UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

California Independent System Operator Corporation	)	Docket No. ER02-1656-000
	)	
Investigation of Wholesale Rates of Public Utility Sellers of Energy and Ancillary Services in the Western Systems Coordinating Council	)	Docket No. EL01-68-017

REQUEST FOR REHEARING AND CLARIFICATION OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION

Pursuant to Section 313(a) of the Federal Power Act, 16 U.S.C. § 825l (a), and Rule 713 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission ("Commission") 18 C.F.R. § 385.713, the California Independent System Operator Corporation ("CAISO")[1] hereby requests that the Commission grant rehearing and clarification of its "Order on the California Comprehensive Market Redesign Proposal" issued on July 17, 2002 in the captioned proceeding ("July 17 Order").

In support here, the CAISO respectfully states as follows:

I. BACKGROUND

On May 1, 2002, the CAISO filed its Comprehensive Market Design proposal ("MD02 Filing") with the Commission. The market design changes proposed in the MD02 Filing addressed deficiencies in the CAISO's existing market design and were intended to enable the CAISO to perform its core function -- providing open access, reliable and non-discriminatory transmission service -- more effectively. In particular,

the proposed market design changes were designed to promote the development of more stable markets by fostering forward markets for Energy, facilitating development of a capacity requirement for operating a reliable Control Area, eliminating the balanced Schedule requirement, allowing multi-part bids and accommodating demand bidding. Further, the CAISO noted that its proposal would provide for improved Congestion management and price transparency by utilizing a full-network model and locational marginal pricing ("LMP").

The CAISO proposed to implement the MD02 proposal in three phases. Phase I, with a proposed effective date of October 1, 2002, included market power mitigation measures designed to prevent physical and economic withholding, an interim residual unit commitment ("RUC") process, a modified Must Offer Obligation, Real Time economic dispatch, use of a Single Energy bid curve, penalties for failure to comply with Schedules, as modified by Dispatch instructions, a rolling 12-month Market Competitiveness Index ("12-month MCI") and a cap on negative decremental bids.[2] In its MD02 Filing, the CAISO advocated extension of the existing west-wide price mitigation scheme beyond September 30, 2002. In the alternative, the ISO proposed that the Commission adopt a damage control bid cap ("DCBC") of $108/MWh and automated mitigation procedures ("AMP")

Phase II, which had a target date of Spring 2003, included*, inter alia*, elimination of the market separation rule and balanced Schedule requirement and implementation of simultaneous Congestion Management, Energy market, Ancillary Services

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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] The ISO also proposed to implement on July 1, 2002 certain locational market power mitigation measures.

procurement and long-term unit commitment on a zonal basis. Phase III, which had a target effective date of Fall 2003, provided for implementation of the full network model, redesigned firm transmission rights ("FTRs"), a resource adequacy obligation for LSEs, and an integrated Congestion Management, Energy and Ancillary Services Market based on LMP.[3]

The CAISO requested that the Commission issue an order by July 1, 2002 accepting the Tariff provisions for the Phase I elements and granting preliminary conceptual approval of the Phases II and III elements. The CAISO indicated that conceptual approval of the long-term elements by July 1, 2002 was imperative because Phases II and III required extensive software and systems development and testing. The CAISO indicated in its MD02 Filing that it would need a lead-time of approximately 12-18 months to procure, install and adequately test and provide training on the new software and systems before they become fully operational.

In its July 17 Order, the Commission accepted, rejected, and modified in part the CAISO's MD02 Filing. With respect to the general market power mitigation issues, the Commission: (1) approved a west-wide bid cap of $250/MWh and the extension of the west-wide Must-Offer obligation; (2) modified the CAISO's AMP proposal by adopting a price screen and approving looser conduct and market impact thresholds; (3) approved the CAISO's proposed negative decremental bid cap of negative $30/MWh while making that cap a "soft" cap; (4) rejected use of the proposed 12-month MCI for mitigation purposes, but directed the CAISO to file the information produced by this index weekly with the Commission's Office of Market Oversight and Investigation; and

[3] The ISO also proposed to impose an available capacity ("ACAP") obligation on Load Serving Entities ("LSEs") commencing January 1, 2004.

(5) rejected the CAISO's proposed local market power mitigation measures and, instead, directed the CAISO to apply modified AMP procedures to test for and mitigate the exercise of local market power.

As to the other Phase I elements, the Commission rejected the CAISO's RUC proposal, but approved the proposed penalties for uninstructed deviations, conditioned upon the CAISO implementing specified software modifications. The Commission also approved the CAISO's Target Price proposal and use of a single Energy bid curve, effective October 1, 2002.

With respect to the Phase II elements of the CAISO's MD02 Filing, the Commission directed the CAISO to expedite implementation of the integrated Day-Ahead Market, Ancillary Services Market reforms and proposed reforms to the Hour-Ahead and Real Time Markets. Specifically, the Commission directed the CAISO to implement these reforms by January 1, 2003. Finally, the Commission authorized the CAISO to expend funds for the development of LMP and the full network model, but determined that the specifics of implementation of those elements should be addressed in the technical conferences established by the July 17 Order.

II. GROUNDS FOR REHEARING AND SPECIFICATIONS OF ERROR

The CAISO submits that the Commission erred in making the following determinations:

(1) the AMP thresholds should be modified to provide for (a) a conduct threshold of 200 percent or $100/MWh above the reference price and (b) a market impact threshold of 200 percent or $50/MWh increase in the market clearing price ("MCP");

(2) there should be an AMP price screen of $91.87/MWh;

(3) the CAISO's proposal for local market power mitigation is inappropriate, and the CAISO should apply modified AMP procedures to test for the exercise of local market power;

(4) the interim RUC proposal is not critical at this time and is therefore rejected;

(5) the CAISO is required to implement the Phase II elements of the MD02 Filing, effective January 1, 2003; and

(6) the CAISO is authorized to clear Price Overlap in the Real-Time Market commencing October 1, 2002 even though the CAISO will not be able to impose uninstructed deviation penalties by that date.

The CAISO will discuss these issues seriatim. The CAISO requests that the Commission grant the instant request for rehearing and vacate the foregoing determinations consistent with the discussion herein.

A. The Commission's Modifications to The CAISO's Proposed AMP Thresholds Are Not Justifiable

In its MD02 Filing, the CAISO proposed to apply AMP in its Day-Ahead and Real Time Imbalance Energy Markets. Similar to the AMP used by the New York Independent System Operator ("NYISO"), the CAISO's AMP proposal relied on two (2) threshold screens to determine need to apply AMP to mitigate bids: one threshold screen for conduct and a second threshold screen for market impact. The conduct screen would evaluate a bid for market conduct that is inconsistent with workable competition. The market impact screen would evaluate bids to determine if such bids have a substantial impact on market prices. If both of these conditions are met, prospective mitigation to a unit-specific reference price would be imposed automatically. Specifically, under the CAISO's proposal, when bids exceed the reference price by the lesser of 100 percent or $50/MWh, and such bids raise the market price by the lesser of

100 percent or $50/Mh, AMP would mitigate such bids to their respective reference levels.

In its July 17 Order, the Commission found that applying the conduct and threshold screens at the levels proposed by the CAISO might result in mitigating bids unnecessarily. July 17 Order, slip op. at 27. Accordingly, the Commission required the CAISO to apply three (3) screens using the following thresholds: (1) for the conduct screen, the threshold would be whether a bid results in a 200 percent or a $100/MWh increase above the reference price, whichever is less; (2) for the market impact screen, the threshold would be whether the aggregated bids that fail the price screen would result in a 200 percent or $50/MWh increase in the MCP, which ever is less; and (3) a price screen such that, if the MCP is $91.87/MWh or less in all zones, AMP will not be applied. *Id.* at 28.

The thresholds approved by the Commission are wholly inappropriate for the California market, insufficient to protect against the exercise of market power under current market conditions, and likely to result in the payment of unjust and unreasonable rates. Instead of approving the CAISO's proposed AMP screens and thresholds, which are fairly and reasonably tailored to the lack of competitive markets in California, the Commission approved thresholds that are more comparable to those utilized by the NYISO, an independent system operator whose markets have been recognized as being workably competitive. Indeed, two of the Commission-approved thresholds -- the $100 increase over reference price for the conduct threshold and the 200% increase in MCP for the market impact threshold -- are identical to the thresholds that the Commission approved for the NYISO. *See* July 17 Order, slip op. at 25. While the

NYISO's more generous bid and market impact thresholds might be appropriate in workably competitive markets such as those operated by the NYISO, such thresholds are too large to provide effective mitigation in the California market that is not competitive at the present time and likely will not be competitive for some period of time.

The CAISO notes that the NYISO's Market Advisor, Dr. David D. Patton, in his "Annual Assessment of the New York Electric Markets 2000," as presented to the joint Board of Directors and Management Committee meeting of April 17, 2000, stated that "markets have been competitive in most conditions." Mr. Patton's statements were placed in the record in Docket No. ER01-2076, *i.e.*, the proceeding in which the Commission initially accepted the NYISO's AMP proposal. *See* Request for Leave to Reply and Reply of the New York Independent System Operator, Inc. to Comments and Protests, Docket No. ER01-2076, pp. 2-3 (June 8, 2001). Mr. Patton's Affidavit attached to the NYISO's pleading (page 4) also indicated that "markets have generally been workably competitive". Thus, the Commission initially approved the NYISO's AMP thresholds on an interim basis with the understanding – and based on substantial record evidence -- that the NYISO's markets were generally competitive.[4] Further, in its March 20, 2002 Compliance Filing in Docket Nos. ER01-3155 (page 18), the NYISO recognized that "[t]he approved conduct thresholds in the Market Mitigation Measures are also set at levels that recognize that the New York electric markets are in general

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[4] Further, in the 2001 "Annual Report on the New York Electricity Markets" dated June 2002, Mr. Patton stated: "[m]any of the findings regarding the market's performance in 2002 continued to hold in 2001. The markets remained workably competitive." The 2001 "Annual Report on the New York Electricity Markets" also states that "[a]nalysis of the market conduct of both suppliers and the load serving entities shows that the markets have been workably competitive." Likewise, the NYISO's 2000 Annual Report (p. 12) states that "the markets, except for isolated instances operated competitively and electricity prices during 2000 were not unreasonably high."

competitive". At page 23, the NYISO noted that "[t]he [market impact] thresholds set forth above are intended to catch significant episodes of market power in markets that are generally expected to be workably competitive." Based on the information provided in the Compliance Filing, the Commission approved AMP on a permanent basis, including the thresholds identified above. *New York Independent System Operator, Inc.,* 99 FERC ¶ 61,246 (2002).

Unlike New York, California's electricity markets are not generally competitive, particularly during low hydroelectric generation periods. Moreover, no party in this proceeding has claimed that workable competition presently exists in California, and the Commission did not make such a finding in its July 17 Order. Further there is no factual basis for the Commission to make such a finding. To the contrary, the Commission has expressly found that the California wholesale Energy market is dysfunctional and seriously flawed. *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services into Markets Operated by the California Independent System Operator and California Power Exchange,* 93 FERC ¶61,121 at 61,349 (2000)("November 1 Order"); 93 FERC ¶61,294 at 61,981 (2000)("December 15 Order"); and 95 FERC ¶61,418 at 62,546 (2001) ("June 19 Order"). The Commission has expressly found rates in California's wholesale Energy market to be unjust and unreasonable. *See* June 19 Order at 61,218; December 15 order at 61,998.

Further, the Commission has been presented, via the various Enron memos, with evidence of "gaming" and manipulation in the California Energy market, and the Commission, in Docket No. PA02-2, is currently conducting an extensive investigation

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into the manipulation of Energy prices in California.[5] Moreover, the Commission has set for hearing complaints filed by the California Public Utilities Commission and Electricity Oversight Board alleging that sellers of Energy in California markets have exercised market power in certain of their long-term power sales contracts. *Public Utilities Commission of the State of California v. Sellers of Long-Term Contracts to the California Department of water Resources, et al.,* 99 FERC ¶ 61, 087 (2002).

The NYISO markets are free of such allegations, findings and filed complaints. The Commission necessarily has recognized that dramatically different competitive circumstances exist in California than in New York, because the Commission approved a $1,000/MWh damage control bid cap in New York but only a $250/MWh bid cap in California. Yet, inconsistent with these decisions, the Commission has (1) approved for the CAISO two AMP thresholds that are identical to thresholds in effect in the NYISO and (2) increased one threshold that it is now closer to the corresponding threshold in effect at the NYISO.

In determining the appropriate AMP thresholds for California, the Commission needs to recognize that there are market structure flaws in California and less competitive market conditions than exist in the NYISO and other independent system operators. One significant difference between the CAISO and the NYISO and other eastern independent system operators is the severe supply shortage that exists in California. The Commission has recognized that there is inadequate supply in California and that the supply shortage, in conjunction with other market flaws, has caused, and has the potential to continue to cause, unjust and unreasonable prices for

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[5] Commission Chairman Pat Wood III testified that such practices are "clearly wrong". *Inside FERC* at 1 (May 20, 2002).

energy. *See*, *e.g*., June 19 Order at ¶ 62,546; November 1 Order at ¶ 61, 349.[6] The Commission has not made similar findings with respect to the NYISO and other eastern independent system operators. In fact, the installed capacity reserve margins in the NYISO and other eastern independent system operators are considerably higher than the reserve margins in California.[7]

Due to the significant supply shortage in California, suppliers in California have far greater opportunities to exercise market power compared to the NYISO and other eastern independent system operators.[8] Accordingly, there is a need for lower AMP thresholds in California to reduce such opportunities. The July 17 Order fails to reflect market realities in California.

Yet another significant structural difference between the CAISO's markets and the markets in the NYISO and other eastern independent system operators is California's over-reliance on the spot market and corresponding lack of long-term forward Energy contracting. While, the State, acting through the Department of Water Resources' California Energy Resources Scheduling division ("CERS") has entered into

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[6] The Commission has not found –nor can it find – that the supply-demand imbalance no longer exists. Indeed, in the July 17 Order, the Commission expressly acknowledges that there is insufficient generation capacity in California. July 17 Order, slip op. at 16.

[7] For example, the New York State Reliability Council (NYSRC) established a statewide annual Installed Capacity Requirement ("IRM") of 18 percent for the period of May 2002 through April 2003. This decision results in an Installed Capacity Requirement ("ICR"), implemented by the NYISO, equal to 118 percent of the forecasted peak load. The CAISO notes that its 2002 Summer Assessment shows an expected reserve margin of only 3.4 percent.

[8] In its Fourth Quarterly Report filed in Docket Nos. EL00-95, *et al.* on June 14, 2002, the CAISO noted that, between April 1, 2002 and June 1, 2002, only 100.5 MW of new Generation had been brought on-line and that more than 1,770 MW of previously planned new generation had been cancelled, withdrawn or put on indefinite hold. Furthermore, 653 MW have been retired or are off-line due to environmental problems. Finally, the CAISO has received indications that an additional 1,400 MW of existing Generation in Southern California may be retired by the end of 2002 due to facility owners' decisions to not incur business costs of upgrading plants to meet environmental regulations. Thus, the fundamental lack of a supply-demand balance in California has not changed since the time the Commission first imposed strict market power mitigation measures. Given that California continues to suffer under the same conditions that are conducive to the exercise of market power, the Commission should not arbitrarily adopt loose AMP thresholds.

certain long-term forward contracts for a significant amount of capacity, such contracts leave significant exposure to short-term Energy purchases as needed to serve Load at peak periods. For example, based on Loads similar to August 2001, CERS' portfolio covers on average, approximately only 70 percent of California's investor-owned utilities' ("IOUs") net short-Energy requirement as is needed to serve the IOUs' total Load requirements during peak periods. MD02 Filing, Affidavit of Gregory Cook at 11. Thus, a significant amount of Load remains exposed to volatile spot market prices and, therefore, to the abuses of market power. Under such circumstances as these, AMP thresholds stricter than those approved by the Commission in its July 17 Order are critical. Given CERS' shortfall in forward contracting, and the inability of the two largest California IOUs to contract on their own, CAISO spot markets are all but guaranteed to be used extensively, and prices are likely to be unreasonably high and extremely volatile due to the loose AMP thresholds that the Commission has approved.[9] This highlights yet another compelling reason that the Commission approve the reasonable AMP thresholds proposed by the CAISO that properly account for the non-competitive reality in CAISO markets.

In its July 17 Order, the Commission states that if AMP thresholds are too restrictive, new Generation may choose to locate outside of California. July 17 Order, slip op. at 28. This conclusion is confusing and inconsistent with the Commission's position that "bilateral contracts should be the principal means by which generators recover their total costs" not the spot market. *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services Into Markets Owned and Operated by the*

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[9] Moreover, the State has only authorized CERS to procure Energy and capacity on behalf of California's IOUs through December 31, 2002.

California Independent System Operator and the California Power Exchange, 95 ¶ 61,115 at 61,364 (2001) ("April 26 Order"). Further, in its price mitigation orders, the Commission found one of the major flaws in the California market to be an excessive reliance on the spot market, and stated that "the cornerstone of remedying the dysfunctions in the energy markets in the West…is eliminating California's excessive reliance on spot markets." June 19 Order at 61,347. It logically follows that if the spot markets shrink, Generators will not be inclined to build new plants in California for the purpose of serving shrinking spot market Load. Accordingly, Generators will not be "scared away" from investing in California due to stricter AMP thresholds. Similarly, because AMP reference prices are based on accepted bids, peaker units will not shy away from the California market due to strict AMP thresholds because their reference prices will be high to begin with given that they typically bid when demand and, hence, prices are high. The CAISO notes that in the standardized market design Notice of Proposed Rulemaking in Docket No. RM01-012, the Commission states that "a requirement to assure adequate long-term generation is currently needed because spot market prices do not consistently signal the need for new infrastructure in the electric power industry", and "the spot market does not yet work well to produce long-term reliability investment…for several reasons." Notice of Proposed Rulemaking in Docket No. RM01-12-000 issued July 31, 2002 at P 461-462. Thus, the Commission's conclusion that strict AMP thresholds will hamper resource adequacy in California is not reasonable given the Commission's prior findings that there is no causal connection between spot market prices and new generation investment.

In summary, workable competition does not generally exist in California, and there is no evidence in this proceeding to suggest otherwise. Accordingly, there is no basis for the Commission to impose thresholds comparable to the thresholds in place in the NYISO that were adopted in an environment of robust competition. The loose AMP thresholds are especially inappropriate given that the Commission has approved an increase of the bid cap from $91.87/MWHh to $250/MWh. The prudent course of action would be for the Commission to approve lower AMP thresholds until market conditions in California improve and existing market design flaws are determined to have been corrected. The high bid cap, in conjunction with high AMP thresholds, will increase California consumers' exposure to unjust and unreasonable electricity prices brought on by the exercise of market power by suppliers.

The CAISO submits that, compared to the AMP thresholds approved in the July 17 Order, the thresholds proposed in the MD02 Filing offer a more reasonable balance between the need to provide adequate safeguards against market power abuse and the desire to allow market forces to provide sufficient price signals for demand response, forward contracting, and investment in new Generation within California. Specifically, based on current prices and the marginal costs of the typical Generation unit in California, the CAISO's proposed thresholds would allow suppliers to double their bids (under comparable conditions) without becoming subject to mitigation under AMP. Moreover, the AMP thresholds are indexed to natural gas prices, so suppliers are adequately protected if natural gas prices rise. On rehearing, the Commission should approve the conduct and impact thresholds proposed by the CAISO in its MD02 Filing.

B. The Commission's Price Screen Test Under AMP Is Inappropriate

In its MD02 Filing, the CAISO proposed to apply AMP in its Day-Ahead and Real Time Imbalance Energy Markets. As detailed above, the CAISO proposal for AMP—consistent with the NYISO's AMP – utilized two screens: conduct and market impact. Also as noted above, in its July 17 Order, the Commission required the CAISO to apply a third screen – a price screen -- to determine whether AMP will be applied. Specifically, AMP will not apply if the MCPs for all zones are equal to or less than \$91.87/MWh. July 17 Order, slip op. at 28. On rehearing, the Commission should eliminate the price screen for the reasons set forth below.

First, the concept of a price screen is at odds with the Commission's stated rationale for approving AMP. In that regard, in its July 17 Order, the Commission found that AMP "should simply limit the ability of suppliers to artificially raise prices when market conditions may create a temporary ability to do so.[10] July 17 Order, slip op. at 27. However, existence of a price screen could enable suppliers to exert market power on a temporary basis without being subject to mitigation. For example, if a unit consistently bids \$30/MWh (which would then be that unit's reference price) and during a particular week a single different large unit or a number of smaller units are forced out of service or go off-line for scheduled maintenance; the unit previously bidding \$30/MWh could raise its bids to \$91.87/MWh in light of the reduced competition in the market. This example typifies the behavior that AMP is designed to prevent, and,

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[10] In another order addressing price mitigation in California, the Commission noted that it has taken steps to ensure that suppliers "cannot benefit from any market power they may temporarily possess." *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*, 97 FERC ¶ 61,275 at 62,173 (2001).

indeed, the Commission acknowledges this fact. Unfortunately, the constant presence of a price screen would “shield” such bids from AMP thereby permitting suppliers to exercise market power on a temporary basis without being subject to mitigation. Such a result is inappropriate. The Commission must be mindful that market power has been exploited not only during absolute system peak conditions, but also during other months when scheduled and unscheduled outages have led to imbalances between supply and Demand.[11]

Second, it appears that the Commission’s decision to approve a price screen for the CAISO’s AMP is also based, in part, on the erroneous conclusion that the NYISO has a fixed AMP price screen in effect. Specifically, in its July 17 Order, the Commission states that the NYISO has a price screen of $150/MWh. July 17 Order, slip op. at 25. That is not correct. The NYISO does not have a specified AMP price screen incorporated into its tariff. The NYISO does possess authority to forego use of AMP for any day-ahead market for which it has made an initial determination that the

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[11] Experience demonstrates, however, that it is not the peak Load that necessarily results in shortages of supply and the opportunity for the exercise of market power., Rather, it is the relationship between *available* supply and current demand. In 2001, the ISO shed firm Load on January 17, January 18, January 21, March 19, March 20, May 7, and May 8. These emergencies occurred when system demands were below the Summer peak. However, due to planned and unplanned outages, the ISO experienced significant imbalances between supply and demand. Similarly, the overwhelming number of 136 Stage 1 emergencies, 107 Stage 2 emergencies, and 39 Stage 3 emergencies experienced by the ISO during 2001 took place prior to May. Moreover, analysis clearly demonstrates that the problems of market power are more pervasive, occurring at all times and under all conditions. In an affidavit filed with the Commission in this proceeding on October 20, 2000, Dr. Eric Hildebrandt of the CAISO’s Department of Market Analysis presented results of a more systematic, quantitative analysis of market power and scarcity over the first two and one half years of ISO operations. Results of this analysis showed a significant degree of market power during the months of May to September 2000. Dr. Hildebrandt noted that:

> While a significant portion of the increase in wholesale costs above this competitive baseline have been incurred during hours of potential absolute resource scarcity, the bulk of these additional costs are attributable [to] a lack of competition, rather than scarcity. In addition, prices continued to significantly exceed competitive levels even after the ISO’s real-time price cap was lowered to $250 in August.

Declaration of Eric Hildebrandt filed with Proposed Offer of Settlement in Docket Nos. EL00-95 *et al.* on October 20, 2000 at pp. 5-7.

likelihood of mitigation being triggered by AMP is unlikely. Specifically, Section 3.2.2(c) of the NYISO's Market Mitigation Rules provides as follows:

> [t]he NYISO shall forego performance of the additional SCUC passes necessary for automated mitigation of bids for a given Day Ahead Market if evaluation of unmitigated bids results in prices at levels at which it is unlikely that that the thresholds for which bid mitigation is unlikely.

See NYISO Tariff Sheet No. 472. In other words, the NYISO *voluntarily and unilaterally* does not run AMP if it believes that the thresholds which trigger mitigation likely will not be met. This level generally has been around the $150 level. The NYISO has expressly stated that AMP does not establish a $150 threshold for the imposition of mitigation measures. In that regard, in a May 17, 2001 "Exigent Circumstances Filing of the NYISO at the Direction of the Board of Directors to Implement Automated Mitigation Procedure, Request for June 15th Effective Date and Request for Shortened Comment Period," in Docket No. ER01-2076, the NYISO indicated that:

> *the AMP does not establish a new threshold of $150 for the imposition of mitigation measures.* Instead, the NYISO proposes to set an initial pricing point at which is makes sense to activate the AMP to determine whether automated mitigation is warranted. In all cases, whether the AMP is used or not, the imposition of mitigation measures requires that the conduct and market impact thresholds specified in the Market Mitigation Measures be crossed. *The NYISO has initially determined, however, that given the shape of the supply curve in New York and the level of the market impact thresholds, it is very unlikely that the thresholds for mitigation will be crossed if prices in a given area of New York are below $150.* Thus, if the initial SCUC evaluation of unmitigated bids indicates that prices will be below that level, *it makes little sense to force the SCUC to perform an additional series of complex calculations that are very unlikely to serve any useful purpose and could cause delays in posting Day Ahead Market prices.* Authority for the NYISO to forgo use of the AMP for any Day Ahead Market for which an initial determination has been made that the likelihood of mitigation being triggered is minimal is set forth in new § 3.2.2 (c) of the Market Mitigation Measures. Of course, all other provisions of the Market Mitigation Measures, including its manual mitigation procedures, would remain applicable to any such DAM. (emphasis added).

In its Order approving AMP on an interim basis, the Commission too recognized that the NYISO's AMP did not establish a threshold to $150 for the imposition of mitigation measures. *New York Independent System Operator, Inc.*, 95 FERC ¶ 61,471 at 62,689 (2001).

Unlike the NYISO, the CAISO does not have experience to show that it will not apply AMP to bids below $91.87/MWh. Absent this experience, and in light of the example and explanations set forth above, it is inappropriate for the Commission to assume that AMP will never apply to bids below $91.87/MWh

In any event, because the Commission did not approve an AMP price screen for the NYISO, there is no basis for the Commission to impose an AMP price screen on the CAISO. In particular, the Commission has not enunciated any reasons for treating the CAISO differently than it has treated the NYISO. The CAISO submits that the Commission and cannot justify adopting a price screen in the California market which is significantly less competitive than the NYISO market. Under these circumstances, the Commission's adoption of a $91.87/MWh price screen under AMP is inappropriate in that it would significantly undermine the effectiveness of AMP as a market power mitigation tool and result in unjust and unreasonable rates.

Third, implementation of a $91.87/MWh price screen will result in prices that are unjustly and unreasonably high. Stated differently, a $91.87/MWh price screen is not supported by substantial evidence, and there is no rational basis upon which the Commission can rely for its adoption of a $91.87/MWh price screen. If the Commission concludes on rehearing that a price screen is appropriate, the CAISO submits that a price screen of $91.87/MWh is too high and should be substituted with a

lower price screen that reflects current market conditions in California. Nowhere in the July 17 Order does the Commission even attempt to explain why a $91.87/MWh price screen is just and reasonable. The CAISO notes that, in its July 11, 2002 price mitigation order, the Commission approved a price cap of $91.87 through September 30, 2002. *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*, 100 FERC ¶ 61,050 (2002). The $91.87/MWh price cap was based on the particular date and spot gas prices the last time a non-emergency clearing price was set, *i.e*. May 31, 2001. The applicable gas price at that time (as determined in accordance with the Commission-approved price mitigation methodology) was $6.641/MMBtu. *See 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,* 97 FERC ¶ 61,293 at 62,375 (2001) ("December 19 Compliance Order"). Today the applicable gas price using the Commission-approved methodology is $2.71/MMBtu. A $91.87/MWh price screen is excessive and unjustifiable under these circumstances.

In particular, it is inappropriate for the Commission to rely on stale gas cost data that is more than one year old to set a price screen. The CAISO submits that if the Commission believes that a price screen is necessary, the level of the price screen should be updated to reflect current market conditions. Specifically, the price screen should be based on the highest heat rate unit on the system, *i.e.,* approximately 20,000 Btu/MWh, the current monthly gas index plus a $6.00 O&M adder. Applying this methodology to the current month of August would produce a price screen of

$60.20/MWh[12]. Under these circumstances, AMP would not apply if prices are below the current marginal cost of highest marginal cost unit. This is inherently a more logical approach than a price screen based on an arbitrary $91.87/MWh. This approach will better ensure that AMP is not applied in hours where it is unlikely to trigger mitigation, which is precisely the rationale the NYISO used in "voluntarily" electing not to run AMP when market prices are below $150/MWh.

Additionally, since October 1, 2001, the average cost of Energy and Ancillary Services has ranged from $39 to $46 per MWh.[13] *See* Fourth Quarterly Report of the California Independent System Operator Corporation, Docket Nos. EI00-95-012, *et al.* (June 14, 2002). A $91.87/MWh price screen allows units to bid more than twice their marginal cost and more than twice prevailing prices in California without any possibility of mitigation. Such a scheme is patently unjust and unreasonable and will only serve unnecessarily to drive up the cost of electricity to California consumers.

One of the Commission's stated justifications for the AMP thresholds it has approved is to encourage investment in new generation in California. While the Courts have recognized that encouragement of new supply is a permissible objective for the Commission to pursue, the rates *must not be more than is needed for the purpose*:

> While as we have indicated the Commission may be empowered to consider some of these factors it must also, and always, relate its action to the primary aim of the Act to guard the consumer against excessive rates. If the Commission contemplates increasing rates for the purpose of encouraging exploration and development . . . it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose.

[12] Based on the Commissioned approved current (August) monthly gas index of $2.71/mmbtu.

[13] As indicated in the Fourth Quarterly Report (page 7), energy prices in California prior to the energy crisis averaged $33/MWh.

City of Detroit v. FPC, 230 F.2d at 817. The Court affirmed this determination in *Farmers Union*, criticizing the Commission for failing to "even attempt to calibrate the relationship between increased rates and the attraction of new capital."[14]

Accordingly, the Commission must eliminate the price screen in its order on rehearing or, at a minimum, adopt the more reasonable price screen proposed above.

C. The Measures Approved By The Commission To Mitigate Local Market Power Are Inadequate and Will Result in Unjust and Unreasonable Rates

In light of increased Intra-Zonal Congestion on the CAISO Controlled Grid, in its MD02 Filing, the CAISO proposed to implement local market power mitigation measures. Under the CAISO's proposal, when the CAISO is required to Dispatch a unit out of merit order to alleviate Intra-Zonal Congestion, the CAISO would mitigate the bid of such unit to the lesser of a unit-specific proxy price or the MCP. In instances where decremental bids are needed, the CAISO proposed to charge the unit the lower of the unit-specific proxy price or the MCP for decremental bids. MD02 Filing, Attachment B. In its July 17 Order, the Commission rejected the CAISO's proposed local market power mitigation measures and ordered the CAISO to apply AMP when the CAISO must take bids out of merit order in order to alleviate Intra-Zonal Congestion. July 17 Order, slip op. at 33.

Under the Commission-approved local market power mitigation measures, a bid less than $91.87/MWh that is taken out of merit order would *not* be subject to mitigation. *Id*. A bid at or above $91.87/MWh taken out of merit order would be deemed to have

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[14] *Farmers Union Cent. Exch., Inc. v. FERC*, 734 F.2d 1486, 1502-03 (D.C. Cir.), *cert. denied sub nom. Williams Pipe Line Co. v. Farmers Union Cent. Exch., Inc.*, 469 U.S. 1034 (1984) ("*Farmers Union*"). *See also City of Detroit, Michigan v. FPC*, 230 F.2d 810, 818-19 (D.C. Cir. 1955), *cert denied. sub nom. Panhandle Eastern Pipe Line Co. vs. City of Detroit*, 352 U.S. 829 (1956).

failed the AMP conduct test. If the out-of-merit bid is more than 200 percent or $50 greater than the MCP, the bid would be mitigated and the generator would be paid the higher of its reference price or the MCP. *Id.* Such an out-of-merit bid would be ineligible to set the MCP.

As discussed in greater detail below, the local market power mitigation measures approved by the Commission are flawed in several respects and will result in unjust and unreasonable rates being paid by consumers. Accordingly, on rehearing, the Commission should approve the local market power mitigation measures proposed by the CAISO in its MD02 Filing. If the Commission still believes that it is appropriate to apply AMP, then the Commission should, at a minimum, approve the alternative local market power mitigation measures set forth herein that also make use of the AMP procedure.

1. The Commission Erred In Rejecting The CAISO's Proposal

It is axiomatic that the Commission has the authority to reject tariff changes filed by a public utility only if it finds that the changes proposed by the public utility are not just and reasonable. *Atlantic City Electric Company, et al. v. FERC,* 295 F.3d 1 (2002). In rejecting the CAISO's proposed local market power mitigation measures, the Commission has failed to comply with this requirement. In that regard, in the July 17 Order, the Commission did not find the CAISO's proposal to be unjust and unreasonable. In any event, the CAISO submits that the Commission would not have any basis to find that the CAISO's proposed local market power mitigation measures are unjust and unreasonable because such measures are comparable to those which the Commission approved for PJM. *See Atlantic City Electric Company, et al.,* 86

FERC ¶ 61,248 (1999). The Commission is not permitted to reject proposed revisions simply because a "better" alternative is available. Yet, that is exactly what the Commission has done in this instance.[15]

The Commission states that the CAISO's proposal is "inappropriate in light of the existence of a three-zone congestion management model." July 17 Order, slip op. at 33. However, the Commission does not explain why the existence of a three zone system causes the CAISO's proposal to be "inappropriate". Indeed, the CAISO's proposal uses the same price mitigation methodology that the Commission previously approved system wide during reserve deficiency hours in the three-zone CAISO grid. Under these circumstances, the Commission's decision to reject the CAISO's proposal is arbitrary and capricious.

2. The Commission's Measures Fail To Address The "DEC" Game

The Commission-approved local market power mitigation mechanism is flawed because it does not address the "DEC" game, *i.e.*, it does not include any measures to mitigate decremental Energy bids ("DEC bids") that result from the exercise of local market power. The Affidavit of Dr. Eric Hildebrandt, which was submitted as Attachment P to the MD02 Filing, explained how suppliers have been exercising local market power under the CAISO's existing market rules and provided examples of how suppliers have been playing the DEC game. Specifically, because of their local market power, certain suppliers have been called out-of-sequence (*i.e.,* not in the economic

15 *See New England Power Company*, 52 FERC ¶ 61,090 at 61,336 (1990), *reh'g denied,* 54 FERC ¶ 61,055, *aff'd Town of Norwood v. FERC*, 962 F.2d 20 (D.C.Cir. 1992); *citing City of Bethany v. FERC*, 727 F.2d 1131, 1136 (D.C.Cir. 1984), *cert. denied*, 469 U.S. 917 (1984) (utility need establish that its proposed rate design is reasonable, not that it is superior to alternatives); *OXY USA, Inc. v. FERC*, 64 F.3d 679, 692 (D.C.Cir. 1995) ("[T]he Commission may approve the methodology proposed in the settlement agreement if it is 'just and reasonable'; it need not be the only reasonable methodology or even the most accurate.").

merit order of the CAISO BEEP stack) and are paid prices for decremental Energy that are significantly lower than the Real Time Imbalance Energy MCP and the suppliers' own marginal costs for production of such decremental Energy. In fact, suppliers with local market power routinely submit negative decremental bids that are far in excess of any variable production costs suppliers incur in connection with reducing a Generating Unit's output (*i.e.,* "DEC-ing" such a unit), and the CAISO is often forced to accept such bids because competitive alternatives are not available. This results in the CAISO paying the supplier to reduce Energy output.[16] No intervenor challenged Dr. Hildebrandt's statements and conclusions. Likewise, the Commission did not make any factual findings contrary to the factual predicate set forth in Dr. Hildebrandt's affidavit. Indeed, the Commission previously has recognized that in California there are conditions where no effective competition exists to relieve certain transmission constraints giving rising to Intra-Zonal Congestion, and there is no market discipline on the price bid by a Generator possessing the ability to reduce its Schedule (*i.e., DEC its unit).* *California Independent System Operator Corporation*, 90 FERC ¶ 61,000 at 61,011 (2000). Given the reality of the circumstances in California, the Commission's failure to approve local market power mitigation measures to address to "DEC" game is

[16] The ISO also notes that in Docket No. EL02-51, the California Electricity Oversight Board filed a complaint against numerous generators alleging that such generators were exercising market power by submitting anticompetitive negative "DEC" bids. The EOB complaint identified examples of suppliers submission of anticompetitive "DEC" bids. The Commission dismissed the EOB complaint without prejudice finding that it was premature to undertake a piecemeal modification to the ISO's market design given that the filing of a revised market design was imminent. *California Independent System Operator Corporation*, *et al.*, 98 FERC ¶ 61,327 (2002). The Commission indicated that it "expect[ed] the Cal ISO to address the EOB's concerns in the revised market design." The ISO did just that in proposing mitigation for "DEC" bids in connection with the exercise of local market power. However, the Commission did not address the CAISO's arguments and evidence, and the Commission-approved local market power mitigation measures fail to address the "DEC" game.

not the product of reasoned decision making and is not supported by substantial evidence.

The CAISO will be especially susceptible to the "DEC game" in the absence of a security-constrained Day-Ahead nodal Energy market. In that regard, the CAISO cannot limit Schedules based on localized constraints but would be required to do so in real time. Thus, if there is a transmission contingency such as a facility derating or outage and, as a result, a local Generation pocket is constrained, a Generator can submit a Schedule for Generation in excess of the constrained transmission capacity in the CAISO's Day-Aahead Market, and the CAISO would be required to reduce such a Schedule in real time. Under these circumstances, the Generator would be able to submit high negative DEC bids that bear no relation to the costs incurred to back down or DEC the unit because there would be no other unit the CAISO could call upon due to the lack of competition in the constrained pocket. The CAISO would have no other alternative but to pay the unit to reduce its output.

Because such circumstances occur regularly, it is imperative that the CAISO have adequate measures in place to address the "DEC game". Although the negative $30/MWh cap on DEC bids approved by the Commission applies system-wide, such cap is not primarily intended -- nor is it sufficiently effective -- to prevent the DEC game. The negative $30 cap on DEC bids was proposed primarily to address CAISO Controlled Grid (system-wide) over-generation. The negative cap does not provide adequate protection against local market power. That is why the CAISO proposed additional local market power mitigation measures applicable to decremental bids. MD02 Filing, Attachment A at 136. In the local market power context, no competition

exists in the DEC market. The Commission has noted that in a well-functioning, competitive market, suppliers generally would compete in the decremental Energy market by submitting positive decremental bids that reflect a Generator's avoided costs. Indeed, the Commission has recognized

> [i]n a competitive situation, a generator would set its bid at the level of costs it can avoid by not generating. Because each generator has been paid the market clearing price for its commitment to operate in real-time, each generator would be indifferent to operating and incurring running cost, or not operating and paying the ISO an amount equal to its running cost.

California Independent System Operator Corporation, 90 FERC ¶ 61,006 at 61,012 (2000).

However, in the circumstances that exist in California, as described herein and in multiple pleadings in this and other dockets, any "constrained" Generator can submit high negative DEC bids that the ISO would be forced to accept. The negative $30/MWh cap does not provide adequate protection in these circumstances. Because the market is not competitive in a constrained generation pocket, greater protection than the negative $30/MWh bid cap is necessary to mitigate market power in connection with "DEC" bids.[17]

For these reasons, on rehearing, the Commission should accept the CAISO's initial proposal to prevent the "DEC game." If the Commission desires to apply AMP instead, then the Commission should adopt the alternative discussed below to address local market power in the decremental bid market. Specifically, the CAISO proposes -- as an alternative to the Commission-approved methodology – that DEC bids be tested

[17] In its Answer to Protests filed on June 17, 2002, the CAISO explained in detail why it was necessary to place a cap on negative DEC bids. In particular the CAISO showed that there was no cost justification for large negative DEC bids. The CAISO hereby incorporates by reference its Answer to Protests.

for market impact when such bids are taken out of merit order and deviate more than 10 percent below the unit-specific reference price. In such cases, the bids would be mitigated to their reference price if doing so decreases the local re-dispatch costs by 10% or more (*e.g.,* has a significant market impact). Under this approach, the dispatch cost for each out of merit order bid would be valued at the lower of the zonal MCP or the bid price. Mitigated "DEC" bids would be charged the lower of the applicable unit-specific reference price or the MCP applicable to "DEC" bids. The CAISO believes this approach provides a more appropriate conduct and market impact test and bases bid mitigation on reference prices that are determined, to the extent possible, on historically accepted bids during competitive hours (e.g. hours where the resource was not being dispatched out of merit order).

Unit reference prices would be determined in accordance with the general AMP procedures approved by the Commission (Appendix A: "ISO Market Monitoring Plan - Market Mitigation Measures"). Furthermore, the CAISO would propose to modify section 3.3 of the general AMP procedures, so that if a market participant anticipates submitting bids in a market administered by the ISO that will exceed the "local market power" thresholds specified above, the market participant may contact the ISO to provide an explanation of such bids. If the reasons for the bidding behavior indicate that the conduct is consistent with competitive behavior, the bids will not be mitigated. Moreover, section 6 of the general AMP procedures provides, market participants, via the CAISO's dispute resolution process, with further recourse to pursue additional compensation in the event they feel they were unfairly mitigated. This approach will enable the CAISO to apply AMP to local market power mitigation as the Commission

desires, and it will provide the CAISO with adequate tools to protect market participants from the "DEC" game.

3. The Commission's Measures Are Inadequate To Protect Against The Exercise Of Local Market Power In Connection With Incremental Energy Bids

The CAISO also submits that the mitigation mechanism approved by the Commission is wholly inadequate to protect against the exercise of local market power in connection with incremental Energy bids. The Commission has recognized that there are locations in California where certain suppliers have locational market power because other generation cannot provide service in the Load pocket. *AES Southland, Inc. and Williams Energy Marketing and Trading Company*, 94 FERC ¶ 61,248 at 61,871-72 (2001). Owners of Generation in such Load pockets (where there is limited transmission capacity to the main grid) are able to demand unreasonable prices for additional Generation needed by the CAISO to ensure local reliability. In his Affidavit, Dr. Hildebrandt discussed how suppliers have successfully exercised local market power so that they can be called out-of-sequence by the CAISO in real time and be paid bid prices for incremental Energy significantly in excess of the real time MCP and their marginal costs of Generation. In particular, Dr. Hildebrandt stated that on numerous occasions, Generators have played the incremental Energy bid game ("INC game) and bid capacity at a very high price in the real time market thereby forcing the CAISO to meet local reliability requirements by Dispatching Generation out-of-sequence at uncompetitively high prices. Neither intervenors nor the Commission denied that these problems exist.

However, the present remedy adopted by the Commission is inadequate to address the INC game. Under the mechanism approved by the Commission, resources having local market power can simply bid $91.87/MWh or the expected zonal MCP plus $49.99/MWh, whichever is more profitable, to avoid being mitigated by AMP. Although the CAISO believes that a price screen is not appropriate under any circumstances, a price screen (and in particular the $91.87/MWH price screen approved by the Commission) is especially inappropriate and unjustifiable in the local market power mitigation context because generally there is no (or very little) effective competition in Load pockets. A supplier can bid $91.87/MWh and be reasonably assured that there will not be any competition for its Energy. At least system wide there is the possibility that competition will constrain prices. As indicated above, under current market conditions, a $91.87/MWh price screen would allow suppliers to bid more than twice the level of prevailing prices in the CAISO's markets (and more than twice the marginal cost of the typical Generating Unit) before they would be subject to AMP. Because of the lack of competition in constrained Load pockets, suppliers with local market power are virtually guaranteed the ability to charge prices that are more than twice the "going rate". The Commission's decision is arbitrary and capricious and will result in unreasonable rates being borne by California consumers.[18]

Some parties have argued that Generating Unit owners would not use the $91.87 price screen as a bidding target because they cannot predict in advance the hours in which they will have local market power. The CAISO's experience has shown that local

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[18] If the Commission believes that a price screen is appropriate even in circumstances where local market power can be exercised, the Commission should adopt the CAISO's alternative price screen discussed in Section II.B *supra*.

market power situations typically arise due to the outage of a major Generating Unit or transmission facility and that such outages typically last several days. Because these events are well known to the market, it is easy for Generating Unit owners to predict when they can successfully exercise local market power.

Furthermore, the limits on bidding flexibility that the Commission has approved in the July 17 Order are significantly less protective of consumers than those which the Commission has approved for other ISOs in order to address local market power. For example, in PJM, the bids of Generators called to operate for local reliability purposes are capped at: (1) the average LMP during a recent comparable period when the Generator was in merit order dispatch or (2) a level based on cost plus a 10 percent adder. *Atlantic City Electric Company, et al.*, 86 FERC ¶ 61,248 at 61,899 (1999). In ISO New England, units running out of economic merit order are subject to a screen price ranging from five to fifty percent above the reference price. If the reference price, multiplied by the screening percentage is less than the current day or hour out-of-merit bid, and the market structure screen identifies fewer than three total competitors, mitigation pricing will apply. *See* Section 17.3.2.2 and Appendix 17-A of NEPOOL's Market Rules and Procedures. The NYISO sets In-City load pocket conduct and impact thresholds according to a formula[19] that is proportional to the number of congested hours experienced over the preceding 12-month period. The In-City bid will be mitigated if it exceeds the reference level by more than two percent.[20] *New York Independent System Operator, Inc.,* 99 FERC ¶ 61,246 at 62,046 (2002). The

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[19] Load Pocket Threshold = 2% * Avg. Price * 8760.

[20] The two percent is the maximum sustained price increase that a bidder can realize over the course of a year. As the number of congested hours increases, the conduct and impact thresholds would decrease to ensure that annual exposure to price increases is limited to two percent.

Commission fails to explain why it has approved less protective market power mitigation measures in California than it has for other ISOs.

The Commission-approved mechanism is also flawed because the Commission has applied the same price screen and market impact threshold to bids in constrained Load pockets that it has applied to the State of California as a whole. There is no rational basis for this approach. In its July 17 Order the Commission recognizes that:

> Transmission constraints or concentration of generation ownership may cause situations to arise in which the number of bids in certain areas of the grid or across transmission pathways is not sufficient to consider them competitive. Load pockets, generation pockets or local reliability problems resulting from such a situation may place a generating unit in a position to exercise market power.

July 17 Order, slip op. at 32. In other words, the Commission has found that suppliers can exercise market power when there are transmission and reliability constraints, *i.e.*, the only instances in which the local market power mitigation measures would apply. It is unreasonable and counterintuitive for the Commission to approve use of the same price screen and market impact threshold both for circumstances where it acknowledges market power can readily be exercised and for circumstances where it has not found a potential for market power to be exercised. Clearly the former scenario requires that greater protections be in place.

The treatment the Commission has accorded the CAISO under these circumstances is inconsistent with the treatment that the Commission has accorded the NYISO. In that regard, the Commission approved lower conduct and market impact thresholds to address locational market power issues in New York City when constraints exist than it did for New York State as a whole. *New York Independent System Operator, Inc*. 99 FERC ¶ 61,246 at 62,039, 62,046 (2002). Both the Commission and

the NYISO recognized that thresholds lower than those generally applicable to the system as a whole were necessary due to the increased potential for suppliers to exercise market power when constraints exist. *Id.* at 62,039-40, 62,046-48; *see also* Compliance Filing of the NYISO Regarding Comprehensive Market Mitigation Measures and Request for Interim Extension of Existing Automated Mitigation Procedure, Docket No. ER01-3155, *et al*., pp. 38-41 and Affidavit of David Patton at 12-19 (March 20, 2002) ("NYISO AMP Filing"); NYISO Limited Answer to Comments and Protests, Docket Nos. ER01-3155, pps.2-4 (May 13, 2002). In addition, as discussed *supra,* the Commission-approved NYISO tariff provisions *do not* include a price screen such as the Commission has imposed on the CAISO. *See* NYISO AMP Filing, Tariff Sheet Nos. 470-470B (the NYISO's tariff provisions applicable to In-City mitigation).

The NYISO succinctly set forth the reasons why stricter thresholds are necessary to address locational market power:

> the frequency of congestion into and within New York City creates opportunities for a persistent exercise of market power, that is, for sellers to bid persistently right below the normal Market Mitigation Measures thresholds and realize monopoly rents at that level. Because that pricing could be sustained, it would become significant over time. Thus, while the In-City market and sub-load pockets will be subject to the same thresholds that are appropriate for unconcentrated areas of the New York Control Area when they are not experiencing persistent congestion, in the face of such congestion, these areas would be subject to potential market power abuse without additional mitigation in the form of tighter mitigation thresholds.

NYISO AMP Filing at 39-40. For the same reasons, the CAISO submits that the Commission should: (1) approve a tighter market impact threshold to address locational market power than it has for California as a whole and (2) eliminate the price screen test for locational market power.

Unlike the Commission's treatment of the NYISO, the Commission has: (1) imposed a price screen on the CAISO's AMP and (2) approved the same market impact threshold to mitigate bids when constraints exist as it has system-wide. It is axiomatic that an agency must conform to its prior practice, policy and decisions or explain the reasons for its departure from such precedent. *See United Municipal Distributors Group v. FERC*, 732 F.2d.202, 210 (D.C. Cir., 1984); *Greater Boston Television Cooperation v. F.C.C.*, 444 F.2d.841, 852 (D.C. Cir.), *cert. denied*, 403 U.S. 923 (1971) (agency must give reasoned analysis for departures from prior agency practice). The Commission has failed to conform to this mandate. Specifically, the Commission has not enunciated any valid reasons for granting the NYISO tighter thresholds in circumstances where local market power can be exerted (compared to the thresholds that generally apply in the NYISO's markets).

Accordingly, consistent with its treatment of locational market power in the NYISO, the Commission should reverse its prior decision herein and (1) eliminate the price screen and (2) adopt tighter conduct and market impact thresholds (compared to the generally applicable market impact threshold) to address local market power. If the Commission does not approve the CAISO's proposal contained in the MD02 Filing, then the CAISO recommends, at a minimum, that the Commission approve the following alternative to the mechanism approved in the July 17 Order. Specifically, the Commission should adopt a conduct threshold equal to 10% of the unit's reference price for bids taken out of economic merit order. Bids taken out of merit order that violate the conduct threshold will be mitigated to their reference price if doing so decreases the local re-dispatch costs by 10% or more (e.g. has a significant market impact). Under

this approach, the dispatch cost for each out of merit order bid is valued at the higher of the zonal MCP or the bid price. Mitigated "INC" bids will be paid the higher of the applicable unit-specific reference price or the MCP applicable to "INC" bids. This will reasonably balance the need to mitigate prices when the potential for the exercise of locational market power exists with the desire to avoid unnecessary mitigation. Again, as discussed above, the CAISO would propose to modify section 3.3 of the general AMP procedures, so that if a market participant anticipates submitting bids in a market administered by the ISO that will exceed the "local market power" thresholds specified above, the market participant may contact the ISO to provide a legitimate basis for the changed bids.

D. The Commission Erred In Rejecting The Residual Unit Commitment ("RUC") Proposal

In its MD02 Filing, the CAISO proposed a RUC mechanism that would allow the CAISO to commit additional resources needed to meet the CAISO's forecast of the next day's Load. Under the RUC proposal, once the CAISO determines that it does not have sufficient resources committed after the close of the Day-Ahead Market to meet the next day's forecasted Load, the CAISO would use the RUC process to commit additional capacity and pay the "committed" suppliers for certain costs incurred to commit their heretofore uncommitted resources.[21]

[21] The CAISO's proposed RUC was designed to strike a careful balance among the following principles and objectives: (1) ensure that enough capacity will be on-line and available for real time, (2) provide a reasonable capacity payment for committed Must Offer Obligation resources, until such time as ACAP is effective, and (3) provide a way for imports to offer supplies and be procured on a day-ahead basis to supplement in-state supplies. The ISO believes that its RUC proposal provides a necessary, effective and reasonable reliability tool, and that it incorporates appropriate modifications associated with each phase of MD02 implementation, so that in the ultimate long-term design the ISO's procurement role in the forward markets is minimized.

The Commission rejected the CAISO's proposed RUC mechanism as "not critical at this time" because the Commission was continuing the existing Must Offer Obligation. July 17 Order, slip op. at 43. The Commission concluded that there were sufficient assurances embedded in the Must Offer Obligation that Generators would make their uncommitted capacity available to the market. *Id*. The Commission also concluded that RUC was not necessary because the CAISO was committed to the development of a long-term permanent solution to resource adequacy. *Id*.

The CAISO submits that the Commission acted arbitrarily and capriciously in rejecting the CAISO's interim RUC proposal. Contrary to the Commission's assumption, RUC and the Must –Offer Obligation are not substitutes for each other, they are complementary. The CAISO notes that the Must Offer Obligation is an obligation for Generators with Participating Generator Agreements as well as Generators outside the CAISO Control Area who participate in ISO markets or use the ISO Controlled Grid, with the exception of hydroelectric Generators, to offer to the CAISO, in real time, all of their available capacity. All such Generators must offer available capacity that is not (1) on an outage; (2) under CAISO Dispatch, (3) already scheduled to run through bilateral arrangements. April 26 Order at 61,355.

On the other hand, RUC is a unit commitment process designed to enable the CAISO to meet forecasted load. By itself, RUC contains no provision to compel supply resources to participate in the California market. Therefore, to be effective, RUC must be supplemented by some mandatory participation requirement for Generators such as the Must Offer Obligation. The CAISO's proposed RUC procedure was an integral element of the MD02 comprehensive market design, is fully consistent with the

implementation of LMP by other ISOs and is an absolutely necessity for the ISO to perform its core function of reliable grid operation under a market system in which the forward markets are primarily financial rather than physical commitments.[22] Although the CAISO's Waiver procedure, as adopted by the Commission, does take into account a Generating Unit's Minimum Down Time, including its Start-up Time, the Must Offer Obligation implementation methodology, including the granting, denying and revoking of Waivers, such Waiver process is not an effective substitute for a true unit commitment process.

In addition, it appears that the Commission, in rejecting RUC, was operating under the erroneous assumption that the CAISO considers cost minimization in making Waiver decisions under the Must Offer Obligation.[23] *See* July 27 Order, slip op. at 27 (the CAISO is using TCUC software). To the extent the Commission incorrectly assumed that the CAISO uses economic considerations in making Waiver decisions under the Must Offer Obligation, the Commission then erroneously assumed that the CAISO had no need for a true RUC process, including a full software program for unit commitment that considers costs. Presently, the CAISO does not consider cost

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[22] Certain considerations led to the CAISO's proposed RUC design. When the forward markets are primarily financial rather than physical commitments, the system operator cannot depend on either the submitted ("preferred") or final forward schedules to accurately reflect expected real-time loads and generation levels. Rather, market participants will utilize the forward markets for arbitrage. Such arbitrage enhances market efficiency, provided it does not interfere with reliable operation of the transmission system, and this will be the case if the system operator has effective tools to ensure that adequate capacity will be available in real time and will perform in a predictable fashion. The RUC procedure is one of those tools. It enables the system operator to identify and commit additional supply resources on a day-ahead basis when it determines that the resources scheduled day ahead will not be sufficient to meet the next day's load and reserve requirements.

[23] The CAISO also believes that the Commission might have rejected the interim RUC proposal to allow the expedited implementation of the Day-Ahead market and other Phase II market reforms. Actually rejection of RUC has complicated matters because the CAISO must now disaggregate AMP from unit commitment in the software the CAISO will utilize.

minimization in making Must Offer Obligation Waiver decisions. Specifically, the CAISO has not developed a true unit commitment software program. Thus, the CAISO cannot implement RUC as proposed after the close of either the proposed Day-Ahead Energy Market or the existing Hour-Ahead Market.

Finally, the RUC procedure is comparable to the unit commitment processes employed in markets overseen by the eastern independent system operators. In that regard, every other independent system operator in operation has a day-ahead unit commitment process designed to commit sufficient units to meet the independent system operator's forecasted Load and minimize total costs. *See New England Power Pool*, 88 FERC ¶ 61,147 at 61,491 (1999) (independent system operator commits sufficient reserves to ensure that it has adequate supply committed to meet forecasted Load); *Central Hudson Gas & Electric Corporation, et al.,* 86 FERC ¶ 61,062 at 61,222(1999) (NYISO commits sufficient capacity to meet the load forecast and provide ancillary services); *see also* PJM West Reliability Assurance Agreement, Article 8. Thus, in proposing RUC, the CAISO was not seeking any authority that the Commission has not already approved for other independent system operators.

Indeed, the primary difference between the RUC proposed by the CAISO and the RUC processes already approved for other independent system operators is that the CAISO would run RUC after the close of the Day-Ahead Market. However, this is a difference without distinction because RUC performs the same function as the unit commitment procedures in PJM, NYISO and NEISO. The Commission has not stated any reasons why PJM, NYISO, and NEISO should be permitted to have a unit commitment process but the CAISO should not nor made findings that distinguish

amongst and between the CAISO and these other independent system operators that illuminate the Commission's decision to deny use of RUC to the CAISO alone. Accordingly, the Commission's rejection of the CAISO's RUC proposal is arbitrary and capricious and not the product of reasoned decision making.

E. It Is Neither Prudent Nor Practical To Implement The Day-Ahead Market And Related Market Reforms By January 1, 2003

Commencing in the Spring of 2003, the CAISO proposed to establish a new integrated Day-Ahead Market and replace the existing separate optimization of Congestion management and Ancillary Services with a simultaneous optimization of Energy, Congestion management and Ancillary Services Market. The CAISO also proposed a Spring 2003 implementation date for certain Ancillary Services Market reforms including reforms to the price determination mechanism for Ancillary Services and permitting multi-part bids. Finally, the CAISO proposed to revise the timing of the Hour-Ahead and Real Time Markets by moving the hour-ahead timeline as close to real-time as possible. In the July 17 Order, the Commission directed the CAISO to expedite implementation of these market reforms so they can be in place effective January 1, 2003. July 17 Order at 40. The Commission's decision to expedite implementation of the integrated market reforms is arbitrary and capricious. As discussed in greater detail below, the CAISO submits that expedited implementation of the integrated market reforms would be imprudent.

The CAISO has established an MD02 implementation team headed by a CAISO Director who is dedicated exclusively to MD02 implementation. The CAISO is diligently pursuing the reforms approved by the Commission in the July 17 Order, including implementation of the integrated Day-Ahead market and other market reforms.

However, based on the significant number and the extent of the changes to the CAISO's and Market Participant's software and systems, and the scope of testing that must be undertaken to ensure proper functioning, the CAISO does not believe that the aforementioned elements of the CAISO's market redesign can be implemented effective January 1, 2003. The CAISO already had developed and proposed an aggressive timeline for implementing the Phase II market reforms. This timeline is as follows:

(1) Specification Stage—completed by September 30, 2002;

(2) Sourcing Stage—completed by mid-October 2002;

(3) Development Stage—completed by December 31, 2002;

(4) CAISO Testing [24]—completed by mid-February 2002;[25] and

(5) Market Testing (*i.e.,* market simulation)—completed by April 30, 2003.

Under this timeline, the Phase II elements could, subject to no unforeseen contingencies, be implemented effective May 1, 2003.

However, the July 17 Order leaves unresolved certain critical issues that must be resolved prior to the Specification Stage identified above. For example, the Commission failed to resolve all outstanding issues with respect to the design of the integrated market. [26]

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24 This stage includes integration testing, technical testing, and acceptance testing. The purpose of this stage is to ensure that the delivered product matches the specifications.

25 The move from the existing Congestion management system to a co-optimized forward Energy and Ancillary Services Market requires a complete replacement of existing scheduling applications. As a result, the CAISO will be required to implement the new system and architecture while at the same time maintaining the existing system. This parallel operation will require a significant amount of development and testing. The inclusion of forward Energy and Ancillary Services Markets will require the CAISO to change its data requirements and develop a different electronic scheduling template or format for use by CAISO Scheduling Coordinators.

26 A number of intervenors raised issues of concern with respect to the Optimal Power Flow (OPF) or optimization program that will be used to determine prices and schedules in the integrated market. For example, Southern California Edison Company raised concerns that the minimum cost objective function of the optimization was in conflict with the proposed pricing for the underlying and related services.Protest

While the CAISO could presume that by not specifically addressing these issues the Commission was rejecting the arguments raised, and thus accepting the CAISO's proposal, such an interpretation would appear to be in conflict with other directives in the order. In that regard, the July 17 Order expressly stated that the Commission would address the proposed tariff language for the Phase II elements in a separate order. July 17 Order, slip op. at 10, n. 15. Similarly, the July 17 Order set for technical conference issues related to the development and implementation of LMP. Although the CAISO did not propose to implement LMP until the Fall of 2003 (Phase III), the same OPF engine that will determine Locational Marginal Prices in Phase III will first determine prices for the integrated market in Phase II. Thus, the July 17th Order is internally inconsistent – the CAISO cannot both proceed with implementation of the Phase II integrated market, yet continue to discuss the parameters and design details of the Phase III LMP-based integrated market.

Furthermore, the Commission has left unresolved the status of certain of the critical elements of the new integrated market. While the July 17 Order specifically rejected the CAISO's proposed interim Residual Unit Commitment ("Interim RUC") proposal, the Commission did not specifically address the merits of the CAISO's RUC process as it fits into the long-term design elements. Once again, a number of parties raised issues with respect to the CAISO's proposed RUC process and these issues have not been addressed in the Commission's order. As noted above, the CAISO believes that RUC is a critical and essential tool for reliable grid operation and is far superior to the rough and crude waiver process currently in place.

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and Motion to Reject of Southern California Edison Company filed in Docket No. ER02-1656-003 on July 19, 2002 at 23.

Even under the CAISO proposed timeline, all unresolved issues regarding the integrated market would have to be resolved (and accepted by the Commission) by no later than September 30, 2002. This is an extremely unlikely outcome. In that regard, the July 17 Order directed the CAISO to file a compliance filing regarding the Phase II integrated market by October 21, 2002. July 17 Order, slip op. at 40. Thus, presuming a sixty-day period for the Commission to act on the compliance filing, the Commission itself would not provide definite guidance on the design details of the integrated market until late December, 2002. This would leave at most a few weeks for specification, sourcing, development, and testing (both ISO and market participant) of the new market before it goes live on January 1, 2003 – an absurd and patently unreasonable implementation timetable. If the CAISO were to meet the Commission's mandate for an integrated market effective January 1, 2003, and still satisfy the minimum timeline requirements for specification, sourcing, development and testing, all policy and design issues would have needed to be resolved in the July 17 Order – they were not.

Absent resolution of these issues, the CAISO cannot proceed with specification, sourcing and development of the integrated market-related software. [27] The CAISO also notes that its proposed timeline is based on the prudent consideration of certain critical issues with regard to implementation of the aforementioned Phase II elements. These issues are discussed below.

The depth and breadth of system modifications are highly complex and involve multiple systems. The specification and design process reasonably must involve

[27] The CAISO notes that, at the same time it is required to develop the integrated market, it must proceed with the implementation of AMP, real-time economic dispatch and uninstructed deviation penalties.

stakeholders in order to support their ability to modify their processes and systems required to participate in the markets. Any compression of time for the CAISO to engage in the necessary specification and design activities necessarily will have a corresponding impact on stakeholders. The Commission-adopted timeline necessarily will limit the stakeholder process in connection with the design and specification, thereby significantly increasing the risk of failure. Similarly, such timeline would reduce the vendor's delivery time and assumes, without any factual basis, that the vendor can deliver a product within such timeframe.

The CAISO's timeline is based on pre-detailed design estimates and recognizes that the commitments necessary to implement Phase II are not all the CAISO's. In that regard, as explained above, prior to the Specification Date (*i.e.,* September 30, 2002), all policy issues must be resolved so that the CAISO does not have to go back and modify the design and specifications after the product has already been sourced to the vendor. Moreover, although the Commission has approved the integrated market reforms in concept in its July 17 Order, the Commission has not approved the CAISO's proposed tariff language that was submitted on June 17, 2002. Thus, the CAISO's proposal is subject to modification as a result of the upcoming stakeholder technical conference process ordered by the Commission. Any changes to the CAISO's proposal would be reflected in the October 21, 2002 compliance filing. At some date thereafter, the Commission will issue an order regarding the specifics of the CAISO's integrated market proposal. If the Commission were to modify the proposal in such order, the CAISO would then have to go back and modify the specifications, thereby resulting in additional delay. Given these circumstances, to avoid costly change orders, the CAISO

timeline assumes that decisions regarding the optimization objectives be resolved prior to the CAISO issuing final scope of work documents to its software vendors.

Finally, the CAISO's timeline recognizes that, given the complexity and extensive scope of the changes, adequate time for both CAISO testing and testing by market participants will be necessary. The Commission's decision would reduce the time for testing, and any necessary remediation. To the extent that effective product testing cannot be completed, the integrity of the CAISO's systems will be jeopardized. The inclusion of forward energy and Ancillary Services markets will require the CAISO to change its data requirements and format with Scheduling Coordinators. Scheduling Coordinators will require time to conform their software to the new format. As a result of these significant changes, the CAISO and Market Participants will need to conduct a significant amount of testing to ensure the new formats and interfaces function properly.

The Phase II integrated market represents a complete paradigm shift in the way the CAISO and market participants do business. Upon relaxation of the existing market separation and balanced schedule requirements, and thus introduction of the new energy market, the fundamental structure of the bidding, scheduling and pricing of the market will change. It will by necessity take time for market participants to acclimate to this new system. By way of example, when the CAISO implemented its ten-minute market design proposal – at that time, the most significant change in the California markets since the start-up of the CAISO – the CAISO went through an extensive, lengthy internal and market participant testing process. The magnitude of the Phase II integrated market proposal dwarfs implementation of ten-minute markets. Specifically, ten-minute markets required the development of significantly fewer lines of software

code than the MD02 integrated market will require. The Commission must allow the necessary time for proper development of the Phase II integrated market. For the foregoing reasons, the CAISO requests that the Commission modify the requirement that the ISO implement the integrated market reforms by January 1, 2003.

F. The Commission Should Require That The Penalties For Uninstructed Deviations And Real-Time Economic Dispatch Be Implemented Simultaneously

The Commission approved the CAISO's proposed penalties for excessive uninstructed deviations, but conditioned their implementation on certain software modifications. Specifically, the implementation of uninstructed deviation penalties was conditioned on the implementation of improved software designed to receive and incorporate communications on outages, derates and operating problems in real time, as well as software improvements to allow more accurate representation of ramp rates at various operating points of a unit. The Commission also unconditionally approved the CAISO's proposal to implement software that uses real time economic dispatch to clear the Price Overlap.

The CAISO is pleased that the Commission approved these two important elements of the MD02 proposal and appreciates the Commission's desire to delay implementation of the uninstructed deviation penalties until improved software is installed to reflect a unit's operating limitations. However, the CAISO believes that the Commission erred in not requiring that the uninstructed deviation penalties and the Price Overlap provisions be implemented simultaneously. If the CAISO were to implement real time economic dispatch without the uninstructed deviation penalties, unit owners would have no financial incentive to follow dispatch instructions. The CAISO's

current real-time pricing software produces separate prices for incremental "INC" and decremental "DEC" dispatches in each 10-minute interval. To discourage uninstructed deviations, resources that engage in positive deviations are paid the "DEC" price, and resources that engage in negative uninstructed deviations are charged the "INC" price. The CAISO's real-time economic dispatch proposal will eliminate separate "INC" and "DEC" pricing and produce a single market clearing price applicable to both instructed and uninstructed deviations. Absent a penalty provision for excessive uninstructed deviations, unit owners would have no incentive to follow instructed deviations. To avoid this problem, the CAISO requests that the Commission condition implementation of real-time economic dispatch on the implementation of penalties for uninstructed deviations. In other words, the Commission should require that both of these elements be implemented simultaneously once the CAISO implements the aforementioned software improvements.

III. REQUEST FOR CLARIFICATION

Several aspects of the July 17 Order require further clarification from the Commission. The specific findings in the July 17 Order for which the ISO seeks clarification are discussed below.

A. The Commission Should Clarify The ISO Is Permitted To Use Its TCUC Software To Grant Must-Offer Waivers And Commit Units In A Manner Consistent With The Authority Granted To Other ISOs

In response to the Commission's December 19, 2001 market mitigation orders in Docket Nos. EL00-95, *et al.*, in its May 1 Filing, the CAISO noted that it was currently developing unit commitment software to support the Must Offer Obligation Waiver process that the CAISO developed as a part of the implementation of the Must Offer

Obligation. MD02 Filing, Attachment A at 109-110. The CAISO noted that the process for granting or denying waiver requests and for recalling units that were previously granted waivers was basically a residual unit commitment or RUC process. The CAISO indicated that the unit commitment process that was being developed had as its objective the minimization of commitment costs of serving residual Load, *i.e.*, the difference between the CAISO forecasted Load and the day-ahead Scheduled Load (assuming the forecast is greater than the Schedule). Adjustments would be made to the residual Load to be served by the unit commitment process to account for expected hour-ahead Load Schedule changes and expected real-time Supplemental Energy bids. The CAISO indicated that the software being used employs the Transmission Constrained Unit Commitment ("TCUC") software similar to the software used by the NYISO for its unit commitment process. To replace the existing Must Offer Obligation and its Waiver process, the ISO proposed to extend and modify the use of the TCUC program for the proposed RUC procedure.

As noted supra, in its July 17 Order, the Commission rejected the CAISO's proposed RUC procedure, finding that the CAISO's process of granting or denying Waivers and for recalling units that were previously granted a Waiver is essentially a unit commitment process. July 17 Order, slip op. at 27. The Commission stated that the CAISO was using TCUC software to do this and directed the CAISO "to apply the AMP procedures at the time it runs the TCUC for granting waivers for the must-offer obligation." *Id.*

Thus, the Commission approved the use of TCUC in its July 17 Order. TCUC is designed so that it will optimally commit units based on system reliability, transmission

constraints, expected Load and economics. TCUC essentially effectuates a security constrained economic unit commitment based on projected dispatch. In other words, TCUC reviews the MW net short and Dispatches Energy to cover that amount, generally committing units higher up on the bid curve depending on transmission constraints and unit capabilities. In this process, TCUC is designed to incorporate the process the CAISO had previously proposed for granting waivers under the Must Offer Obligation.

Although the July 17 Order authorizes the ISO to implement TCUC as proposed in the MD02 Filing, prior Commission orders create confusion as to the extent the CAISO can employ TCUC. In that regard, in its May 15, 2002 “Order Accepting In Part and Rejecting in Part Compliance Filing” in Docket Nos. EL00-95-058, *et al.*, the Commission ruled that when generators request Waiver of the Must Offer Obligation, the CAISO cannot apply the following two criteria in determining whether to grant a waiver: (1) minimize the start-up and minimum load costs necessary to meet the CAISO’s forecasted demand; and (2) provide a fair and reasonable assurance of competitive outcomes. *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 at 61,630 (2002)(“May 15 Order”). Rather, the Commission found that the CAISO could only provide exemptions from the Must Offer Obligation so as to (1) provide sufficient on-line generating capacity to meet operating reserve requirements and (2) account for other physical operating constraints of generating units. *Id.* The Commission stated that “[w]hile minimization of costs is generally desirable in the context of our Must-Offer Obligation, where the primary focus is to ensure that there is sufficient energy to meet

load, the exemption procedure should not be used to minimize costs to the detriment of reliability. *Id.*

Further, in a prior order discussing implementation of the Must Offer Obligation, the Commission stated that the Must Offer Obligation process allows "the ISO to make reasoned decisions about its generation requirements in order to maximize economic and reliable operations." *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,* 97FERC ¶ 61,293 at (2001).

Thus, the Commission's orders regarding TCUC and the must-offer waiver process send conflicting messages regarding the extent to which the CAISO can take economics into account in committing units (*i.e.,* making Waiver decisions). At the present time, the CAISO is not using TCUC because of the directive in the May 15 Order that the CAISO cannot consider economics in deciding to which units it should grant waivers. This has created significant difficulty for the CAISO in making non-discriminatory and rational decisions about which units should be required to run at Minimum Load under the Must Offer Obligation when some, but not all of the units seeking a Waiver need be committed to maintain grid reliability.

On rehearing, the Commission should clarify that the CAISO is permitted to commit units in economic merit order (*i.e.,* grant waivers to the highest cost units requesting a waiver) once the ISO determines that sufficient capacity is available to maintain reliable operations and meet forecasted load. Every other independent system operator is authorized to commit units in a manner consistent with the CAISO's TCUC software as described *supra*. For example, the NYISO computes a day-ahead unit

commitment schedule to accomplish four goals: (1) supply Energy to satisfy all accepted buyer bids in the day-ahead market; (2) provide sufficient Ancillary Services to support the Energy purchased; (3) commit sufficient capacity to meet forecasted Load; and (4) meet all bilateral schedules submitted in the day-ahead market. The Schedule is developed with the objective of minimizing total costs of Generation, operating reserves and regulation subject to transmission constraints. *Central Hudson Gas & Electric Corporation, et al*., 86 FERC ¶ 61,062 at 61,222 (1999). This is accomplished through the Security Constrained Unit Commitment program that selects the least cost mix of Energy and Ancillary Services. *Central Hudson Gas & Electric Corporation, et al*., 88 FERC ¶ 61,138 (1999). ISO New England ("ISONE") uses a unit commitment model to determine a day-ahead, *least cost* schedule and real time Dispatch of Generation to meet Load based on submitted bids. *New England Power Pool*, 85 FERC ¶ 61,379 at 62,459-60 (1998). ISONE's unit commitment process, which is set forth in NEPOOL's Market Rules and Procedures, Section 2-Scheduling and Dispatch instructions, Appendix 2-A, expressly provides that the "overall objective of unit commitment is to minimize production cost" (while complying with all applicable operating and reliability requirements). Similarly, PJM employs a day-ahead reliability assessment and dispatches generation in economic merit order. *Atlantic City Electric Company, et al*., 86 FERC ¶ 61,248 at 61,893 (1999); *see also* PJM FERC Electric Tariff, Fifth Revised Volume No. 1, Section 1.10.8.

Given that the Commission has stated that the Must Offer Obligation Waiver procedure is just like a unit commitment process, there is no valid reason for the Commission to deny the CAISO the ability to commit units and grant Waivers in a

manner consistent with that used by the eastern independent system operators to commit units. The courts have stated that "[f]or the agency to reverse its position in the face of precedent it has not persuasively distinguished is quintessentially arbitrary and capricious." *Louisiana Public Service Corporation v. FERC*, 184 F.3d. 892, 897 (D.C. Cir. 1999). Consistent with the authority the Commission has granted other independent system operators, the Commission should clarify that the CAISO can utilize its TCUC software to grant Waivers and commit units using a security constrained, least cost algorithm.

B. The Commission Should Clarify That The CAISO Is Not Required To Provide Day-Ahead Pricing Information Under The 12-Month MCI Until The CAISO Implements a Day Ahead Market

To establish an objective standard for determining whether market outcomes meet the just and reasonable rate standard, in its MD02 Filing, the CAISO proposed a 12-month MCI that would compare on a rolling 12-month basis, actual average market cost to a competitive baseline average cost. If the 12-month rolling average mark-up is above $5/MWh, then strict price mitigation measures automatically would be implemented. Under the CAISO proposal the CAISO would track day-ahead, hour-ahead and real-time Energy prices and compare those prices to competitive baseline prices. In the absence of a forward Energy market, the CAISO proposed to rely on CERS' day-ahead and hour-ahead scheduled quantities and the corresponding short-term contract prices. In the July 17 Order, the Commission rejected the use of the 12-month MCI for mitigation purposes. However, the Commission directed the CAISO to file the information weekly with the Commission's Office of Market Oversight and Investigation. July 17 Order, slip op. at 36.

The CAISO requests that the Commission clarify that the CAISO is not required to report information regarding day-ahead prices until the CAISO actually implements its Day-Ahead Market. As proposed in its MD02 Filing, the ISO planned to use CERS short-term contract price data as a surrogate for actual Day-Ahead Market price data in the absence of a Day-Ahead Market operated by the ISO. Currently, however, CERS data is submitted to the ISO after a considerable time lag.[28] The time lag makes it infeasible for the CAISO to disseminate timely and accurate market information and constrains the CAISO's ability to provide up-to-date, real world examples of the competitiveness index. The time lag also lessens the utility of the CERS data. Given this time lag and the fact that the 12-month MCI will be used for informational purposes only, the CAISO submits that the CAISO should not be required to file the 12-month MCI until the CAISO's Day-Ahead Market is implemented. In the alternative, the CAISO could submit the 12-month MCI data on a bi-monthly basis as CERS data becomes available. In any event, the CAISO should not be required to file the 12-month MCI data more often than once per month once the day-ahead market is implemented or bi-monthly if CERS data is to be used because significant resources are required to ensure that the index accurately computed.

C. The Commission Should Clarify That It Is Not Directing The ISO to "DEC" RMR Units In Order To Alleviate Intra-Zonal Congestion

In authorizing the CAISO to apply AMP as a test for the possible exercise of local market power, the Commission directed the CAISO to use its existing Reliability-Must-Run ("RMR") generation to the full extent for reliability purposes and to alleviate Intra-

[28] CERS provides purchase data to the CAISO on a bi-monthly basis following a 45 day lag (e.g., January and February CERS data is not provided to the CAISO until mid April)

Zonal Congestion. July 17 Order, slip op. at 33. However, the Commission noted that RMR resources are not subject to AMP and do not set the market clearing price. *Id.*

As the Commission is aware, the CAISO has RMR contracts with specific Generators that are required to run under certain conditions as needed to maintain grid reliability. However, while the CAISO maintains broad authority to increase a Generating Unit's output for reliability purposes, the CAISO's ability to reduce a RMR unit's output under the RMR contract is limited to reducing a unit's output to provide Ancillary Services. In other words, the CAISO's executed RMR contracts do not permit the CAISO to reduce, or DEC, output from an RMR unit to mitigate Intra-Zonal Congestion.

Given the terms of the CAISO's existing RMR contracts, the Commission should clarify that its directive that the CAISO use RMR contracts to the fullest extent possible to alleviate Intra-Zonal Congestion does not contemplate that the CAISO will violate the RMR contract and DEC output from RMR units. If it is the Commission's intent that the CAISO have the authority to order RMR units to DEC output, then the Commission should issue such a directive in its order on rehearing and order the CAISO and RMR contract holders to renegotiate their RMR owners to provide the CAISO with such authority.

D. The Commission Should Clarify That Intertie Schedules Are Excused From Uninstructed Deviation Penalties Only When The CAISO Makes Inter-Hour Changes To Dispatch Instructions

In its protest of the MD02 Filing, the Bonneville Power Administration argued that the CAISO should limit the application of uninstructed deviation penalties to Market Participants with the ability to respond to the CAISO's 10-minute instructions. In its July

17 Order, the Commission noted that Section 11.2.4.1.2(b) of the proposed tariff language – which the Commission approved – provides an exemption for such cases. July 17 Order, slip op. at 49.

The CAISO hereby seeks to clarify how uninstructed deviation penalties will apply to intertie schedules. Section 11.2.4.1.2(b) provides that uninstructed deviation penalties will apply to intertie schedules if a pre-Dispatch instruction is declined or not delivered. However, Uninstructed Imbalance Energy resulting from declining intra-hour instructions will not be subject to uninstructed deviation penalties. Thus, if the CAISO pre-Dispatches an intertie bid, and the pre-Dispatch instruction is declined or the Energy is not delivered, an uninstructed deviation penalty will apply. However, if the CAISO makes an intra-hour change to a Dispatch instruction for a tie schedule, the CAISO will not impose an uninstructed deviation penalty.

Thus, the Commission should clarify that tie schedules are not subject to uninstructed deviation penalties only in the context of intra-hour changes in their Dispatch instructions. This is appropriate because ties cannot respond to 10-minute Dispatch instructions. It is not appropriate to forgive uninstructed deviation penalties when a intertie supplier declines a pre-Dispatch instruction or otherwise fails to deliver Energy where such action cannot be excused on the basis that the tie is unable to react in a timely manner.

E. The Commission Should Clarify That Marketers And System Resources Are Not Required to Bid $0/MW And Be Price Takers

In the July 17 Order, the Commission approved the CAISO's proposal to apply AMP to imports. July 17 Order, slip op. at 29. The Commission also approved the CAISO's proposal to implement software that contains an economic dispatch algorithm

to continuously clear overlapping real-time Energy bids so that there will be a single price in each ten-minute interval.[29] *Id.* at 45. However, it its May 15, 2002 "Order on Rehearing and Clarification" in Docket Nos. EL00-95-053, et al., the Commission denied the CAISO's request for rehearing of the requirement that marketers and System Resources bid $0/MWh and be price takers. *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services Into Markets Operated By The California Independent System Operator and California Power Exchange*, 99 FERC ¶ 61,160 at 61,650-51 (2002). The Commission should clarify that in approving (1) the application of AMP to imports and (2) clearance of the price overlap, its intent is that marketers and System Resources are no longer required to bid $0/MWh and be price takers. If this was not the Commission's intent, then the Commission should grant rehearing on this issue for the reason set forth below.

If marketers and System Resources are required to bid $0/MWh, that will continue to turn out-of-state suppliers away from the California market and make clearing of the price cap problematic. Forcing System Resources to bid at $0/MWh and be price takers will cause a price overlap condition with any DEC bid that is greater than zero. System Resource bids will always end up clearing at $0/MWh. In other words, imports would be paid $0/MWh for their energy. This is unreasonable. Accordingly, the Commission should make it clear that it adopted the CAISO proposal in the MD02 Filing, *i.e.*, System Resources can bid non- $0/MWh but cannot set the MCP and would be guaranteed the average of the interval prices and their bid.

[29] The CAISO proposed to issue Dispatch instructions to all overlapping bidders, thereby requiring bidders to buy Energy (*i.e.* reduce Generation) or sell Energy (*i.e.* increase Generation) at the applicable 10-minute price. By clearing the price overlap for each 10-minute interval, the separate incremental and decremental prices converge to a single market clearing price.

The CAISO recognizes that the Commission's primary reason for imposing the $0/MWh bid requirement was to address the issue of "megawatt laundering." However, in its July 17 Order, the Commission has approved a $250/MWh west-wide price cap and subjected imports to AMP. These actions should be sufficient to protect against "megawatt laundering". However, the $0/MWh bidding requirement needs to be eliminated to encourage import participation in the CAISO's markets and enable price overlap clearing to function properly.

F. The Commission Must Clarify What Price Cap Will Apply If AMP Cannot Be Implemented By October 1, 2002

In the July 17 Order, the Commission approved a $250/MWh price cap commencing October 1, 2002. The Commission also approved AMP effective October 1, 2002. However, the Commission directed the CAISO to hire an independent entity to calculate the AMP reference prices. The Commission required to CAISO to issue a Request For Proposals ("RFP") within 30 days to retain the services of a qualified independent organization to perform the task of determining reference prices.

The CAISO requests that the Commission clarify what the applicable price cap will be if, despite the CAISO's best efforts, AMP cannot be implemented by October 1. The CAISO has been diligently prosecuting this matter. The requisite RFP was issued on August 9, 2002, *i.e.,* a week earlier than required by the July 17 Order. At this time, the CAISO does not know how many, if any, parties will respond to the RFP. The CAISO does not know what the total cost of this project will be and it is possible that the costs

could present a significant economic hardship for the CAISO or even be prohibitive.[30] Assuming the CAISO is able to award the project to a qualified entity, the CAISO also cannot predict how long it will take such an independent entity to calculate the reference prices, although the CAISO does know that it will be a significant undertaking. Thus, the possibility exists that, as a result of factors outside of the CAISO's control, AMP will not be in place by October 1, 2001. Unfortunately AMP is the only mechanism that can mitigate suppliers' bids and prevent suppliers from simply bidding $250/MWh. Thus, the Commission should clarify that it will ensure that adequate measures are in place to mitigate prices in the event AMP is not in place on October 1, 2002.

IV. CONCLUSION

WHEREFORE, for the foregoing reasons, the CAISO respectfully requests that the Commission grant the instant request for rehearing and vacate the following rulings made in its July 17 Order: (1) approval of an AMP conduct threshold of the lower of a 200 percent or $100/MWh increase in the reference price and an AMP market impact threshold of the lower of a 200 percent or $50/MWh increase in MCP; (2) approval of an AMP price screen of $91.97/MWh; (3) approval of the same price screen and market impact threshold for circumstances when local market power can be exercised that the Commission approved for the system as a whole; (4) rejection of the CAISO's interim RUC proposal; (5) the requirement that the CAISO implement the Day- Ahead Market and other specified market reforms by January 1, 2003; and (6) approval of an effective

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[30] The CAISO has requested that persons submitting bids in response to the CAISO's RFP indicate both the cost of calculating reference prices daily and the cost of calculating reference prices on a daily basis and on a monthly basis.

date for the economic dispatch/Target Price proposal that is different than the effective date for uninstructed deviation penalties.

On rehearing, the CAISO requests that the Commission eliminate the AMP price screen of $91.87/MWh. Further, for the application of AMP to the CAISO Control Area transmission system, the Commission should adopt the AMP conduct and market impact thresholds originally proposed by the CAISO in its MD02 Filing, *i.e.*, a conduct threshold of a 100 percent or $50 increase over the reference price and a market impact threshold of 100 percent or $50 increase in MCP. For purposes of testing for local market power, the Commission should approve the proposal set forth in the MD02 Filing. In the alternative, the Commissions should approve the modified AMP proposal discussed above. The Commission also should (1) approve the CAISO's RUC proposal as an integral element of its comprehensive market design and (2) find that the Phase II market reforms and Day-Ahead Market should be implemented by May 31, 2003. Finally the Commission should grant the requested clarifications as set forth herein.

Respectfully Submitted,

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Filed: August 16, 2002

CALIFORNIA ISO

California Independent
System Operator

August 16, 2002

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

Re: California Independent System Operator Corporation
Docket No. ER02-1656-000

Investigation of Wholesale Rates of Public Utility Sellers and Ancillary Services in the Western Systems Coordinating Council
Docket No. EL01-68-017

Dear Secretary Salas:

Enclosed for electronic filing please find a Request for Rehearing and Clarification of the California Independent System Operator Corporation in the above-referenced dockets.

Thank you for your assistance in this matter.

Respectfully submitted,

Anthony J. Ivancovich
Counsel for The California Independent
System Operator Corporation

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 docket.

Dated at Folsom, California, on this 16th day of August, 2002.

____

Anthony J. Ivancovich