

February 17, 2005

The Honorable Magalie R. Salas  
Secretary  
Federal Energy Regulatory Commission  
888 First Street, NE  
Washington, DC 20426

**Re: *California Independent System Operator Corporation*  
Docket No. ER05-\_\_\_\_\_ - 000  
Amendment No. 65 to the ISO Tariff**

Dear Secretary Salas:

Pursuant to Section 205 of the Federal Power Act ("FPA"), 16 U.S.C. § 824d, and Sections 35.11 and 35.13 of the regulations of the Federal Energy Regulatory Commission ("Commission"), 18 C.F.R. §§ 35.11, 35.13, the California Independent System Operator Corporation ("ISO") respectfully submits for filing an original and six copies of an amendment ("Amendment No. 65") to the ISO Tariff.<sup>1</sup> Amendment No. 65 revises the ISO Tariff to establish an additional criterion governing when the offer-based methodology should be used to calculate decremental reference levels. The ISO notes that the revision proposed in this filing is the same revision that the ISO filed in its compliance filing of May 17, 2004 in Docket No. ER03-683, the proceeding concerning Amendment No. 50 to the ISO Tariff ("Amendment No. 50"). In its January 6, 2005 Order in that proceeding, the Commission directed the ISO to submit the revision in a stand-alone filing under Section 205 of the FPA.<sup>2</sup> On February 7, 2005, the ISO sought rehearing of that ruling. The ISO is submitting Amendment No. 65 to implement the Tariff revision in case the Commission does not grant the ISO's request for rehearing.

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

<sup>2</sup> *California Independent System Operator Corporation*, 110 FERC ¶ 61,007, at P 31 ("January 6 Order").

Thus, the filing of Amendment No. 65 is without prejudice to the ISO's request for rehearing of the Commission's January 6 Order.

## I. BACKGROUND

On March 31, 2003, the ISO filed its proposed Amendment No. 50 to provide a revised method for managing Intra-Zonal Congestion. Amendment No. 50 established that when it was necessary for the ISO to decrement a resource out-of-sequence ("OOS") due to Intra-Zonal Congestion, it would do so according to that unit's decremental reference level rather than the unit's decremental bid price. Decrementing in-sequence would continue to occur in bid-price merit order, and only OOS decrementing would be affected. The purpose of decrementing units according to their reference prices rather than their bids was to prevent generators in export-constrained areas from bidding strategically (*i.e.*, bidding extremely low) and manipulating the market. The decremental reference levels would be calculated using a decremental reference level methodology, the default position for which would be a ninety-day rolling average of the accepted in-sequence decremental bid prices. An independent entity (Potomac Economics) was designated to calculate these decremental reference prices.

In an order issued May 30, 2003, *California Independent System Operator Corporation*, 103 FERC ¶ 61, 265, the Commission accepted Amendment No. 50, subject to modifications, effective May 30, 2003, and directed the ISO to submit a compliance filing on several issues. On June 30, 2003, the ISO submitted tariff changes to comply with the order, and on July 18, 2003, the ISO submitted an addendum to the June 30, 2003 compliance filing ("July 18, 2003 Addendum"). In the July 18, 2003 Addendum, the ISO, after consulting with Potomac Economics, filed a five-step methodology for calculating decremental bid reference levels. The ISO proposed that the methodology be included in Section 7.2.6.1.1(a) of the ISO Tariff. As relevant here, the first step in the methodology (contained in Section 7.2.6.1.1(a)(1)) provided that in certain circumstances a resource's decremental bid reference level would be based on its bids during recent "competitive periods." The term competitive period is not defined in the ISO Tariff. Rather, it is a term of art in economics that normally means those periods in which offers are accepted in sequence – that is, in which units are accepted (or curtailed) in order of their relative cost (across the relevant zone).<sup>3</sup> The term "competitive period" is included elsewhere in the ISO Tariff, and in the New York ISO and Midwest ISO tariffs, without further definition.

On January 16, 2004, Potomac Economics identified a concern with the methodology used to determine decremental reference prices based on bids during

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<sup>3</sup> See Comments of Potomac Economics Ltd. to the Supplemental Protest of Coral Power, L.L.C., Energia Azteca X, S. de R.L. de C.V. and Energia de Baja California, S. de R.L. de C.V, Docket No. ER03-683-003 (filed Feb. 17, 2004), at 6.

competitive periods – an incentive for some generators to manipulate their reference levels by bidding extremely low and only having a few bids accepted in-sequence, secure in the knowledge that, due to Intra-Zonal Congestion, the ISO would have to dispatch the vast majority of their capacity OOS. In response to this concern, Potomac Economics implemented a new standard to identify competitive periods for the purpose of calculating decremental reference levels. The competitiveness standard essentially stipulated that if a unit wished to have its decremental reference levels calculated using the default bid-based methodology approved by the Commission, then the majority of its accepted decremental bids must have been accepted under competitive conditions (meaning in-sequence). On January 20, 2004, Potomac Economics implemented this competitiveness standard and the ISO issued a market notice announcing its implementation. That market notice is included in Attachment A to the present filing.

In an order on compliance filing issued on April 16, 2004, *California Independent System Operator Corporation*, 107 FERC ¶ 61,042, the Commission, *inter alia*, accepted the decremental bid reference level methodology contained in the ISO's compliance filing. The Commission also found the competitiveness standard implemented by Potomac Economics to be "necessary to correct a fundamental flaw in the proposed decremental reference level methodology," and ordered the ISO to incorporate the new decremental reference level methodology into its tariff. *Id.* at P 62. As noted above, the ISO filed the new decremental reference level methodology with the Commission as part of a compliance filing made in Docket No. ER03-683 on May 17, 2004.

In the January 6 Order, the Commission stated that the competitiveness standard would not become effective until the ISO made a stand-alone filing pursuant to Section 205 of the FPA and that filing was accepted by the Commission. January 6 Order at PP 2, 31. As indicated above, the ISO has sought rehearing of the requirement for the implementation of the competitiveness standard through a stand-alone Section 205 filing, rather than a compliance filing. By making the instant Section 205 filing, the ISO is not waiving its position that the competitiveness standard does not need to be spelled out in the tariff or, alternatively, that if such standard must be included in the ISO Tariff, then the ISO already has satisfied that requirement by submitting such standard in the May 17, 2004 compliance filing. The ISO is submitting this Amendment No. 65 to ensure that the competitiveness standard is included in the ISO Tariff as promptly as possible because it is necessary to protect against the exercise of market power in the decremental bid market.

## II. PROPOSED CHANGES

The ISO proposes to modify Section 7.2.6.1.1(a)(1) of its Tariff to add language to specify a standard governing when the offer-based methodology should be used to calculate decremental reference levels. This criterion was set forth in a January 16,

2004 memorandum from David B. Patton of Potomac Economics to the ISO's Market Monitoring Unit. This memorandum is included in Attachment A.<sup>4</sup> The Tariff language that the ISO is filing herein is identical to language that was included in the ISO's May 17, 2004 compliance filing in Docket No. ER03-683. As indicated above, the Commission has already found such Tariff language to be "necessary to correct a fundamental flaw in the proposed decremental reference level methodology." The proposed standard is necessary to address the concern that certain generators in narrow export-constrained areas are in a position to exercise market power and exact excess rents by depressing the reference levels that are used for mitigation.

### III. EFFECTIVE DATE

The ISO respectfully requests, pursuant to Section 35.11 of the Commission's regulations, 18 C.F.R. § 35.11, that the Commission waive its notice requirements for Amendment No. 65, accept Amendment No. 65 for filing, and permit it to become *effective one day after filing*, on February 18, 2005. While the ISO believes, for the reasons explained below and in its request for rehearing of the January 6 Order, that the methodology set forth in the proposed revision should take effect on January 20, 2004, an effective date of February 18, 2005 is consistent with the Commission's ruling in the January 6 Order that the methodology should go into effect on a prospective basis only following Commission approval of a Section 205 filing. See January 6 Order at P 31. At the same time, granting a waiver of the 60-day notice period to allow the Tariff revision to become effective on February 18, 2005 would reduce the amount of time that the "fundamental flaw" the Commission found in the decremental reference bid methodology would persist.

*In the alternative, the ISO requests waiver of Section 35.11 to permit Amendment No. 65 to become effective on January 20, 2004. Good cause exists for granting the requested waiver, for four reasons.<sup>5</sup> First, as explained above and in the ISO's request for rehearing of the January 6 Order, the ISO submitted tariff language establishing that bids during "competitive periods" would be used to establish reference price levels as part of its July 18, 2003 Addendum in Docket No. ER03-683. On January 20, 2004, the*

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<sup>4</sup> The memorandum was included as an attachment to the January 20, 2004 market notice provided in Attachment A to the present filing.

<sup>5</sup> In its February 7, 2005 request for rehearing, the ISO explained why these same reasons justify an effective date of January 20, 2004. ISO Request for Rehearing at 15-18. The ISO also explained that, in the alternative, the Commission should require an effective date of April 16, 2004, which was the date on which the Commission first found Potomac Economics' standard to be "necessary" and directed the ISO to include that standard in the ISO Tariff. ISO Request for Rehearing at 18-20. The ISO complied with that directive by including Potomac Economics' standard in the ISO's May 17, 2004 compliance filing.

ISO provided notice to Market Participants that Potomac Economics had implemented the competitiveness standard, and provided details concerning the standard in the January 16, 2004 memorandum from Potomac Economics. Thus, since January 20, 2004 all Market Participants have been on notice both that a "competitive period" standard would apply and as to the standard's implementation and specifics. Second, the Commission itself has recognized that the standard is "necessary to correct a fundamental flaw" in the decremental reference bid methodology. The standard should be made effective at the point in time it was implemented to correct the fundamental flaw: January 20, 2004. Third, as also explained in greater detail in the ISO's request for rehearing of the January 6 Order, the ISO appropriately submitted the methodology contained in Amendment No. 65 in the May 17, 2004 compliance filing in Docket No. ER03-683. As the Commission has recognized, "related necessary changes" in a compliance filing can become effective on the date that the underlying rates went into effect.<sup>6</sup> The Potomac Economics competitive periods standard clearly constituted "related necessary changes" to the mechanism filed in the July 17, 2003 Addendum and, as such, should be made effective on the date the standard was implemented – January 20, 2004. The ISO's resubmission of that methodology in the present filing should not change the date it takes effect. Fourth and finally, if the waiver were to not be granted retroactive to January 20, 2004, the ISO would be compelled to undertake the costly, cumbersome, and unnecessary tasks of (i) having to rerun its process for Intra-Zonal Congestion Management in order to reproduce the results of the flawed methodology, and (ii) having to make refunds based on that flawed methodology. Granting the requested waiver, therefore, is appropriate.

#### IV. COMMUNICATIONS

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

Charles F. Robinson  
Anthony J. Ivancovich  
The California Independent System  
Operator Corporation  
151 Blue Ravine Road  
Folsom, California 95630  
Tel: (916) 351-4400  
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Kenneth G. Jaffe  
Julia Moore  
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Washington, D.C. 20007  
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<sup>6</sup> *New York Independent system Operator, Inc.*, 99 FERC ¶ 61,125, at 61,536 (2002).

**V. SERVICE**

The ISO has served copies of this transmittal letter, and all attachments, on the California Public Utilities Commission, the California Energy Commission, the California Electricity Oversight Board, all parties with effective Scheduling Coordinator Service Agreements under the ISO Tariff, and all parties in the proceedings in Docket No. ER03-683 (concerning Amendment No. 50). In addition, the ISO is posting this transmittal letter and all attachments on the ISO Home Page.

**VI. ATTACHMENTS**

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

- |               |   |
|---------------|---|
| Attachment A  | January 20, 2004 ISO Market Notice and January 16, 2004 Memorandum of David B. Patton of Potomac Economics  |
| Attachment B1 | Revised ISO Tariff sheets (in the event that Amendment No. 65 becomes effective before the ISO's February 14, 2005 compliance filing in the Amendment No. 50 proceeding (Docket No. ER03-683) becomes effective) <sup>7</sup> |
| Attachment B2 | Revised ISO Tariff sheets (incorporating changes proposed in the ISO's February 14, 2005 compliance filing in the Amendment No. 50 proceeding (Docket No. ER03-683))  |
| Attachment C1 | Black-lined ISO Tariff provisions (in the event that Amendment No. 65 becomes effective before the ISO's February 14, 2005 compliance filing in the Amendment No. 50 proceeding (Docket No. ER03-683) becomes effective)      |
| Attachment C2 | Black-lined ISO Tariff provisions Revised ISO Tariff sheets (incorporating changes proposed in the ISO's February 14, 2005 compliance filing in the Amendment No. 50 proceeding (Docket No. ER03-683))                        |
| Attachment D  | Notice of this filing, suitable for publication in the Federal Register (also provided in electronic format).   |

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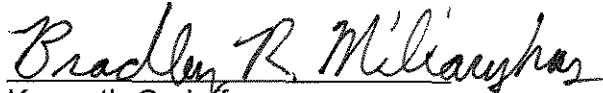
<sup>7</sup> In the February 14, 2005 compliance filing in the Amendment No. 50 proceeding, the ISO proposed changes to Section 7.2.6.1.1(a)(1), which is the same section for which changes are proposed in Amendment No. 65.

# SWIDLER BERLIN LLP

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Two extra copies of this filing are also enclosed. Please stamp these copies with the date and time filed and return them to the messenger. Please feel free to contact the undersigned if you have any questions concerning this matter.

Respectfully submitted,



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General Counsel  
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**ATTACHMENT A**



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**From:** CRCommunications [CRCommunications@caiso.com]  
**Sent:** Tuesday, January 20, 2004 3:19 PM  
**To:** ISO Market Participants  
**Subject:** CAISO Notice: Re: Decremental Reference Levels



Dec Ref Level  
Memo.doc (72 KB)...

**MARKET NOTICE**

January 20, 2004

Re: Decremental Reference Levels

**Market Participants:**

On January 20, 2004, Potomac Economics revised the methodology it uses to determine the decremental reference price. As described in the attached memo, Potomac will apply a test (the ratio of energy decremented out-of-sequence to energy decremented in sequence) to determine what constitutes "competitive conditions".

The decremental reference price is used in managing intra-zonal congestion as set forth by the May 30, 2003 order of the Federal Energy Regulatory Commission in Docket No. ER03-683, 103 FERC ¶ 61, 265.

If you have any questions, please contact Mr. David Patton at Potomac Economics. He can be reached at 703-383-0720. Potomac Economics' web site is located at <http://www.potomaceconomics.com>.

<<Dec Ref Level Memo.doc>>  
Client Relations Communications.0725  
CRCommunications@caiso.com

**MEMORANDUM**

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**TO:** CAISO Market Monitoring Unit  
**FROM:** David B. Patton  
**DATE:** January 16, 2004  
**RE:** Decremental Reference Level Test

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*This memorandum identifies a concern with criterion used to determine when the offer-based methodology should be used to calculate decremental reference levels.<sup>1</sup> To address this concern, we describe in this memo a new test we will be implementing to determine when this methodology is appropriate.*

Reference levels are used to evaluate participant conduct to determine when mitigation is warranted. Section 7.2.6.1.1 of the ISO Market Monitoring & Information Protocol specifies how reference levels are to be computed. The preferred method of calculating reference levels is to compute “. . . the lower of the mean or the median of a resource’s accepted offers if such a resource has more than one accepted offer in competitive periods over the previous 90 days for peak and off-peak periods, . . .”. The new test described in this memo would establish an additional criterion governing when an offer would be deemed to have been accepted in competitive periods.

Normally, competitive periods are defined as those in which the offers are accepted in sequence. In the case of some of the units in the CAISO market, however, this hourly test alone is inappropriate. Certain units in the CAISO market are frequently decremented. In the vast majority of these cases, the decremental offers accepted are out of sequence. For these units, it is rational for the suppliers to incur some lost profit by offering artificially low decremental offers in the minority of hours that they are decremented in-sequence in order to decrease their reference levels and, thereby, increase their profit when mitigated in the majority of the hours.

In fact, given the profits and losses under these two situations, one can show that this incentive would exist when the ratio of MWh of energy decremented out of sequence to total MWh of energy decremented is well below 50 percent. This occurs because the risk of losses per hour associated with bidding artificially low in hours that the unit would be economic to decrement in

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<sup>1</sup> The calculation and use of reference levels for market power mitigation is governed by the ISO Market Monitoring & Information Protocol.

sequence are necessarily less than the profit of having the low reference price in hours when the decremental offer is accepted out of sequence.

To address this concern, we will apply a test to the prior 90-day period using an overall ratio for the period to determine whether any of the decremental offers during the period should be deemed to have been submitted during competitive periods. The test will require that ratio of out of sequence decremental MWh to its total decremental MWh during the prior 90 days be less than a threshold level before the offer-based approach for calculating the unit's decremental reference levels would be used.

Given the incentives described above, we believe a conservative threshold for this test would be 50 percent, which we will apply initially. This ratio would be applied each day on a rolling 90-day basis as an integrated component of the reference level software. One ratio would be calculated for each unit with no differentiation for various output segments on the unit since it is intended to be an overall evaluation of the period that is not specific to any particular output range.

We believe this new test will address the legitimate concern that certain generators in narrow export-constrained areas are in a position to extract excess rents from the California market by depressing the reference levels that are used for mitigation. Please contact me if you have any questions or comments regarding this memo.

DBP

**ATTACHMENT B1**

Intermittent Resources, or Qualifying Facilities to manage Intra-Zonal Congestion after redispatching all other available and effective generating resources, including Reliability Must-Run Units.

**7.2.6.1.1 Decremental Bid Reference Levels.** Decremental bid reference levels shall be determined for use in managing Intra-Zonal Congestion as set forth above in Section 7.2.6.1.

(a) Determination. Decremental bid reference levels shall be determined by applying the following steps in order as needed:

1. Excluding proxy bids, mitigated bids, and bids used out of merit order for managing Intra-Zonal Congestion, the accepted decremental bid, or the lower of the mean or the median of a resource's accepted decremental bids if such a resource has more than one accepted decremental bid in competitive periods over the previous 90 days for peak and off-peak periods, adjusted for monthly changes in fuel prices using the proxy figure for natural gas prices posted on the ISO Home Page. For the purposes of this Section 7.2.6.1.1, to determine whether accepted decremental bids over the previous 90 days were accepted during competitive periods, the independent entity responsible for determining reference prices will apply a test to the prior 90-day period. The test will require that the ratio of a unit's accepted out-of-sequence decremental bids (MWh) for the prior 90 days to its total accepted decremental bids (MWh) for the prior 90 days be less than 50 percent. If this ratio is greater or equal to 50%, accepted decremental bids will be determined to have been accepted in non-competitive periods and cannot be used to determine the decremental reference price. This test would be applied each day on a rolling 90-day basis. One ratio would

be calculated for each unit with no differentiation for various output segments on the unit. Accepted and justified decremental bids below the applicable

**ATTACHMENT B2**

Intermittent Resources, or Qualifying Facilities to manage Intra-Zonal Congestion after redispatching all other available and effective generating resources, including Reliability Must-Run Units.

**7.2.6.1.1 Decremental Bid Reference Levels.** Decremental bid reference levels shall be determined for use in managing Intra-Zonal Congestion as set forth above in Section 7.2.6.1.

(a) Determination. Decremental bid reference levels shall be determined by applying the following steps in order as needed:

1. Excluding proxy bids, mitigated bids, and bids used out of merit order for managing Intra-Zonal Congestion, the accepted decremental bid, or the lower of the mean or the median of a resource's accepted decremental bids if such a resource has more than one accepted decremental bid in competitive periods over the previous 90 days for peak and off-peak periods, adjusted for daily changes in fuel prices using the gas price determined by Equation C1-8 (Gas) of the Schedules to the Reliability Must-Run Contract for the relevant Service Area (San Diego Gas & Electric Company, Southern California Edison Company, or Pacific Gas and Electric Company), or, if the resource is not served from one of those three Service Areas, from the nearest of those three Service Areas. There will be a six-day time lag between when the gas price used in the daily gas index is determined and when the daily gas index based on that gas price can be calculated. For the purposes of this Section 7.2.6.1.1, to determine whether accepted decremental bids over the previous 90 days were accepted during competitive periods, the independent entity responsible for determining reference prices will apply a test to the prior 90-day period. The test will require that the ratio of a unit's accepted out-of-sequence decremental bids



(MWh) for the prior 90 days to its total accepted decremental bids (MWh) for the prior 90 days be less than 50 percent. If this ratio is greater or equal to 50%, accepted decremental bids will be determined to have been accepted in non-competitive periods and cannot be used to determine the decremental reference price. This test would be applied each day on a rolling 90-day basis. One ratio would be calculated for each unit with no differentiation for various output segments on the unit. Accepted and justified decremental bids below the applicable

**ATTACHMENT C1**

**7.2.6.1.1 Decremental Bid Reference Levels.** Decremental bid reference levels shall be determined for use in managing Intra-Zonal Congestion as set forth above in Section 7.2.6.1.

(a) Determination. Decremental bid reference levels shall be determined by applying the following steps in order as needed:

1. Excluding proxy bids, mitigated bids, and bids used out of merit order for managing Intra-Zonal Congestion, the accepted decremental bid, or the lower of the mean or the median of a resource's accepted decremental bids if such a resource has more than one accepted decremental bid in competitive periods over the previous 90 days for peak and off-peak periods, adjusted for monthly changes in fuel prices using the proxy figure for natural gas prices posted on the ISO Home Page. For the purposes of this Section 7.2.6.1.1, to determine whether accepted decremental bids over the previous 90 days were accepted during competitive periods, the independent entity responsible for determining reference prices will apply a test to the prior 90-day period. The test will require that the ratio of a unit's accepted out-of-sequence decremental bids (MWh) for the prior 90 days to its total accepted decremental bids (MWh) for the prior 90 days be less than 50 percent. If this ratio is greater or equal to 50%, accepted decremental bids will be determined to have been accepted in non-competitive periods and cannot be used to determine the decremental reference price. This test would be applied each day on a rolling 90-day basis. One ratio would be calculated for each unit with no differentiation for various output segments on the unit. Accepted and justified decremental bids below the applicable soft cap, as set forth in Section 28.1.3 of this Tariff, will be included in the calculation of reference prices;

**ATTACHMENT C2**

**7.2.6.1.1 Decremental Bid Reference Levels.** Decremental bid reference levels shall be determined for use in managing Intra-Zonal Congestion as set forth above in Section 7.2.6.1.

(a) Determination. Decremental bid reference levels shall be determined by applying the following steps in order as needed:

1. Excluding proxy bids, mitigated bids, and bids used out of merit order for managing Intra-Zonal Congestion, the accepted decremental bid, or the lower of the mean or the median of a resource's accepted decremental bids if such a resource has more than one accepted decremental bid in competitive periods over the previous 90 days for peak and off-peak periods, adjusted for daily changes in fuel prices using the gas price determined by Equation C1-8 (Gas) of the Schedules to the Reliability Must-Run Contract for the relevant Service Area (San Diego Gas & Electric Company, Southern California Edison Company, or Pacific Gas and Electric Company), or, if the resource is not served from one of those three Service Areas, from the nearest of those three Service Areas. There will be a six-day time lag between when the gas price used in the daily gas index is determined and when the daily gas index based on that gas price can be calculated. For the purposes of this Section 7.2.6.1.1, to determine whether accepted decremental bids over the previous 90 days were accepted during competitive periods, the independent entity responsible for determining reference prices will apply a test to the prior 90-day period. The test will require that the ratio of a unit's accepted out-of-sequence decremental bids (MWh) for the prior 90 days to its total accepted decremental bids (MWh) for the prior 90 days be less than 50 percent. If this ratio is greater or equal to 50%, accepted decremental bids will be deemed to have been accepted in non-competitive periods and cannot be used to determine the decremental reference price. This test would be applied each day on a

rolling 90-day basis. One ratio would be calculated for each unit with no differentiation for various output segments on the unit. Accepted and justified decremental bids below the applicable soft cap, as set forth in Section 28.1.3 of this Tariff, will be included in the calculation of reference prices;

\* \* \*

**ATTACHMENT D**





Comment Date: \_\_\_\_\_