

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

AES Redondo Beach, LLC)	Docket No. ER98-2843-000
)	
AES Huntington Beach, LLC)	Docket No. ER98-2844-000
)	
AES Alamitos, LLC)	Docket No. ER98-2883-000
)	(Not Consolidated)
Long Beach Generation, LLC)	Docket No. ER98-2972-000
)	
El Segundo Power, LLC)	Docket No. ER98-2971-000
)	
)	(Not Consolidated)
Ocean Vista Power Generation, LLC)	
Mountain Vista Power Generation, LLC)	
Alta Power Generation, LLC)	Docket No. ER98-2977-000
Oeste Power Generation, LLC)	
Ormond Beach Power Generation, LLC)	

**COMMENTS OF
THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION
ON REPORTS REGARDING ANCILLARY SERVICES MARKET OPERATION**

Pursuant to the Commission's July 17, 1998, Order in the above-captioned proceeding, the California Independent System Operator Corporation (ISO) respectfully submits these comments on the "Preliminary Report On the Operation of the Ancillary Services Markets of the California Independent System Operator Corporation (ISO)," prepared by the Market Surveillance Committee of the ISO (MSC), and the "Report on Market Issues in the California Power

Exchange Energy Markets,” prepared by the Market Monitoring Committee of the California Power Exchange (MMC).

Summary

The Reports of the MSC and the MMC, after careful analysis and discussion of the ISO’s Ancillary Services (A/S) markets, both independently reach the same overarching conclusions:

- the ISO’s A/S markets do not yet operate in a manner consistent with workable competition; and
- the ISO should retain the authority to impose a “damage control” price cap and exercise that authority until these markets are demonstrably competitive.

A competitive market is one in which two conditions exist: no single supplier or select few suppliers can raise the market price to the detriment of consumers and demand is sufficiently flexible enough to respond to prices. The ISO is committed to fostering a fully competitive market in its Control Area, one in which price caps are not necessary. In the interim, however, the ISO agrees with the Committees’ recommendation -- the ISO must retain the authority to impose damage-control price caps as a short-term measure until such time as workably competitive markets are developed.

A second issue is how best to proceed towards workably competitive markets. Because of the interrelationships among the ISO-administered markets, as well as the PX and other energy markets, structural changes in one

market may affect the incentives and functioning of other related markets. The ISO has therefore commenced an integrated approach toward achieving long-term structural solutions for the A/S markets. The ISO proposes to develop improvements to the A/S market through a collaborative and deliberative process that will solicit input from all interested parties and propose solutions by action of the stakeholder ISO Governing Board.

The ISO respectfully submits that an integrated approach will be the most effective and timely means for evaluating and implementing the Committees' recommendations and those of the stakeholders. The Committees' reports form the necessary basis on which to proceed on the ongoing market development process. The adoption of any one recommendation in isolation, however, without consideration of both the larger market development process and the operations of the related A/S and Energy markets, could have undesirable consequences. Thus, the ISO urges the Commission to defer to this ongoing market development process and allow the ISO to serve as the forum for integrated analysis of, and response to, problems in the market structure.

Consistent with this approach, the ISO has combined the Committees' recommendations with other initiatives currently underway and developed a work plan that is identified in Appendix C to these Comments. There are, however, two recommendations from the MSC that the ISO does not intend to pursue at this time. First, the ISO does not concur with the MSC's findings and recommendations with regard to the structure of the current RMR Agreements. The current RMR Agreements are the subject of an extensive and intense

settlement effort at the Commission. The ISO believes this settlement, if it proceeds to a successful conclusion, can alleviate some of the MSC concerns. Moreover, to seek fundamental changes in RMR Agreements now would likely derail the settlement process and the substantial cost savings it promises.

Second, the proposal to use RMR Agreements as local fill-in in the presence of congestion, following a statewide auction for all A/S, would expand the ISO's reliance on RMR Agreements beyond their stated purpose of ensuring System Reliability and stability. This would be a fundamental shift in the ISO market design --away from a "market first" paradigm. Thus, the ISO would propose to look at this issue only in the context of longer-term changes.

The ISO recommends that the Commission, in order to assist the ISO in its efforts to arrive at a consensus, take the following action with respect to the Committees' reports:

- (1) Confirm and extend the ISO's authority to establish damage control price caps for A/S until such time as A/S markets are demonstrably functioning in a workably competitive manner;
- (2) Permit the ISO to retain its central role as sponsor and facilitator of the A/S redesign process; and
- (3) Endorse the following key objectives for the redesign of A/S markets:
 - Protecting consumers from excessive prices when markets are not competitive, including the maintenance of damage control price caps to protect buyers until they can protect themselves -- through self-provision of A/S, contracts for differences, long-term supply contracts, interruptible contracts, or other means;
 - Eliminating cost-based rate caps on individual Generators to encourage competitive supply of A/S;
 - Ensuring that damage control price caps do not inhibit investments in new capacity;

- Ensuring that damage control price caps do not bias market choices, but rather promote equilibration between markets; and
- Promoting the rational purchase of various A/S products – i.e., that superior services (such as spinning reserve) can substitute for inferior services (such as replacement reserve) where the prices for the inferior products are higher.

1. Summary of the MSC Report

The MSC Report identifies the following nine underlying factors contributing to the inefficient operation of the ISO's A/S markets:

- (1) some firms are subject to cost-based price caps while others are allowed to earn market-base rates;
- (2) the demand for A/S has been higher than anticipated;
- (3) the amount of each A/S demanded by the ISO does not depend on market prices and these demands are not procured in a rational manner;
- (4) perverse incentives guiding generator bidding behavior have been created by RMR Agreements;
- (5) the ISO has on many occasions purchased A/S separately in small geographic areas, increasing the potential for the exercise of market power;
- (6) the ISO's dispatch practices have not been transparent to Market Participants;
- (7) the allocation of A/S costs to Scheduling Coordinators has been flawed;
- (8) suppliers of A/S from outside the ISO Control Area have been excluded; and
- (9) the ISO's computer systems are still facing various software difficulties that are not yet fixed.

To resolve the problems the Committee perceives, and to encourage the development of workably competitive A/S markets, the MSC recommends that the ISO:

- (1) adopt rational and transparent purchasing practices for A/S, seeking additional regulatory flexibility as needed;
- (2) revise and supplement the RMR contracts;

- (3) support the move towards market-based rates for all Market Participants, using the requirement that owners of significant amounts of generation capacity sign financial contracts for differences to mitigate their incentives to exercise market power in these markets;
- (4) retain the authority to impose a "damage control" price cap and exercise that authority until these markets are demonstrably competitive;
- (5) purchase A/S through a state-wide auction, using RMR Agreements to supplement zonal shortfalls in capacity; and
- (6) revise purchasing protocols to help reduce the need for regulation services.

2. Summary of the MMC Report

The MMC's Report includes three main findings concerning the A/S markets in relation to the PX Energy markets. First, the MMC finds considerable evidence that the PX Energy markets are themselves at times thin and not fully competitive. It therefore concludes that any actions taken by the ISO to improve the A/S markets should be carefully scrutinized to be sure they do not adversely affect the PX Energy markets. Second, the MMC's analysis of market share numbers indicates that at certain levels in the aggregate supply curve, a very small number of firms have the effective ability to determine the prices in the A/S market. The MMC concludes that, in a competitive equilibrium, the option prices (to buy energy) represented by A/S Capacity prices should be closely related to, and no greater than, the underlying Energy prices. Third, the MMC states that the ISO's A/S markets are far from equilibrium, because (1) A/S Capacity prices change radically while Energy prices follow a regular pattern and (2) A/S Capacity prices are well above Energy prices.

The MMC offers a number of policy recommendations. First, it concludes that, in the short run, some intervention, such as a price cap, is needed in the A/S markets. Second, the MMC sets forth a number of preconditions to competitive A/S markets, including:

- (1) additional supply of A/S Capacity;
- (2) a mechanism to allow A/S demand to respond to price signals;
- (3) the development of proper incentives in RMR Agreements;
- (4) implementation of a rational buyer approach that may include buying Energy when it is cheaper than A/S Operating Reserve Capacity; and
- (5) the removal of cost-based caps on Operating Reserve prices.

3. The Authority To Impose Price Caps Remains Critical in the Absence of Workable Competition

The MSC and MMC reports, and the ISO's Comments, focus on longer-term programs to improve the functioning of the A/S markets and formulate a plan that will lead to the development of workable competition in the ISO's A/S markets and eliminate the need for price caps. The ISO joins the Committees in urging the Commission to focus on the long-term goal of establishing efficient and workably competitive A/S markets.

Nonetheless, the ISO, stakeholders and the Commission must not ignore the current problems with the A/S markets. As demonstrated in Appendices A and B to these Comments, although opening the A/S markets to External Imports and Commission approval of Regulation Energy Payment Adjustments (REPA) have

improved the supply of A/S, bid insufficiencies still occur regularly in certain hours. Significantly, however, the imposition of bid price caps by the ISO has not aggravated bid insufficiency, i.e., price caps have not reduced the supply of A/S capacity. Therefore, the ISO supports the recommendation of the MSC and MMC that the ISO retain the authority to impose a “damage control” price cap and exercise that authority until these markets are demonstrably competitive. (MSC Report, Summary of Findings and Recommendations, paragraph 5 and MMC Report, page 27.)

In considering the continuing need for and level of damage control price caps, the ISO balances several objectives. In operating California’s A/S markets, the ISO continues to pursue the following goals:

- Protecting consumers from excessive prices when markets are not competitive, including maintenance of some A/S market price caps to protect buyers until they can protect themselves -- through self-provision of A/S, contracts for differences, long-term supply contracts, interruptible contracts, or other means;
- Eliminating cost-based rate caps on individual Generators to encourage competitive supply of A/S;
- Ensuring that damage control price caps do not inhibit investments in new Capacity;
- Ensuring that damage control price caps do not bias market choices, but rather promote equilibration between markets; and
- Promoting the rational purchase of various A/S products – i.e., that superior services (such as spinning reserve) can substitute for inferior services (such as replacement reserve) where the prices for the inferior products are higher.

The ISO fully realizes that the task of setting the damage control caps at levels that promote these objectives will require careful analysis. Therefore, in

pursuit of these objectives, the ISO will consider the following factors in determining the continued need for and setting the levels of the price caps in the A/S markets:

- Impact of price caps on short-term supply;
- Whether market conditions and bidding behavior indicate that market power is being or may be exercised;
- Whether price caps offer sufficient incentives for long-term investment
- Whether price caps encourage gaming and shifting market problems from one market to another;
- Impacts of price caps on grid operations and any associated reliability concerns.

The MSC and MMC conclude, and the ISO agrees, that there may be serious consequences if the ISO's authority to use damage control price caps is abolished prior to the development of demonstrably competitive A/S markets. The industry as a whole -- including generators, the IOUs, and representatives of consumers -- is moving towards a market-managed system. The ISO respectfully suggests that it is in the best interest of all stakeholders and the Commission that the development of such a system be implemented through the ISO's stakeholder-driven market development process proposed herein.

4. The Issues Identified in the Reports Require Integrated Treatment in the Redesign of A/S Markets

The ISO adopts, and urges the Commission to affirm, the Committees' recommendations that the ISO develop mechanisms and systems to encourage the development and functioning of competitive A/S markets, while in the short

term continuing to use its authority and discretion to impose damage control price caps as necessary to protect against the consequences of noncompetitive markets. The ISO employs a development program that is open and transparent, encourages input and cooperation of Market Participants and other stakeholders, and provides for regulatory oversight. The ISO's program includes the development of new procedures and practices, design and redesign of markets for A/S, development of new software, and other activities to move California's electric industry towards a market-managed system directed by price signals.

The MSC Report in particular identifies nine factors it concludes are bases for the current dysfunction of the A/S markets and gives six specific recommendations. In the previous section, the ISO discussed one of those recommendations (with which the MMC agrees), i.e., that the ISO continue to use a price cap until the A/S markets are demonstrably competitive. That recommendation is intended to be a short-run intervention, to be lifted when other actions to improve market function are effective.

The other five recommendations of the MSC are directed towards longer-term market development. These recommendations have considerable merit; however, all require coordination with other elements of ISO's market development program and process. Each proposal for market redesign requires an analysis of the proposal's specific impact on the market and the means by which the specific proposal can be integrated into the entire market redesign effort. The ISO's market development process is designed to identify and

resolve conflicts between different proposed market functions, making sure that market development proceeds smoothly and efficiently.

The ISO respectfully but emphatically asks that the Commission not adopt a piecemeal approach to the Committees' recommendations. Adoption of one or another of the recommendations, without consideration of both the larger market development process -- both long- and short-term -- and the operations of the various Ancillary Service and Energy markets, can have undesirable impacts on the entire ISO market structure. The ISO's comprehensive market development process is designed to identify and avoid precisely the potential adverse consequences of adopting only certain elements of the redesign effort in isolation.

The ISO urges the Stakeholders and the Commission to join the ISO in using the Reports as a basis for an integrated approach to market redesign and further dialogue with all stakeholders. The Committees' Reports represent a concrete and positive contribution to the ongoing process of market development and establish a solid foundation for further market development efforts. The ISO believes that its market development process is the appropriate forum for integrated analysis of, and response to, problems in the structure of the A/S markets. The ISO thus asks the Commission to defer to this process and affirm the ISO's role in managing the market development process.

5. MSC Recommendations Not Considered Feasible at Present

There are two recommendations from the MSC that the ISO does not propose to pursue at this time. First, the ISO respectfully disagrees with the MSC's findings and recommendations with regard to the structure of the current RMR Agreements. The ISO does not have the power to change the contract terms unilaterally. On the contrary, these contracts are controlled by the sellers (rather than the ISO, which is the purchaser). The current RMR Agreements are the subject of an extensive and intense settlement effort at the Commission. Any effort to alter the way in which RMR units are used may put those negotiations at serious risk and delay substantial savings the settlements are likely to produce.

Second, the proposal to use RMR Agreements as local fill-in in the presence of congestion, following a statewide auction for all A/S, conflicts with the ISO Tariff's "market first" paradigm. The market design assumes RMR Agreements are solely to ensure System Reliability and stability, not to keep prices low. The ISO does not agree with the suggestion of the MSC that RMR Agreements, in their present form, can contribute usefully to the resolution of this problem without imposing significant additional costs on the end-users. The ISO proposes mitigating potential zonal market power through price caps, as explained earlier, but will consider proposals to be implemented over the long term if advanced in the Market Development process.

6. The ISO Process for A/S Market Development

In the ongoing process of developing the A/S markets, the ISO acts as a necessary facilitator of the dialogue that actively encourages contributions from Market Participants, independent experts, and the ISO's own Operations and Management staff. The objective is, above all, to identify and implement procedures and processes that facilitate achieving workably competitive markets and for which a consensus can be built. Through this process, it is the hope of all participants to develop procedures that maximize market efficiency while minimizing any adverse cost consequences on Market Participants. In any market redesign effort, however, there may be winners and losers. The ISO intends through its long-term redesign process to identify the course of action that best promotes the development of well-functioning markets. The ISO's proposed process involves seeking input from all parties, and, if necessary, Commission approval of proposed changes to the ISO Tariff. The objective of the ISO's response is to encourage early and widespread discussion of proposed actions, so that those actions can, where appropriate, be implemented quickly, leading to a more rapid achievement of the goal of effectively competitive markets.

The MSC and MMC Committee reports submitted to the Commission and the corresponding comments on those reports will form the foundation of the ISO's market evaluation and redesign efforts. In responding to the Committees' recommendations, the ISO has identified certain proposals (as well as other prospective actions) which can be implemented without substantial disruption to

other elements of the ISO's program. The ISO proposes to consult with the MSC and stakeholders, and to bring recommendations to the ISO Governing Board in moving forward on these elements. Other recommendations of the Committees and the ISO will require modification and elaboration, as well as input from stakeholders, before they can be implemented.

Appendix C, which outlines the ISO's detailed Work Plan, thus categorizes actions that are to be taken in three separate time frames:

(1) actions currently in progress -- involving contract, Tariff, or software changes to increase the supply of A/S -- which should be completed within the next few months in 1998,

(2) short-term potential proposals -- addressing key problems identified in the MSC and MMC Reports and under active discussion within the ISO and with Market Participants and other stakeholders -- which may be implemented within about 6 to 9 months; and

3) options for longer-term market redesign -- with implementation likely to take one year or longer.

Conclusion

Based on the Committee's findings, the ISO respectfully requests that the Commission extend the authority of the ISO to impose damage control price caps in the A/S markets. The ISO and all interested parties will proceed expeditiously to develop programs and procedures that will lead to a workably competitive market and will permit the removal of all price caps. The ISO anticipates that

such efforts will require a number of months to implement, as described in more detail in the ISO's proposed Work Plan (See Appendix C). In order to implement this aggressive response to the problems encountered in the ISO-administered markets, the ISO proposes the following short-term program:

- The ISO will aggressively pursue implementation of those items identified as "Actions in Progress" in Appendix C, and will report on the implementation of those items at the ISO Governing Board meeting of September 24; and
- The ISO will present to its Board, by September 24, proposals for implementing the items identified as "Short-Term Planned Proposals" in Appendix C. To the extent the ISO has not developed any proposals for implementing these items, the ISO will explain why such proposals have not been prepared.

The ISO will advise FERC by an October 1 update in this docket:

- on the status of short-term actions, with proposed ISO Tariff amendments if needed;
- on any revisions to the work plan; and
- on the status of the long-term A/S market redesign process.

Respectfully submitted,

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