

ISO MANAGEMENT BACKGROUND AND ISSUES FOR CONSIDERATION

1. The ISO is charged with maintaining reliability within its Control Area:
 - Short-term reliability is affected by the scheduling decisions of Loads and Generators (i.e., what markets these entities choose to participate in - forward Energy and Ancillary Service markets and/or the Real Time Energy Markets).
 - Long-term reliability is dependent upon creating appropriate incentives for investment in new transmission and new generation facilities within the Control Area and streamlined regulatory approval of such facilities.

Absent an immediate and significant increase in generation and transmission capacity at levels greater than the significant load growth now being experienced by California and other western states, there will be an increase in both the frequency and duration of power interruptions on peak summer days.

2. The ISO has received requests to lower its price caps in the ISO ancillary services, real time and congestion management markets. Price caps in general, particularly at levels below those now in place, without substantial immediate action by market participants and regulatory authorities likely would not produce the desired benefits to consumers, and could produce the ill effects described below:
 - Lowering the price caps will increase out-of-market activity necessary by the ISO to maintain reliability within its Control Area. This also increases the ISO's role as the provider of last resort (i.e., ensuring that the transmission system remains in balance). Greater dependency on out-of-market activity may result in payments higher than any savings that might be realized from lowering the caps.
 - Increased out-of-market activity by the ISO also likely will result in additional strain on the real time activity of maintaining reliability by increasing the volume of energy purchases required and the number of transactions required in real time, all of which are handled manually here at the ISO operations floor as well as neighboring Control Areas. This strain will increase the likelihood of scheduling errors and other real time problems that affect reliability. In addition, in order to ensure reliability, it may become necessary for the ISO to engage in activity in advance of the PX and ISO Day-Ahead markets. This will undoubtedly have an effect on these markets by thinning the markets and raising prices.

- Lowering the price caps reduces the opportunity for suppliers to recover their investments during peak periods and thereby requires suppliers be compensated through the use of some form of guaranteed long-term payment.
 - Lowering the price caps (i.e., a reduction in the potential upside available to suppliers) increases the likelihood of withholding or reduced supply due to concerns about adequate compensation and decreases the incentive to build generation in-state.
3. Proponents of a price cap reduction believe that such a reduction will mitigate price spikes and, thereby, benefit consumers. Given the magnitude of recent price spikes, the ISO is prepared to mitigate this impact with a temporary reduction in the price cap, but only as part of a larger effort to be undertaken by all market participants, as well as state regulatory agencies to develop the tools and incentives listed below:
- Entities that schedule load should immediately apply for and use appropriate risk management tools, including use of medium and long term forward energy contracts as a means to mitigate price volatility on behalf of consumers.
 - Generators should actively seek participation with loads in forward energy contracts as a means toward price stabilization for consumers. Furthermore, generators should bid all available capacity in existing markets, particularly during periods of high load.
 - Regulatory agencies and/or the Legislature should:
 - a) Remove constraints on hedging opportunities for UDCs.
 - b) Remove constraints on participation by load in demand relief programs.
 - c) Enable consumers to receive real time price information, through real time metering or other enabling technologies.
 - d) Expedite, within a target period of one year, the approval of projects to build new generation and transmission facilities where needed within the state of California.

The above activities are viewed by the ISO to be essential in mitigating the near term and long term consequences of operating the market with price caps.

4. The ISO recognizes the impact of market behavior on costs to consumers. There is currently only one region of the state that is no longer insulated from price volatility due to the rate freeze introduced with AB 1890. Recent heat waves, combined with western region-wide shortages of electricity supply, have resulted in substantial hikes in bills in this region. Furthermore, consequences of load making decisions to schedule in real time markets can exacerbate price volatility

- by shifting the cost of energy into the real time markets.
5. The ancillary services and real time markets operated by the ISO make up only 5 to 10% of total energy costs on average. A reduction in price caps of these markets will not, therefore, provide substantial price relief to retail customers. Consequently, until appropriate tools are available and widely used to assist consumers in managing price risk, and until the market is appropriately competitive, the state legislature and regulators could consider taking regulatory and/or legislative action, such as a temporary extension of the rate freeze, to carry consumers through a transition period. Any action taken by the state's policymakers to regulate the price through rate freeze or other mechanisms should be temporary. A competitive market ultimately needs to contain clear price signals in order to encourage appropriate investment incentives and demand responsiveness.