.*, 119 FERC ¶ 61,076 (2007) ("April 20 Order"); Order on Compliance Filings, *Cal. Indep. Sys. Operator Corp.*, 119 FERC ¶ 61,313 (2007) ("June 25 Order"); *Cal. Indep. Sys. Operator Corp.*, 120 FERC ¶ 61,023 (2007) ("July 6 Order"); *Cal. Indep. Sys. Operator Corp.*, 120 FERC ¶ 61,271 (2007) ("September 24 Order"); *Cal. Indep. Sys. Operator Corp.*, 121 FERC ¶ 61,030 (2007) ("October 15 Order").

[2] Comments or protests concerning the SU-ML Cap Amendment were submitted by the following entities: California Department of Water Resources State Water Project ("SWP"); Northern California Power Agency ("NCPA"); NRG Power Marketing Inc., Cabrillo Power I LLC, Cabrillo Power II LLC, El Segundo Power LLC, and Long Beach Generation LLC (collectively, the "NRG Companies"); and the Western Power Trading Forum ("WPTF").

answers that are otherwise prohibited if such answers clarify the issues in dispute, *Southwest Power Pool, Inc*., 89 FERC ¶61,284 at 61,888 (2000); *Eagan Hub Partners, L.P*., 73 FERC ¶ 61,334 at 61,929 (1995), or assist the Commission, *El Paso Electric Co.*, 72 FERC ¶ 61,292 at 62,256 (1995). The CAISO submits that this answer does both, and therefore respectfully requests that, to the extent that this pleading involves answers to protests, the Commission accept this answer.

For the reasons explained below, the Commission should reject comments seeking alterations to the CAISO's proposals as set forth in the SU-ML Amendment.

I. BACKGROUND

In the SU-ML Cap Amendment, the CAISO proposed to amend its MRTU Tariff to provide limits to Start-Up and Minimum Load Costs for suppliers that are eligible to recover such Costs in accordance with the Registered Cost Option, as set forth in Section 30.4 of the MRTU Tariff. As the CAISO explained in the transmittal letter accompanying the filing, it proposed adding these limits in order to protect against the potential exercise of market power by suppliers through the submission of extremely high Start-Up and Minimum Load Costs, particularly in resource-constrained areas of the CAISO grid.

The CAISO's proposal consists of two levels of caps, based on whether a unit is located in a Local Capacity Area ("LCA"). For those units within LCAs, Start-Up and Minimum Load Costs under the Registered Cost Option may not exceed 200 percent of the unit's projected Start-Up and Minimum Load Costs. For units outside of LCAs, Start-Up and Minimum Load Costs under the Registered Cost Option may not exceed 400 percent of the unit's projected Start-Up and Minimum Load Costs. One of the main components in determining projected unit costs is the price of gas. In the SU-ML Cap Amendment, the CAISO explained that it would determine gas prices used in calculating caps based on the highest price for monthly gas contracts at Henry Hub over a forward-looking six month period. Also, in order to address concerns expressed by generators that caps under the Registered Cost Option could increase the risk that spikes in the spot market for gas could cause their actual Start-Up or Minimum Load cost to exceed their Registered Costs, the CAISO is proposing that in the event that daily spot market gas prices increase to the point where a unit's Start-Up or Minimum Load costs (calculated based on daily spot market gas prices) exceed the amount registered in the Master File under the Registered Cost Option, units will have the option to switch to the Proxy Cost Option. If the unit elects to switch, then it will remain under the Proxy Cost Option for the remainder of the six month period.

II. ANSWER

A. The CAISO's Proposal to Require Scheduling Coordinators that Switch to the Proxy Cost Option due to Fuel Price Spikes to Remain With That Option For the Balance of the Six-Month Period is Just and Reasonable

WPTF and NRG, while generally supporting the SU-ML Amendment, take issue with several of the details of the CAISO's proposal. First, WPTF and NRG contend that the CAISO should not limit Scheduling Coordinators who elect to switch from the Registered Cost option to the Proxy Cost option due to fuel price spikes from switching back to the Registered Cost option during the six-month period. WPTF and NRG argue that the CAISO has not explained why it wishes to impose this limitation, and contend that this limitation will expose Scheduling Coordinators to unrecovered costs, because, according to WPTF and NRG, the Proxy Cost option does not account for costs such as gas imbalance penalties and unit wear and tear.[3] As explained below, WPTF and NRGs' argument should be rejected because, in fact, there are good reasons for this limitation, and there is no merit to the allegation that the Proxy Cost option would expose generators to unrecovered costs.

Under the CAISO's proposal, a unit that elects to have its Start-Up and Minimum Load Costs determined under the Registered Cost (*i.e.* market-based) option may switch to the Proxy Cost (i.e. cost-based) option if the unit's costs, as calculated pursuant to the Proxy Cost option, exceed the costs specified by the unit under the Registered Cost Option. However, if a unit does decide to switch to the Proxy Cost option under this provision, then it must remain with the Proxy Cost option for the balance of the six month period. The CAISO agreed to include this "safety net" option in order to address concerns expressed by some generators that caps under the Registered Cost Option could increase the risk that spikes in the spot market for gas could cause their actual Start-Up or Minimum Load costs to exceed their Registered Costs. However, even without caps on Start-up and Minimum Load Costs, units that selected the Registered Cost option would still face the risk that fuel prices could increase over the six month lock-in period such that their costs at spot market prices exceeded their bids. The "safety net" option – which allows generators to switch to the Proxy Cost option under this scenario – essentially eliminates this risk. By allowing units to switch to the Proxy Cost option under these conditions, the CAISO has essentially eliminated all of the risk associated with gas price spikes, even for those generators that submit costs below the Registered Cost Option caps.

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[3] WPTF at 4-6; NRG at 2.

The CAISO believes that it would be unreasonable to not only eliminate all of the gas price risk inherently associated with the Registered Cost option, but to do so in a manner that would allow generators to exercise potential market power or game market rules by switching back to the Registered Cost option when decreases in spot market gas prices cause their actual Start-up and Minimum Load Costs to drop below their registered levels under the Registered Cost option. This is, however, precisely what WPTF and NRG ask for in their proposal to allow units to switch between the Registered Cost and Proxy Cost options depending on gas prices. If the limitation on switching between these two options were to be eliminated as WPTF and NRG request, units would be in the enviable position of having a "safety net" that eliminates all of the downside risk of gas price spikes under the Registered Cost option, while being able to immediately switch back to the Registered Cost option so as to take advantage of any subsequent reduction in gas prices. Under such circumstances, there may be no reason for generators with the potential to exercise market power to remain under the Proxy Cost option, because they would always have the guarantee of being able to recover their gas costs, and at the same time, maximizing their ability to profit from uncompetitively high Start-up and Minimum Load registered levels under the Registered Cost option.

Thus, the ability to switch between the Proxy Cost and Registered Cost options without limit, as proposed by WPTF and NRG, could encourage units to submit uncompetitively high Start-up and Minimum Load Costs under the Registered Cost option, rather than selecting the Proxy Cost option. This incentive runs counter to the entire purpose of the SU-ML Cap Amendment, which is to deter the exercise of market power and bidding strategies that lead to market inefficiencies.

The requirement that units opting to switch from the Registered Cost option to the Proxy Cost option remain under the Proxy Cost option for the remainder of the six month election period represents a key component of the CAISO's overall proposal. The rationale for this requirement was specifically noted in the stakeholder process by the CAISO's Department of Market Monitoring, which noted that:

> Although this [overall proposal] could conceivably result in more units selecting the bid-based option [*i.e.* Registered Cost option] . . . . local market power would effectively be mitigated for the remainder of this period in the event this option was triggered. Thus, the option seems to provide lower overall risk of excessive local market power, while still reducing the gas price risk inherent in the six month bid-based [*i.e.* Registered Cost] option. [4]

In its opinion in support of the proposal, the CAISO's Market Surveillance Committee ("MSC") endorsed this requirement, reasoning that "generation unit owners should not be allowed to exercise the option of switching back to cost-based levels anytime after the fuel spot price has exceeded the threshold implicit in the bid cap relevant to that market participant."[5]

Moreover, WPTF and NRG are incorrect that the CAISO's Proxy Cost option does not provide adequate cost recovery for generators. The CAISO's MRTU software will, in calculating the Proxy Cost option for generators, take into account both gas costs as well as other costs incurred by generators during Start-up and Minimum Load operations. With respect to Start-Up costs, the CAISO will include both gas costs as well as auxiliary electrical energy costs. In calculating Minimum Load Costs, the CAISO will

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[4] MRTU Market Power Mitigation: Bid Caps for Start-up and Minimum Load costs, Draft Revised Proposal, Department of Market Monitoring, August 8, 2007 at 3. This document is available on the CAISO website at http://www.caiso.com/1c34/1c34c8c15a770.pdf

[5] MSC Opinion on Start-up and Minimum Load Bid Caps under MRTU, August 20, 2007 at 3. This document is available on the CAISO website at http://www.caiso.com/docs/2000/09/14/200009141610025714.html

account for gas costs as well as O&M costs.[6] Thus, there is no merit to WPTF and NRG's argument that it is necessary to allow units to switch freely between the Registered Cost and Proxy Cost options in order to avoid exposure to unrecoverable costs under the Proxy Cost option. Finally, it is important to understand that Start-up and Minimum Load Costs represent the *minimum* amount that a generator committed by the CAISO to Start-up or operate at Minimum Load will be paid pursuant to the Bid Cost Recovery mechanism. In practice, units can earn significant revenues in excess of Start-up and Minimum Load Costs through dispatched energy bids and for Ancillary Services.

B. The CAISO Has Included Sufficient Details Regarding Gas Prices Used in Setting Start-Up and Minimum Load Bid Caps in its Most Recent Draft BPM for Market Instruments

Under the SU-ML Cap Amendment, Start-up and Minimum Load caps will be determined based on a unit's "Projected Proxy Costs." For natural gas fired resources, the Projected Proxy Cost will be based on applying the highest average price for monthly forward gas contracts at Henry Hub for the six-month period during which the Registered Cost option is in effect to the fuel consumption parameters used for calculating the Proxy Cost, as set forth in the Market Instruments BPM4. WPTF and NRG argue that the proposed definition of "Projected Proxy Cost" is ambiguous, reasoning that the phrases "based on," "highest average" and "as set forth in a Business Practice Manual" do not fully explain how the gas price used in the Projected Proxy Cost calculation will be determined. WPTF and NRG ask the Commission to eliminate this ambiguity by

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6 The details concerning these costs are currently in the Scheduling and Infrastructure Bidding Rules also known as the SIBR rules, attached to the Market Instruments BPM. See Rules 41120-23 for fuel costs and auxiliary power costs and Rules 41205-07 for minimum load and O&M costs. The O&M costs will be in the Master File ($2 per MWh or $4 per MWh) as specified in Section 39.7.1.1 of the MRTU Tariff. The CAISO would agree, on compliance to add detail to Section 30.4 indicating that auxiliary power costs and O&M cost are included in the Proxy Cost option.

directing the CAISO to calculate Projected Proxy Cost using the highest daily closing price for the NYMEX Henry Hub Natural Gas Futures contract reported during the 30-day period immediately preceding the Registered Cost Option bid due date for any month in the six-month period during which the Registered Cost Option would be in effect and to include language so stating in the MRTU tariff.[7] WPTF maintains that if the Commission does not direct the CAISO to adopt this recommendation, the Commission should instead require the CAISO to expressly set forth in the MRTU Tariff, as opposed to a Business Practice Manual, how the "highest average" price underlying the Projected Proxy Cost will be determined.[8]

Specific details concerning how the CAISO will calculate the Projected Proxy costs have been included in the most recent draft of the BPM for Market Instruments, as posted on the CAISO website on November 15, 2007. As shown in this BPM, the CAISO will calculate and update the projected gas price used in determining maximum startup and minimum load bids under the Registered Cost option on a monthly basis using a two-stage process:

1) Daily closing prices for monthly NYMEX Natural Gas Futures contracts at Henry Hub for each of the next six monthly contracts are averaged over the first twenty one days of the month. A separate average is calculated for each of the six monthly contracts, based on the average closing price of the contract over the first twenty-one days. For example, at the end of the month of May, six separate averages would be calculated for the daily closing prices over the first twenty one days of May for monthly NYMEX natural gas contracts at Henry Hub for the contract months of June through October.

2) The maximum of the six monthly averages are used as the gas price applicable for calculating Start-up and Minimum Load caps. For example, the maximum of the six separate averages calculated for the contract months of June through October would be used as the projected price of gas used in calculating Start-up and Minimum Load caps for units submitting Start-up and Minimum Load

7 WPTF at 6-7; NRG at 3.

8 WPTF at 7.

> Costs under the Registered Cost option any time from the end of May until the time when the cost was updated at the end of the following month.

The averaging of closing NYMEX prices in the first stage of this process is designed to smooth out the effect of extreme day-to-day spikes in futures prices that may occur over the course of this 21 day period. Meanwhile, the projected price of gas used in calculating Start-up and Minimum Load Bid caps is based on the *maximum* of these resulting six month averages in order to ensure that caps provide significant "headroom" above actual gas prices during most or all of the subsequent six month period, while providing appropriate protection against excessive Start-up and Minimum Load Costs that reflect the exercise of market power.[9]

The CAISO believes that this process is preferable to the one advocated by WPTF for two reasons. First, without the averaging performed in the first stage of the CAISO's methodology, the resulting Start-up and Minimum Load Cost caps could be significantly higher due to short day-to-day spikes that can occur in futures prices over the course of a month. Thus, adopting the methodology proposed by WPTF could effectively raise the CAISO's proposed caps beyond the 200% and 400% levels determined by the CAISO, pursuant to an extensive stakeholder process, to be the most reasonable options. Because the CAISO's proposal already provides for significant "headroom" under the Registered Cost option, and includes a "safety net" provision to eliminate risk for all generators

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[9] This two-step methodology reflects the same methodology that was used by the CAISO in its extensive analysis of the volatility of actual spot market gas prices over the last five years relative to prices that would result from the methodology proposed by the CAISO for setting Start-up and Minimum Load Cost caps. Results of this extensive analysis shows that even under the proposed 200% cap for units within LCAs, the chance that spot market prices would increase to the point where a unit's actual Start-up and Minimum Load Costs would exceed the relevant caps over the six month "lock in" period is extremely unlikely, and that any such scenarios would likely persist for only a few days.

selecting the Registered Cost option, the modification proposed by WPTF should be rejected.

Additionally, WPTF's proposal would not provide the CAISO with sufficient time to calculate the projected price of gas. Under the CAISO's proposal, which utilizes closing NYMEX futures prices over the first 21 trading days of each month, the CAISO will have approximately five business days to complete the calculation process and post the projected price on its website. It would be administratively unfeasible to utilize prices over the 30-day period immediately preceding the Registered Cost Option bid due date for any month in the six-month period during which the Registered Cost Option would be in effect as proposed by WPTF, because this would afford the CAISO almost no time whatsoever to perform and post the necessary calculations.

Finally, the CAISO disagrees with WPTF's assertion that the Commission should require the CAISO to set forth in the MRTU Tariff additional detail concerning the gas prices to be used in calculating the Projected Proxy Cost. The definition of Projected Proxy Cost, as set forth in the SU-ML Cap Amendment, contains sufficient detail to satisfy the Commission's "rule of reason," which requires the filing of only those practices that *significantly* affect rates and service, that are realistically susceptible of specification, and that are not so generally understood in any contractual arrangement as to make recitation superfluous.[10] That definition makes clear the fundamental approach to determining gas prices used in calculating Start-up and Minimum Load Cost caps: that they are to be based on the highest average price for monthly forward gas contracts at

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[10] *Prior Notice and Filing Requirements Under Part II of the Federal Power Act,* 64 FERC ¶ 61,139 at 61,988 (1993). The Commission has recently confirmed that it will continue to apply its rule of reason in a manner that would not require all of a transmission provider's business practices to be included in its tariff. *See Preventing Undue Discrimination and Preference in Transmission Service*, Order No. 890, 72 FR 12266 (March 15, 2007), FERC Stats. & Regs. ¶ 31,241 (2007) ("Order No. 890"), *reh'g pending.*

Henry Hub for the relevant six month period. The additional detail set forth in the BPM does not in any way modify or fundamentally expand upon this methodology. Rather, the BPM merely clarifies certain details consistent with the definition already provided in the proposed tariff language. Therefore, the CAISO's proposal to reserve certain details concerning the gas price determination for a BPM is consistent with the Commission's rule of reason, and WPTF's request should be denied.

III. CONCLUSION

Wherefore, for all the reasons stated above, the CAISO respectfully requests that the Commission accept the SU-ML Cap Amendment as filed.

Respectfully submitted,

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Dated: November 26, 2007

Certificate of Service

I hereby certify that I have this day caused a copy of this document to be served upon all parties listed on the official service list compiled by the Secretary in the above-captioned proceeding, 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 26th day of November, 2007 at Washington, D.C.

/s/ Michael Kunselman
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