

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Regional Transmission Organizations) Docket No. RM99-2-000

**INITIAL COMMENTS OF THE CALIFORNIA INDEPENDENT
SYSTEM OPERATOR CORPORATION**

Pursuant to the Notice of Proposed Rulemaking on Regional Transmission Organizations (“NOPR” or “Proposed Rule”) issued by the Commission on May 13, 1999 in this docket, the California Independent System Operator Corporation (“Cal-ISO”) submits these initial comments. As an established Independent System Operator (“ISO”) operating transmission facilities on a regional scale, the Cal-ISO supports the Commission’s two principal objectives in the NOPR: (1) promoting the development of regional transmission organizations (“RTOs”) to support the broadest possible regional electricity markets and (2) ensuring that those RTOs are able to operate the region’s transmission facilities on a basis independent of the interests of any market participant. In these Comments, the Cal-ISO addresses selected issues presented by the Proposed Rule that are of particular relevance to the operation of the Cal-ISO transmission network.

I. EXECUTIVE SUMMARY

The Cal-ISO

- Since March 31, 1998, the Cal-ISO has run the second largest regional electricity grid in the United States operated on an independent basis. In addition, the Cal-ISO operates three open, competitive markets: for real-time imbalance energy, for ancillary services, and for congestion management.

The Transition to RTOs

- The Commission should recognize that existing ISOs generally meet the criteria for RTO eligibility; where complete satisfaction is lacking, the ISOs should be permitted to evolve to full compliance.
- Where there is an existing regional transmission entity in place, the Commission, rather than requiring separate reporting from each of its members, should permit the regional entity to file the required report on compliance by October 15, 2000 and then offer interested parties an opportunity to comment.
- The Commission should encourage the establishment of a regional transmission entity in regions whose utilities have thus far been unable to agree on the formation of an ISO.

RTO Characteristics and Functions

- The Commission correctly identifies independent operation of the transmission system as *the key* to promoting competitive electricity markets.
- The RTO, its employees, and any non-stakeholder directors must not have a financial interest in any member participant.
- The Cal-ISO's Commission-approved design has served the electricity market in California well by acting as an independent market facilitator rather than a market participant.
- The RTO must have a decision-making process that is independent of control by any market participant or class of participants, but, as the Commission has already recognized, such independence can be achieved with a properly designed stakeholder board.
- With regard to the Transco versus ISO debate, the form of organization is

not what is determinative of success in stimulating a robust, competitive market. Either form can be consistent with the goal of independent and innovative management. The Commission should remain focused on independence and results, providing each region the flexibility to fashion the RTO in a manner that works best for that area and is most conducive to encouraging the broadest possible participation.

- The RTO must have the independent authority to file tariff changes.
- The Cal-ISO agrees that RTOs must be of adequate size to maximize market efficiency. As the nation's second-largest control area in terms of demand, with a grid combining four separate control areas and encompassing 124,000 square miles, the Cal-ISO satisfies the minimum size criteria for an RTO. However, the current boundaries do not represent the maximum feasible area.
- Given the difficulty of achieving 100 percent participation, the Cal-ISO supports the proposition that RTO status be granted when a region achieves a critical mass of participation.
- An RTO should have operational responsibility for the transmission facilities under its control, and the authority for maintaining the short-term reliability of the grid that it operates, including the exclusive authority for receiving and implementing interchange schedules and the authority to redispatch generating units as necessary to maintain reliability.
- An RTO should have authority over the approval of maintenance outages for both transmission facilities and generating units connected to the transmission facilities under its control.
- RTOs should only be liable for gross negligence.
- The Cal-ISO supports the minimum functions for an RTO, as defined in the Proposed Rule.
- RTOs should have the authority to review and approve requests for new interconnections; transmission owners should be part of this process.
- The Final Rule should provide some flexibility as to the functioning of an OASIS site, in order to accommodate network systems such as that of the Cal-ISO, in which transmission service is not explicitly reserved.
- The Cal-ISO supports the Commission's proposed requirements for market monitoring by RTOs. The RTO should have an internal staff unit

dedicated to monitoring and analyzing market performance and developing market design modifications to improve performance. The RTO should be required to file regular reports including quantitative summaries and analyses of the performance of the systems and markets the RTO operates.

- The ability of an RTO to perform objective assessments of markets will be affected by its structure. Where a for-profit entity is the RTO, there would appear to be a greater need for an independent monitoring organization empowered to issue reports without the RTO's approval.
- For RTOs to be in a position to fully assess market interactions, the Commission will eventually need to address controversial information-access issues, such as the ability of an RTO to have access to market information beyond what it obtains in the normal course of managing the grid and the markets that it operates.
- The Commission should facilitate collaborative market monitoring and assessment by neighboring RTOs within each region of the country, and to some extent by all RTOs at a national level. RTOs should be directed to establish formal relationships with the state commissions where they operate, to be able to identify and address areas of common concern, and to be able to support each other's monitoring activities.
- Ideally an RTO would become a self-regulatory organization, in which market participants accept the mutual responsibility for ensuring behavior that sustains healthy, competitive markets through compliance with market rules.
- The Commission's Open Architecture proposal properly recognizes the importance of allowing for further developments in market structure. Open architecture should embrace not only internal changes, but the creation of a structure that facilitates the addition of new participants, both within and outside of the existing RTO boundaries.
- The Cal-ISO supports the flexibility proposal in the NOPR for pricing of transmission service.

Other Issues

- The Cal-ISO strongly supports the full participation in an RTO by public power entities and encourages the Commission to work with other agencies such as the Internal Revenue Service to remove possible barriers to entry. The Commission should also encourage participation by federal power agencies.

- With respect to the treatment of existing contracts, the California experience suggests that the Commission should encourage, whenever possible, that all entities in the region abide by the new paradigm of the RTO even if to do so requires a “compelling public interest” determination. Permitting entities to enjoy the benefits of RTO efficiency while retaining special rights in areas such as scheduling and metering serves as a deterrent to full participation.
- It is not necessary for RTOs to be affiliated with Power Exchanges.

II. COMMUNICATIONS

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III. INTERESTS OF THE CAL-ISO

Since March 31, 1998, the Cal-ISO has run the second-largest regional electricity grid in the United States on an independent basis in conformance with the ISO principles enunciated in Order No. 888.¹ The Cal-ISO controlled grid covers approximately 124,000 square miles, or 75 percent of the State of California. Connected to the grid are power plants capable of meeting up to 45,000 megawatts of peak demand. The Cal-ISO was formed as the critical step

¹ Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, 61 Fed. Reg. 21,540 (1996), FERC Stats. & Reg. 31,036 (1996) (Order No. 888); *order on reh’g*, Order No. 888-A, 62 Fed. Reg. 12,274 (1997), FERC Stats. & Regs. 31,048 (1997); *order on reh’g*, Order No. 888-B, 62 Fed. Reg. 64,688, 81 FERC ¶ 61,248 (1997); *order on reh’g*, Order No. 888-C, 82 FERC ¶ 61,046 (1998), *appeal pending*.

in the evolution to a competitive retail electricity market in California. The cost at the end-user meter of the total retail volume of electricity in the first year of deregulation in California was over \$28 billion, of which \$6 billion was for wholesale energy and \$1.47 billion was for ISO-provided services (close to 90 percent of which represents the direct cost of procuring generation services for system operations and reliability).

The Cal-ISO operates the transmission facilities of the California investor-owned utilities to ensure non-discriminatory access to the largest competitive wholesale and retail market in the country. In its first nine months of operation, the Cal-ISO routed approximately 167 billion kilowatt hours of energy. The Cal-ISO's mission is to operate the transmission system reliably through dependence, to the greatest extent possible, on the market. The Cal-ISO conducts three open-competition markets: a real-time imbalance market, an ancillary services market, and a congestion management market.

IV. IN THIS TRANSITIONAL PERIOD, THE COMMISSION SHOULD RECOGNIZE THAT EXISTING ISOs GENERALLY SATISFY THE CRITERIA FOR RTOs AND SHOULD CONCENTRATE ON THE ESTABLISHMENT OF RTOs WHERE NO REGIONAL TRANSMISSION ENTITIES CURRENTLY EXIST

A. The Commission Should Recognize that the Existing ISOs Generally Satisfy the Criteria for RTOs

The Commission is correct to have issued the NOPR at this stage in the restructuring of the electric industry. The Cal-ISO shares the Commission's view that appropriate RTOs can increase efficiencies in transmission grid management, enhance grid reliability, improve market performance and remove remaining opportunities for discriminatory transmission practices. NOPR, *FERC Statutes and Regulations, Proposed Regulations* ¶ 32,541 at 33,685-686 (hereafter, "NOPR"). In addition, the Cal-ISO strongly supports the

Commission's view that:

A properly structured RTO will be an entity that is independent from all generation and power marketing interests, and has the exclusive responsibility for grid operations, short-term reliability, and transmission service within a region.

NOPR at 33,714. Furthermore, the Cal-ISO is appreciative of the Commission's proposed flexibility in the treatment of existing regional transmission entities. While the Cal-ISO believes that its organization substantially satisfies the Commission's proposed four minimum characteristics and seven minimum functions for an RTO, the Commission is correct to allow existing regional transmission entities to evolve over time to full compliance with the minimum characteristics and functions adopted in a Final Rule. NOPR at 33,758. The Cal-ISO has been developed in a manner entirely consistent with prior policy direction of the Commission, including specifically the eleven ISO principles promulgated in Order No. 888, and it continues to make modifications based on experience and under the Commission's guidance. A process that allows the Cal-ISO to continue to evolve in order to satisfy all of the requirements of an RTO will minimize the expense of, and disruptions in, the ongoing implementation process.

B. The Commission Should Require The Existing Regional Transmission Agency to Report on the Progress Toward Compliance with the Minimum RTO Requirements

The Commission proposes to require that each public utility member of an existing regional transmission agency make a filing no later than January 15, 2001 that explains the extent to which the transmission entity in which it participates either meets the minimum characteristics and functions for an RTO or proposes modifications to become an RTO. NOPR at 33,687, 33,758. The Cal-ISO suggests that rather than having each "public utility that is a member of

an existing regional transmission entity” make this filing, that the existing transmission entity itself make the filing. The existing ISO could file a report on compliance with the minimum RTO characteristics and functions with a subsequent comment period for public utility members and other market participants. For example, the existing ISOs could file their reports by October 15, 2000,² with a subsequent period (*e.g.*, 30 days) for comment by all public utility members and other market participants.³ Proceeding in this fashion not only would serve to streamline the process, it would encourage all participants within a region to work collaboratively, particularly in the identification of necessary changes.

In the intervening period between issuance of a Final Rule on RTOs and October 15, 2000, the Commission should evaluate the filings of the existing ISOs for consistency with the Commission's RTO policies. Indeed, the Commission might want to require that such filings include a description of the consistency with the Commission's RTO policies. By doing so, the Commission would better assure that the existing regional transmission entities will be evolving toward full satisfaction with the required characteristics and functions of an RTO, and with the Commission's Open Architecture policy.

The Cal-ISO supports the Proposed Rule's emphasis on establishing appropriate RTOs as rapidly as possible. As the Cal-ISO's experience demonstrates, the establishment of independent regional transmission entities is critical for the development of competitive retail markets. By stating its willingness to consider a variety of institutions as RTOs, as long as they possess the minimum characteristics and fulfill the minimum functions, the Commission

² October 15, 2000 is the same date the Commission proposes for reports by those public utilities that are not part of existing regional transmission organizations. NOPR at 33,686.

³ Thus, the Commission would still obtain the opinion of each public utility that is a member of an ISO. The Cal-ISO also believes that other market participants, as well as the transmission-owning members, should be able to comment on the report of the existing ISO.

should encourage the establishment of regional transmission entities in regions where the local utilities thus far have been unable to agree on the formation of an ISO.

V. THE COMMISSION HAS PROPOSED APPROPRIATE MINIMUM CHARACTERISTICS AND FUNCTIONS FOR REGIONAL TRANSMISSION ORGANIZATIONS

The Proposed Rule identifies the important characteristics and functions that the Commission believes are necessary to create effective RTOs capable of maintaining reliability and facilitating efficient electricity markets. The Cal-ISO supports the minimum characteristics as defined in the NOPR, and believes that it already substantially complies with these minimum requirements. The Cal-ISO has prepared a matrix of the Commission's requirements with a preliminary overview of the extent to which the Cal-ISO would comply with those requirements, which is provided for the Commission's information as ***Attachment A***.

A. The Commission Has Identified Appropriate Minimum Characteristics for RTOs

As discussed in the following sections, the Cal-ISO supports the minimum characteristics for RTOs identified in the NOPR. Entities that satisfy these criteria should have sufficient independence and responsibility to ensure efficient, reliable, and non-discriminatory access to the transmission grid.

1. The RTO Must Be Independent of Market Participants - Proposed § 35.34(i)(1)

In the NOPR, the Commission builds on its policy of independent governance set forth in Order No. 888 in relation to ISOs. In Order No. 888, the Commission made fair and non-discriminatory governance the first of eleven ISO principles and recognized independent operation of the transmission system to

be a crucial precondition to the promotion of competition in the electric industry. Order No. 888 at 31,730. The Commission's primary objective was to assure fair and non-discriminatory access to the transmission system, and it did so, in principal part, by insisting that "an ISO should be independent of any individual market participant or any one class of participants" and that an "ISO's rules of governance . . . should prevent control, and appearance of control of decision-making by any class of participants." Order No. 888 at 31,730-731.

In the NOPR, the Commission again correctly identifies independent operation of the transmission system as the key to promoting competitive electricity markets at the wholesale and retail levels. All other beneficial attributes of existing ISOs and future RTOs depend upon the independent operation of the transmission system, the "electron highway" on which wholesale and retail markets depend. The Commission's core requirement of independent operation necessitates that an RTO have exclusive responsibility for: (a) grid operations, (b) short-term reliability, and (c) transmission service within a region.

The Cal-ISO fully supports this allocation of responsibility and notes that, in fulfillment of this responsibility, an operator will be called upon to make numerous operational choices each hour. In addition, regardless of the design choices made in a particular region (*e.g.*, the manner in which ancillary services are provided, the type of transmission pricing used, or the congestion management scheme, *etc.*), the transmission system operator will play a crucial role in facilitating the market design, which will add to the myriad of decisions that literally must be made on a moment-to-moment basis.

Given that these decisions will have direct monetary consequences for market participants, an ISO or RTO is sure to be questioned and/or criticized about some of the actions it takes. It is critical, therefore, that in making these decisions, the operator must be seen as impartial, and its motives must be

beyond reproach. Without complete independence, the ISO or RTO inevitably will be subject to allegations that it has crossed the line from an independent market facilitator and become a market participant. Any legitimate perception that this has occurred can only serve to discourage entry by those who can add to the robustness of the competitive market.⁴ It would be helpful if, in its Final Rule, the Commission were to emphasize the distinction between a “market facilitator” (*i.e.*, a properly structured ISO or RTO), and a “market participant.”⁵

The design of the Cal-ISO, and the Commission’s approval of that design, has served the electricity markets in California well by ensuring that the Cal-ISO is in fact, and fairly is perceived to be, an independent market facilitator, not a market participant.⁶ The Cal-ISO was designed as a non-profit public benefit corporation with no financial interest in California electricity markets. While the Cal-ISO is responsible for the reliable operation of a grid comprising the transmission systems of the California investor-owned utilities, it does not own any transmission lines or generation plant. Moreover, in its ancillary services and imbalance energy markets, the Cal-ISO’s procurement is on behalf of others and is strictly governed by its tariff.

In the NOPR, the Commission divides the concept of independence into three sub-categories: (a) financial independence; (b) decision-making

⁴ In the NOPR, the Commission highlights that an RTO must be independent in “both reality and perception.” NOPR at 33,726. The Cal-ISO supports the Commission’s statements and shares its view that the appearance of impartiality is as important to the full development of competitive markets as is actual impartiality. Market participants must have confidence that the operator of the transmission system is independent from participation in competitive generation markets (other than to provide nondiscriminatory transmission access to all market participants).

⁵ See, *e.g.*, the Cal-ISO’s July 23, 1999 Answer at 19-20, in *California Independent System Operator Corporation*, Docket No. ER99-3158 (Annual Report on Market Issues and Performance), indicating that the Cal-ISO is a market facilitator as opposed to a market participant.

⁶ The Cal-ISO has a strategic objective of improving market rules to facilitate markets and promote economic efficiency. This objective, coupled with a mandate to ensure grid reliability and open access transmission service, constitutes the ISO’s Mission. See, “The Strategic Plan for the California Independent System Operator”, as approved by the Cal- ISO Governing Board on October 22, 1998, submitted as **Attachment B**.

independence; and (c) independence in making tariff filings. *Id.* at 33,726-729. The Cal-ISO supports the Commission's determination that an RTO must demonstrate independence in each of these areas. The California experience, moreover, demonstrates that a properly designed stakeholder board can exercise the requisite decision-making independence.

- a. The RTO, its employees and any non-stakeholder directors must not have financial interests in any electricity market participants - Proposed § 35.34(i)(1)(i)

Financial independence requires, at a minimum, that the RTO, its employees, and any non-stakeholder directors must not be allowed to have a financial interest in any participants in the electricity market. Clearly, if an RTO were not to meet this straightforward standard, there would be little confidence that it would avoid self-dealing. As a result, even apparently fair decisions would be questioned and second-guessed.

The Cal-ISO supports the proposed criteria for financial independence, and already meets this standard.

- b. An RTO must have a decision-making process that is independent of control by any market participant or class of participants - Proposed § 35.34(i)(1)(ii)

As regards decision-making, the NOPR would require an RTO to have a process that is independent of control by any market participant or class of participants. NOPR at 33,727. As the Commission notes, however, there is a tension between independence on the one hand and expertise on the other. *Id.* If the Commission's goal of optimally-sized RTOs is to be met, the resulting RTO necessarily will combine many disparate systems, across multiple states, each system coming to the table with its own perspectives and interests. The governance of an RTO, while taking into account these varying points of view,

must not be vulnerable to the control of any one group. This bedrock principle has its foundation in Order No. 888: “[an] ISO’s rules of governance should prevent control, and the appearance of control of decision making by any class of participants.” Order No. 888 at 31,730-731.

The Commission proposes that a non-stakeholder board (a governing board of individuals without any financial ties to market participants or to their affiliates) would be deemed to satisfy the independence criteria. NOPR at 33,727. However, the Commission “propose[s] to consider other governance and ownership proposals, which will be judged on a case-by-case basis against the general requirement of independent decisionmaking.” *Id.* The Cal-ISO urges the Commission to find expressly that properly designed stakeholder boards, such as the one that has been approved for California, can meet the criteria for independence in decision-making.

- (1) The Commission has already properly recognized that independence of decision-making can be achieved by a properly designed stakeholder board.

The Cal-ISO currently is the only operating FERC-jurisdictional ISO with a stakeholder board. The Commission has already determined that, upon the resolution of certain issues relating to the role of the California State agencies, the Cal-ISO satisfies the independence requirement as applied to ISOs. *Pacific Gas and Electric Company, et al.*, 81 FERC ¶ 61,222, 61,435 (1997). The Cal-ISO respectfully requests that the Commission recognize the continuing acceptability of stakeholder boards. We invite the Commission, its staff, and any other interested parties, to attend stakeholder board meetings of

the Cal-ISO to see first hand that this form of governance can and does work, toward fulfillment of the Commission's competitive marketplace objectives.

Through a Governing Board that includes stakeholder representatives, including a majority of Governors representing the interests of end-use customers and the public interest, the Cal-ISO's governance structure is designed simultaneously to assure independence from control by any market participant or class of market participants and to assure the availability of expertise that is critical to full ventilation of the issues that come before the Board.

- (2) Experience has validated the concept of a stakeholder board.

The Cal-ISO has over two years of experience and almost a year and a half of actual operation with its stakeholder board structure. The Cal-ISO Governing Board has effectively provided direction on a number of significant issues, including modifications to the design of the ancillary services markets, implementation of firm transmission rights, and the temporary implementation of price caps. Moreover, the Board has acted in accordance with its Open Meeting Policy with an audience that typically includes over 50 stakeholder representatives, and with a Information Availability Policy that makes all documents available to the public except in the case of specific exemptions. A copy of each of these policies is included for the Commission's information at ***Attachments C and D.***

Based on our experience in discussing our policies with other ISOs, the Cal-ISO believes its degree of accessibility to the public is unique. We submit that this type of openness must and, in practice, will be the rule, not the exception, for ISOs and RTOs not yet formed. In regions where RTOs must be

created without the history of an operating pool, and, in particular, in the context of state retail competition, there will be a demand from the public that the RTO decision-making be in the open. A stakeholder board is one part of the “public decision-making” process.

The Cal-ISO stakeholder board has worked. Its experience to date demonstrates that a governing body that allows for stakeholder representation can render informed, knowledgeable decisions. Cal-ISO Board members have successfully maintained their fiduciary responsibility to the ISO while representing the views and opinions of the classes they represent. The Commission should confirm in the Final Rule the acceptability of a stakeholder participation approach to governance, provided that it is structured to ensure that no market participant or class of market participants can control the decisions of the RTO.

- (3) A disinterested board is not necessary to protect the interests of market participants

Generally, ISOs with non-stakeholder boards have formed committees of stakeholders to provide expertise and guidance to ISO management.⁷ Thus, the primary issue is not whether there should be participation by stakeholders in policy formulation but whether an additional layer of disinterested individuals is necessary to ensure independence. The experience of the Cal-ISO and the other ISOs with non-stakeholder boards indicates that either approach can work. Where an RTO has an appropriately structured governing body that permits stakeholder representation, including the ability of all interested entities to participate in the stakeholder processes and to belong to a sector represented

⁷ *Central Hudson Gas & Electric Company, et al.*, 83 FERC ¶ 61,352, 62,408-09 (1998); *Pennsylvania-New Jersey-Maryland Interconnection, et al.*, 81 FERC ¶ 61,257, 62,263-65 (1997).

on the governing board, the Cal-ISO believes that imposing the requirement of an additional, non-stakeholder governing body is unnecessary.

- (4) The issue is independence and proper incentives, not ISOs vs. Transcos or profit vs. non-profit

The Commission asks which type of institution would better serve the goal of independence, a for-profit Transco with a *de minimis* ownership interest and non-stakeholder board or a non-profit ISO with a non-stakeholder board. NOPR at 33,728-729. Throughout the NOPR, the Commission asks a number of questions that compare Transcos and ISOs.⁸ The Cal-ISO responds to many of these questions in subsequent sections of these comments.

The Cal-ISO respectfully suggests that the crucial issue is the "bedrock" principle of independence. To focus on corporate form is to be derailed by a subsidiary issue. In other words, much of the debate between for-profit Transcos versus not-for-profit ISOs is misplaced. Both models can work, and each has advantages and disadvantages.

One advantage of ISOs is in the area of transmission planning and expansion. When a generation-related project is competing with a transmission-related project in a planning process, market participants can appropriately ask whether a for-profit Transco (if it has ratemaking incentives to increase rate base assets) would be biased in favor of transmission-related projects. Generation projects and transmission projects often are alternative means of satisfying the needs identified in planning studies. Unless the Commission adopts new rate policies that eliminate the bias toward increased rate base (for example, by rewarding the operator for the efficiency with which its operation of transmission

⁸ See, e.g., NOPR at 33,720 (regarding alternative dispute resolution); NOPR at 33,728-729 (regarding independence); NOPR at 33,737 (regarding maintenance schedules and performance standards); NOPR at 33,749 (regarding market monitoring); and NOPR at 33,757 (regarding transfer of operational control).

promotes vibrant competitive electricity markets), Transcos will (and must) carry that bias into planning decisions. Again, the independence of the operator (and *planner*) of the transmission system is the crucial factor, not whether one entity owns all of the transmission facilities.

Some stakeholders claim that not-for-profit organizations necessarily are less efficient than for profit organizations. Others counter that for-profit organizations are necessarily less capable of considering the public interest. Neither contention is true or false in the abstract.

Not-for-profit organizations can and should be given incentives to operate effectively and efficiently. There are many examples of efficiently operated not-for-profits. The issue is one of designing proper incentives and creating a work culture that produces the desired results. From inception, the Cal-ISO Governing Board has been committed to hiring and retaining world-class employees and giving them incentives to operate a cost-effective ISO. The compensation of every Cal-ISO employee is significantly dependent upon the achievement, by the Cal-ISO, of its corporate mission. Apart from promoting teamwork, the incentive can be far more powerful than the more amorphous threat of stockholder condemnation. A recent assessment by the Hay Group, a national consulting firm, compared the Cal-ISO's workforce culture to that of the "Most Admired Companies" as reported in *Fortune* magazine. A summary of the results is contained in **Attachment E**. It shows that the Cal-ISO has a management culture matching that typical of a high-tech start-up company. Hay's nationally-recognized work also shows that many public utilities still have far different cultures and are seeking to convert to that already enjoyed by the Cal-ISO precisely because it is the type of culture that is imperative to the achievement of success in a competitive environment. In other words, the form of organization neither ensures nor prevents the type of customer-driven,

innovative management that we all desire in our service providers today.

The Commission's rules should, therefore, remain focused on independence and results. Different regions deserve the flexibility to fashion their RTO in the manner that works best for their region and satisfies the concerns of the largest number of stakeholders, so long as the RTO's independence is maintained.

- c. The RTO must have exclusive and independent authority to file changes to its transmission tariff with the Commission - Proposed § 35.34(i)(1)(iii)

The Commission is correct to require that an RTO have independent authority to file for changes to its tariff. The RTO's authority in this regard should extend to the terms and conditions of transmission service, to the provisions governing ancillary services, and to grid management. To accomplish its primary purpose (*i.e.*, to assure fair and non-discriminatory access to transmission service), an RTO must have control over the administration of its tariff. Its ability to file with the Commission must not be dependent upon first receiving the approval of transmission owners or market participants. The only approval required should be that of the RTO's governing board. Without unilateral authority to establish terms and conditions of its tariff, an RTO would not be in a position to assure that the terms and conditions are fair and nondiscriminatory.

The Cal-ISO administers its own tariff and has "exclusive and independent authority to file changes" as the Commission would require of RTOs. NOPR at 33,729. This authority includes the authority to modify the design of rates for transmission and ancillary services, but does not extend to the authority to propose changes in the revenue requirements of the transmission owners that make their facilities available through the Cal-ISO's

tariff. The Cal-ISO does not believe it is necessary for an RTO to possess such authority.

2. The RTO Must Serve an Appropriate Region. The Region Must be of Sufficient Scope and Configuration to Permit the RTO to Effectively Perform its Required Functions and to Support Efficient and Nondiscriminatory Power Markets - Proposed § 35.34 (i)(2)

The Proposed Rule properly emphasizes the importance of adequate size to maximize market efficiency, internalize constraints and loop flow issues, and support efficient regional transmission planning. A large RTO would enhance reliability by minimizing the number of control area boundaries in a region. Every control area boundary represents a point of market inefficiency and a source of potential reliability problems. Having fewer control area boundaries reduces the potential for miscommunication or inadequate communication within a region; improves coordination in emergency planning and the implementation of emergency procedures; and enhances the coordination of market rules and operations.

The Cal- ISO controls the second-largest control area in terms of demand in the country (behind only PJM) and the fifth largest in the world. The Cal-ISO controlled grid covers approximately 124,000 square miles. It combines four former control areas,⁹ internalizes a variety of constraints, and includes a large variety of large and small buyers and sellers. California represents about 10 percent of the nation's electricity markets and 40 percent of the load in the Western Systems Coordinating Council. Clearly, the existing scope of the Cal-ISO satisfies the minimum size criteria for an RTO, but equally clearly, its current

⁹ The control areas are those formerly operated by Pacific Gas and Electric Company, Southern California Edison Company, San Diego Gas & Electric Company, and the City of Pasadena.

boundaries do not represent the maximum feasible or even optimal size for an RTO that includes California. In the Final Rule, the Commission should encourage RTOs that can grow, and make it clear that in acting on proposals it will expect and require that the proposal facilitates, rather than delays, formation of large RTOs with the ability to grow even larger as technology develops.

The Commission has asked whether RTO status should be denied where the applicant represents less than 100 percent participation of a region's transmission assets. NOPR at 33,733. One hundred percent participation from the outset should not be a prerequisite, although unquestionably there will be substantial loss of market efficiency and the challenges to reliability will be greater if "holes in the Swiss cheese" exist and continue.

RTO status should be granted when a region achieves a "critical mass" of participation. Exactly what level of participation constitutes "critical mass" will vary. Regions must be accorded the flexibility to adapt to their respective circumstances, and the Commission should be willing to defer at times to configurations with broad stakeholder support. The goal would be to allow the RTO to expand through the addition of transmission owners over time.

Nevertheless, the Commission's role in preventing holdouts should not be overlooked. Just as the Commission should expect proposals to represent an appropriate regional scope, so should it expect, at a minimum, full participation of FERC-jurisdictional entities. In the case of the Cal-ISO; the non-participants are public power entities exempt from Part II of the Federal Power Act. They have yet to join because, in significant part, they perceive that they are better off under existing transmission and interconnection agreements ("Existing Contracts") than they would be as full Cal-ISO participants. Further thoughts on the implications of Existing Contracts to RTO development is provided in Section VI. B. below.

3. The RTO Must Have Operational Responsibility for all Transmission Facilities Under its Control - Proposed § 35.34(i)(3)

The Commission recognizes the importance of an RTO having “operational responsibility for all transmission facilities under its control.” The NOPR would allow the RTO to operate the facilities directly or to delegate responsibility for certain tasks to third parties. NOPR at 33,734. An RTO would not be required to operate a single control area, but would be responsible for providing non-discriminatory transmission for all participants, and for ensuring the short-term reliability of the grid. *Id.* In addition, the RTO would be required to serve as the NERC security administrator for its region. Finally, the NOPR calls for a report from the RTO within two years of startup detailing its success in designing and running its operational system. NOPR at 33,735.

The Cal-ISO supports these criteria and currently performs all of these tasks. We note that, to be a security coordinator for a region, one must be the control area operator. The Cal-ISO believes RTOs must be control area operators. Through agreements with generators, transmission owners and utility distribution companies, the Cal-ISO has operational control over transmission and generation facilities, including redispatch authority for congestion relief and to respond to emergencies. It operates the ancillary service markets, and is responsible for transmission access and collection of usage charges, congestion management, and short-term reliability. The Cal-ISO also serves as a Western Systems Coordinating Council (“WSCC”) security coordinator. See Cal-ISO Tariff, Section 2.3.1.1.6. These are proper functions to be discharged by an RTO which must include being control area operator.

4. The RTO Must Have Exclusive Authority for Maintaining the Short-Term Reliability of the Grid that it Operates - Proposed § 35.34(i)(4)

No task of RTOs is more significant than maintaining the reliability of the transmission grid. The Cal-ISO agrees that RTOs should have authority to receive and confirm interchange schedules, to redispatch generators and to approve the scheduling of outages. Rather than providing for notification to the Commission if reliability criteria pose problems for RTO operations, the Cal-ISO believes a better approach would be to permit the RTO to establish and revise the criteria.

- a. The RTO must have exclusive authority for receiving, confirming and implementing all interchange schedules - Proposed § 35.34(i)(4)(i)

The Commission proposes that, in the context of its role as the recipient and evaluator of requests for transmission service under a FERC-approved tariff, an RTO which is a control area operator must also receive, confirm, and implement all interchange schedules between adjacent control areas. NOPR at 33,735-36. The Commission expresses concern that, where an RTO is not the operator of a control area, the control area operator or operators within that RTO's region may be able to obtain an unfair competitive advantage through knowledge of competitors' schedules or transactions and asks whether there is any Commission action, other than its current code of conduct standards, and short of requiring consolidation of all control areas within a region, which could address this problem.

The Cal-ISO supports the proposed interchange schedule criteria and already meets this standard. As operator of one of the largest control areas in the country, the Cal-ISO is responsible for maintaining interchanges with other control areas and is the entity which receives, confirms and implements all interchange schedules with such other control areas. The Cal-ISO agrees with the Commission's concerns about the provision of interchange schedule

information which might give market participants a competitive advantage. The Cal-ISO notes, however, that RTOs that are control area operators will likely be subject to provisions requiring them to maintain the confidentiality of certain details concerning a market participant's schedules or transactions.¹⁰

- b. The RTO must have the right to order redispatch of any generator connected to transmission facilities it operates if necessary for the reliable operation of these facilities - Proposed § 35.34(i)(4)(ii)

The Commission proposes that RTOs have authority to order redispatch of any generating unit when necessary for the reliability of the grid. NOPR at 33,736. The Cal-ISO agrees wholeheartedly that a system operator must exercise a sufficient degree of control over all generators connected to the grid if reliability is to be maintained.

In describing this proposed standard, the Commission acknowledges that “the dividing line ‘between transmission control and generation control is not always clear because both sets of functions are ultimately required for reliable operation of the overall system’” and that “[t]he entity that controls the transmission system must have some degree of control over some generation.”¹¹ Certainly, an RTO must have adequate control over generating units that sell reliability-related services to the operator. Such control must be made available pursuant to RTO tariff provisions or standard or *pro forma* contracts. In 1998, the Cal-ISO had to administer contracts with 118 Reliability Must Run (“RMR”) Generating Units. That number increased for 1999. The notion of calling on

¹⁰ See, e.g., section 20.3 of the Cal-ISO Tariff.

¹¹ NOPR at 33,736, citing *Midwest Independent Transmission System Operator, Inc.*, 84

these units (and operating the system) under contracts with varying terms and conditions is untenable. Moreover, the administrative burden on the Commission would be substantial if each contract were governed by a different set of terms and conditions. The Commission should require that reliability-related services be provided to RTOs under a set of uniform rates, terms, and conditions.

In addition, an RTO must have the ability to control generation units as necessary to address system emergencies. RTO control of generating units in emergency circumstances must be made a condition of use of the transmission facilities controlled by an RTO and should be set forth in an RTO tariff.

Specific issues or problems can arise where an RTO is a control area operator in which not all of the transmission facilities within the control area are under the RTO's control.¹² This situation could occur either because a transmission owner decided not to join the RTO or where the transmission owner is not subject to the Commission's jurisdiction. An RTO's ability to control generation that is outside of the transmission facilities it operates but within its control area could have impacts on reliability. Certainly, during a system emergency, one would expect a high degree of cooperation between the owners of facilities not under the control of the RTO and the RTO itself. To the extent that an owner is subject to Commission jurisdiction, the Commission may be able

FERC ¶ 61,231 at 62,159.

¹² The Cal-ISO notes that the Commission has not proposed to require that RTOs be control area operators even though four of the five ISOs approved by the Commission so far are single control areas. RTO NOPR at 33,730-731. The Commission solicited comments on the limitations in the scope of an RTO if it has control area responsibilities. *Id.* at 33,731.

to resolve control issues by using incentives and disincentives to encourage such parties to, at a minimum, give the RTO adequate control so as to be able to maintain grid reliability in emergencies.

- c. The RTO must have authority to approve and disapprove all requests for scheduled outages of transmission facilities to ensure that the outages can be accommodated within established reliability standards - Proposed § 35.34(i)(4)(iii)

The Commission properly recognizes that control over transmission maintenance is a necessary RTO function because planned and unplanned outages of individual transmission facilities affect the overall transfer capability and reliability of a transmission grid. In the NOPR, the Commission proposes a requirement that an RTO which operates transmission facilities owned by other entities be authorized to approve or disapprove all requests for scheduled outages in order to ensure that maintenance outage schedules meet applicable reliability standards. NOPR at 33,736-37. The Commission solicits comments on a number of questions related to the proposed requirement, such as whether the requirement would cede too much or too little authority to the RTO and whether a transmission owner should be compensated for any costs resulting from the rescheduling of planned maintenance required by an RTO.

The Cal-ISO strongly believes that an RTO must, at a minimum, have the authority embodied in the proposed requirement. This authority is both necessary and appropriate for an entity that is responsible for ensuring the reliable operation of transmission facilities owned by one or more other entities.

The Commission has already approved the authority of the Cal-ISO to coordinate and approve maintenance outages of transmission facilities forming part of the Cal-ISO controlled grid.¹³ Where an RTO properly exercises such authority by requiring a transmission owner to reschedule a maintenance outage, that transmission owner is not entitled to compensation for the costs associated with rescheduling. As the Commission acknowledges in its discussion of the proposed requirement, planned outages can adversely affect the reliability of a transmission system. A transmission owner should have no expectation that it can schedule outages at a time when the outage will adversely affect reliability. The transmission owner therefore has no valid basis for expecting compensation when it is required to reschedule such outages.

The Commission states that this requirement, as currently proposed, would not give an RTO authority over proposed generation maintenance outage schedules. Recognizing that generation control is necessary for reliable operation of a transmission system, the Commission asks whether an RTO should have some authority over generation maintenance schedules, and, if so, how much. NOPR at 33,737. The Cal-ISO already has the authority to approve or disapprove maintenance outages of generating units which have been designated as Reliability-Must Run units. See Section 2.3.3 of Cal-ISO Tariff. The Commission has also approved the Cal-ISO's authority to approve changes in the scheduled maintenance of other generating units where the Cal-ISO is given less than seven days advance notice of a change in a generating unit's

¹³ See, e.g., *Pacific Gas & Electric Co. et al.*, 81 FERC at 61,456-57.

maintenance schedule. *Pacific Gas & Electric Co. et al.*, 81 FERC at 61,513-14. The Commission recognized that the Cal-ISO needed such authority over the scheduling of generation maintenance outages in order to ensure transmission system reliability. For similar reasons, the Commission should provide RTOs with authority over generation maintenance schedules. The level of that authority should depend on a variety of factors, including the degree to which the generating units in question have been identified as necessary to provide reliability-related services.

The Commission also seeks input on the feasibility of market mechanisms for inducing transmission owners to plan maintenance outages so as to minimize reliability effects. NOPR at 33,737 The Cal-ISO supports market mechanisms which will encourage transmission owners to take reliability concerns into account in planning maintenance. Nonetheless, an RTO must have the necessary authority to ensure that outages do not affect reliability where such mechanisms prove to be ineffective. For example, the Cal-ISO Tariff provides for the implementation of maintenance standards, and penalties under those standards, to ensure both adequate maintenance and system reliability. These provisions, however, act in concert with the Cal-ISO's previously discussed authority to coordinate and approve maintenance outages.

The Commission also seeks comments on whether an RTO that is an ISO should have any authority to require rescheduling of maintenance if it anticipates that the planned maintenance schedule will adversely affect power markets As

the Commission recognizes in the NOPR, the unavailability of certain transmission facilities can have a substantial effect on electricity market prices. NOPR at 33,737 n.216. The Cal-ISO believes that RTOs, including ISOs, should have the authority to require rescheduling of maintenance outages where the outages are anticipated to have a substantial effect on electricity market prices.

The Commission also states that where the RTO is an ISO, the member transmission owners who own generation might try to strategically schedule transmission maintenance to increase their power sales. NOPR at 33,737 n.217. In this situation, the Commission expects an RTO to, among other things: receive requests for authorization of preferred maintenance schedules; review and test these schedules against reliability criteria; and approve specific requests to scheduled outages. *Id.* The Cal-ISO supports the authority of an RTO to approve maintenance schedules and act in the manner stated by the Commission.

d. RTOs should be given authority to set reliability standards - Proposed § 35.30(i)(4)(iv)

In the NOPR, the Commission discusses the problem of determining the appropriate entity to develop reliability standards. The Commission has acknowledged that: (a) regional or sub-regional reliability groups may not be as independent from market participants as RTOs, and (b) almost every reliability standard will have a commercial consequence. NOPR at 33,739. The Commission proposes to require an RTO to notify it immediately “if implementation of externally established reliability standards will prevent it from meeting its obligation to provide reliable, non-discriminatory transmission

service.” *Id.*

First, the Commission’s finding that “almost every reliability standard will have commercial consequences” is correct as far as it goes. In fact, our experience is that every reliability standard will, in the restructured world, have a commercial consequence. The Cal-ISO’s mission statement is “Reliability Through Markets”, and we have from start-up endeavored to rely on “markets first” for all reliability services. As generation is divested completely in other regions, markets there will likewise be the sole source for generation-based reliability products. As California now knows, with independent generators in direct competition with transmission alternatives, even transmission planning will of necessity transition toward competitive solicitations.

The Commission’s vision is for RTOs to serve wide areas, as the operator (and planner) of a large regional transmission grid. RTOs would have “exclusive authority for maintaining short-term reliability of the grid”. NOPR at 33,735. That will of necessity include control of markets for short-term reliability products. In that paradigm, RTOs are the appropriate entities to establish reliability standards. Moreover, affording RTOs that authority and responsibility has the additional advantage of fostering a “bottom-up” development of those standards. Regional organizations (not a single national standard-setter) should have the flexibility to develop standards that reflect regional priorities as well as individual issues related to particular areas or configurations in the transmission grid.

In addition, melding responsibility to develop reliability standards with their implementation should minimize the difficulty of dealing with multiple organizations within a region with overlapping and potentially contradictory authority on reliability and system planning issues. Moreover, the presence of different forums increases the likelihood that some issues will fall through the

cracks should each organization anticipate that an issue will be addressed elsewhere.¹⁴ Thus, RTOs could reduce the need for entities to present or reargue their positions in several different fora and could help to ensure that all issues are addressed fully.

The evolution of the RTO into the regional reliability entity cannot happen overnight. The Cal-ISO believes, however, that the RTO as the regional reliability entity is a natural end-state to the road mapped by the NOPR. If the Commission embraces this objective, it should consider how best to facilitate the objective in the reliability legislation currently before Congress.

Giving RTOs the authority to establish reliability standards does not, however, eliminate the need for an impartial national entity with oversight responsibility to facilitate any necessary interregional discussions, and to mediate among the regions (and internationally). The North American Electric Reliability Organization (“NAERO”) contemplated by the North American Electric Reliability Council (“NERC”) could play this role.

RTOs, however, would replace the Affiliated Regional Reliability Entities currently contemplated by NERC. *See, e.g.*, Consensus Legislative Language on Reliability Approved by the NERC Board of Trustees, February 1, 1999. Moreover, the relationship among NAERO and RTOs would have to afford RTOs adequate independent authority to develop and implement regional reliability standards.

¹⁴ The Commission has already begun the task of consolidating existing entities charged with reliability responsibilities by requiring in the NOPR that an RTO be the security coordinator for the transmission facilities that it controls. Security Coordinators typically coordinate reliability between multiple control areas within a region. NOPR at 33,735.

In sum, an RTO should have the authority and responsibility to develop regional reliability standards, subject to general oversight by an appropriate independent national reliability organization such as NAERO.

5. RTOs Should Only Be Liable for Gross Negligence

The NOPR requests comments on the appropriate extent of an RTO's liability in connection with actions taken to ensure reliability. NOPR at 33,738. The Commission has previously addressed issues concerning the appropriate scope of liability in its order on the Cal-ISO's initial tariff filing, on rehearing, and on a subsequent amendment. Cal-ISO anticipates bringing to the Commission a new proposed amendment by year-end to address this issue in light of operational experience.

The *pro forma* tariff specified by Order No. 888 is silent on liability, reflecting a Commission decision to rely upon state law to establish the appropriate standard. *See Consolidated Edison Co.*, 84 FERC ¶ 61,163 (1998). The *pro forma* tariff also includes a fairly standard indemnification provision. In the Final Rule, the Commission needs to reexamine both the issue of limitation of liability and that of indemnification, in light of changing institutions, and create a clear and consistent policy applicable to *Regional* Transmission Organizations. Because RTOs will by their nature operate across multiple states, with different statutes and judicial precedent, deferral to state law is no longer appropriate.

For example, in California, state statutes limit the liability of state-regulated electric utilities in a very specific manner. Electric utilities cannot be

found liable for actions if such liability would interfere with policies of the California Public Utilities Commission. Cal. Pub. Util. Code § 2106. If other states have similar provisions, an RTO would be subject to multiple and conflicting standards.

Limitations on the liability of public utilities are founded in the public's interest in minimizing utility rates. The Supreme Court has recognized that "it might be hard to say that public policy demands that the [customer] should at once have the benefit of a rate [computed on the basis of limited liability] and be able to repudiate the correlative obligation of procuring its own insurance." *Southwestern Sugar and Molasses Co. v. River Terminals Corp.*, 360 U.S. 411, 417-19 (1959). Courts have widely recognized that the use of gross negligence or willful misconduct standards may be justified by rate concerns. *See, e.g., Computer Tools & Engineering, Inc. v. Northern States Power Corp.*, 453 N.W. 2d 569, 573 (Minn. Ct. App. 1990); *Singer Company, Link Simulation Systems Division v. Baltimore Gas & Elec. Co.*, 558 A.2d 419, 427 (Md. App. 1989); *Landrum v. Florida Power & Light Co.*, 505 So. 2d 552, 554 (Fla. Ct. App. 1987); *DeFrancesco v. Western Pennsylvania Water Co.*, 478 A.2d 1295 (Pa. Super. Ct. 1984); *Garrison v. Pacific Northwest Bell*, 608 P.2d 1206, 1211 (Ore. Ct. App. 1980)

Indeed, the Commission has itself recently approved the use of a gross negligence standard for services beyond basic open access transmission. In *Central Hudson Gas & Electric Corporation, et al.*, 88 FERC ¶ 61,138 (slip op. at

14) (1999), the Commission accepted such a standard for a variety of ISO-administered markets under the New York ISO Services Tariff, including the ancillary services market, the LBMP market, and the installed capacity market. *See also* ISO New England's Tariff for Dispatch and Administrative Services, section 5.3; PJM Operating Agreement, section 16.6.

The Cal-ISO's experience suggests that the public interest is best met by a balanced liability policy. RTOs can and should obtain an appropriate amount of insurance – sufficient to cover all physical harm and damage to physical property.¹⁵ Liability for business losses, however, creates a greater risk that calls for limitations. When markets operate, control area operations of necessity need to be more transparent to all parties. When mistakes are made, someone gains and someone loses. In no event, however, does the not-for-profit ISO stand to gain. Even if the Commission believes the cost of insuring against such losses is acceptable at this time, it should recognize that, in light of the historic volatility of insurance costs, the risk of major and rapid premium increases (and, indeed, of availability) outweighs any benefits of broad liability.

The Cal-ISO therefore believes that it is both necessary and appropriate for the Commission's rules to allow RTOs to limit liability for business losses (as opposed to physical harm or property damage) except in circumstances of gross negligence or willful misconduct – a limitation on liability provision that has been standard in commercial arrangements for many years.

¹⁵ The Cal-ISO urges the Commission to address the issue of the recoverability of uninsured damages in the context of a not-for-profit RTO, such as an ISO, which lacks an equity base. The absence of a clear-cut policy allowing the recovery of such costs in rates will interfere

B. The Commission Has Identified Appropriate Minimum Functions for an RTO.

The Cal-ISO supports the minimum functions of RTOs as delineated in the NOPR. Again, the Cal-ISO believes that it substantially performs each of these functions.

1. The RTO Must Administer Its own Transmission Tariff and Employ a Transmission Pricing System That Will Promote Efficient Use and Expansion of Transmission and Generation Facilities - Proposed § 35.30(j)(1)

In the NOPR, the Commission states this function is intended to establish a general requirement that will encourage RTOs to develop innovative transmission access and pricing proposals. NOPR at 33,739-40. The Commission mentions a number of proposals developed by various ISOs, including the Cal-ISO's firm transmission right proposal, as the types of innovations it seeks to encourage with this requirement. The Commission also asks whether more specific guidance on this function is necessary. The Cal-ISO strongly supports the Commission's goal of encouraging innovation, as described in its discussion of this function in the NOPR. In general, the Cal-ISO believes that the Commission should not establish excessive detail with respect to the proposed function, because such additional detail could be contrary to the stated goal of encouraging innovative approaches to transmission access and pricing. By definition, many of these innovations have not yet been imagined by the Commission or any other entity and therefore could not be reflected in any additional level of detail. The Cal-ISO does offer comments on the standards

with the financing of new RTOs.

the Commission has already proposed for this function below.

- a. The Regional Transmission Organization must be the only provider of transmission service over the facilities under its control, and must be the sole administrator of its own Commission-approved open access transmission tariff. The Regional Transmission Organization must have the sole authority to receive, evaluate, and approve or deny all requests for transmission service. The Regional Transmission Organization must have the authority to review and approve requests for new interconnections. (Proposed § 35.30(j)(1)(i))

The Commission states that only an RTO which is the sole provider of transmission service over the transmission facilities it controls or owns can ensure nondiscriminatory transmission service to all market participants. The Commission also clarifies that this proposed standard could not be fulfilled by an entity which simply monitors the scheduling decisions of current transmission system owners or which offers service under another entity's tariff. NOPR at 33,740. The Cal-ISO supports and satisfies this standard. All requests for transmission service over the facilities controlled by the Cal-ISO are submitted to the Cal-ISO in the form of transmission schedules. The Cal-ISO then evaluates and approves or denies such requests for service, pursuant to the terms of the Cal-ISO Tariff. In addition, as explained in its discussion of Characteristic 1, the Cal-ISO has exclusive and independent authority with respect to its FERC-approved tariff. That authority includes both the authority to file changes to the tariff and to administer the tariff in the provision of transmission service. The Commission is correct that all RTOs must have similar authority to administer their own tariffs.

- b. Regional Transmission Organizations should have the authority to review and approve requests for new

interconnections

In the NOPR, the Commission explains that nondiscriminatory provision of transmission service extends to new customers as well as existing users. The Commission proposes that RTOs, "rather than existing transmission owners," have the authority to review and approve requests for interconnections. NOPR at 33,740. The Commission recognizes, however, that it may be difficult for RTOs that are ISOs and not transmission owners, to exercise such authority without the involvement of existing transmission owners. The Commission expresses concerns that existing transmission owners might also be competitors of a new entrant seeking interconnection and invites comment on how this standard can be applied to ISOs in such a circumstance.

The Cal-ISO agrees that the RTO must have the authority to review and approve requests for new interconnections. However, this standard does not preclude an RTO from involving transmission owners in the evaluation of interconnection requests and the Cal-ISO encourages the Commission to apply this standard in a manner which takes into account the role of existing transmission owners in evaluating interconnection requests. For example, in California, responsibility for review of interconnection requests and performance of the necessary studies is currently divided among the Cal-ISO and the transmission owners. Under such a collaborative approach, an RTO can ensure that a request for interconnection by a new generator or other entity seeking interconnection is not denied by a transmission owner due to competitive concerns, while allowing the entity that owns the facilities to which interconnection is sought to have a role in the process.

The Cal-ISO has recently submitted an amendment to its tariff that would confirm and strengthen the Cal-ISO's role in the review and approval of requests for new interconnections, while continuing to rely on the transmission owner or

another party approved by the Cal-ISO to conduct the necessary studies. The Cal-ISO anticipates that, over time, it may develop the capability to take on even greater responsibilities in this area.

In the NOPR, the Commission asks if this standard should be expanded to give an RTO the authority to review and approve all new interconnections (such as the interconnection of facilities to improve reliability or to increase trading opportunities with neighboring regions) or all transmission investments above some threshold dollar amount. NOPR at 33,740. An RTO should have the authority to review and approve other types of new interconnections, including those identified in the NOPR. The principles of facilitating nondiscriminatory access to transmission service for new entrants are equally applicable to these other types of new interconnections. The Cal-ISO would oppose the establishment of a financial threshold for the review and approval of interconnections or transmission investments. The impact and importance of new or interconnected facilities may often be wholly unrelated to the costs associated with such a project. Not only are such costs unrelated to the purpose of providing RTOs with review and approval authority, they are also likely to vary widely over time and from region to region, making it impossible for the Commission to establish any type of justifiable threshold.

c. The RTO Tariff Must Provide Service at Non-pancaked Rates - Proposed § 35.34(j)(1)(ii)

One of the principal benefits of RTOs is greater access to electricity suppliers without the necessity of paying multiple transmission charges. Under the Cal-ISO Tariff, transmission customers pay an access charge based on the rolled-in embedded cost of the transmission owner's system where the scheduled power leaves the ISO controlled grid. The Commission has already determined that this approach satisfies these requirements, as applied to ISOs.

Pacific Gas & Electric Co. et al., 81 FERC at 61,455-56.

2. The RTO Must Ensure the Development and Operation of Market Mechanisms to Manage Transmission Congestion - Proposed § 35.34(j)(2)

The NOPR calls for a market approach to congestion management, which the Commission feels will lead to more efficient transmission prices. NOPR at 33,742. In order to satisfy the Commission's proposed standard, a congestion-management market mechanism must: "accommodate broad participation by all market participants, and must provide all transmission customers with efficient price signals regarding the consequences of their transmission usage decisions." *Id.* at 33,741. The Commission also would require the RTO to manage such a market itself, or to delegate the responsibility of doing so to an unaffiliated third party. *Id.*

The Cal-ISO agrees that the RTO must be responsible for managing congestion and that market approaches can be utilized for this task. The Commission has accepted the zonal approach to congestion management employed by the Cal-ISO, which relies on market mechanisms to manage inter-zonal congestion. Next year, the Cal-ISO will begin implementing the system of firm transmission rights (FTRs) approved by the Commission to provide market participants with a means to hedge fluctuations in congestion costs.¹⁶

3. The RTO Must Develop and Implement Procedures to Address Parallel Path Flow Issues Within Its Region and With Other Regions - Proposed § 35.34(j)(3)

The Commission aptly describes the difficult problems of equity and reliability that arise from inadvertent use of parallel paths or "looping" by

¹⁶ *California Independent System Operator Corporation*, 87 FERC ¶ 61,143 (1999); *order on reh'g*, 88 FERC ¶ 61,156 (1999).

electrons of electricity. In the NOPR, the Commission expresses hope that the growing use of and expansion within RTOs will go far towards lessening these problems. NOPR at 33,744. The Commission's approval of the Cal-ISO demonstrates the promise of an RTO's ability to deal with loop flows. The Cal-ISO approach to scheduling transmission services eliminates any questions of loop flows as among the systems of the participating transmission owners. Contract paths play no part in determining the level of the transmission access charge, the allocation of access charge revenues, or the responsibility of market participants for usage charges.

The NOPR calls for closer coordination between and among RTOs to address loop flows, and allows for a three-year period after start up for a given RTO to complete measures to promote such coordination. *Id.* The Cal-ISO coordinates with neighboring control areas on this issue, and is prepared to expand such coordination to address parallel path flow issues within the three-year time frame provided in the NOPR.

4. An RTO Must Serve as the Supplier of Last Resort of all Ancillary Services - Proposed § 35.34(j)(4)

The Cal-ISO agrees that an RTO must serve as the supplier of last resort of all ancillary services and that, where feasible, all market participants should have the option of self-supplying or acquiring ancillary services from third parties. The Cal-ISO strongly supports the proposal that: (1) the RTO must have the authority to decide the minimum required amounts of each ancillary service and, if necessary, the locations at which these services must be provided and (2) that all ancillary service providers must be subject to direct or indirect operational control by the RTO. NOPR at 33,745.

With respect to the proposed requirement that the RTO must ensure that its transmission customers have access to a real-time balancing market (NOPR at 33,746), the Cal-ISO currently operates markets for the procurement of imbalance energy and other ancillary services, with the exception of voltage control and reactive support. Market participants also have the ability to provide their own capacity to meet their ancillary service obligations or to engage in trades outside the Cal-ISO's markets. The Cal-ISO is currently developing mechanisms for the competitive procurement of reactive support, as well as black start service. This latter service is required for reliability, although it is not included among the ancillary services required under Order No. 888.

5. The RTO Must be the Single OASIS Site Administrator for all Transmission Facilities Under Its Control and Independently Calculate TTC and ATC - Proposed § 35.34(j)(5)

Under the provisions of the NOPR, the RTO must be the sole administrator of the OASIS (Open Access Same-Time Information System) site for all transmission facilities under its control. Moreover, the RTO is required to calculate both Total Transmission Capability ("TTC") and Available Transmission Capability ("ATC") independently. NOPR at 33,747.

The Cal-ISO determines TTC and ATC of the transmission facilities it operates for purposes of scheduling transactions and determining the number of firm transmission rights that can be made available. Through the ISO's web-based scheduling interface, Scheduling Coordinators receive current and nondiscriminatory access to this information. In addition to data on transmission

system conditions, the Cal-ISO publishes a variety of information relating to the markets it operates through its Public Market Information (PMI) display. The ISO publishes information on load forecasts, reserve and ancillary services requirements, total and available capacity of inter-zonal interfaces, scheduled line outages, and generator meter multipliers (losses). The ISO also publishes information on prices for its various markets as well as amounts procured. This information can be used by Scheduling Coordinators in developing market strategy.

6. The RTO Must Monitor Markets for Transmission Services, Ancillary Services and Bulk Power to Identify Design Flaws and Market Power and Propose Appropriate Remedial Actions - Proposed § 35.34(j)(6)

a. Structure and Responsibilities

The market monitoring function was first introduced as a response to the request of the California Public Utilities Commission that such a function be included as part of the Cal-ISO. *Pacific Gas & Electric Co., et al.*, 77 FERC ¶ 61,265, 62,087 (1996). Subsequent ISO orders incorporated this requirement. *See, e.g., Central Hudson Gas & Electric Corp., et al.*, 86 FERC at 61,238. The Cal-ISO supports the Commission's proposed requirements for market monitoring by RTOs.

The RTO should have an internal staff unit dedicated to monitoring and analyzing market performance and developing market design modifications to improve performance. For example, Cal-ISO's Department of Market Analysis ("DMA") includes five Ph.D. economists, a Ph.D. statistician and a M.S. economist, with their own market monitoring hardware and software. In addition, the Cal-ISO understands it is currently the only ISO with a standing, external,

independent monitoring committee (“IMC”), its Market Surveillance Committee (“MSC”). Our MSC is funded by the ISO and empowered to issue reports to the Board (and, concurrently, the public) without ISO management or Board approval. It comprises three nationally-recognized experts capable of assessing market performance and making recommendations where it finds improvement warranted. The members are independent of any economic interest in Cal-ISO activities. Finally, the MSC has access to whatever market data it needs from Cal-ISO to conduct its assessments.

The RTO should be required to file regular reports on the market structure and design issues that it has addressed and anticipates it will address. These reports should include quantitative summaries and analyses of the performance of the systems and markets the RTO operates. Such reports should be publicly available and the Commission should accept formal comments on them by interested parties.

The Cal-ISO believes that experience shows that an internal unit meets the need for independent and professional analysis, although having an IMC creates an additional opportunity for expert input on the most significant issues. Market participants are assured that the results of the internal unit’s work are without bias through the combination of: (1) the requirement to produce substantive, analytical reports, (2) the publication and formal filing of these reports, (3) the opportunity for formal public comments, and (4) access by market participants, independent research organizations, and government agencies to adequate RTO data to perform their own analyses and verify the internal unit’s findings.

Although the details of market monitoring activities and the contents of reports should be tailored by the RTO to fit its own structure and context, the Commission should provide guidance for RTO market monitoring by

developing a set of well-defined principles. These principles should address such areas as objectivity and protection of confidential information, among others.

- (1) An internal unit is fully capable of assessing markets that the RTO is operating (*e.g.*, ancillary services).

Although electric restructuring involves a reduction in the scope of regulation, the entity that operates the transmission grid will continue to function as a regulated monopoly, and should have a clear understanding that its primary mission is to provide reliable, non-discriminatory services to the consumers and market participants who pay for those services. In granting authorization to either a for-profit or a non-profit RTO, the Commission should require, as a condition of the conferral of RTO status, the performance of objective market monitoring and assessments, and should stipulate that failure to perform this function could lead to loss of the RTO status. Under such a model, and with an open reporting and public review process, the Cal-ISO believes it is quite reasonable to expect the RTO to perform objective self-assessments of both its markets and its grid operations.

- (2) Different RTO structures will require different market monitoring design.

The ability of an RTO to perform objective assessment of markets will depend to a large extent on the RTO's structure. When a for-profit entity is the RTO there would be a greater need for an IMC empowered to issue reports without the RTO's approval. Such an IMC should have the needed expertise to assess the RTO's performance and make recommendations where it finds improvement warranted, and its principals should be certifiably independent of any economic interest in the RTO's activities. The IMC should also have access

to whatever market data it needs from the RTO to conduct its assessments.

Although we believe that an internal unit can operate effectively, the for-profit entity by its form of organization creates a dichotomy between the interests of shareholders and customers. When the interests of the two conflict, the for-profit entity owes its duty first to its shareholders. We recommend that the Commission require more independence of an IMC, and increase the IMC's resources accordingly, when the RTO owns the transmission facilities that it operates and is in a position to profit from the manner in which market participants use those facilities.

b. To Function Effectively, Market Monitoring Entities Must Have Access to Necessary Market Information

RTOs are very well placed to monitor market performance. At the same time, an RTO's access to market information that is relevant to its own performance is not complete. The Cal-ISO has little or no access to information on bilateral contract terms, yet the Commission has recognized that activities in the bilateral markets are interrelated with and can affect performance of ISO markets. For example, a supplier's ability to arbitrage between its own bilateral contract commitment and the ISO's real-time energy market will depend on the terms and conditions of the bilateral contract that currently are deemed private information.

The Cal-ISO does not at this time advocate access by an RTO to such information. However, for RTOs to assess market interactions fully, the Commission eventually will need to address controversial information-access issues, such as the ability of an RTO to have access to market information beyond what it obtains in the normal course of managing the grid and its own markets. To some degree the RTO's information needs may be met through information-sharing arrangements with neighboring RTOs, but even this may be

controversial. A fundamental policy tradeoff exists between the RTO's ability to monitor and assess its interrelations with other markets and the desire of market participants to keep confidential the terms of their bilateral contracts and their behavior in different RTO markets.

In other exchanges such as NASD and NYMEX, the membership rules allow the exchange to conduct an audit of a company under investigation for breaking the rules of the exchange. Such a provision should be required for RTO participants if the Commission intends to require the greater scope of market monitoring suggested in the Proposed Rule. This is another instance where the form of organization of the RTO becomes relevant. Market participants would understandably be more reluctant to submit to such audits if they are conducted by a for-profit RTO, especially one whose affiliates may be participating in electricity markets.

c. The Market Monitoring Unit of an RTO Should Coordinate With Other Authorities

The Commission proposes "to require RTOs to provide periodic assessments as to the effect of existing structural conditions on the competitiveness of their region's electricity markets," citing the RTO's expected independence and access to detailed information. NOPR at 33,750. The Cal-ISO reads this as assuming that the RTO would be looking principally at its own "region," but could be looking outside its own geographic boundaries to assess even larger regional performance. The most effective way to accomplish this across-border assessment is for the Commission to require and facilitate collaborative market monitoring and assessment by neighboring RTOs within each region of the country, and to some extent by all RTOs at a national level.

Participating in collaborative efforts would be less burdensome and more productive than the RTO trying to do regional assessments on its own, particularly if the Commission were to provide direction for such collaboration. At present, even with the small number of functioning ISOs, there would be substantial mutual benefit from the establishment of regular channels for collaborative problem solving on common issues. A key to facilitating this collaboration would be to clarify that monitoring units may share data without violating confidentiality provisions of existing tariffs. The Commission did this in California by establishing the expectation that the Power Exchange market monitoring unit and the Cal-ISO unit would cooperate in monitoring activities. *Pacific Gas & Electric Co., et al.*, 81 FERC at 61,552.

The RTO (and, where applicable, its IMO) should be part of the “first line of defense,” in conjunction with the entities that have authority within the RTO’s service area, such as state energy commissions, public utilities commissions, and local regulatory authorities. As a general principle, because of their jurisdiction over the retail sector, the Commission should anticipate that state agencies would want to take the lead as advocates and protectors of consumer interests. The RTO monitoring function is less well-suited for such a role, and should instead focus on the design and performance of the markets and systems operated by the RTO. On the other hand, as has been the case in California, because the RTO performs functions that affect retail competition, the RTO will of necessity be the first line of defense both for wholesale and retail customers.

It would likely not be possible to specify a workable structure by which the RTO interacts with these other authorities in the Commission’s rulemaking, because states and regions differ. Rather, the Commission should require the RTO to propose, as part of its initial design, specific provisions for working with such entities to resolve market performance and market power issues

of mutual concern. Such provisions should include regular exchanges of information and collaborative investigations when incidents cross jurisdictional boundaries.

Another reason for the RTO to be the first line of defense is that the RTO, as the operator of its markets and systems, will be able to respond to design flaws and market power abuses more quickly than any other entity. Certainly, market participants will want the continued ability to address their concerns directly to FERC, but such concerns should be brought to the RTO in the first instance, with recourse to FERC investigation and dispute resolution only after the decision processes of the RTO have been exhausted. In addition, as noted above, the Commission should specify regular reporting requirements for the RTO's internal monitoring unit on market performance issues, and should manage the procedure for formal public comments on these reports.

Sanctions and penalties, NOPR at 33,751, is another area where the RTO should coordinate with FERC. RTO's should be allowed (and should be expected) to impose specific penalties and sanctions for non-compliance with the RTO's rules for participation in its markets. These should be based on liquidated damages, and should not be punitive. For cases of repeated or intentional violations of the RTO's rules, or serious abuses of market power, the RTO should seek relief, including imposition of punitive damages, from the FERC or other appropriate agencies.

d. The Role of State Commissions in Market Monitoring Should Continue in Specific Areas

In spite of the apparent bifurcation of the industry into retail and wholesale sectors, there are several areas where effective state monitoring and oversight are important to the success of the RTO. To give one example, the state commission should collaborate with the RTO to establish an integrated

(wholesale-retail) system to ensure the accuracy of end-use meter data. The efficiency of the markets operated by the RTO depends on the confidence market participants have in the accuracy of the RTO's settlement systems, which in turn depend on the accuracy of the end-use meter data that comes to the RTO from state-jurisdictional end-use customer meters. Monitoring of the numerous activities involved in acquiring, processing and exchanging end-use meter data must therefore be a joint effort by the RTO and the state commission.

Other examples where collaborative oversight can be crucial to the success of both retail and wholesale market performance are: (1) open access to the distribution system by distributed generation resources, which, from the RTO point of view, can help to relieve local reliability and congestion problems; and (2) price responsiveness of loads, which can reduce the opportunity to exercise market power on the wholesale side, but which depends on restructuring policy decisions at the state or even local (*e.g.*, municipal) level.

RTOs should be directed to establish formal relationships with the state commissions where they operate, to be able to identify and address areas of common concern, and to be able to support each other's monitoring activities. The Commission could also clarify that its policy is for RTOs to share detailed market-monitoring information with state commissions as needed to serve the public-policy needs of the state commissions. State commissions should in turn inform the RTO of concerns or investigations regarding retail market participants, as these may affect the RTO's markets.

Because "one size does not fit all," an appropriate means to ensure coordination is to require the RTO to address the issue of coordination with state commissions in its design and organization.

- e. The Commission Should Look to Analogies With Other Organized Exchanges

The Commission cites the argument of some that “RTOs are somewhat akin to organized stock exchanges and that the Commission should follow the SEC precedent of requiring extensive and sophisticated market monitoring by all of the organized exchanges” NOPR at 33,750.

The California ISO has examined some of the practices of stock exchanges and commodity and futures exchanges, and has found many valuable lessons that may be applied to RTOs. The analogy is highly appropriate because the RTO must be, first and foremost, a non-discriminatory provider of services to an industry upon which all households, institutions, and economic sectors depend. The RTO is the infrastructure that makes competitive electricity trading possible, just as organized exchanges are the infrastructure for trading the equities and financial instruments that support commercial activity more generally.

Although no specific exchange provides a directly transferable model for RTOs, there are two high-level observations about organized exchanges that are applicable. First, all exchanges and their participants recognize that the notions of “free market” and “competition” cannot be interpreted to mean that parties’ behavior should be unbridled. It is generally accepted that participation in the exchange, like participation in RTO markets, is founded on long-term trading relationships among the traders, the benefits of which outweigh any potential short-term profits that may be captured by trying to extract the highest possible price in any given situation. These exchanges and their participants thus accept the need for and support the use of various mechanisms to ensure compliance with rules and to deter what may be called “inappropriate” behavior even when such behavior may strictly be permitted under the rules. Over the years, then, these exchanges have developed effective market monitoring units, which investigate anomalies and disruptive behavior and report back to

enforcement authorities often within the exchange structure itself.

Second, certain exchanges function as self-regulatory organizations (“SROs”). The Chicago Board of Trade was the originator of this model in the nineteenth century, and the SRO has since been codified in the Commodity Exchange Act of 1975 (Sections 5, 5a, 6, and 7 U.S.C. §§ 7, 7a and 8). Under the SRO model, exchange members accept total responsibility for monitoring and enforcing appropriate behavior, and create an internal arbitration committee that hears cases and assesses discretionary and potentially severe penalties such as punitive damages and dismissal of the member from the exchange. Under this model, members waive the right to appeal such decisions to an outside court or authority, a condition they find acceptable when balanced against the benefits of membership in the SRO.

The Commission notes that “some have argued that RTOs should not be charged with any market monitoring responsibilities particularly with respect to market power abuses. They argue that the antitrust laws and the Commission offer sufficient protection against competitive abuses.” NOPR at 33,750. The antitrust laws and the Commission do offer protection, but not sufficient protection, particularly in the operation of hourly and real-time markets where potential buyers may not have the ability to decline electric service. Moreover, the transmission and ancillary services markets tend to have high concentrations, supply constraints and locational market power problems that require “close-up” monitoring that only the RTO can provide on a day-to-day basis. The RTO must therefore have the direct responsibility for operating fair and efficient markets, monitoring performance, and ensuring compliance with market rules. Ideally the RTO would become a self-regulatory organization, in which market participants accept the mutual responsibility for ensuring behavior that sustains healthy, competitive markets through compliance with

market rules.

f. The Market Monitoring Function Is a Cornerstone to Correcting Market Design Flaws

California's experience, beginning in the days before start-up, is that market monitoring is a cornerstone to proper market design. Thus, for RTOs running markets (at a minimum, ancillary services and balancing energy markets), market monitoring is a necessary component to a well-run RTO. Even if the Commission did not require market monitoring, RTOs would engage in monitoring in order to understand whether markets are well-designed and properly functioning.

The market design function extends well beyond the DMA staff, with leadership on market design and redesign activity, coming as well from the ISO's Operations Division, and major contributions from departments across the organization. A significant portion of the redesign expertise lies in the expertise (and experience) of the monitoring staff. Since the beginning of the Cal-ISO, market design has been a major focus of the entire organization, including market participants and the Governing Board. Given the level of innovation required in creating the new market structure, the Cal-ISO expects that considerable effort on market design will be necessary for several more years.

We agree with the Commission on the value of an effective market monitoring plan to detect market power abuses. At the same time, effective monitoring does not obviate the need to design RTO markets to incorporate incentives which discourage market power abuse. RTOs should be directed to anticipate temporary or localized instances of market power, and to devise market or out-of-market procedures, including administrative and engineering approaches and contractual arrangements, to allow reliable operation of the regional transmission network at reasonable cost even in the presence of

potentially abusive market power. For market power problems that cannot be so mitigated, the RTO should report the instances to the FERC and seek relief from FERC, the Department of Justice, or other agencies as appropriate. The RTO should also report to the FERC on the structural features contributing to the market power, and identify options for FERC action to change these features. We believe that “regular assessments as to whether they [RTOs] have sufficient operational authority” would be a useful subject included in a required annual market-monitoring report. NOPR at 33,751

7. The RTO Must Be Responsible for Planning Necessary Transmission Additions and Upgrades That Will Enable It To Provide Efficient, Reliable and Non-discriminatory Transmission Service and Coordinate Such Efforts with the Appropriate State Authorities - Proposed § 35.34(j)(7)

The Cal-ISO agrees with the Commission that an RTO should review, evaluate, and approve all transmission expansion projects pertaining to facilities under its control. As the single entity with overall responsibility for transmission planning and expansion, an RTO can serve as a focal point for coordination with, and the participation of, transmission owners, market participants, public authorities, and state agencies. In addition, the RTO should develop, with input from transmission owners, the applicable grid planning criteria necessary to ensure the continued reliable operation of the regional transmission system.

Moreover, transmission owners do not have to be supplanted by the RTO in the planning process. On the contrary, the transmission owners could still conduct their planning activities in the first instance (*e.g.*, annual transmission assessments), with the RTO having the authority to review and evaluate all the proposed transmission projects. The transmission owners themselves are the entities most familiar with their transmission systems and they can provide

technical expertise and resources to the RTO. However, the RTO should be given the authority to direct studies to be undertaken by the transmission owners. Such studies could be in response to projects sponsored by transmission owners, projects sponsored by RTOs, or projects sponsored by third parties.

Often the state regulatory approvals required for a transmission project include several state agencies including the state's public utility commission, state environmental agencies and state agencies that have public health and safety responsibilities. The RTO is a logical focal point for coordination with state regulatory agencies involved in the certification and siting of new transmission facilities, as well as with other state agencies. State agencies should be involved in the RTO planning process. In addition, the RTO planning process could reduce or streamline parallel state agency procedures (*e.g.*, a determination of need in the RTO process could be given weight or deference in the environmental review process, or the RTO planning process might be able to facilitate an expedited review at the state agency with siting authority).

One of the standards under the Transmission Planning and Expansion function would require that an RTO's planning and expansion process be coordinated with existing Regional Transmission Groups ("RTGs"). NOPR at 33,752. The Cal-ISO supports this requirement. The regional scope of an RTO could allow for the consolidation of existing organizations charged with regional planning responsibilities. For example, within the WSCC there are currently three different RTGs, the Western Regional Transmission Association ("WRTA"), the Southwest Regional Transmission Association ("SWRTA"), and the Northwest Regional Transmission Association ("NRTA"), as well as the Colorado Coordinated Planning Group ("CCPG") and an umbrella organization covering all these groups called the Western Interconnection Coordination

Forum ("WICF"). An RTO could assist in streamlining or consolidating the various entities charged with regional transmission planning responsibilities.

Finally, the power of eminent domain is a critical element in the planning and siting process. The RTO must be able either to obtain eminent domain authority or have an existing agency exercise eminent domain on its behalf.

The Cal-ISO is currently engaged in a stakeholder process to develop principles that will govern an integrated regional transmission planning process. The goal is to coordinate the planning activities of the Cal-ISO, the transmission owners and the pertinent state agencies. The Cal-ISO expects to bring the results of this process to the Commission early next year.

C. The Cal-ISO Strongly Supports the Commission's Proposal Concerning Open Architecture

The Proposed Rule would establish a policy of "Open Architecture" for RTOs. NOPR at 33,753. This policy is intended to permit RTOs and their members to improve and modify their organizations over time, as needed to reflect changing market needs. *Id.* Under this policy, the Commission would not accept any proposal that precludes an RTO from making such changes in the future. *Id.* For example, the Commission envisions that an RTO that does not initially own any transmission facilities might at some later point seek to acquire ownership of some or all of the facilities it controls. *Id.* The Commission would require that an RTO's enabling agreements not prevent the RTO from instituting such changes. *Id.*

The Commission's policy properly recognizes the importance of allowing for further development in market structure as conditions change and experience is gained. With operational experience, the Cal-ISO has had to make important adjustments to its Tariff and operational practices. Further improvements are likely to be identified with additional experience, as markets mature and as

evolution of the competitive paradigm continues.

The Cal-ISO notes that “Open Architecture” can and should extend beyond the concept of organizational modification. It is imperative that the Commission favor RTO structures that facilitate and encourage *expansion*. For example, the Cal-ISO is the first ISO to go into operation “from the ground up,” without having succeeded a tight power pool. It operates congestion, ancillary services, and real-time balancing energy markets, but does not operate forward energy markets. The Cal-ISO is also the first ISO to be established as an instrument of retail competition. Yet, by not being a “poolco,” the Cal-ISO offers a structure that facilitates expansion to other states wishing to implement retail competition in different ways. For example, in its discussions with the State of Nevada, the Cal-ISO has offered to provide a variety of service options that best suits that State’s needs. In other words, the Commission should encourage RTOs to use architecture that can accommodate not only internal changes, but also different markets for new participants.

Finally, one caveat to “Open Architecture” should be that RTOs are allowed, indeed encouraged, to put into place permanent safeguards to the extent necessary to meet the minimum criteria and functions set forth in the NOPR, particularly the requirements for independence. Thus, while the Commission should continue to discourage structural and corporate features that impede market and operational development, it should encourage features that would give permanence to fundamental RTO requirements, such as independence.

D. Ratemaking for Transmission Facilities Under RTO Control: Pricing Issues

The NOPR addresses a number of issues related to transmission pricing for facilities under RTO control. NOPR at 33,754-756. The Commission

recognizes that the prospect of recovering transmission capital costs through a single access rate has raised issues of transmission cost shifting in every ISO the Commission has approved to date. *Id.* at 33,754. The Commission notes that it has permitted these ISOs to use "license plate" transmission pricing for at least limited periods in order to address such cost-shifting issues. *Id.* In the NOPR, the Commission states its intent to continue this flexibility under the proposed RTO regulations. The Commission requests comment on whether the "license plate" approach to fixed cost recovery is appropriate as a long-term measure. *Id.* The NOPR also includes a discussion of possible incentive pricing benefits to encourage public utility participation in RTOs. *Id.* at 33,755.

The ISO supports the flexibility proposed in the NOPR for the pricing of transmission service. In accordance with State law and the Commission's authorizing orders, the Cal-ISO currently is involved in a stakeholder process regarding its access charge. California Assembly Bill 1890, § 9600(a)(2); *Pacific Gas and Electric Company, et al.*, 81 FERC at 61,501; ISO Tariff at 7.1.6.

The Commission requests suggestions on incentives to encourage transmission owners to join RTOs. At a minimum, the Commission must eliminate factors that would *discourage* entities from participating, as would the assessment of Commission annual fees to both RTOs and public utilities. The Commission recently recognized this problem in a July 28, 1999 order providing a temporary waiver from payment of annual fees to PJM and other ISOs and Power Exchanges. *PJM Interconnection L.L.C.*, 88 FERC ¶ 61,109 (1999). The Cal-ISO appreciates the Commission's action on this issue in an interim manner, and urges the Commission to adopt permanent relief as part of the Final Rule. As in the case of the interim solution, annual fees should be assessed either on the RTO or the transmission owner but not both entities.

VI. OTHER ISSUES

A. The Commission Should Take the Lead at the Federal Level in Facilitating Public Power Participation in RTOs

The Cal-ISO strongly supports full participation in RTOs by public power entities. In anticipation of their full participation in the Cal-ISO, our Governing Board includes six voting members from public power entities in California and advisory members from the Bonneville Power Administration and Powerex, the marketing subsidiary of BC Hydro. Currently, two public power entities have signed Utility Distribution Company (“UDC”) agreements and one UDC with its own control area, the City of Pasadena, has turned its control area operation over to the Cal-ISO. The Cal-ISO filed comments on the Internal Revenue Service private use rules supporting changes needed to resolve private use issues. We note that IRS Code Restrictions also create issues for investor-owned utilities (including San Diego Gas & Electric Company) with facilities financed with “local furnishing” bonds. We welcome any steps the Commission can take to facilitate the elimination of barriers to full participation by public power entities and others with tax-exempt financing.

The issue of full participation by federal power marketing agencies is also one where the Commission is in the position to lead inter-agency discussions at the federal level on ways to facilitate early and full participation by these entities in RTOs. For example, in California, the Western Area Power Administration (“WAPA”) owns significant transmission and generation assets. The Cal-ISO is already the control area operator for WAPA Central Valley Project Facilities. A WAPA employee sits as a voting member of the Cal-ISO Board of Governors.

B. The Commission Should Consider How Pre-existing Transmission Contracts Fit into the Strategy of Large Regional Transmission Organizations

Earlier in our comments, the issue of “hold-outs” or the “Swiss cheese problem” was noted. The Cal-ISO confronts this problem in two contexts: (1) where it serves as the control area operator for public power entities that have transmission and/or distribution facilities that have not been placed under the control of the ISO, and (2) where public power entities in California, with their own control areas, have not joined the Cal-ISO. For the former – entities in the Cal-ISO control area who have not committed their facilities to the ISO-Controlled Grid – a substantial (but certainly not the only) stumbling block is Existing Contracts.

The Commission specifically asks whether the financial impact of foregoing an advantageous transmission arrangement is significant enough to act as a disincentive to RTO membership. From our experience in California, the answer appears most definitely to be “yes”.

It is understandable that an entity that enjoys existing valuable rights would be reluctant to relinquish those rights without compensation. Thus, it comes as no surprise that entities (including public power entities and qualifying facilities) with Existing Contracts wish to continue to enjoy the benefits of those contracts until such time as it is manifest that joining the ISO or RTO is a more economic alternative.

The Commission’s policies on Existing Contracts deserve revisiting, at a minimum for the limited purpose of conforming scheduling and metering rules to those of the RTO/control area operator. The Cal-ISO has experienced first-hand the challenges of workability: when the RTO is required to honor Existing Contracts but not permitted to interpret them or conform their scheduling rules to those of the regional organization, , the seller of transmission under the Existing Contract has no incentive to bear any increased cost of RTO operation, and the buyer of transmission services under the Existing Contract may rightfully

demand the services specified at the contract cost, notwithstanding changes necessitated by the move to an RTO.

This is not simply an issue of transmission pricing; rather, it is in the area of scheduling and information gathering that the Cal-ISO has experienced the most significant market inefficiencies associated with Existing Contracts. For example, because, in effect, “two pipes” for transmission must be maintained, and because Existing Contract holders have the ability to utilize scheduling rights much closer to the hour than the market design can accommodate, other users end up paying for congestion that does not in fact exist.

We are cognizant that much of this relates to the decision that was made to honor Existing Contracts in the restructuring of California’s electricity market. While we do not seek to modify this commitment, it is important that it neither be unnecessarily perpetuated nor adopted by others. Moreover, we are sensitive to the argument that contractual terms fairly bargained for not be abrogated lightly, even for the good of the market overall. We believe that the Cal-ISO will resolve many of its challenges with Existing Contracts well in advance of when a Final Rule is issued. Nevertheless, the Commission must be sensitive to the problems that have occurred to date as it promulgates its long-term RTO policy.

The Commission should use its powers to ensure, wherever possible, that all entities in a region abide by the “new” paradigm of the RTO, particularly those entities that are within the RTO’s control area, even if it requires a “compelling public interest” determination that the new rules must be followed by all. This can be accomplished in a way that preserves the economic benefits of Existing Contracts for the parties to those arrangements. All entities in the RTOs will benefit from the increased efficiency of the RTO. Entities that are allowed to enjoy the benefits of an RTO’s efficiency, while retaining special rights on scheduling and metering to the detriment of other market participants,

will be far less interested in participation. The Commission should invoke ways to minimize this situation.

C. The Commission Should Find that Existing Regional Transmission Entities Generally Meet the RTO Criteria

The Commission seeks comment on how existing regional transmission entities approved under the Order No. 888 ISO principles should be treated. NOPR at 33,758. The Commission should confirm its determination not to require substantial changes in approved ISOs, which would undermine the hard-won progress in creating non-discriminatory competitive markets made by ISOs thus far. In addition, the Commission should approve the filing requirement for existing regional entities that the Cal-ISO suggests below.

D. Existing Regional Transmission Organizations Should be Responsible for RTO Filing Requirements

The Commission proposes to require that each public utility member of an existing regional transmission agency make a filing no later than January 15, 2001 that explains the extent to which the transmission entity in which it participates meets the minimum characteristics and functions for an RTO or proposes to modify the existing institution to become an RTO. NOPR at 33,758. As discussed earlier, rather than having each public utility that is a member of an existing regional transmission entity make this filing, the existing ISO could file a report on compliance by October 15, 2000 with a subsequent comment period for all public utility and other market participants.

E. It Is Not Necessary for RTOs to Be Part of or Affiliated With Power Exchanges

Regions should have the flexibility to make these decisions by themselves. In California, the PX/ISO dichotomy has been largely successful. We have found that competition for pooling services is developing.

VII. CONCLUSION

The Cal-ISO respectfully urges the Commission to take the foregoing comments into account in its development of a Final Rule.

Respectfully submitted,

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