



March 1, 2004

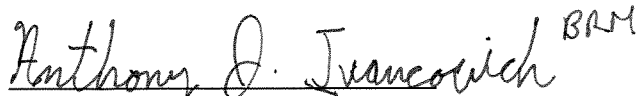
The Honorable Magalie Roman Salas
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

**Re: California Independent System Operator Corporation,
Docket No. ER02-1656-009, 010 and 011 and Investigation of
Wholesale Rates of Public Utility Sellers of Energy and
Ancillary Services in the Western Systems Coordinating
Council, Docket No. EL01-68-017**

Dear Secretary Salas:

Enclosed for filing in the above-captioned dockets, please find the Status Report of California Independent System Operator Corporation ("ISO").

Respectfully submitted,

Handwritten signature of Anthony J. Ivancovich in cursive script, with the initials 'BRM' written in the upper right corner of the signature.

Charles F. Robinson
Anthony J. Ivancovich
The California Independent System
Operator Corporation
151 Blue Ravine Road
Folsom, CA 95630

Attorneys for the California Independent
System Operator Corporation

**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
)	
)	

**STATUS REPORT OF THE
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION**

The California Independent System Operator Corporation (“ISO”)¹ respectfully submits this monthly progress report (“Report”) in compliance with the Commission’s November 27, 2002 “Order Clarifying The California Market Redesign Implementation Schedule”, 101 FERC ¶ 61,266 (2002) (“November 27 Order”), issued in the above-referenced dockets.

The November 27 Order required the ISO to file reports on the first Monday of each month, beginning in January 2003, to update the Commission on the ISO’s progress in designing and implementing the market redesign effort. The Commission directed the ISO to file a full market redesign implementation plan, including a detailed timeline with the sequential and concurrent nature of the design elements, the software and vendors (once selected) to be used and the cost estimates for each element. The November 27 Order required that the first report include explanations of the following: (1) any alternative methods of

developing market redesign elements; (2) the ISO's progress in developing the market redesign elements; (3) the action required to establish such elements; and (4) a detailed breakdown of the total start-up costs.² The Commission directed the ISO to update the market redesign implementation plan on a monthly basis, indicating the progress made and the upcoming steps.

On January 10, 2003, the ISO filed its first Status Report in compliance with the November 27 Order. Subsequent to the first filing, the ISO continues to file monthly Status Reports with the Commission on the first Monday of each month. The instant Report is intended to satisfy the monthly reporting requirement in the November 27 Order, update the information included in prior Status Reports and generally advise the Commission of the current status of the market redesign implementation effort.

I. MARCH STATUS REPORT

Sections A and B include a narrative of the significant changes to the "Program Plan – High Level" schedule activity that have occurred since the filing of the prior month's Status Report. Section C includes a narrative regarding the budget along with an updated Budget Tracking and Status Report³. Section D identifies the ISO's key market redesign implementation issues including the previous month's accomplishments, major milestones, upcoming activities, issue

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

² November 27, Order at P 9.

³ The narrative includes only non-confidential information.

resolution with stakeholders and items requiring timely resolution by the Commission in order to meet the project schedule.

A. Phase IB Status

Overall: Phase IB involves implementing software that (1) contains an economic dispatch algorithm to clear overlapping Real-Time Energy bids continuously so that there will be a single price in each five-minute interval, and (2) allows, *inter alia*, generators to modify unit availability in Real-Time and enable the ISO to impose penalties for uninstructed deviations.

Due to the current status of critical system functionality and the need to assure adequate market simulation, the ISO has determined that the Phase IB implementation date will not occur on April 1, 2004. If several critical milestones are met in early March, the ISO anticipates “going live” May 1, 2004. However, at this point, the ISO cannot definitively determine the “go live” date and will reserve making that determination until it is reasonably certain as to when such date will be. The ISO will apprise the Commission of the final “go-live” date upon completion of its assessment.

In the February 2, 2004 Status Report, the ISO reported that there were four critical areas that have a potential risk to the Phase IB schedule: (1) successful completion of market simulation activities, (2) Real-Time Market Application functionality, (3) load and performance testing, and (4) permanent training environment for ISO Operator training.

Market Simulation: On February 20, 2004, the ISO and participants completed the third round of market simulation with the focus being full

participation in real-time markets by the 23 key participants. The fourth round of market simulation begins on March 8th and concludes on March 19th. During the two weeks of down-time the ISO and participants will update their systems so changes can be tested when market simulation resumes.

The ISO will conduct the third round of one-on-one conference calls with the 23 participants from March 1-3, 2004. In response to the previous conference calls conducted in February, the ISO traveled to southern California the week of February 22nd to meet with some participants. The purpose of both the visits and conference calls is to (1) review each participants overall readiness assessment for implementing Phase IB and 2) review the Exit Criteria with each participant.

Real-Time Market Application Functionality: The core operational software element of the Phase IB project is the Real-Time Market Application (RTMA), which is being tested in the market simulation. In addition, resolution of critical variances and necessary enhancements are being developed with final delivery expected by March 5, 2004. These items will then be tested and introduced into the market simulation. Once all the RTMA software items have been tested, no additional changes to any code will be accepted in preparation for rollout.

Load and Performance Testing: In addition to completing the RTMA functional testing, the ISO must be certain that the system will meet all the load and performance requirements including fail-over and fallback capability.

Training Environment: In preparation for the final round of hands-on training for the ISO operating personnel, development of specialized training scenarios is required. This effort has been impeded by the integration of some of the applications into the training environment. Progress continues to be made and the ISO operator hands-on training remains on track to begin on March 15th and conclude on April 15th. It should be noted that a separate training environment has been installed to facilitate the training without impeding the Market Simulation progress.

Phase IB Weekly Conference Calls: The ISO continues to hold weekly conference calls every Friday. The conference calls are open to all Market Participants and are structured to keep stakeholders informed about the progress of Phase IB implementation and respond to questions.

Market Simulation Exit Criteria: The ISO reviewed the Exit Criteria with participants during the weekly conference calls on February 13, 2004. The ISO and participants are making progress towards successful completion of market simulation. The purpose of the Exit Criteria is for both the ISO and participants to determine when market simulation can be deemed complete and successful.

B. Integrated Forward Market/Locational Marginal Pricing Status

In the February 2, 2004 Status Report, the ISO reported that Siemens Power Transmission and Distribution Inc. ("Siemens") was awarded the contract for providing the software, installation, licenses and maintenance of a software system to execute an optimized forward energy market using a full network

model, produce locational marginal prices and execute a real-time dispatch using a full network model to produce nodal prices. The ISO and Siemens continue to work on detailed project planning, requirements clarifications and design specifications with a final design targeted by the end of March 2004. Particular attention is being paid to the outstanding design issues being discussed in the Commission's technical conferences so that design resolutions can be incorporated into the project plan and design process. In addition, the ISO and Siemens are working on a testing strategy so that the Factory Acceptance Testing and System Acceptance Testing durations can be incorporated into a detailed project schedule.

C. Market Redesign Budget Update

Attachment A -- the Budget Status and Tracking Report is not being provided this month as the overall program budget is currently under review by an independent consultant who was hired at the request of the ISO Board of Governors. Although the independent consultant gave a status report to the Board at their January 22nd meeting, it is anticipated that the consultant will make his complete assessment, including recommendations of the format of the budget reporting going forward, at the April meeting. Due to the timing of acceptance of that report by the Board, the ISO does not have complete information to continue reporting in the format we have used in the Status Reports to date. The Budget Status and Tracking Report will be re-formatted to incorporate this information and provided in future monthly Status Reports. The Budget Status and Tracking Report will remain confidential until such time that the information contained in

the report does not disclose confidential business information or jeopardize the ISO's negotiations with vendors regarding implementation of the market redesign.

D. Key Issues

1. Settlements and Market Clearing Request for Proposals

The Settlements and Market Clearing Project selected a preferred vendor for the Market Clearing portion of the project through a separate Request for Bid process on February 13, 2004. The ISO started Detailed Statement of Work ("DSOW") efforts and contract negotiations with this preferred vendor.

Throughout January and February the Settlements and Market Clearing Project team have been working on a DSOW and finalizing contract negotiations with the preferred Settlements vendor. The scheduled completion date for the Settlements DSOW is the first week of March 2004.

2. Congestion Revenue Rights ("CRR") Study

The first draft of the "CRR Study 2 - Proposed Processes, Input Data and Modeling Assumptions" was posted to the ISO website on February 5, 2004⁴, with comments from market participants due back on March 1st. The ISO continues to hold bi-weekly Congestion Revenue Rights conference calls with Market Participants to solicit input into the CRR Study 2.

In addition to the release of the CRR Study 2, the ISO offered CRR Educational classes that are designed to provide Market Participants the opportunity to learn the basics associated with CRRs. The ISO presented the

first series of ten presentations over a three-day period from February 17-19, 2004⁵. In addition to a second set of face-to-face classes, a third and final series of educational classes will be offered via the internet (Placeware) during the month of April. The ISO will send out a Market Notice once the dates are finalized.

The ISO sent out a Market Notice on February 24th notifying Market Participants that the CRR Study 1 Data Set was available to Stakeholders participating in the MD02 process and representatives of governmental agencies whose jurisdiction is affected by the MD02 process. The Market Notice is Attachment B of this Status Report.

4. CPUC Procurement Proceedings

On February 13, 2004, the assigned administrative law judge (ALJ) issued a ruling on the scope and schedule of resource adequacy workshops (workshops). These workshops are contemplated to develop consensus on the detailed implementation issues and other topics not addressed by the Initial Decision that was issued by the California Public Utilities Commission ("CPUC"), on January 22nd. The ALJ's ruling establishes a schedule for the workshops and for the parties to provide opening comments (March 4th) and reply comments (March 11th). The ALJ ruling provides guidance on the ten initial topics that are to be addressed during the first workshop on March 16th. These issues include load forecasting, counting criteria for resources, treatment of energy efficiency and

⁴ The Draft CRR Study 2 – Proposed Processes, Input Data and Modeling Assumptions can be found on the ISO website at <http://www.caiso.com/docs/2004/02/05/200402051239096356.pdf>.

⁵ Descriptions of the ten presentations along with the dates and location were posted to the ISO website at: <http://www.caiso.com/docs/2004/02/05/200402051241327029.pdf>.

demand response. In addition, it is planned that there will be an initial discussion on the issue of deliverability assessment. Subsequent workshops are scheduled for April 12-14. These sessions are expected to address three areas: (1) issues not resolved on March 16th, (2) complete the discussion on deliverability assessment and (3) two additional topics of penalties and reporting requirements. The ISO is currently preparing its written comments and is planning to be an active participant in the workshop discussions. The ISO briefed the Board at the February 26th meeting regarding the CPUC's February 13th ruling on the scope and schedule of resource adequacy workshops and is Attachment C of this Status Report⁶.

5. FERC Technical Conferences

The ISO participated in the first of a series of technical conferences being conducted by the Commission in Washington, DC on January 28-29, 2004. The purpose of these technical conferences is to promote further discussion and resolution of the remaining MD02 design proposal issues. The discussion topics at the first technical conference included (1) Flexible Offer Obligation; (2) Residual Unit Commitment; (3) deferment by the ISO of a portion of its required Ancillary Services procurement from the Day Ahead to the Hour Ahead market; (4) allowing Constrained Output Generating resources to set market-clearing prices in forward markets; and (5) re-allocation of excess revenues collected by the ISO due to incorporation of marginal transmission losses in Locational Marginal Prices. As a follow-up to this technical conference, parties submitted

⁶ Attachments A and B of the Resource Adequacy Briefing Memorandum can be found on the ISO website at: <http://www.caiso.com/docs/09003a6080/2d/aa/09003a60802daa6a.pdf> and

written comments on February 17, 2004. The ISO submitted its comments, including some proposed modifications to its July 2003 MD02 design proposal, on February 24, 2004⁷.

The ISO will participate in the Commission's second technical conference on March 3-5, 2004, in San Francisco to try to achieve resolution of these design issues. The proposed design modifications the ISO filed on February 24th are designed to move the process towards resolution by achieving a reasonable balance among the various concerns expressed by the parties while preserving the internal consistency of the comprehensive MD02 design proposal. In addition, the Commission staff will present their views on Market Power Mitigation and convene a subsequent conference dedicated for further discussion on this topic.

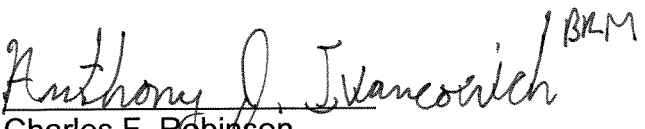
<http://www.caiso.com/docs/09003a6080/2d/aa/09003a60802daa6b.pdf>, respectively.

⁷ Comments of the California ISO Regarding Technical Conference in Docket No. ER02-1656-000 can be found on the ISO website at: <http://www.caiso.com/docs/2004/02/24/2004022414521420750.pdf>.

II. CONCLUSION

In Section I of this Report, the ISO has responded to the Commission's request for specific information on progress, critical issues, budget and alternative methods for the market redesign implementation effort. The ISO appreciates having the opportunity to comment and report on the progress being made on its market redesign.

Respectfully submitted,


Charles F. Robinson
Anthony J. Ivancovich

Counsel for the California Independent
Operator Corporation

Dated: March 1, 2004

ATTACHMENT A

[Not provided, as described on page 6 of the Status Report filed today]

ATTACHMENT B

From: CRCommunications
Sent: Wednesday, February 25, 2004 2:18 PM
To: ISO Market Participants
Subject: CAISO Notice: UPDATE: CRR Study 1 Data Set Available to Market Participants

MARKET NOTICE
February 24, 2004

UPDATE: CRR Study 1 Data Set Available to Market Participants

ISO Market Participants:

On January 6, 2004 the CAISO indicated that it would make available supporting data for its "Congestion Revenue Rights Preliminary Study Report" released on October 1, 2003 ("CRR Study 1"). In response several Market Participants raised valid concerns on a few of the limitations that were placed on the use of the supporting data. Accordingly, the CAISO will now make the following information available to Stakeholders in the MD02 process and representatives of governmental agencies whose jurisdiction is affected by the MD02 process in accordance with: (i) the attached revised non-disclosure, license and use of information agreement¹; and (ii) the further revised draft of the ISO Register screening procedures².

1. Network model used in CRR Study 1;
2. Thermal Limits;
3. Interface constraints definitions;
4. Interface constraint limits;
5. AP node mapping (sinks, sources, trading hubs); and
6. Load distribution factors.

In order to be granted access to the information, it is important that the CAISO receive both: (i) the information requested by the draft screening procedure, and (ii) a fully completed and signed form of the agreement. Please return these completed materials to:

Romny Ryan
California ISO
151 Blue Ravine Rd.
Folsom CA 95630

Requests should include an e-mail address in order for the CAISO to reply to requestors with instructions for downloading the supporting data from the CAISO secured web site.

¹ Entities that executed the previous form of agreement are advised to fill in all blanks and sign the new form of agreement and supply the information requested by the draft screening procedure.

² The network model used in CRR Study 1 contains some transmission equipment thermal limit information from the ISO Register, which is subject to the access restrictions in accordance with the Federal Energy Regulatory Commission (FERC) order issued on January 24, 2003 (as modified on February 14, 2003) in Docket No. ER03-219. Due to timing issues and the need to expeditiously release this data, the ISO will be following the further revised draft procedure for this process.

If you have any questions regarding access to the secure web site, please contact Romney Ryan at rryan@caiso.com or 916-351-2360.

If you have any questions regarding the data itself, please contact Scott Jercich at sjercich@caiso.com <<mailto:sjercich@caiso.com>> or 916-608-5987 or Ziad Alaywan at zalaywan@caiso.com <<mailto:zalaywan@caiso.com>> or 916-351-2140.

Client Relations Communications.1120
CRCcommunications@caiso.com <<mailto:CRCcommunications@caiso.com>>

ATTACHMENT C



Memorandum

To: ISO Board of Governors
From: Elena Schmid, Vice President, Corporate and Strategic Development
Steve Greenleaf, Director of Regulatory Policy
For the Resource Adequacy Team
CC: ISO Officers; Board Assistants
Date: February 20, 2004
Re: Resource Adequacy – Policy Issues and Potential Options

This item does not require Board action.

EXECUTIVE SUMMARY

As the Board is aware, resource adequacy (i.e., having enough generation to serve load) is a fundamental prerequisite to a properly functioning electricity market. Absent adequate resources, electricity markets are inherently unstable, likely to produce "unreasonable" prices, and potentially threaten the reliability of the system resulting in blackouts.

At the November 21, 2002 Board meeting the Board directed ISO Management to defer to State efforts to address the broader issue of resource adequacy. In addition, the Board directed Management to actively engage in the California Public Utilities Commission's ("CPUC" or "Commission") ongoing proceeding regarding the establishment of procurement rules for the state's Investor Owned Utilities (IOUs), Southern California Edison Company, San Diego Gas & Electric Company and Pacific Gas & Electric Company ("Procurement Proceeding"). At that meeting the Board acknowledged the State's legitimate and primary role in addressing matters related to resource adequacy or, more specifically, the obligations of load-serving entities to procure enough resources to serve their load plus reserves. Finally, the Board invited the State to brief the Board, by November 2003, on the status of the State's efforts to address the resource adequacy issue.

On November 18, 2003, the Administrative Law Judge ("ALJ") at the CPUC assigned to the Procurement Proceeding issued a "Preliminary Decision" regarding the matters addressed in the proceeding. Concurrently, President Peevey of the Commission, who is the assigned commissioner to the proceeding, issued an Alternate Ruling ("Peevey Alternate") regarding the same. At that time, ISO Management indicated its support for the Peevey Alternate. ISO Management supported the Peevey Alternate because it substantially addressed most of the concerns raised and recommendations proffered by the ISO in the Procurement Proceeding.

On January 22, 2004, the CPUC issued its decision in the Procurement Proceeding. That decision deviated from the Peevey Alternate and failed to adopt a number of the important recommendations supported by the ISO and adopted in the Peevey Alternate. In particular, and of critical importance to the ISO, the CPUC's decision deferred full implementation of the adopted procurement rules until 2008. The Peevey Alternate proposed to implement the new requirements in 2005. In addition, the decision fails to detail, in any material respect, how compliance with the long-term rules will be monitored and enforced and significantly reduces the role of the ISO in implementing the final procurement rules. (**Attachment A** to this memorandum compares the CPUC's decision with the ISO's

previously preferred Peevey Alternate). As a result of the delay in implementing the final procurement rules and the ambiguity regarding both the ISO's role and the interplay between the procurement rules and ISO's market rules, the ISO is once again faced with the need to address certain key policy issues and to determine what course of action is appropriate in light of the State's action, or lack thereof.

Management identifies and defines below certain of the key policy issues the Board must consider over the next several months. In addition, Management also identifies certain of the key interrelationships between resource adequacy and the MD02 proposal. As FERC noted in its October 28, 2003, MD02 order (October 28th Order), certain elements of the MD02 proposal, such as price mitigation, are directly related to the measures in place to ensure resource adequacy. In fact, consistent with the Board's direction when it approved the MD02 conceptual design last summer, FERC, in the October 28th Order, directed the ISO to propose necessary modifications to the MD02 proposal sixty days after the CPUC issues its procurement order. That date is March 22, 2004. Thus, per FERC's direction, the ISO must decide how to respond to the CPUC procurement ruling within this timeframe.¹

Finally, this memorandum also seeks to identify and, in part, define potential ISO options for responding to the CPUC's procurement decision. In many respects, each of the identified options is complementary to the CPUC's efforts. In the end, the key difference between the alternatives is the level of ISO oversight and involvement in the larger market, i.e., the role of the ISO in the electricity market. The purpose of the memorandum is to seek Board guidance regarding this important policy issue.

BACKGROUND

Ever since the onset of the 2000-2001 electricity crisis in California, the ISO has recognized that no market can function effectively – i.e., reliably, with limited volatility, and resulting in reasonable prices – in the absence of adequate infrastructure or resources. Thus, as part of the ISO's original Market Design 2002 ("MD02") proposal, the ISO proposed to establish a clear obligation on the part of load-serving entities to procure, well in advance of the ISO's spot markets, sufficient resources to serve their load plus a reasonable reserve margin. Fundamentally, the ISO reasoned that such an obligation, working in concert with the proposed changes to the ISO's markets, would: 1) support reliable operation of the transmission system; 2) substantially mitigate the ability of suppliers to exercise market power and engage in anomalous behavior in the ISO's markets; and 3) promote both reasonable and stable prices in the ISO's markets. The goal of such an integrated design is to ensure the seamless hand-off of resources procured by load-serving entities to serve their load to the ISO for use in real-time dispatch to balance generation and load. Lacking such integration and coordination, the ISO may be forced to rely on high-priced electricity offered in the real-time market or may be forced to curtail load. Either result would be unfortunate and is avoidable.

Notwithstanding the clear benefits of such an integrated design, the ISO also acknowledged that such a resource or capacity obligation or, more specifically, the rules and activities surrounding resource procurement, are matters best addressed at the state or local level. To that end, at the November 21, 2002, Board meeting the Board directed Management to defer implementation of the ISO's preferred "Available Capacity" or "ACAP" Obligation proposal and to instead dedicate staff's efforts towards active participation in the CPUC's Procurement Proceeding.

¹ In order to fully develop the ISO response to the CPUC's ruling and in order to provide ample opportunity for the Board to review these issues, the ISO intends to request a slight extension of FERC's sixty-day compliance deadline so that Management can present a recommendation to the Board at its March 25th meeting.

During the spring and summer of 2003, the ISO actively participated in the Procurement Proceeding. The ISO filed written testimony, later testified in the hearings, and submitted briefs. The salient recommendations made by the ISO were as follows:

- A state-sponsored program that includes a set of comprehensive, meaningful, and mandatory resource adequacy requirements is needed urgently.
- The ISO believes such program includes six essential elements:
 - Required *planning* Reserve Margin (ISO supported adoption of the California Power Authority's recommended 17% reserve margin)
 - Restricted reliance on the Spot Market to satisfy *capacity* requirements
 - Rules for counting of resources towards meeting a Load Serving Entity's obligations
 - Specific deliverability criteria
 - Established and standardized Load Forecast
 - Availability of Load Serving Entities' procured resources for possible use by the ISO

In addition, the ISO espoused four overarching characteristics that would complete an effective resource adequacy framework. First, ex-ante procurement and cost-recovery rules that allow Load Serving Entity's to enter into long term contracts which in-turn will commit available resources to California load and stimulate needed investment in electricity infrastructure. Second, a reporting mechanism that uses consistent formats and information to update each LSE plan on an ongoing basis. Third, well-defined consequences for Load Serving Entity's who do not procure sufficient capacity and ultimately contribute to a supply shortage. Finally, adoption of rules and procedures that provide a clear understanding regarding ISO real-time actions in the event of a supply shortage.

DISCUSSION

On January 22, 2004, the CPUC issued a decision on the threshold issues regarding the procurement requirements for California's Investor Owned Utilities ("IOUs"), Pacific Gas & Electric Company ("PG&E"), San Diego Gas & Electric Company ("SDG&E") and Southern California Edison Company ("SCE"). Among other things, the decision addressed certain elements of resource adequacy such as: appropriate planning reserve margin, phase-in period, competitive bidding for new power requirements, and cost recovery. Further, the CPUC stated it will open a new "procurement related rulemaking", in the first quarter of 2004 to address other matters such as compliance reporting measures, deliverability, and other issues.² The new rulemaking will use a "workshop" format to address technical issues.³ In addition, the CPUC decision authorizes the IOUs to continue to operate under the established short-

² The new rulemaking will also address the IOUs revised 2004 long-term plans. In addition, the CPUC ruling identified the following additional important milestones: 1) the IOUs should file by the end of March 2004 a working outline of their long-term plans; 2) Interested parties may file comments on the IOUs outlines by mid April 2004; 3) the IOUs shall file long-term plans on a biennial cycle, on a date to be determined; and 4) the Commission will issue a final decision by the end of 2004 (the ruling states that the Commission "plans to finish this well before the end of the year").

³ The presiding Administrative Law Judge ("ALJ") apparently proposes that the first workshop should focus on technical issues such as how Load Serving Entities forecast demand and how supply resources should be valued. Specifically, the ALJ proposes to address: forecasting issues (use of co-incident peaks), consistency between Load Serving Entities, development of Energy Service Provider forecasts, the phase-in of the planning reserve margin; development

term procurement rules through the third quarter of 2005. The salient features of the decision are further detailed in Attachment A.

The key issue before the Board over the next month is how to respond to the CPUC's decision. Clearly, the adopted decision varies from the alternate decision supported by the ISO. First and foremost, the adopted decision pushes the implementation timeline back so that the new procurement rules are not implemented in full until 2008. Because the ISO has raised concerns about potential supply shortages beginning in 2005, the ISO is concerned that any delay in procurement-related activities will only hasten anticipated future supply shortages. Moreover, the ISO continues to believe that now is the time to lock up additional *capacity*, since there is currently an excess supply in the West.⁴

The ISO is also concerned that the CPUC decision fails to ensure a framework for monitoring and enforcing appropriate forward procurement/contracting by the IOUs. While the ISO advocated the adoption of strict annual and monthly reporting obligations and clear and *ex ante* consequences (i.e., penalties for those load-serving entities that failed to procure adequate capacity), the CPUC did not adopt such measures and the CPUC's reporting and enforcement rules are instead ambiguous, at best.

In addition, the ISO continues to have concerns that the CPUC decision fails to ensure that resources procure by the IOUs are "deliverable" to load on the system and that resources procured by the IOUs are made available to the ISO in the day-ahead timeframe so that the ISO can ensure that adequate resources are on line in real time to serve the anticipated real-time load. Such measures are critical to ensure a seamless transition from the long-forward markets to the ISO-facilitated spot markets, as proposed under MD02 (See **Attachment B** for further detail).

How the ISO proposes to respond to each of these identified concerns will define the ISO's role with respect to creating a viable resource adequacy framework in California.

Policy Issue – What is the ISO's Role in Resource Adequacy?

Since the beginning of the MD02 effort the ISO has acknowledged that it only is but one player in reforming and stabilizing the California electricity market. Bounded by that understanding, the ISO has sought to focus its market reform efforts on the ISO's *core functions* – the provision of reliable, open and non-discriminatory transmission service. Thus, the primary thrust of the ISO's MD02 proposal is focused on reforming the ISO's mechanisms for scheduling and managing transmission usage, facilitating the markets/services necessary to support such transmission services, and balancing real-time supply and demand. While the ISO originally focused on and proposed a resource adequacy mechanism, the ISO always acknowledged the primacy of the State in addressing

(definition) of "peak demand" for summer months; counting of utility retained generation; treatment of Qualifying Facility resources; the counting of the CDWR contracts; availability of spot capacity; counting of "other" long-term contracts; treatment of energy efficiency, demand response, distributed generation; and deliverability requirements (initial discussion). Clearly, an "aggressive" agenda. The ALJ also proposed the following schedule: March 4, 2004 - Opening Comments; March 11, 2004 - Reply Comments; March 16, 2004 - Initial Workshop; and April 12-14, 2004 - Second Workshop (as needed).

⁴ While the focus to date has primarily been on long-term procurement (i.e., two years and greater), the ISO is equally concerned with the short-term procurement rules in place today and that, under the January 22nd ruling, would continue through the first three quarters of 2005. Although capacity is available, it appears the IOUs are not locking up available capacity now for use over the next year or two. The IOUs contend that, in the aggregate, they are fully resourced (i.e., they can cover their net short position, the difference between their expected load and their own generation) because of the State long-term contracts. Unfortunately, as the ISO is well aware, not all of the energy under the State contracts is deliverable to load because of constraints on the transmission system.

such matters. In fact, the ISO acknowledged that the State, based on its authority to oversee IOU procurement activities, is the appropriate entity to ensure that, on a long-term basis, there are sufficient resources to serve load.

The CPUC's procurement ruling provides the ISO with an opportunity to either reaffirm this approach or establish that the ISO must assume larger responsibilities in order to ensure both short-term as well as long reliability. Regardless of the path taken, we are at a critical crossroad and must take this opportunity to clearly delineate ISO responsibility versus State⁵ responsibility.

The Path Less Taken – A Focus on Core Function

The California electricity crisis of 2000-2001 clearly emphasized the need for coordinated reform of the electricity market, be it to ensure consistency between the forward markets and the real-time market, alignment of state-governed retail market policies with federal-governed wholesale market policies, or the need for infrastructure to support both. To those objectives, the ISO has striven to reform its own markets, focusing on its core statutory responsibilities: safe and reliable operation of the grid and efficient use and allocation of the transmission system. Under this construct, the ISO operates the grid reliably and ensures non-discriminatory access to the grid and the State procurement policy manages the risks associated with keeping the lights on for consumers. Such an approach is not necessarily how the ISO has functioned in the past, nor is it policy that necessarily keeps the lights on. That is, under such a paradigm, the ISO's policies must respect the right of the State to manage the risks associated with its adopted procurement policy, and to take ownership of the consequences of their risk management policies. These risks include:

- 1) Potential frequency and magnitude of exposure to high real-time energy costs (through the spot markets as well as ISO out-of-market spot purchases when necessary);
- 2) Potential frequency and magnitude of involuntary load shedding; and
- 3) Potential for plant closings and decline in non-IOU investment in new generation, due to lack of sufficient revenue stream for non-IOU suppliers.

In order for such an approach to work (i.e., establish clear accountability) the ISO, the State, and other affected parties must clearly establish their roles and responsibilities. The ISO would need to:

- 4) Clearly articulate the requirements of reliable grid operation, and the distinction between reliable grid operation versus keeping the lights on for consumers;
- 5) Clearly detail ISO procedures for how the ISO will address real-time shortages of supply while maintaining reliable grid operation (Out-Of-Market purchases, load shedding, and any other options);
- 6) Propose some reasonable criteria and effective procedures for identifying potential shortages on at least a day-ahead basis, and for identifying which Load Serving Entities are short by how much;
- 7) Not compensate for inadequacies the ISO perceives in State procurement policies by expanding forward or spot purchases of energy or capacity (i.e., see Summer 2000 IOS Reliability Peaker Program); and

⁵ Use of the word "State" in this context goes beyond CPUC regulation of the IOUs and non-IOU Energy Service Providers or "ESPs" and is intended to include the Local Regulatory Authorities that regulate municipal utilities.

- 8) Not be critical of State policy or the CPUC Procurement Ruling. In fact, the ISO's core responsibility remains the same regardless of the details of the CPUC ruling – even if the Peavey decision were adopted the ISO would still have to propose procedures for reliable real-time grid operations.

Clearly, such policies may at times put load at risk and thus are antithetical to an ISO operations culture that desires to keep the lights on at all costs – no small sentiment when the health and safety of California citizens are at stake.

The Path More Traveled – A Proactive Role for the ISO in Capacity Procurement

In contrast to the philosophy outlined above, the ISO could instead fill in the perceived gaps in the CPUC's procurement policy. Caulking the seams is second nature to the ISO but comes at a price – making decisions that inevitably others view as outside your domain of expertise or authority and that are almost always second-guessed.

With respect to resource adequacy, that means taking steps to ensure that all Load-Serving Entities in the state are fully resourced so that they can satisfy their peak load plus a reserve margin. In addition, it would require the ISO to establish clear and transparent reporting and compliance mechanisms so that the ISO – and the appropriate regulatory authorities – could clearly identify those Load-Serving Entities that failed to procure adequate resource and apply appropriate remedies and take appropriate action. Such remedies and actions could include:

- 1) **Penalties** - Financial penalties for those Load-Serving Entities that under-procure adequate resources. Such penalties could come in the form of either explicit *ex ante* penalties (\$/MW) for shortages identified prior to real time (e.g., annually, monthly, or day-ahead) or surcharges for energy purchased out of the real-time market (\$/MWh).
- 2) **ISO Capacity Procurement** - Capacity procurement by the ISO either on a short-term or long-term basis, or both. Under this approach, the ISO would "back fill" to ensure that adequate *capacity* to serve anticipated real-time load, including a planning reserve margin, is under contract, committed to serve California load and on-line in real-time when needed by the ISO. The ISO could either procure such capacity directly (e.g., Summer 2000 Peakers) or the ISO could facilitate a "residual" capacity auction and thus solicit bids to provide capacity. Once again, this could be on either a short or long-term basis or both. Under any of these scenarios, the ISO would allocate the costs of such capacity purchases to those Load-Serving Entities that under-procured in the forward market, based on ISO forecasted load.
- 3) **Deliverability** - Establishment of an explicit deliverability requirement. Such a requirement would establish that each Load Serving Entity demonstrate, pursuant to defined standards and under a given set of system conditions, that the resources they have procured can be delivered to satisfy aggregate system load, and that local transmission constrained areas have sufficient transmission and generation resources to ensure that available generation resources located outside the local area can be adequately delivered to the local load. Such a requirement would include a deliverability test similar to the deliverability benchmark (but not requirement) proposed by the ISO as part of the ISO's newly developed Large Generator Interconnection Procedures.
- 4) **Resource Qualifications** - Establishment of clear and transparent methods for "counting" resources. That is, clear standards for what resources would qualify as "capacity" resources. This would require the ISO to develop and establish methods for determining, for example, what portion of the State's Long-term Contracts would qualify as a "capacity" resources. This would also require the ISO to determine standards for qualifying or "counting" renewable resources such as wind and biomass facilities and would also necessitate assessing the extent to which hydroelectric resources can qualify as capacity resources. Clearly, such assessments and criteria seep into areas of state public policy.

- 5) **Availability Provisions** - Finally, the ISO would establish clear and transparent requirements for all capacity resources procured in the manner outlined above to be available for possible ISO commitment in the day-ahead market. Under this approach, the ISO would use the available "pool" of resources to ensure that, in the aggregate, and as locationally needed throughout the system, sufficient resources were on-line and committed to serve the next day's anticipated load, based on the ISO's forecast. The ISO would respect each Load-Serving Entities' preferred or scheduled use of such resources and would endeavor to respect all operating and other use constraints.

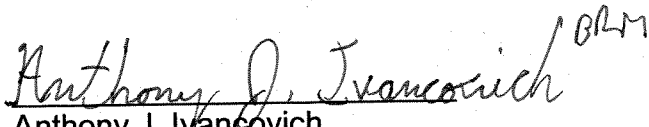
CONCLUSION

The two different paradigms outlined above essentially define the end points of a fairly broad continuum. Variations on each of these approaches are possible and may be appropriate. For example, the ISO's earlier proposed Available Capacity or "ACAP" proposal could be viewed as an intermediate proposal, but falling closer to the "proactive ISO role" end of the spectrum. In addition, while the Board may ultimately determine that it is inappropriate for the ISO to back-fill and thus procure capacity on behalf of load, the Board may nonetheless determine that it is appropriate for the ISO to establish and administer a "Deliverability Requirement" so as to minimize the likelihood of the ISO having to manage related supply and delivery issues in the spot market. Such a selective or limited approach to addressing resource adequacy related issues is possible. At this juncture, and before Management proceeds with identifying its preferred recommendation, Management seeks guidance from the Board as to which end of the continuum the ISO should tilt. Getting a sense of the Board at this time would be helpful as the ISO proceeds expeditiously in resolving the entirety of open MD02-related design issues.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon the Public Utilities Commission of the State of California, upon all parties of the official service lists maintained by the Secretary for Docket Nos. ER02-1656-000 and EL01-68-017.

Dated at Folsom, California, this 1st day of March 2004.


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