



October 19, 2004

VIA ELECTRONIC FILING

The Honorable Magalie R. Salas
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, D.C. 20426

**Re: California Electricity Oversight Board v. California
Independent System Operator Corporation,**

Docket No. EL04-139-000

Dear Secretary Salas:

Enclosed please find the Answer of the California Independent System Operator Corporation to the Complaint of the California Electricity Oversight Board, submitted today in the above- captioned proceeding.

Thank you for your attention to this matter.

Respectfully Submitted,

/s/ Gene L. Waas

Gene L. Waas

Counsel for the California Independent
System Operator Corporation

Enclosures

cc: All parties of record

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

California Electricity Oversight Board)	
)	
v.)	Docket No. EL04-139-000
)	
California Independent System Operator Corporation)	
)	

**ANSWER OF THE CALIFORNIA INDEPENDENT SYSTEM
OPERATOR CORPORATION TO THE COMPLAINT OF
CALIFORNIA ELECTRICITY OVERSIGHT BOARD**

Pursuant to Rules 206 (f) and 213 of the Commission’s Rules of Practice and Procedure, 18 C.F.R. §§ 385.206(f) and 385.213 (2004), and the Notice of Filing issued on September 30, 2004, the California Independent System Operator (“CAISO”) submits this answer in response to the Complaint filed by the California Electricity Oversight Board (“CEOB”)¹.

I. INTRODUCTION AND SUMMARY

In its complaint the CEOB raises the issue of the technical operation of the Automatic Mitigation Procedures (“AMP”) contained within the CAISO Tariff and Operating Procedures and seeks modification of these procedures through a Federal Power Act Section 206 complaint. The gravamen of the complaint is that

¹ Capitalized terms not otherwise defined herein shall have the meaning set forth in the Master Definitions Supplement, Appendix A to the ISO Tariff.

the CAISO's system price mitigation software that relies on a prediction² of the real time price exceeding the threshold of \$91.87/MWh in the next hour to determine whether AMP will be triggered should be revised such that AMP is run in all hours in which the hourly ex post price exceeds \$91.87/Mwh³. In addition, the CEOB argues that the \$91.87 price threshold for mitigation should be eliminated. The CAISO supports the second proposal, but believes the first to be impossible to implement because System AMP must, by definition, run in a predictive mode in order to mitigate market impacts.

The CEOB's complaint refers to the CAISO's AMP limiting local market power⁴. However, the CAISO's current price mitigation methodology contains provisions for both local and system market power mitigation. The AMP provisions that the CEOB appears to take issue with are system and not local market power procedures. However, there is simply no way that the system AMP for the CAISO Real-Time Market can operate other than on a forecasted or predicted basis.

² The system AMP procedure includes: (1) a price screen, where the price must exceed \$91.87 before mitigation occurs; (2) a conduct test, which examines whether a supplier's bid is greater than the lesser of 200% or \$100 above the supplier's reference level bid price, and (3) an impact test, which tests to determine if bids that failed the conduct test would increase the zonal price by the lesser of 200% or \$50 above the price that would occur with conduct test failing bids mitigated to their reference levels. Under System AMP if a resource fails the conduct and impact tests, its bid is replaced with the reference price. Local AMP applies a market impact test to out of merit order bids. Specifically, if the bid is \$50/MWh or 200% greater than the market clearing price, the bid is mitigated to its reference level and the generator is paid the higher of the reference price or the market clearing price. There is no price screen for the local market power mitigation. 105 FERC ¶ 61,140 notes 115 and 117.

³ CEOB complaint at 3.

⁴ CEOB complaint at 1.

II. COMMUNICATIONS

Communications regarding this matter on behalf of the CAISO should be directed to the following individuals whose names should be entered on the official service list maintained by the Secretary for this docket:

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III. DISCUSSION

A. The CEOB Complaint misunderstands the CAISO's current system of price mitigation at the local and system level and their associated constraints

Since the start of market operations, the CAISO has focused a great deal of attention on seeking to ensure that adequate measures are in place to protect against the exercise of market power by sellers in its market. The CAISO's concern over market power has been both at the local and system level. The outcome of the California Refund proceeding, Docket No. EL00-95-000 et al., provides all of the emphasis one needs to indicate what can happen when the proper market power mitigation is not in place. Both the CEOB and the CAISO have been active participants in this litigation in an effort to return unjust and unreasonable market payments to California. However, it is absolutely essential that the Commission and the CEOB fully understand the way in which the

CAISO's current system of market power mitigation operates. Once this methodology is clearly set forth in the record, it will become apparent that there is no basis for at least part of the complaint.

The CEOB complaint appears to confuse local market power mitigation and system mitigation procedures⁵ by inappropriately requesting in effect, a predictive algorithm not be used in triggering AMP calculations. The local market power mitigation methodology utilizes after-the-fact bid mitigation because bids that are dispatched for local constraints are taken out-of-sequence and settled on an "as-bid" basis (i.e., they do not effect market clearing prices). However, system mitigation in the CAISO Real Time Market requires that the process be triggered prior to dispatch and price determination. Because the basis of bid mitigation under system AMP is whether bids that violate the conduct threshold have a material impact on market clearing prices (as defined by the market impact thresholds)-- and such bids, whether mitigated or not mitigated, are eligible to set the market clearing price--, the system mitigation procedure must run before the Real-Time Market final dispatch and market clearing prices are determined. To base bid mitigation on an after-the-fact procedure would be too late because such mitigation would not affect the market clearing prices as is intended by AMP. Currently the system AMP procedures are run about 53 minutes prior to the operating hour to account for the time it takes to run the procedures and still allow adequate time for the pre-dispatch and Control Area check-outs of inter-tie bids. The CAISO can try to reduce the amount of lead

⁵ See footnote 2 for a complete discussion of the procedures associated with local and system mitigation.

time, but AMP must be applied on a before-the-fact basis to function as intended. Stated differently, AMP must predict whether an anticipated violation of the AMP price screen will occur so that a bid mitigated real time merit order bid stack can be established prior to the actual operating hour.

Under the CAISO's Phase 1B market model, AMP is capable of looking out even further from a time perspective; so, the problem that the CEOB has identified is less likely to occur. Specifically, under Phase 1B, instead of looking out for the next operating hour, the software looks at the next two operating hours in terms of the demand forecast for imbalance energy and a determination of a reference price. Thus, the Phase 1B market design and software that went into effect on October 1, 2004 is partially solving the problem that the CEOB has identified.

B. The CAISO agrees with the CEOB that the \$91.87/MWh mitigation threshold is inappropriate and should be eliminated

The CAISO agrees with the CEOB's assertion⁶ that the specific price screen of \$91.87/MWh is not an appropriate indicator of whether market power is being exerted. Indeed, the CAISO previously has argued this position at great length before the Commission.⁷ The CAISO restates below the reasons why the price screen should be eliminated. First,⁸ the basic concept of a price screen is in conflict with the Commission's basic rationale for approving AMP. The mere

⁶ Ibid.

⁷ See, Request for rehearing of the California Independent System Operator, Docket No.ER02-1656-000, August 16, 2002 ("Request for Rehearing").

⁸ Ibid. pages 14-20

existence of a price screen could enable suppliers to exert market power on a temporary basis without being subject to mitigation. For example, if a unit consistently bids \$30/MWh (which would then be the unit's reference price) and during the week a single large unit or a number of units are forced out of service; the unit previously bidding \$30/MWh could raise its bids to \$91.87/MWh in light of the reduced competition in the CAISO Market. This example illustrates the type of behavior that AMP is designed to prevent. The Commission has even acknowledged that fact. However, the existence of the \$91.87/MWh AMP price screen permits this clearly inappropriate result to occur. In this instance the price screen simply allows the seller to raise its bids, without any risk of bid mitigation, from a more competitive price up just below the level of the price screen realizing greater economic rents in the process. Market power has been exercised not only during peak conditions, but also during other months when scheduled and unscheduled outages have led to supply-demand imbalances. The \$91.87/MWh price screen can allow market power to be exercised in such circumstances without any recourse for consumers.

Second, it appears that the Commission's decision to implement a fixed price screen for the CAISO was based, in part, on the erroneous conclusion that the New York Independent System Operator ("NYISO") has a fixed price screen in effect. This can be inferred from the Commission's July 17, 2002 "Order on the California Comprehensive Market Redesign Proposal" wherein the Commission approved the AMP mechanism. *California Independent System Operator Corporation*, 100 FERC ¶ 61,060 (2002). However, this is not correct.

The NYISO does not have a specified price screen included in its tariff. The NYISO possesses the authority to forgo the use of AMP for any day-ahead market for which it has made a determination that the likelihood of AMP mitigation being triggered is minimal. In other words, the NYISO voluntarily does not run AMP if it believes that the threshold that will trigger AMP mitigation likely will not be met. In fact, the NYISO has expressly stated that the AMP does not establish a \$150/MWh threshold for the imposition of mitigation measures.⁹

Like the NYISO, the CAISO has the experience to know that the \$91.87 price screen will not prevent market power mitigation from occurring. Thus, because the Commission did not approve a fixed price screen for the NYISO, there is no argument that the Commission should impose a fixed AMP price screen on the CAISO. The Commission has not announced any reasons for treating the CAISO differently than it has treated the NYISO. The Commission cannot justify adopting a fixed price screen for the CAISO when the Commission did not require NYISO to implement a fixed prices screen.¹⁰

Third, a \$91.87/MWh price screen is not supported by substantial evidence in any proceeding and there is no rational basis to rely upon this fixed threshold.¹¹ The CAISO has fully evaluated this issue and can find no current “real world” justification for the very specific fixed threshold of \$91.87. This

⁹ See New York Independent System Operator, Inc., 95 FERC ¶ 61,471 at 62,689.

¹⁰ It is axiomatic that an agency must conform to its prior practice, policy and decisions or explain the reasons for its departure from such precedent. See *United Municipal Distributors Group v. FERC*, 732 F.2d 202, 210 (D.C. Cir. 1984); *Greater Boston Television Corporation v. FCC*, 444 F.2d 841, 852 (D.C. Cir.), *cert. denied*, 403 U.S. 923 (1971) (agency must give reasoned analysis for departures from prior agency practice). The Commission has failed to conform to this mandate. Specifically, the Commission has failed to enunciate any reasons why a formal price screen is appropriate for the CAISO but not for the NYISO.

¹¹ Op cit Request for Rehearing at 17.

specific price cap was approved by the Commission on July 17, 2002, based on a particular set of spot prices that prevailed at a certain point in time. There is no reason that this specific cap should continue to apply. It makes far more sense to review the appropriateness of a given cap at least on an annual basis. More than two years have elapsed since the \$91.87/MWh price screen was approved. The CAISO submits that it is time to implement a more flexible mechanism. A \$91.87/MWh price screen allows some units to bid more than twice their marginal costs in instances where they can exercise market power without any mitigation being applied. That is inappropriate.

Thus, the CAISO joins the CEOB in asking the Commission to remove the price screen so that more meaningful price mitigation standards can be applied.

IV. CONCLUSION

Wherefore, for the reasons discussed above, the first request for relief in the CEOB complaint, that system market mitigation operate on an after- the- fact basis should be denied, and the second request for relief of the CEOB complaint, that the \$91.87/MWh threshold be removed should be granted.

Respectfully Submitted,

/s/ Gene Waas

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Date: October 19, 2004

CERTIFICATE OF SERVICE

I hereby certify that I have on this 19th day of October 2004, served copies of the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

/s/ Gene L. Waas
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