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September 17, 1999

The Honorable 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. ER99-____-000
Amendment No. 21 to the ISO Tariff
Extension of Authority to Cap Energy and Ancillary Service
Bids**

Dear Secretary Boergers:

Pursuant to Section 205 of the Federal Power Act ("FPA"), 16 U.S.C. § 824d, and Section 35.13 of the Commission's regulations, 18 C.F.R. § 35.13, the California Independent System Operator Corporation ("ISO")¹ respectfully submits for filing six copies of an amendment to the ISO Tariff ("Amendment No. 21"). As explained below, the proposed amendment would extend for one year the authority of the ISO to disqualify Energy and Ancillary Service bids that exceed levels specified by the ISO's Board of Governors. Absent approval of Amendment No. 21 by the Commission or the Commission's favorable action on the ISO's pending request for rehearing of the Commission's May 26, 1999 order in *AES Redondo Beach, L.L.C., et al.*, 87 FERC ¶ 61,208 (1999) (the "May 26 Order"), that authority would expire on November 15, 1999.

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

I. Background and Reasons for Filing

A. The ISO's Authority To Cap Prices in Energy and Ancillary Service Markets

Since the ISO commenced operations on March 31, 1998, it has had the authority to reject bids in its real-time Energy market that exceed a ceiling price level established by the ISO. Initially, this authority was required to address certain software problems identified in pre-operational testing.² During the summer of 1998, when the partial lifting of cost-based pricing restrictions on sales of Ancillary Service capacity led to extremely high prices in those markets, revealing that they were not workably competitive, the ISO sought and the Commission approved extending the ISO's price cap authority to Ancillary Service markets.³

Subsequently, in January of this year, the Commission confirmed the ISO's authority to reject bids that exceed price caps in its Energy and Ancillary Service markets, pending the submission, approval and implementation of reforms in the Ancillary Service markets.⁴ The Commission determined that the ISO should have the flexibility necessary to adapt its price caps to conditions in those markets, as they change over time.⁵

In the May 26 Order, the Commission approved all elements of the ISO's Ancillary Service market redesign proposal, in some cases with reporting or other conditions. The May 26 Order also confirmed the ISO's authority to impose caps on the prices it would pay for Ancillary Services and Imbalance Energy, but limited the duration of that authority to November 15, 1999.⁶ The Commission reasoned that, by that date, the Ancillary Service market reforms would have been implemented and tested during a summer peak season and their efficacy would have been reviewed in reports that the Commission ordered to be submitted by the ISO's Market Surveillance Committee ("MSC") and the California Power Exchange Market Monitoring Committee ("MMC"). The Commission stated that the ISO could file to extend that authority if it found it necessary to do so, based on: (a) the summer's experience with the

² *California Independent System Operator Corporation*, 83 FERC ¶ 61,209 (1998). The price caps applicable to Imbalance Energy bids are also applicable to Adjustment Bids submitted for purposes of Congestion Management.

³ *See AES Redondo Beach, L.L.C., et al.*, 84 FERC ¶ 61,046, *on rehearing*, 85 FERC ¶ 61,123 (1998).

⁴ *See California Independent System Operator Corporation*, 86 FERC ¶ 61,059 (1999) (the "January 27 Order").

⁵ *Id.* at 61,202.

⁶ 87 FERC at 61,818-19.

improvements in the Ancillary Service markets implemented by Amendment No. 13 and Amendment No. 14; and (b) on the reports filed by the MSC and the MMC, which were due on October 15, 1999.⁷

The ISO sought rehearing of this aspect of the May 26 Order, asking the Commission to extend the ISO's price cap authority until February 15, 2000 to give the ISO adequate time to consider the reports of the MSC and the MMC before making any necessary filing by December 15 (to go into effect by February 15). The ISO also noted that, due to the time required to develop, install and test the software implementing the Ancillary Service market reforms approved in the May 26 Order, those reforms would be in effect only for a portion of the summer peak period and that another important market reform, relating to Reliability Must-Run ("RMR") generation, could not be implemented until after the summer. The ISO indicated that, without the requested extension, the ISO would feel compelled to submit a filing well before November 15, 1999 (taking notice requirements into account) to extend its price cap authority and would have to do so without the benefit of the reports of the MSC and the MMC. This request was supported by a memorandum from members of the MSC and the MMC, urging the Commission not to require the lifting of price caps until the redesign of Ancillary Service markets and the reform of RMR contracts were both fully implemented.⁸ The Commission has not acted on this request.⁹

B. The ISO Governing Board's Consideration of the Continued Need for and Form of Price Caps.

At its meetings in June and August 1999, the ISO Governing Board evaluated the continued need for price cap authority, in light of the progress in implementing Ancillary Service market reforms. These issues were also discussed during stakeholder meetings throughout the summer.

At its June meeting, the Board directed ISO management to develop a replacement for the existing price caps that would be implemented on the later of September 30, 1999 or the conclusion of a four-week period during which the effectiveness of the software implementing the Ancillary Service market reforms could be confirmed. The mechanism under consideration, termed a "price volatility limit mechanism" or "PVLM" would replace fixed price caps with a

⁷ *Id.* The May 26 Order also confirmed that the ISO acted properly in treating Ancillary Service bids submitted above the price caps as bids at the applicable price cap level. *Id.* at 61,822-23.

⁸ A copy of the joint MSC/MMC memorandum is included as an attachment to the memorandum prepared for the ISO Governing Board's August meeting, which is contained in Attachment F. That memorandum also describes the consideration given to this issue during stakeholder discussions.

⁹ The Commission acted on another issue raised in the ISO's rehearing request in an order issued on July 26, 1999. *AES Redondo Beach, L.L.C., et al.*, 88 FERC ¶ 61,096 (1999).

moveable limit that would allow prices to rise without limit over time, while controlling the amount of movement within a single day so that market participants would have an opportunity to respond.¹⁰ The Board's June decision in favor of the PVLM sought to balance the desire to remove administrative controls and allow prices to reflect underlying supply and demand conditions, against the need for additional experience with the market redesign elements which would only be implemented toward the end of the 1999 peak season.

Many of the Ancillary Service market reforms were indeed implemented in mid-August. Three important components of the reforms, however, were delayed due to software problems.¹¹ As a result, the ISO has not had the opportunity to confirm the efficacy of the Ancillary Service market reforms to maintain competitive conditions during a summer peak season.

During discussions with stakeholders which took place in July and August, including two public sessions of the MSC, the ISO addressed options for the design of a PVLM mechanism, as well as other price cap alternatives. As directed by the Board's June decision, the ISO examined mechanisms used to limit price movements in other mature markets (*e.g.*, commodities and futures), measures and remedies for market power, and the need for damage control caps. Options considered, in addition to several forms of PVLM, included:

- eliminating price caps altogether, subject only to the reservation of authority for the ISO to establish price caps upon evidence that a market is not workably competitive (referred to as a "safety net");
- replacing the current price caps of \$250 per MWh or MW with "damage control" price caps at the \$2,500 level;
- maintaining fixed price caps, but raising them from their current levels in predetermined increments, keyed to progress in the implementation and evaluation of reforms in Ancillary Service markets and RMR contracts; and
- maintaining price caps at the current \$250 level for at least an additional year.

In comparing some PVLM designs against some of the fixed-price-cap alternatives, the ISO and the market participants realized that the desirable

¹⁰ The issues considered by the ISO Governing Board at its June meeting are described in the memorandum contained in Attachment E.

¹¹ Two of these reforms -- the automation of instructions to participants in the Imbalance Energy market and the "no pay" reform, under which payments would be withheld for Ancillary Service capacity that was used for the uninstructed generation of Energy -- are expected to be implemented in October 1999. The capability for trades of Ancillary Service capacity between Scheduling Coordinators is being implemented in mid-September.

features of the PVLM -- *e.g.*, responsiveness to supply and demand conditions, and elimination of an absolute cap -- would come at a significant cost to simplicity and predictability. Given the ISO's intention to utilize the PVLM only as a transitional mechanism, to provide protection against unforeseen market design flaws and market power between now and the end of the summer 2000 peak season, the ISO ultimately opted for simplicity and decided to recommend that the Board adopt fixed price caps that would move in two increments over the coming year.¹²

The ISO's strong preference would be to eliminate price caps completely in its Energy and Ancillary Service markets, so that market participants could receive undiluted price signals that would provide incentives for investment in new generation resources and in enhanced capability of Demand to respond to prices. The ISO Governing Board also recognized, however, that the effectiveness of the Ancillary Service market reforms to maintain competitive conditions has not been established through practical experience and that RMR contracts have not yet been reformed in a manner consistent with the recommendations of the MSC and the MMC. In addition, the ability of entities serving Demand to protect customers against high prices through Demand management and hedging products is limited.¹³

Taking these factors into account, the ISO Governing Board adopted a resolution that attempts to balance its preference for reliance on markets against the need to protect consumers against the exercise of market power, while making it clear to the market that such protection will be a temporary feature only. That resolution provides in summary as follows:

- the price caps in Ancillary Service and Imbalance Energy markets would be raised from \$250 to \$750 (per MW or MWh, respectively), effective September 30, 1999;
- the price caps will be reduced to \$500 effective June 1, 2000 if the ISO Governing Board determines, based on a report from ISO management, that:
 - the markets are not workably competitive;
 - there are not practicable demand side management options in place;
or

¹² See Attachment F for details of this recommendation, and a "simple PVLM" design that was offered as an alternative.

¹³ These and other considerations underlying the policy adopted by the Board are addressed in the memorandum prepared by the ISO's Department of Market Analysis, which is contained in Attachment C.

- the IOU Utility Distribution Companies have sought and not obtained practicable options to self-provide Ancillary Services and applicable hedging products in the Power Exchange consistent with California Public Utilities Commission Preferred Policy Decisions;
- ISO Management is authorized to lower price caps in a market without Board action upon Management's assessment that the affected market is not workably competitive, provided that Management promptly notifies the Board of its action and presents supporting analysis to the Board; and
- ISO Management is directed, after completion of the summer of 2000, to analyze the results and recommend to the Board an implementation plan to eliminate price caps.

Under this approach, price caps would be lifted promptly, albeit not to the levels advocated by some stakeholders, to confirm the ISO's commitment to markets. At the same time, the ISO Governing Board will impose lower caps before the year 2000 summer peak season, if markets are determined to be non-competitive or the options available to Demand have not been expanded. Even in that circumstance, the lower cap would be double the level of those now in effect and would effectively permit sellers to collect up to \$1000 in periods of shortage should the caps be hit if the seller provides both capacity in the Ancillary Services Market and Energy in real-time.

A critical feature of this plan is that the ISO would maintain the authority to impose more stringent caps as a "safety net." Finally, the ISO Governing Board has made clear its ultimate intention to eliminate price caps by directing Management to recommend a plan for doing so following an analysis of the next summer peak season, after the recently adopted market reforms have demonstrated their effectiveness

II. Description of Filing

The ISO can implement the portion of the Governing Board's resolution relating to the revision of the price caps on September 30, 1999 under the flexible authority confirmed by the Commission's January 27 Order, and the ISO intends to do so. Other components of the Governing Board's resolution, which relate to the manner in which price caps would operate after November 15, 1999, however, require the Commission's approval. The ISO accordingly proposes in Amendment No. 21 to modify Section 28 of the ISO Tariff to extend its authority to establish maximum price levels for Energy and Ancillary Service bids, in

conformance with any limitations and conditions adopted by the ISO Board of Governors, through November 15, 2000.¹⁴

The ISO believes that the limited extension of its price cap authority in accordance with the resolution adopted by the Board of Governors is appropriate under the criteria specified in the May 26 Order and necessary to ensure that prices in the ISO's Imbalance Energy and Ancillary Service markets are just and reasonable.

In the May 26 Order, the Commission indicated that the ISO could apply for extension of its price cap authority based on the summer's experience with Ancillary Service market reforms and on the evaluations of the MSC and MMC. First, as noted earlier, the Ancillary Service market reforms were ready for implementation too late for the ISO to have the benefit of a full summer's experience to confirm their effectiveness, or even more than a few days' experience in hot weather given the delay in software implementation.

Moreover, during the relatively moderate peak weather conditions experienced in July and early August, before the reforms were implemented, prices in the ISO's Ancillary Service and Imbalance Energy markets reached the \$250 caps in a number of hours. While high prices, in and of themselves, do not necessarily indicate that market power is being exercised, the occurrence of such prices, in conjunction with the delay in implementation of Ancillary Service market reforms, makes it impossible to conclude that the market design problems identified previously have all been remedied. In these uncertain circumstances, the proposed increase in the price cap levels, in conjunction with the ISO's retained "safety net" authority, is a reasonable approach that balances the need to protect captive customers from possible market design flaws and the commitment of the ISO to full transition to markets for reliability as soon as possible.

Second, the ISO's need to ensure that there is no gap in its authority to cap prices has made it impossible for the ISO to wait until after the MSC and MMC reports are due on October 15 before submitting Amendment No. 21. The delay in the implementation of Ancillary Service market reforms, moreover, makes it unlikely that those committees will be able to conduct extensive analyses of the effectiveness of those reforms. The MSC and the MMC did,

¹⁴ Rather than expressly incorporating the limitations reflected in the ISO Governing Board's resolution into the ISO Tariff, Amendment No. 21 specifies that any price caps imposed by the ISO must be consistent with the criteria adopted by the Board and must be published on the ISO Home Page or WEnet. This approach is consistent with the January 27 Order, in which the Commission rejected a tariff amendment that would have incorporated into the ISO Tariff limitations on the ISO's authority to cap prices, while confirming the ISO's authority to cap prices at levels it deems appropriate. It also reflects the potential for changes to price cap levels that is incorporated in the Governing Board's resolution.

however, express their views in the joint memorandum dated June 25, 1999 (see Attachment F). In that memorandum, the committees noted their continuing "concerns about the competitiveness of California energy and ancillary-services markets." They also stated that:

. . . price caps should not be raised until the ISO's redesign of its ancillary service markets and the reform of the [RMR] contracts are fully implemented. . . . [S]etting a date for the removal of the price caps that is independent of the completion of these necessary redesign and reform efforts . . . leaves the California markets unprotected from massive unanticipated price movements that could arise from market-design flaws or the exercise of market power.

Taking these circumstances and the views of the MSC and the MMC into account, the ISO Board determined that a middle ground was appropriate. The implementation of Ancillary Service market reforms supported an increase in price cap levels, but the lack of experience with those reforms warranted the retention of price caps through the summer of 2000, as well as the specification of the ISO's authority to impose lower caps on short notice, should it become necessary. Complete elimination of the ISO's price cap authority, at this juncture, would not assure that prices in the Imbalance Energy and Ancillary Service markets would remain just and reasonable, because there is not yet adequate assurance that the markets will be a workably competitive. At the same time, the substantial increase in the levels of the price caps and the requirement that ISO management present a plan for their elimination after the summer of 2000 were intended to demonstrate the ISO's commitment to achieving "Reliability through Markets," and to assure potential market entrants that prices would not be constrained unnecessarily or indefinitely.

One additional Tariff change is proposed in Amendment No. 21. Because the level of permissible bids affects the values implicitly assigned by the ISO's software to schedules involving Existing Contracts and Reliability Must-Run Generation as well as the range of Adjustment Bids that Scheduling Coordinators currently submit for certain schedules, the revision of the price caps on September 30, 1999 will affect the values set forth in Section 4.6 of the Schedules and Bids Protocol. SBP 4.6 is simply a description of how the ISO's software assigns Adjustment Bid values, and therefore contains a level of detail inappropriate for the ISO Tariff. This is a quintessential example of the type of "'operating guidelines' that simply add details or procedures necessary to implement tariff provisions" which the Commission invited the ISO to file to remove from the ISO Tariff in its December 17, 1997 order that incorporated the Protocols into the filed Tariff.¹⁵

¹⁵ *Pacific Gas and Electric Co. et al.*, 81 FERC ¶ 61,320 at 62,471 (1999).

Moreover, due to software modifications related to the scheduling templates for Existing Contracts and Firm Transmission Rights, all values set forth in SBP 4.6 will soon be assigned by the ISO's software automatically.¹⁶ Scheduling Coordinators will no longer be required to submit any of the Adjustment Bid values set forth in SBP 4.6. Amendment No. 21 would therefore eliminate Section 4.6 of the Settlements and Bids Protocol, effective September 30, 1999. The ISO notes that this action will not affect the relative priorities of transmission service under Existing Contracts or priorities associated with Reliability Must-Run Generation.

III. Effective Date and Request for Waiver

As noted above, the ISO's authority to cap bids in Imbalance Energy and Ancillary Service markets will expire on November 15, 1999, absent further action by the Commission. The ISO accordingly proposes to make the modifications to Section 28 of the ISO Tariff effective on November 15, 1999 and requests waiver of the notice requirements of Section 35.3 of the Commission's regulations, 18 C.F.R. § 35.3, for that purpose. The requested waiver, which only shortens the notice period by a few days, is in the public interest, because it will ensure there is no interruption in the ISO's authority to reject bids that exceed the price ceiling (which will be adjusted upwards in accordance with the policy adopted by the ISO Board of Governors).

The changes to SBP Section 4.6 are necessary to implement the higher price caps that the ISO intends to implement on September 30, 1999, under its existing price cap authority. The ISO accordingly requests waiver of the notice requirements of Section 35.3 to permit those changes to go into effect on September 30, 1999. The requested waiver is in the public interest, as it is necessary to enable the ISO to implement the flexible price cap authority that was confirmed in the January 27 and May 26 Orders and to reflect the planned increase in the price caps, which was approved by the ISO's Board of Governors.

IV. Notice and Service of Documents

Communications regarding this filing should be addressed to the following individuals, whose names should be placed on the official service list established by the Secretary with respect to this submittal:

¹⁶ The ISO notes that proposed Tariff changes related to these software modifications were approved by the ISO Board of Governors at its most recent meeting and will be submitted to the Commission as part of the ISO's quarterly Tariff filing in the next week.

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§385.203.

The ISO has served copies of this letter, and all attachments, on the Public Utilities Commission of California, the California Energy Commission, the California Electricity Oversight Board, and on all parties with effective Scheduling Coordinator Service Agreements under the ISO Tariff. In addition, the ISO is posting this transmittal letter and all attachments on the ISO's Home Page.

V. Supporting Documents

In addition to this transmittal letter, this filing is supported by the following documents:

- The revised tariff sheets reflecting the proposed amendment (Attachment A);
- A black-lined version of Section 28 and SBP Section 4.6 of the ISO Tariff, showing the changes proposed herein (Attachment B);
- A memorandum of the Director of the ISO's Department of Market Analysis describing the need for and basis of the proposed amendment (Attachment C);
- A copy of the resolution adopted by the ISO's Board of Governors at its August 26, 1999 meeting (Attachment D);
- A copy of a memorandum prepared for the ISO's Board of Governors for its June 24, 1999 meeting discussing price caps (Attachment E);
- A copy of a memorandum prepared for the ISO's Board of Governors for its August 26, 1999 meeting discussing price caps (Attachment F);
and

- A Notice of this filing, suitable for publication in the Federal Register, together with a diskette containing that notice in electronic form (Attachment G).

An additional copy of this filing is enclosed, to be marked with your filing stamp and returned to our messenger. If you have any questions about this filing, please contact the undersigned.

Respectfully submitted,

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