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December 4, 1998

The Honorable David P. Boergers
Acting 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 to Section 28 of the ISO Tariff, Relating to the
Disqualification of Certain Energy 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. As explained below, the proposed amendment would modify Section 28 of the ISO Tariff to extend the ISO's authority to disqualify Energy bids that exceed a specified level.

Background and Reasons for Filing

On March 31, 1998, the day of the commencement of ISO operations, the ISO filed Amendment No. 7 to the ISO Tariff. Amendment No. 7 effected a number of modifications to the ISO Tariff, including establishing authority for the ISO to reject bids in its real-time energy market that exceed a price level to be determined by the ISO. The ISO explained that the authority to cap real-time energy bids, embodied in Section 28 of the ISO Tariff, was necessary because of

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

certain shortcomings in the software through which the ISO's real-time energy market would operate.² In pre-operational testing of the BEEP software, the ISO observed higher-than-expected real-time energy prices and concluded that those prices were due in part to the fact that the software based clearing prices in the real-time energy market on the resources it selected for dispatch, even when operational considerations required the ISO dispatchers to select other resources. To address this software problem, the ISO proposed a temporary rule, which it described as:

. . . in effect, a price cap, [that] will remain in place until changes are made to the BEEP software to enable BEEP to calculate the Ex Post Prices based on resources actually dispatched by the operator, rather than on the resources BEEP directs the operator to Dispatch.³

The Commission conditionally accepted the portion of Amendment No. 7 relating to the BEEP price cap by order issued May 28, 1998.⁴ The Commission found that the BEEP price cap proposal: "represents a reasonable framework to address the remaining software problem."⁵ The ISO initially imposed a cap on prices in its real-time imbalance energy market of \$125/MWh. That cap was subsequently raised to \$250/MWh.

Although the development and installation of software has taken longer than originally expected, the ISO now expects the software problems that led to the BEEP price cap proposal to be eliminated by new software that will be operational by January 15, 1999. Absent further action by the Commission, the ISO would accordingly be required to issue the notice specified in Section 28.1 and its authority to cap real-time energy prices would expire seven days thereafter.

The ISO has determined, however, based on analyses conducted by its Market Surveillance Unit ("MSU") and by the independent Market Surveillance Committee ("MSC")(see Attachment D), that continuation of its authority to cap prices paid for real-time imbalance energy, is necessary and appropriate. The Commission recently recognized that the ISO's markets for ancillary service capacity are not workably competitive, making it appropriate to preserve the

² That software is referred to as the "Balancing Energy and Ex Post Price" or "BEEP" software.

³ Letter from F. Wolf to D. Boergers, Docket Nos. EC96-19-023 and ER96-1663-024, at 8 (Mar. 31, 1998).

⁴ *California Independent System Operator Corporation*, 83 FERC ¶ 61,209 (1998).

⁵ *Id.* at 61,923.

ISO's authority to impose a cap on those markets.⁶ The Commission stated, "While our ultimate goal is to eliminate all reliance on price caps, some form of price constraint is needed until the market design flaws are corrected."⁷ The Commission found persuasive a report presented by the ISO's MSC, identifying a number of factors that tended to create excessive prices in the ISO's Ancillary Services markets, *i.e.*, prices higher than those that would prevail in workably competitive markets. The Commission noted, among other things, the MSC's explanation that "if there were little or no market power in the PX or imbalance energy markets then it would expect little or no market power to exist in the Ancillary Services markets."⁸

The Commission recognized that, under the circumstances of the restructured California electricity markets, it "must consider the energy markets and Ancillary Service markets in tandem."⁹ In particular, a principal source of energy for the ISO's imbalance energy market is the capacity that is made available to the ISO for Ancillary Services. The ISO's MSU and the MSC have expressed concern that eliminating the cap on prices in the real-time energy market before necessary changes are made effective in the Ancillary Services markets could afford increased opportunities for the exercise of market power. In particular, the MSC expressed concern that eliminating the price cap in the real-time energy markets could disrupt the efficient functioning of Ancillary Services markets and of the California Power Exchange's forward energy markets. (See Attachment D.)

The MSU and the MSC have also concluded, based on their review of market operations, that market power may have frequently existed in the real-time energy market. The ISO and its MSC have noted a fundamental lack of demand elasticity in that market. The ability of buyers to decline to purchase is a critical component of an effectively competitive market.

Based on the findings of its Market Surveillance Committee and the internal Market Surveillance Unit, the ISO Board has reluctantly concluded that it should seek authority to impose a cap on bids in real-time imbalance energy markets once the current authority, which is based on software design flaws, expires. At the same time, the ISO shares the Commission's reluctance to rely on price caps to restrain market behavior, except where necessary to limit market power. In particular, the ISO wants to be sure that price caps do not inhibit the supply of energy or deter new entrants. The Board of Governors of the ISO has

⁶ *AES Redondo Beach, L.L.C., et al.*, 85 FERC ¶ 61,123, slip op. at 19 (1998).

⁷ *Id.*

⁸ *Id.*, slip op. at 18.

⁹ *Id.*, slip op. at 9.

taken these considerations, as analyzed by the MSU and the MSC, and with several months of opportunity for market participants to comment on a potential proposal to extend the BEEP cap, into account in approving the proposal that is before the Commission.

Description of Filing

The ISO proposes to amend Section 28.1 of the ISO Tariff to extend its authority to establish a maximum price level for Energy bids in its real-time imbalance energy market.

The ISO expects initially to maintain the price cap on Energy bids at the current level, \$250/MWh. In making its decision to seek this authority from FERC, the ISO's Board of Governors found a critical component of the planned approach to be the plan to raise the cap as soon as appropriate. Following the implementation of the improvements to the Ancillary Service markets that are under development for filing with the Commission on or before March 1, 1999, in accordance with the Commission's order in *AES Redondo Beach*, the Board has indicated its intent to raise the level of the price cap to \$750/MWh when the coordinated changes necessary to ensure that energy and Ancillary Service markets function effectively have been made. These changes include the following items or substantially equivalent actions as determined by the Board: (a) implementation of Rational Buyer Protocols, and (b) modification of Reliability Must-Run (RMR) agreements to eliminate or substantially reduce potential incentives for withholding of capacity from the Ancillary Service and other markets. The ISO intends to make these changes by May 31, 1999. Because the timing of the implementation of these changes is currently uncertain, no fixed deadline is included in the amendment.

Whether or not the changes can be implemented as planned for May 31, the ISO's Board of Governors voted to establish an absolute **floor** for the price cap of \$2,500/MWh, to be effective October 1, 1999. This floor is reflected in the amendment to Section 28.2. This ensures the market that by October 1 a price cap may not be less than \$2500, absent further action by the Commission. In other words, by that date, the price cap authority would serve only as insurance against an extreme exercise of market power. Only if the ISO Board determines that anticipated improvements in the design of its markets and in the ability of buyers to respond to prices in real-time energy markets are delayed, will it file with the Commission to adjust this constraint and, of course, before any change is made, the Commission would have to approve the change. This structure is intended to give the greatest possible assurance to the market that prices will support demand-side alternatives and new investment at the earliest practicable date.

The ISO Board did not treat this issue lightly and sought to craft a fair proposal that addressed the concerns strongly expressed by the Market Surveillance Committee and certain market participants, while seeking to maintain to the fullest possible extent its commitment to “Reliability Through Markets” – which is the ISO’s vision statement. The ISO is mindful that this cap extends beyond the Ancillary Services Markets to an energy market – but has been convinced by the market design experts, including the independent Market Surveillance Committee, that this phased approach to lifting the BEEP cap is necessary to protect consumers as we gain knowledge not simply about software flaws, but also about design flaws, in these new markets.

Finally, the amendment also modifies Section 28.2 to recognize that the ISO will (upon Commission approval) be accepting negative Energy bids as a means of addressing overgeneration conditions. This change is the subject of another filing of amendments to the ISO Tariff that will be made in the near future. The ISO proposes in the instant filing to have the authority to impose a limit on both positive and negative Energy bids. Pursuant to the decision of its Board of Governors, the ISO has decided initially to establish the same price caps on positive and negative bids, *i.e.*, real-time energy market prices will be capped at positive \$250/MWh and negative bids cannot be below -\$250/MWh.

Stakeholder Consideration

The ISO is mindful of the Commission’s desire to ensure appropriate procedural protections for parties that are affected by ISO filings. Thus, it only reluctantly seeks waiver of the 60-day notice provision to allow this amendment to be effective upon implementation of the software changes that address the design flaws that formed the basis for the original cap. Although the ISO is seeking expedited Commission consideration, this filing follows a process that has afforded stakeholders ample opportunity to review and comment on both the concept and the wording of the proposed extension.

The need for and terms of an extension of the BEEP price cap was discussed extensively among the ISO and the participants in the restructured California electricity markets. Management first identified the potential that it would recommend a continued BEEP cap at stakeholder meetings in September 1998. A memorandum noting the planned management proposal was presented to the Board of Governors and made available to the public in materials for the September 23, 1998 meeting of the ISO Board. The proposal was discussed at additional stakeholder meetings in October.

Several alternative approaches were presented to and discussed with market participants at the Market Issues Forum held on November 4, 1998. The proposal ultimately adopted by the ISO Board was developed in consultation with the Market Surveillance Committee on November 11, 1998 and was the subject

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of discussion and approval at the November Board meeting, with further opportunity provided for stakeholder input. The ISO's Board of Governors approved the extension of the price cap on imbalance energy bids at its November 19, 1998 meeting. Following that meeting, the ISO Board's Market Issues/ADR Committee considered stakeholder comments on the language of the amendment at a meeting on December 2, 1998. Materials that were made available to the Board and the public in connection with this issue are included at Attachments C and D to this filing.

Effective Date

The ISO requests waiver of the notice requirements of Section 35.3 of the Commission's regulations, 18 C.F.R. § 35.3, to permit the amendment to Section 28 to take effect on the date that the present caps would otherwise have expired (seven days after notice of full functionality of the software). The ISO anticipates that this date may be as early as January 15, 1999. This effective date is necessary to ensure the uninterrupted continuation of the ISO's authority to place caps on bids in its real-time energy market until factors preventing the efficient functioning of that market are addressed and put into effect.

Good cause exists to grant this waiver, as demonstrated by the above discussion. Moreover, affected parties have had substantial input into this proposal, as detailed above. The ISO notes that the views of the Market Surveillance Committee were considered important in fashioning any proposal for a continued BEEP cap. The ISO's consultation with the MSC resulted in modifications to the proposal that were not considered by the ISO's Board of Governors before its November 19, 1998 meeting. This filing was made promptly upon the conclusion of its consideration by stakeholders in a process that permitted the ISO to take into account objections that otherwise would have to be considered by the Commission without prior stakeholder review. The ISO submits that the foregoing factors constitute good grounds for waiver of the Commission's notice requirements in the circumstances presented by this filing.

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:

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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.

Supporting Documents

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

- The revised tariff sheet reflecting the proposed amendment (Attachment A);
- A black-lined version of Section 28 of the ISO Tariff, showing the changes proposed herein (Attachment B);
- A memorandum of the Director of the ISO's Market Surveillance Unit describing the need for and basis of the proposed amendment (Attachment C);
- A Report of the ISO's Market Surveillance Committee addressing the need for the extension of the BEEP price cap (Attachment D); and

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

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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