March 20, 2001

The Honorable David P. Boergers
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

Re: California Independent System Operator Corporation,
Docket No. ER01-____-000
Amendment No. 38 to the ISO Tariff

Dear Secretary Boergers:

Pursuant to Section 205 of the Federal Power Act ("FPA"), 16 U.S.C. § 824d, and Sections 35.11 and 35.13 of the Commission's regulations, 18 C.F.R. §§ 35.11, 35.13, the California Independent System Operator Corporation ("ISO")[1] respectfully submits for filing six copies of an amendment ("Amendment No. 38") to the ISO Tariff. Amendment No. 38 would modify the ISO Tariff in two respects. First, due to the current financial situation of Pacific Gas and Electric Company ("PG&E") and Southern California Edison Company ("SCE") and their inability to make forward purchases to serve their entire Load, Amendment No. 38 would suspend the penalty for underscheduling of Load (*i.e.*, the requirement that Market Participants have at least 95 percent of their Load scheduled prior to real time). The suspension of the penalty is in response to the current conditions in the California electricity market and does not diminish either the importance to forward-schedule resources and Load or the need to limit the amount of activity in the ISO's real time Imbalance Energy market. Thus, the proposed suspension of the penalty is temporary and would be limited to the period from January 1, 2001 through May 31, 2001. Second, Amendment No. 38 would give Market Participants with

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

resources that have been selected to provide Spinning and Non-Spinning Reserves (collectively, Operating Reserves) the ability to indicate that their resources should not be dispatched to provide Imbalance Energy unless there is a Contingency or an imminent or actual System Emergency. The benefits of giving Market Participants this ability include increasing the supply of Operating Reserves available to the ISO and facilitating the preservation of those reserves for Contingency and System Emergency use.

I. Suspension of the Underscheduling Penalty

A. Background

During the last nine months, the ISO consistently has expressed its concern about the underscheduling of Load and its affect on reliability.[2] Underscheduling played a large role in creating the stressful and difficult conditions under which the ISO operated during the past year, and the ISO supported the underscheduling penalty contained in the Commission's November 1, 2000 and December 15, 2000 orders.[3]

The underscheduling penalty was one facet of the Commission's price mitigation plan presented in the December 15 Order in Docket Nos. EL00-95, *et al.*,[4]. The Commission appropriately recognized that underscheduling jeopardizes reliable system operations by forcing the ISO to satisfy far more Load in real time than the intended 5 percent. Indeed, the ISO's real-time imbalance market at times has been called upon to satisfy up to 30 percent or more of the Control Area Load. The Commission found that such a large real time Energy market creates a strong sellers' market and high real time prices. Therefore, the Commission required all Market Participants to preschedule their Load and imposed penalties when real time Load exceeds more than five percent of an entity's scheduled Load. That is,

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2 *See, e.g.*, August 25, 2000 Board Memorandum from Terry Winter to the Board of Governors; October 20, 2000 Offer of Settlement filed by the ISO in *San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and the California Power Exchange, et al.*, Docket No. EL00-95, *et al.* at 7; November 22, 2000 Comments of the ISO on the Commission's November 1, 2000 Order at 18-20; and the January 16, 2001 Request for Rehearing of the on the Commission's December 15, 2000 Order at 3.

3 The only modification to the Commission's actions requested by the ISO was that some form of underscheduling penalty should be applied to Generation as well as Load. November 22, 2000 Comments at 18-19; January 16, 2001 Request for Rehearing at 3.

4 *San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and the California Power Exchange, et al.*, 93 FERC ¶ 61,294 (2000) ("December 15 Order").

95 percent of a Market Participant's Load must be scheduled into the forward markets (*i.e*., the Day-Ahead or Hour-Ahead markets) or scheduled bilaterally prior to real time. The Commission also established a 10 MW minimum deviation to accommodate smaller entities (*i.e*., those with less than 200 MW of Load). Thus, no charge will be assessed for a scheduling shortfall up to the greater of five percent of an entity's Load or 10 MW.

The Commission set the penalty for those entities that exceed the five percent or 10 MW "deadband" for any trading hour at two times the cost of Imbalance Energy during that hour (including any Out-of-Market ("OOM") purchases for that hour), with the penalty not to exceed $100/MWh. The Commission also directed that the penalty revenues be disbursed to those Market Participants that scheduled accurately during the trading hour in which the penalties were incurred. December 15 Order, 93 FERC at 61,982. In its January 2, 2001 filing in compliance with the December 15 Order, the ISO stated that it would institute the underscheduling penalty as directed by the Commission.

On February 2, 2001, SCE and PG&E tendered for filing a Request for Immediate Suspension of the underscheduling penalty adopted by the Commission in its December 15 Order ("Request").[5] In their filing, SCE and PG&E recognize that the purpose of the penalty was to alleviate the reliance on the ISO's Imbalance Energy Market to meet Load. Request at 3. They note, however, a series of events that render it impossible for them to expand their forward purchases. First, the California Power Exchange ("PX") has ceased operating its Day-Ahead and Day-of Markets. *Id*. at 4. Second, credit and supply problems have rendered it impossible for SCE and PG&E to access forward power markets. *Id*.

On March 2, 2001, the ISO filed a Motion to Intervene and Comments in response to SCE's and PG&E Request of February 2. The ISO noted that in response to the current situation in the California electricity market, the ISO Governing Board, at its February 28, 2001 meeting, approved management's recommendation to file a tariff amendment requesting suspension of the underscheduling penalty for the January 1, 2001 to May 31, 2001 period. This filing implements that direction.

B. Need For Amendment

[5] This Request was assigned Docket No. EL01-34-000.

Since January 1, 2001 (the effective date of the underscheduling penalty), a large amount of Load continues to appear unscheduled in real time. Most of the shortfall in the amount of forward scheduled Load is attributable to PG&E and SCE. As has been well documented, these utilities are experiencing severe financial difficulties, rendering them unable to pay for the supply itself, let alone for penalties imposed in addition to the cost of Energy. Without the financial wherewithal to make their own bilateral purchases or access to a forward market, SCE and PG&E are incapable of scheduling 95 percent of their Load. Approximately 15 percent of Load has been, and continues to be, scheduled in real time. From January 1, 2001 to March 14, 2001, the ISO estimates that the penalties will exceed $400 million.[6]

Early in January of 2001, the State of California acted to help to secure supplies for the so-called "net short" Load of the investor-owned utilities ("IOUs").[7] Pursuant to state legislation, the California Department of Water Resources ("CDWR") has been given the responsibility to secure supplies for these net short amounts. This responsibility went far beyond CDWR's previous scheduling activities. Despite extraordinary effort by CDWR to meet the net short needs on forward basis, the amount of Load appearing in real time continues to average approximately 15 percent from January 1, 2001 to March 14, 2001.[8]

As noted earlier, the ISO has been a vigorous proponent of the need to forward schedule resources and Load and thereby reduce the amount of Load to be served in real time. Underscheduling penalties are an appropriate tool to use in ensuring reliable operations and are an important part of the market design in California. Given the current conditions that exist in California, however, a temporary suspension of the underscheduling penalty is warranted. The current

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6 *See* the attached affidavit Spence Gerber, the Director of Settlements at the ISO (Attachment E). Mr. Gerber explains that calculating the penalty amounts requires a comparison of scheduled Loads to real time Loads based on meter data. Since meter data is not yet available for most of the period from January 1, 2001 to March 14, 2001, Mr. Gerber's estimates are based upon comparing the amount of real time purchases to the daily control area Load. This comparison results in an accurate aggregate estimate of penalty revenues. In addition, Mr. Gerber notes that his estimates are based on applying the penalty to all the Load unscheduled in real time once the 5 percent threshold is reached. In other words, if 15 percent of a Scheduling Coordinator's Load were to appear unscheduled in real time, Mr. Gerber applied the penalty to the entire 15 percent. If the penalty were applied to only that amount above the 5 percent threshold, the penalty revenues would be approximately $257 million for the period of January 1 through March 14, 2001.

7 The "net short" position of the IOUs is that amount of their Load that is not met by their own resources.

8 Mr. Gerber estimates that for the first 14 days in March about 13 percent of Load continued to be served in real time.

financial condition of IOUs doesn't allow the penalty to have the desired effect of encouraging forward contracting; rather, imposition of the penalty would only place hundreds of millions of dollars of additional costs on the IOUs at a time of severe financial distress. Moreover, while CDWR recognizes the need to forward schedule the resources it procures and while it has made significant improvement since it began to secure supplies for the net short amounts, it will require more time before it can meet the 95 percent criteria.

Rather than add costs to the financial burdens already facing California consumers, the ISO requests that the Commission approve the suspension of the underscheduling penalty from January 1, 2001 through May 31, 2001. By this date the ISO anticipates either that the state will have remedied the financial situation of SCE and PG&E such that they will be able to enter into forward purchases, or CDWR will be in a position to meet the full net short demands and avoid having the underscheduling penalty assessed on IOU Loads.

II. Split BEEP Stack

A. Background

The ISO's Ancillary Services market consists of an auction for four types of reserves: Regulation, Spinning Reserve, Non-Spinning Reserve, and Replacement Reserve.[9] Bidders for Ancillary Services submit bids with two price components, capacity and Energy. The capacity price component is used in the Day Ahead and Hour Ahead markets to procure the required amount of reserves and the Energy price component is used in the real time Imbalance Energy or "BEEP" stack to determine the order in which capacity from Ancillary Services is converted to Energy.[10] Spinning and Non-spinning Reserves (collectively, Operating Reserves) are intended to be used for Contingencies such as the loss of a generating unit or of a transmission path; or System Emergencies such as the imminent loss of firm load, voltage collapse, or transmission path overload.

The ISO is a member of the Western Systems Coordinating Council ("WSCC") and must maintain the amount of contingency Operating Reserves required by the WSCC's Minimum Operating Reliability Criteria ("MORC"). Under the WSCC MORC criteria, the ISO must have contingency Operating Reserves

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9 Voltage Support and Black Start capability are also Ancillary Services under the ISO Tariff but they are procured using Reliability Must-Run resources.

10 The acronym BEEP comes from the name of the software (*i.e.*, the Balancing Energy and Ex-post Pricing software) used to dispatch Energy from Ancillary Service capacity and Supplemental Energy bids to meet real time demands.

equal to either (a) 5 percent of the Demand to be met by Generation from hydroelectric resources plus 7 percent of the Demand to be met by Generation from other resources, or (b) the single largest contingency, if it is greater.[11] The ISO, with its control area, is subject to the first set of criteria above (the percentage requirements for Operating Reserves).

The ISO has the authority to determine the required amount of Operating Reserves based on the quantity and location of the system requirements.[12] In addition, when dispatching resources in real time, it is within the ISO's discretion to determine the effectiveness of an Energy bid in meeting the real time fluctuation in Demand or Generation.[13]

B. Need For Amendment

As discussed above, it is within the ISO's discretion to consider the effectiveness of resources in determining which, if any, resources contracted to provide Operating Reserves (either procured through the ISO's competitive market, or self-provided by Scheduling Coordinators) should be dispatched to supply Imbalance Energy.[14] During real time, if the amount of Operating Reserves approaches or falls below the minimum requirements, the ISO can use its discretion to withhold or not dispatch the Energy bids associated with the Operating Reserve capacity. For example, the ISO may consider WSCC Operating Reserve requirements and other factors, such as the overall availability of Energy from resources contracted to provide Operating Reserves, in determining the effectiveness of resources to be dispatched. If a resource supplying Operating Reserve is dispatched to provide Imbalance Energy, the ISO must replace the Operating Reserve within the time frame specified in the WSCC guidelines.[15]

Under the ISO's current real time dispatch practices, the decision to withhold Energy bids to prevent a deficiency in Operating Reserves is often an all or nothing proposition. In other words, as the amount of Operating Reserves approaches or falls below the minimum requirements, the ISO will withhold all of the Energy bids

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11 *See* ISO Tariff § 2.5.3.2.

12 *See, e.g.*, ISO Tariff § 2.5.4 and § 2.5.12(b).

13 ISO Tariff §§ 2.5.22.2(e).

14 ISO Tariff § 2.5.22.3.

15 *Id.*

associated with contracted-for Operating Reserves.[16] Stated differently, existing dispatch practices do not afford Market Participants with a mechanism to express their desire to either: (1) have their Operating Reserves dispatched only in the event of a Contingency or System Emergency, or (2) have their Operating Reserves dispatched for Imbalance Energy (*i.e.*, to provide Imbalance Energy in the absence of a Contingency or System Emergency).[17] In order to assist the ISO in preserving contingency Operating Reserves and to increase the supply of those reserves, the ISO proposes to give Market Participants the ability to indicate that these reserves should be dispatched to provide Imbalance Energy only if there is a Contingency or an imminent or actual System Emergency. [18]

With the energy shortages of the past few months, there have been frequent deficiencies in Operating Reserves. These deficiencies put the ISO in the position of declaring System Emergencies and incurring WSCC penalties. The ISO incurred over $1 million in WSCC penalties in the year 2000 due to such shortfalls.[19] The deficiencies have occurred because the Energy associated with Operating Reserves has been dispatched to supply Imbalance Energy and the ISO has been unable to replace the Operating Reserves within the time frames specified in WSCC guidelines.

Moreover, during the past few months, the ISO has observed a marked decrease in the amount of Operating Reserve being bid into the ISO markets.[20] The decrease has been observed with regard to both in-state resources as well as imports of Operating Reserves. Certain suppliers have resource capacity that can be used to supply Operating Reserves but the amount of Energy available for dispatch is limited for some reason (*e.g.*, hydroelectric units with water restrictions or generating units with emission constraints). Part of reason for the decline in Operating Reserves is because these energy-limited resources are not making themselves available to the ISO where the probability of dispatch is high under

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[16] *See, e.g.*, ISO Procedure M-403 ("Balancing Energy Ex Post Pricing") § 1.4, which provides that if all Spinning and Non-Spinning bids are going to be skipped to maintain Operating Reserve criteria, the ISO will send a notice to market participants.

[17] While individual Market Participants may be able to make the ISO aware of the conditions that may relate to the effectiveness of their Energy bids dispatched to supply Imbalance Energy, these currently are non-structured communications and are not integrated into the ISO's business systems.

[18] *See* Attachment F to this filing which contains a February 15, 2001 Memorandum to the ISO Board of Governors and a February 27, 2001 Memorandum to ISO Board of Governors regarding the split BEEP proposals.

[19] *See* Attachment F, February 27 Memorandum at 3.

[20] *Id*. at 1.

current conditions. This problem is further exacerbated by the Commission's approval of market reforms with pricing breakpoints and "as bid" prices above those breakpoints. Before "as bid" pricing, bidders could express the willingness to be dispatched only for Contingencies or System Emergencies by submitting high or near price cap Energy bids. With "as bid" pricing above a $150 break point, bidders submitting high bids may find themselves not only dispatched to provide Imbalance Energy, but faced with the requirement to justify the high price to the Commission.

To correct the above-mentioned problems, the ISO proposes to give Market Participants with resources selected to provide Operating Reserves the ability to indicate whether the dispatch of these resources should, or should not, be limited to Contingencies or System Emergencies. Market Participants will be able to indicate this preference on an hourly basis. The flexibility to restrict the dispatch of Operating Reserves will increase the available supply of Operating Reserves and will assist the ISO in preserving those reserves for Contingency and System Emergency use.

Giving Market Participants the flexibility to designate in each hour whether the Operating Reserves can be dispatched to provide Imbalance Energy will require changes to ISO software. Prior to Commission approval and implementation of software changes, the ISO has asked Market Participants to indicate whether their resources have energy limitations such that the resources should only be dispatched for Contingencies and System Emergencies.

The ISO's request amounts to a one-time election for Market Participants and the information provided will allow the ISO to exercise its existing discretion more efficiently (*i.e.*, to determine whether or not contracted-for Operating Reserves should be dispatched to provide Imbalance Energy). Any Market Participant designations will remain in place until the Commission acts on this filing. If a Market Participant does not make an election, the Energy associated with accepted Operating Reserve bids will be available for dispatch to supply Imbalance Energy.

III. Tariff Changes

The tariff changes necessary for the temporary suspension of the underscheduling penalty amount to adding the phrase "Beginning June 1, 2001" at the start of ISO Tariff Section 2.2.13.2.3.1. The tariff changes associated with the Split Beep proposal involve clarification and modifications to: (1) real time dispatch rules, (2) the information required of bidders for Spinning and Non-Spinning Reserves, and (3) the rules for substitution of Ancillary Services according to the ISO's rational buyer protocol. Revised Tariff Sheets are provided in Attachment A (suspension of underscheduling penalty) and Attachment B (Split BEEP proposal) to this filing. The black-lined Tariff provisions are provided in Attachments C and D, respectively.

IV. Requested Effective Date and Request for Waiver of 60 Day Prior Notice Requirement

A. Split BEEP Proposal.

Due to the software changes and the operational mechanisms required to implement the ISO's Split Beep proposal, the ISO requests an effective date for the Split BEEP proposal on the later of May 18, 2001 or at least ten days after the ISO posts notice on the ISO Home Page that the modified software is ready for use to accommodate this change.

B. Temporary Suspension of the Underscheduling Penalty

The ISO respectfully requests, pursuant to Section 35.11 of the Commission's regulations, 18 C.F.R. § 35.11, that the Commission waive its notice requirements and approve a temporary suspension of the under-scheduling penalty from January 1, 2001 through May 31, 2001. Moreover, the ISO believes that immediate implementation of this provision is necessary so that the IOUs can avoid worsening their already precarious financial situation, at a time when such penalties are not achieving the goals for which they were created.[21]

V. Service

The ISO has served this filing on Public Utilities Commission of the State of California, the California Energy Commission, the California Electricity Oversight Board, and all parties with effective Scheduling Coordinator Service Agreements under the ISO Tariff.

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[21] The Preliminary Settlement Statement for January 1, 2001 was produced and delivered to Scheduling Coordinators on February 26, 2001. This and subsequent Preliminary Statements for January and beyond will not include the penalty and allocation of revenue until the Commission has taken action on this matter. The ISO has and will continue to calculate the penalty and allocation for inclusion in a future Settlement Statement and Invoice should the Commission reject Tariff Amendment No. 38. The design of the penalty is insular in that no other market charges are affected by its implementation, and thus it can be administered independently from any other settlement elements. In a Market Notice issued on February 23, 2001, the ISO notified Market Participants that while the penalty will continue to be calculated, the results will not appear unless the Commission determines that it is appropriate to reject the suspension.

VI. Communication

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:

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VII. Supporting Documents

The following documents, in addition to this letter, support this filing:

Attachment A	Revised Tariff Sheets - Underscheduling Penalty
Attachment B	Revised Tariff Sheets – Split BEEP Proposal
Attachment C	Black-lined Tariff provisions - Underscheduling Penalty
Attachment D	Black-lined Tariff provisions – Split BEEP Proposal
Attachment E	Affidavit of Spence E. Gerber
Attachment F	February 15, 2001 and February 27, 2001 Memoranda to the ISO Board of Governors
Attachment G	Notice of this filing, suitable for publication in the Federal Register (also provided in electronic format).

Two additional copies of this filing are enclosed to be stamped with the date and time of filing and returned to our messenger. If there are any questions concerning this filing, please contact the undersigned.

Respectfully submitted,

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Attachment A

Attachment B

Attachment C

Attachment D

Attachment E

Attachment F

Attachment G