

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

California Independent System
Operator Corporation

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Docket No. RT01-85-000

A STATUS REPORT

I. INTRODUCTION

It is appropriate, as the summer of 2001 draws to a close, to apprise the Commission of the views of the California Independent System Operator Corporation ("CAISO") on the progress made, and on the challenges remaining, to assure for California consumers, and for those in the broader western regional grid, reliable and efficient competitive electricity markets.

As will be described presently, progress has been made. But it is equally true that challenges of unprecedented scope and magnitude have yet to be met successfully. As tempting as it may be, having come through a season of peak demand with reliability intact and prices showing signs of moderation, to leap to conclusions of success that, unfortunately, would be premature. In truth, the success of this summer is the result of a combination of factors, including moderate weather conditions, an economic downturn particularly affecting sectors that traditionally are electricity-intensive, and the unprecedented response of consumers to calls for conservation. Further, an arm of the State of California has had to intercede to provide

the credit assurance that could not be offered by California's predominant traditional wholesale purchasers, the investor-owned utilities.

A competitive electricity market cannot be sustained on hopes of moderate weather conditions, nor should it be able to sustain reliability only during times of economic downturn. And it most certainly should not be dependent on the intervention of a State agency as the predominant creditworthy purchaser. It would be a most serious mistake were the avoidance of catastrophe this summer to lull us into a state of complacency; to lead us to the conclusion that the boat now is sufficiently stable that we again can risk its being rocked. Progress has been made, but the crisis is far from over.

In the pages that follow, the crisis and the challenges that it yet presents will be described. As importantly, the activities of the CAISO in meeting its responsibilities will be discussed. Fairly appraised, they lead to but one conclusion: the ability of the CAISO to meet those responsibilities has been left in tact, and those responsibilities continue to be met with distinction. Moreover, the State has marshaled expertise and resources and embarked upon initiatives directed at meeting the crisis head-on to the end that, at the earliest feasible moment, California can achieve functioning, competitive electricity markets and thereby secure for its consumers the benefits of efficiency and innovation.

But the road to success is littered with formidable pitfalls. Successful navigation requires that California be allowed to stay the course; that disruption creating further unnecessary uncertainty be avoided at least until we confidently can conclude that the crisis truly has been met. This is not to suggest that progress toward market redesign must be sacrificed. To the contrary, as will be described, moving that effort forward will

continue to be a priority for the CAISO. Nor is it necessary to postpone indefinitely dialogue and even change in CAISO governance structure. As also will be described, the CAISO is committed to facilitating greater regional coordination, and is mindful that as regional progress is made, governance issues will require reexamination.

It is not the object of this filing to interpose roadblocks; it is simply to place issues in perspective, and the one perspective that predominates is that California's electricity markets remain in a state of crisis. It would not serve the interests of any interest group to inject added uncertainty at this point, thereby unnecessarily shrouding in doubt the ability of the CAISO to meet the enormous challenges that remain if California's electricity markets are to approach equilibrium in a manner consistent with the public interest.

II. THE CRISIS REMAINS; THE RELEVANT LANDSCAPE IS EVOLVING

That California's electricity markets remain in a state of crisis, and that the next several months are particularly critical to its successful resolution, cannot seriously be doubted. In both its November 1¹ and December 15, 2000 Orders,² the Commission recognized the serious crisis confronting California and the "dysfunctions" that plague its electricity markets.

It is well to step back and to recall the enormity of the challenges that California has had to confront over this past year, a year that began with enormous reliance being placed on spot-markets, with irrational price escalation in those markets, and with the

¹ *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*, 93 FERC ¶ 61,121 (2000), [hereinafter Nov. "1st Order"].

reluctance of suppliers, even with those unacceptably high prices, to bid and the “drying up” of the imbalance energy market (the BEEP stack) as a consequence. The unavailability of bids had reached such crisis proportions that by December 11, 2000, the CAISO had to seek, and on December 14, 2000, the Secretary of Energy granted, relief under Section 202(c) of the Federal Power Act. Thereafter, in response to CAISO certifications and reapplications, the relief was extended until February 7, 2001. With it being clear that the Administration would not further extend emergency relief, the CAISO sought assurance from suppliers that they would respond to real-time dispatch instructions, notwithstanding the precarious financial positions of the investor-owned load-serving entities. When that assurance was not forthcoming, the CAISO was left with no alternative; it was compelled to invoke the equitable jurisdiction of the federal district court seeking supplier compliance with their obligations under the Federal Power Act, under the ISO tariff, and under Participating Generator Agreements. Absent judicial compulsion, the CAISO had no reasonable assurance that generators would comply with real-time dispatch instructions that the CAISO was required to issue in its daily struggle to keep the lights on and to protect the integrity of the interstate grid.³

But by that time, the irrational price escalation had taken its toll. California’s largest investor-owned utility was forced to seek bankruptcy protection, and the second

² *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*, 93 FERC ¶ 61,294 (2000) [hereinafter “Dec. 15th Order”].

³ Unfortunately the injunctive relief, issued by the district court in response to the public interest demonstration of the CAISO and the State of California *California Independent System Operator Corp. et al. v. Reliant Energy Services, Inc. et al.*, CIV S01-238, 2001 WL 881268 (E.D. Cal. Feb. 8, 2001) was lifted by the Ninth Circuit upon being advised by the Commission’s Solicitor that only the Commission could seek enforcement of obligations under the Federal Power Act *California Independent System Operator Corp. et al. v. Reliant Energy Services, Inc. et al.*, Case No. 01-15528, (9th Cir. Apr. 5, 2001). The issue was largely rendered moot by the Commission’s contemporaneous determination that the

largest utility declared its inability to continue to purchase its “net-short,” the gap between supply owned or under contract and total customer demand. That utility as well confronted the very real possibility that bankruptcy protection would prove necessary.

Contemporaneously, two other realities converged to bring the crisis to yet an enhanced level of urgency: the California Power Exchange announced the cessation of its markets (and, with the disappearance of its organized forward markets, increased pressure was placed on CAISO real-time markets and operations) and the Commission began to issue a series of orders on “creditworthiness” that effectively precluded CAISO “purchases” off the BEEP stack or issuance of dispatch instructions in real-time. With the period of summer peak demand rapidly approaching, the California Governor and Legislature took a series of unprecedented steps. Initially, the Department of Water Resources (“DWR”) was provided interim financing to be able to step-in and provide coverage for the net-short demand that the investor-owned utilities no longer could procure. Ultimately, a newly constituted unit of DWR, California Energy Resource Services (“CERS”), was provided the mandate both to acquire the energy needed to meet the net-short, and also to contract on a forward basis with the goal, identified by the Commission also in its November and December Orders, of reducing reliance on spot markets. In related efforts, and again with the objective of establishing the short-term stability necessary to ameliorate the immediate crisis and the long-term stability required to facilitate truly competitive electric markets, the Legislature replaced the CAISO’s stakeholder board with one appointed by the Governor. Additionally, state

CAISO could only issue dispatch instructions if the transaction was backed by a creditworthy entity. *California Independent System Operator Corp.*, 95 FERC ¶ 61,024 (Apr. 6, 2001)

policymakers created the California Consumer Power and Conservation Financing Authority, with a mandate to increase capacity, promote and institutionalize conservation and demand-side management efforts, and to deal with the unique issues associated with meeting peak demand requirements.

CERS responded immediately and aggressively, and its efforts have taken pressure off of the spot markets thereby causing prices in those markets to moderate. But the cost of introducing stability has been high and CERS has yet to secure the permanent financing that it requires to meet its contractual obligations.

To say that the landscape has changed profoundly in a period of a few short months falls far short of acknowledging the true upheaval that has occurred. In January of this year, it was the investor-owned utilities who sought to discharge their continuing obligation to meet load. Today, the only energy purchaser of any significance is a State agency. The activities of the State's largest utility are being supervised by a bankruptcy judge, and absent legislative intervention, the second largest utility may have no alternative but the Chapter 11 path. Additionally, CERS will have to attract from investors financing in an unprecedented amount, financing that is made necessary by the staggering (and unjustified) transfer of wealth that is directly attributable to the unconscionable prices extracted by wholesale suppliers (to a point that necessitated the California and western-wide refund proceedings now fast-tracked before Administrative Law Judges).

III. THE CAISO HAS MET THE CHALLENGE

The changing landscape has confronted the ISO with evolving challenges as well. It was always assumed that there would be functioning forward markets that satisfy the predominant requirements of load, with the real-time markets responsible for a decidedly minimal balancing function. That turned out not to be the case. It was always assumed that the creditworthiness of the major load-serving entities would never truly be in doubt, at least not over prolonged periods. That, too, turned out not to be the case.

As a consequence, the CAISO has been called upon to discharge functions critical not just to California, but to the interconnected western grid, in an atmosphere that previously was even beyond contemplation. The CAISO has responded admirably. As the Commission considers whether, how and, most importantly when to deal with CAISO “issues” that remain unresolved, it would be well to pause over one salient reality: the CAISO continues to discharge its core responsibilities with distinction.

Admittedly the diversion of scarce resources (including, most recently, responding to the enormous data required by the Commission and by the parties in the refund dockets) has not permitted the CAISO to move as fast and as far on certain key issues, for example, market redesign. But, even as the Board composition has changed, the core of senior management remains intact. Indeed, despite the tumult of its work and the surrounding environment the ISO has been a bastion of personnel stability and a model of organizational efficiency. Moreover, the new Board has allowed management the freedom, flexibility and support necessary for optimal performance. Unmistakably, progress has and is being made on many fronts. For example, the

CAISO has moved forward with the development of a grid-wide approach to Transmission Access Charges, and with the reformation of the methodology for billing Grid Management Charges, each initiative with the objective of making CAISO participation more congenial to publicly-owned systems. Progress has been made on new Generator Interconnection Policies as well, and a task force has been re-examining Market Redesign. Additionally, the CAISO is implementing its expanded outage coordination authority while continuing to examine beneficial system enhancements.

Perhaps most significantly, the CAISO has played a leadership role in an effort to promote greater regional coordination. While suggesting, in the first instance, a California-only RTO, the CAISO, in its filing of June 1, 2001, asserted that many of the benefits of broader regional coordination may be attainable even without formation of a regional RTO -- specifically the reciprocal elimination of pancaked transmission charges and the enhanced coordination of planning efforts. Because it is highly unlikely that a functioning region-wide RTO will be in place in the near future, the CAISO advanced the importance of a more measured, cooperative approach and its willingness to play an active promotional role. In the months since, the CAISO has acted on this commitment, spearheading a region-wide effort to deal with "seams" and other western regional issues.

Not only is the CAISO pursuing region-wide coordination and cooperation with the support of its Governing Board, the recent California legislative enactments are in no way hostile to regional expansion and/or integration. The Commission recognized

this when commenting on SB 96,⁴ and nothing in the more recent enactment, AB 5x, is to the contrary.

IV. DESPITE CONSIDERABLE PROGRESS AND THE MAINTENANCE OF STABILITY, THE CRISIS IS FAR FROM OVER AND UNCERTAINTY LOOMS

For the moment, stability has returned to California's electricity markets and reliability has and is being maintained. And, it is to be hoped that, as a result of the contracting efforts of CERS, the commitment of Californians to conservation, and the recent efforts of the Commission to establish just and reasonable wholesale electric charges, prices will continue to moderate. But it is imperative that one not lose sight of the challenges that remain, for they are formidable and many, and if not met successfully, easily could return the California electricity markets and those in the broader interconnected western grid into a state of renewed chaos. Nothing that could in any way add to the complexities should at this point be tolerated.

The financial plight of California's second largest utility remains in doubt. A Memorandum of Understanding ("MOU") designed to help assure recovery has been negotiated by the Governor, but whether it will be allowed to take shape is yet uncertain. If it cannot be implemented, or if it is implemented in a way that falls short of restoring financial stability, a second bankruptcy could prove inevitable.

Meanwhile, the PG&E bankruptcy has entered a critical phase with the filing by the company of a controversial and revolutionary reorganization plan. The fact of the matter is that it is unclear when and by what means California's government will be relieved of the burden of buying the State's electricity.

⁴ *California Electricity Oversight Board*, 88 FERC ¶ 61,172 at 61,577 (1999).

The MOU and the already extant bankruptcy also leave in doubt ultimate ownership of major transmission assets. Recognizing the role of this Commission with regard to reorganization of transmission assets, the fact remains that events over the next several months will bear heavily on transmission ownership issues.

California is hopeful that the newly-formed Authority will succeed in increasing capacity, promoting conservation and demand-side management, and in dealing with the vexing problems associated with meeting peak demand. But the Authority is only now in its formative stages.

California has just initiated the process for raising the very significant public financing necessary to underwrite the State's essential electricity operations. Specifically, financing required to replace bridge loans and to enable CERS to meet its obligations under contracts that have greatly reduced dependence on real-time spot markets with resulting price and reliability benefits. CERS will have to raise approximately \$12.5 billion. As press reports make clear, while the State remains convinced of the marketability of the bonds, investor questions remain and the pricing is to be determined. It is accepted logic that investors abhor uncertainty. Therefore, it behooves all who care about the stability of California's electricity markets to eschew any unnecessary actions that might be perceived as destabilizing.

Finally, there can be little doubt that the stability of California's electricity markets has benefited from unusually moderate weather and, unfortunately, an economic slowdown. The latter, hopefully, will be short-lived; the former is unpredictable. For its part, the CAISO intends to stay focused on its core responsibility: to assure open, comparable access to the transmission grid entrusted to it to the end of promoting a

truly competitive electric marketplace. But the CAISO will require help, including in the nature of forbearance.⁵

Over the next 60 to 90 days, much will become clearer. We should know whether the bankruptcy of the second largest utility has been averted. We may know more about the likely future ownership of major transmission assets. We will know more about the progress of required CERS financing and more about the likelihood that the major load-serving entities will soon be in a position to reassume responsibility for the net-short.

The CAISO is willing to consider anew fundamental issues of market structure and of CAISO governance. Toward these ends, the CAISO Board stands ready to participate in any dialogue that the Commission may wish to initiate, and to do so without preconceptions or preconditions, save for the reality that the State of California has legitimate interests that must be heard.

⁵ For example, on the issue of the control room access provided CERS, the CAISO is not unmindful of the concerns that have been advanced. It is important to recognize that with the issuance by the Commission of its Orders on Creditworthiness, the CAISO no longer could commit to essential real-time transactions on behalf of major load-serving entities. As the Commission suggested, CERS stepped up to those responsibilities, but felt that to ensure its own compliance with responsibilities entrusted to it under State law, control room access was critical, at least during a learning-curve period. Out of necessity, the CAISO acquiesced, knowing that it alone would remain in control of grid operations, and that those operations – and open, comparable transmission access – would not be compromised by the presence of CERS. And, they were not. Be that as it may, to obviate any lingering concerns, the CAISO has effected the complete disengagement of CERS from the control room.

September 28, 2001

VIA MESSENGER

David P. Boergers, Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, D.C. 20426

**Re: California Independent System Operator Corporation
Docket No. RT01-85**

Dear Secretary Boergers:

Enclosed for filing are one original and fourteen copies of the Status Report of the California Independent System Operator Corporation in the above-cited proceeding. Two additional copies of the filing are also enclosed.

I would appreciate your stamping the additional copies with the time/date stamped and returned to us by the messenger. Thank you for your assistance.

Respectfully submitted,

Edward Berlin
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 this proceeding.

Dated at Washington, DC, on this 28th day of September, 2001.

Edward Berlin

