

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

<b>Operational Audit of the California Independent System Operator</b>	) )	<b>Docket No. PA02-1-000</b>
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**Comments of the California Independent System Operator Corporation on  
the Commission's Operational Audit of the CA ISO**

The California Independent System Operator Corporation ("CA ISO") appreciates the opportunity to provide comments on the Commission's Operational Audit of the CA ISO ("Audit"), issued January 25, 2002. The CA ISO is strongly committed to working with the Commission, state policymakers, and other interested parties to address the specific matters raised in the audit and to forge a realistic and integrated plan for addressing the fundamental problems that plague the California electricity market and gave rise to the electricity crisis of 2000 and 2001.

**Executive Summary**

The CA ISO believes that many of the issues and concerns referenced in the Audit are an unavoidable consequence of the conditions in which the CA ISO was forced to operate. The swift and thorough decay of the California electricity market forced both the CA ISO and the State of California to assume enormous responsibilities in order to protect the safety and welfare of the citizens of California. As the financial stability of the California electricity market came into question and confidence in the institutional and market mechanisms eroded, the CA ISO has been forced to provide for the continued and reliable operation of the transmission system under extremely tenuous circumstances. As a result of non-payment and a lack of market transparency,

on a moment-to-moment basis the CA ISO was unsure whether market participants would respond to its instructions. At the same time, the State was forced to quickly procure, both under forward contract and in real time, the capacity and energy necessary to serve the load of its bankrupt or near-bankrupt investor-owned utilities. Thus, considering the circumstances, the findings of the Audit are not surprising. However, throughout this tumult, the CA ISO exhibited a steadfast resolve to both reliably operate the system and pursue all necessary measures to ensure the return of stable and reasonable prices in the market. The CA ISO's efforts in this regard cannot and should not be diminished or tarnished by the failings of the market as a whole. The CA ISO believes the Audit confirms that conclusion.

### ***The Crisis Is Not Over***

As all affected parties begin to understand the need for a solid foundation and framework for a sustainable California energy market, it is imperative that we be mindful that the conditions that gave rise to crisis of 2000 and 2001 still exist and that the crisis of the past two years can easily reappear. Absent forthright and collective action by federal and state policymakers, the fundamental deficiencies that gave rise to the crisis will persist and we will once again find ourselves with a system gone awry. The Commission has asked parties to comment on the specific recommendations of the Audit, and the CA ISO does so below. More importantly, the Commission has asked parties to prioritize those specific recommendations and to discuss the appropriate time frame for their implementation. There is no more important task than to collectively prioritize the necessary actions of all affected parties and to develop an integrated and systematic work plan and schedule for their implementation – a plan and schedule that

reflects a realistic assessment of current and foreseeable conditions. The root cause of the problems that persist in California is not the CA ISO or its markets, but rather a systemic failure to build the infrastructure needed to support a reliable and competitive electricity market.

***Near-term Conditions are Uncertain***

There has always existed a frustrating tension created by the delay between the sending of investment signals and the building of needed infrastructure. Compounding this tension in California is the financial status of state's investor-owned utilities ("IOUs") – it is unclear when these utilities will be restored to financial health (*i.e.*, creditworthiness) and when they will be able to once again plan for and acquire the resources necessary to satisfy their own load. Even if the CA ISO is able to make arrangements (*e.g.*, posting of security or other short-term arrangements) with the IOUs for them to participate in the CA ISO's markets, it is uncertain whether they will be able to build or purchase the resources they require to serve their load on a long-term basis. In fact, the judge's recent ruling in the Pacific Gas & Electric Company's ("PG&E") bankruptcy proceeding may require PG&E to reconsider its fundamental approach to resolving its financial woes.

In addition, the California Department of Water Resource's ("CDWR") authority to procure energy on behalf of the IOUs terminates at the end of this year. It is unclear whether the CDWR, or the State in general, will have the wherewithal to continue in this role. Absent state legislative action to continue the State's role in purchasing power to cover the IOUs' net short position, the IOUs may be once again faced with the prospect of being unable to purchase electricity on a long-term forward basis or through spot

market purchases. The thought of once again placing the CA ISO or the State in a position of relying on the vagaries of a spot market potentially unprotected from the exercise of market power and manipulation may forever erode confidence that such mechanisms (*i.e.*, markets) can reliably and reasonably satisfy the needs of the citizens of California.

Thus, in light of these uncertain circumstances the Commission's actions over the next several months may determine the fate of the California market. Among all the recommendations in the Audit, the CA ISO believes that there is none more important than the call for "jurisdictional cooperation." If this is to occur the CA ISO believes that it is imperative that the Commission restore the State's perception that the Commission will take all necessary actions to protect the public interest.

***The Commission Must Stand Ready to Extend the Existing Price Mitigation in California***

The Commission's June 19 price mitigation measures helped staunch the bleeding from the 2000-2001 electricity crisis. However, the long-term prognosis for market recovery will once again be brought into question if the Commission arbitrarily removes the June 19<sup>th</sup> price mitigation measures before determining that the market is competitive. The Commission's determination to sunset the June 19 price mitigation measures on September 30, 2002, without first determining that the market is healthy (or at least stable) is highly questionable. Moreover, relying on the CA ISO to develop and propose a market monitoring and mitigation plan that can effectively mitigate all vestiges of market power is unrealistic. While the CA ISO can certainly focus on coarse measures to mitigate the exercise of market power, these instruments may not be compatible with the Commission's long-term preferred approach. Most certainly, the

Commission would prefer the development of structural, institutional and market-based mechanisms that ensure that the fundamental deficiencies in the California market (*e.g.*, lack of generation, lack of transmission, lack of price-responsive demand) are addressed. These institutions and measures will take time to develop and implement. More importantly, they require highly-coordinated action by both federal and state policymakers. To think that these measures can be in place and effective by the end of this year is not realistic.

For example, the CA ISO is currently examining, as part of its Commission-directed Market Design 2002 (“MD02”) effort, development and implementation of an Available Capacity Obligation (“ACAP”) on load-serving entities in California. As further explained in the CA ISO’s MD02 documents,<sup>1</sup> the purpose of implementing this requirement is two-fold: 1) to provide incentives for forward contracting between load-serving entities and suppliers and thus incentives for the development of new generation and price responsive demand; and 2) to ensure that the CA ISO has available in the forward market sufficient capacity to serve forecasted load (*i.e.*, ensure reliability).<sup>2</sup> The CA ISO believes that satisfaction of both these objectives will greatly reduce the ability of suppliers to exercise market power in the CA ISO’s spot markets. However, development and implementation of this tool will require close coordination between the Commission, the CA ISO, the California Public Utilities Commission (“CPUC”) and perhaps other state agencies – as well as load-serving entities and suppliers. In fact, when fully implemented, the CA ISO views its role as primarily

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<sup>1</sup> (see <http://www.caiso.com/docs/2002/02/01/200202011618138281.html>)

<sup>2</sup> The CA ISO notes that one of the Audit’s findings suggests the imposition of such a requirement.

“checking the temperature” of the capacity market on a periodic basis. Thus, the CA ISO believes that primary responsibility for effective long-term satisfaction of this requirement lies with load-serving entities in California, as appropriately overseen by the CPUC, and perhaps with the involvement of other state agencies.

Specifically, the CA ISO believes that the manner by which load-serving entities in the state satisfy the obligation is a state public policy decision. For example, it is clearly within the state’s domain to prescribe the mix of resources that a load-serving entity may use to satisfy its capacity obligation. While the CA ISO has a vested interest in ensuring the availability of those resources (and therefore the nature of the product being made available), it is appropriate for the state to establish standards regarding the portfolio of resources to be used to satisfy the capacity obligation. The state may determine that a certain percentage of a load-serving entity’s capacity be supplied from clean-burning resources or other alternative energy resources.

The CPUC has recently instituted a formal rulemaking proceeding regarding the procurement practices of the IOUs (see CPUC Docket No. R01-10-024). As this proceeding has just begun, it is unlikely that the CPUC will issue a final rule before the end of this year. The CA ISO believes that until these procurement rules are established, the IOUs will have little comfort that the capacity or energy they procure to satisfy a CA ISO-imposed obligation will be deemed prudent or reasonable before the CPUC. In these circumstances, even if the IOUs were all financially healthy, it is unlikely that the IOUs will be able or willing to forward contract for the capacity and/or energy necessary to satisfy the CA ISO’s reserve obligation.

It is obvious that a multiplicity of players will have a role in crafting a comprehensive solution to California's energy problems. The roles and responsibilities of all parties must be clearly staked out before we begin to step forward with specific proposals. For too long the CA ISO has been asked by federal and state policymakers to assume responsibilities that are rightly and more appropriately borne by others, including state and federal regulators. That must end.

### ***Priorities and Timeline***

The Commission has asked respondents to prioritize the specific recommendations of the Audit and to discuss an appropriate time frame for implementation of those recommendations. While not necessarily specific to the Audit's findings and recommendations, the CA ISO recommends the following:

- 1) **Jurisdictional Cooperation** - Federal and state policymakers must reach out to one another and form an effective partnership to resolve the problems that plague the market. The Commission, under the new Chairman's leadership, has already committed to forming FERC-State Panels to address issues regarding Regional Transmission Organization ("RTO") development. The CA ISO urges to the Commission to act quickly to create such forums in the West to address the issues raised above.
- 2) **Ensure Effective Price Mitigation** - The Commission must ensure that fail-safe market power mitigation measures are in place in the California market. As stated above, the conditions that gave rise to crisis of 2000-2001 have not abated. Therefore, the Commission must not arbitrarily remove the currently effective price mitigation measures based on a presumption that the market is workably competitive. In fact, the CA ISO believes that the Commission must affirmatively establish that the California market is competitive, comparable to the finding it must make when granting market-based rate authority. To the extent that the Commission is inclined to remove such measures, the Commission must stand ready to act swiftly and effectively (or empower the CA ISO to do so) to reinstitute such measures should the market once again begin to implode.
- 3) **Define Roles & Responsibilities** – Ever since the advent of open access and the issuance of Order Nos. 888 and 2000, issues have been raised with respect to federal-state jurisdiction. Moreover, the roles and obligations of market participants has also been blurred as historical relationships and functions have changed. In fact, the Commission is currently examining the

proper distribution of roles and responsibilities with respect to the core functions of an RTO. Role and responsibility clarity are critical at this juncture. Collectively, none of us should “assume” certain responsibilities will be met. This effort does not require that all parties come to agreement on these issues. The critical first step is for all parties to identify, for the other’s benefit, what role and function they believe they must perform and all must agree to respect the roles of others.

- 4) **Establish a Realistic and Sequential Timeline** – All parties, but especially the Commission, must establish a realistic (but aggressive) schedule for addressing their core responsibilities. The Commission and state policymakers should establish a rational process for the development of sound and appropriate institutional and market mechanisms that will address the fundamental failings of the California market. The CA ISO notes that the Commission has already embarked on an ambitious rulemaking process to determine an appropriate “Standard Market Design.” It seems prudent for the Commission to permit the CA ISO to benefit from the insight gained by the Commission during that process, as opposed to requiring the CA ISO to file a market redesign proposal by May 1, 2002 (as required by the Commission’s December 19 Order). As many participants in California have observed, this may be the last opportunity for the CA ISO to “get it right.” Subsequent to receiving all comments in this proceeding, the CA ISO implores the Commission to develop a schedule that allows for: 1) the thoughtful and complete development of a market design proposal that is integrated and compatible with the timeline for restoring the California IOUs to financial health; 2) the development and implementation of companion state public policy; and 3) compatibility with market development throughout the West. The CPUC and other California state agencies should establish, and commit to, aggressive schedules to determine the future obligations and requirements of the state’s load serving entities, as well as other programs within their jurisdiction (e.g., demand response programs).

The CA ISO believes that should the Commission and others commit to these actions, the balance of the Audit’s recommendations and findings (creditworthiness, trust, process, etc.) can and will be addressed in due course. There is no greater confidence builder to market participants and the financial community than regulatory stability and the commitment by state and federal policymakers to concrete actions plan that clearly address the fundamental flaws of a market.



## Comments on Audit Findings and Recommendations

### ***Background***

On October 9, 2001, the Commission issued a request for proposal to conduct an operational audit of the CA ISO. The Commission selected Vantage Consulting, Inc. (“Vantage”) to perform the Audit. The Commission stated that the audit would cover the period from October 2000, to October 2001. Vantage interviewed CA ISO management, staff and Board members, and also examined extensive documentation. Vantage also interviewed numerous market participants, as well as state and federal regulators and policymakers. Vantage submitted its findings to the Commission in January, 2002 and the Commission released the Audit on January 25, 2002. The Audit makes numerous findings and recommendations, and makes five “global recommendations” towards an “integrated broad-based solution to California’s electric industry problems.” The global recommendations are:

1) **Fiscal stability** described as:

“Re-establish a firm financial foundation that restores confidence and assures cash will continue to flow through the system on a continuous basis even in times of market instability and upset.”

2) **Jurisdictional Cooperation** described as:

“Develop among FERC and the various California regulators and agencies, formal policies committed to enhancing cooperation in the design and subsequent oversight of California’s electric industry.”

3) **Process for Interaction** described as:

“Establish new interaction processes, less bureaucratic and more timely, that balance the needs of all parties with the realities of operating a complex electrical system and associated markets.”

4) **California ISO’s Role** described as:

“Redefine the role and vision of the CAISO within the new industry structure. Establish governance in accordance with that role. Implement an aggressive program, including culture change, to rebuild credibility and confidence in the CAISO.”

5) **Market Design** is described as:

“Assure that there is an effective stakeholder process available to provide meaningful input to the market redesign effort.”

The Audit also makes a number of specific findings and recommendations. The CA ISO responds to each of the specific findings below.

## **Comments on Specific Findings and Recommendations of the Audit**

### ***Findings Regarding Governance and Independence***

The Audit found that the current Governing Board is not independent and that it is not the appropriate Board for the CA ISO going forward. Specifically, the Audit found that:

*The current BOG has served its purpose during the recent crisis, however it is not the appropriate governing body going forward. (Finding III-F7);*  
and

*Despite the best intentions of the new BOG to be fair and independent, the net result of their inception was a loss of independence by the CAISO. (Finding III-F8).*

The Audit stated that:

*One of the Linchpin issues that needs to be resolved is governance of the California ISO, and the perception of an inherent lack of independence... This is clearly the root cause of many other communication, culture and trust problems. Until it is resolved, there is no hope for a comprehensive solution.... Despite the best intentions of the new BOG to be fair and independent, the net result of their inception was a loss of independence by the California ISO.*

The Audit recommended that:

*Establish a new and Independent Board of Governors, along with a formal Stakeholder Committee. (Recommendation III-R1);* and

*Develop a plan for creating an independent board that meets all needed criteria (Recommendation III-R2)*

### ***CA ISO Comments***

The CA ISO does not offer any comments on the future structure and function of its Governing Board, nor the timing for creating a new Board. The CA ISO believes that these are matters for federal and state policymakers to decide. However, the CA ISO does offer the following comments on the function and performance of the existing Governing Board. The CA ISO agrees with the Audit's findings that the current Board "served its purpose" during the recent crisis. More pointedly, the CA ISO believes that its existing Board functioned effectively during the recent crisis and provided a stable platform from which management could perform its day-to-day responsibilities.

The audit also implied, in part, that the new Board lacked expertise in the energy industry. To the contrary, CA ISO management found that the Board quickly came to understand the complex environment in which the CA ISO functioned, and performed with an appropriate balance of deference and guidance. Moreover, to state that the Board lacked expertise is simply not true. For over twenty years prior to his appointment, the Board Chair worked extensively in numerous phases of the energy business. More recently, the Board Chair was the Chair of the California Electricity Oversight Board, the founding Chair of the California Green Energy team, and an active participant in dealing with all aspects of the State's electricity crisis. In addition, two of the Board's other members are, and have been, active participants in the energy market – one as a consumer representative on state and federal electricity matters and another through his leadership of a major energy-intensive manufacturers association.

Finally, the CA ISO offers certain limited comments regarding the notion of independence. While "independence", however defined, is critical to establishing trust

in an organization, the Audit fails to address how states can have a legitimate and meaningful role in governance going forward. States most likely will feel the need, if not obligation, to engage (and be engaged) on these matters. Since inception, the purpose of the CA ISO has been two-fold: 1) ensure open, non-discriminatory transmission service, consistent with the public interest, as a public utility under the Federal Power Act; and 2) serving a public purpose as a private, California state-chartered nonprofit public benefit corporation, and reducing the burdens of state government as an organization exempt from federal income taxation under Section 501(c)(3) of the Internal Revenue Code. In terms of CA ISO actions, up until the crisis of 2000-2001, this duality had not been cause for concern. The CA ISO believes that, going forward, this dichotomy is not in conflict – the public interest is, after all, the concern of both federal and state policymakers and regulators. The CA ISO urges the Commission to forge a partnership with states that results in a “win-win.”

***Findings and Recommendations Regarding DMA’s Independence, Organizational Placement, and Performance***

The Audit found that many market participants had concerns with the CA ISO’s Department of Market Analysis (“DMA”), specifically with respect to its perceived lack of independence and its location within the CA ISO organization. Specifically, the Audit found that:

*Many stakeholders believe the Department of Market Analysis (DMA) is, at a minimum, not independent, and at the extreme, co-opted by management, the BOG, and the Governor. (Finding III-F14); and*

*Due to its location in the CAISO organization, the DMA cannot easily bypass management and report its findings to the CEO, Board, or FERC. (Finding III-F15).*

Among other things, the Audit found that:

*Although many of those interviewed felt that the DMA was staffed with highly professional personnel that are well intentioned, there was a concern regarding the independence of DMA. It is difficult, however, to measure this feedback because many of those we spoke with are in the midst of litigation with the CAISO over huge sums and the DMA is a primary analytical and litigation support tool in these cases. Invariably the other parties would raise the issue of how could the DMA maintain its independence while at the same time supporting the CAISO's litigation positions in complaints before the FERC. The DMA's normal reporting relationship is through the General Counsel. The DMA cannot easily circumvent this reporting relationship and go directly to the CEO, Board, or FERC with the results of its analysis and evaluation of the electricity markets in California. Further, the channels of communication with the FERC are not currently as open as the Director would like.*

The Audit recommended that:

*Define in very certain terms the role of the Department of Market Analysis (DMA) and strengthen its independence by implementing procedures permitting it to bypass its regular reporting relationship and report directly and simultaneously to the CEO, the BOG, or FERC. **(Recommendation III-R3)***

### **CA ISO Comments**

A core function of the CA ISO is to ensure reliable, open, and non-discriminatory transmission service to all customers. The CA ISO satisfies that objective by, in part, facilitating certain discrete markets. In order to ensure that such markets function efficiently and produce incentives that support reliable operation, the CA ISO must monitor and enforce compliance with established market rules. Every market to some extent is founded on trust. In the absence of a legitimate effort to apply rules evenhandedly to all parties, markets lack credibility and are prone to producing unfair results.

The mission of the CA ISO's DMA is to ensure that the CA ISO's markets function efficiently and are not prone to abuse. The DMA plays a critical role in

assisting management and offering vital expertise toward carrying out the above objectives. In this respect, its "independence" is, and should be, no different from that of the organization as a whole. DMA should be free of conflicts and improper influence by participants in the CA ISO's markets. "Independence," however, does not mean, as suggested by some, that DMA must be set apart from Management and the rest of the organization. Rather, the CA ISO believes that, as it currently functions, DMA must remain an integral part of the organization. If the CA ISO as a whole is to fulfill its primary core functions, it must be able to call upon the services of DMA and to direct its resources. The one exception to this conclusion is, of course, where DMA discovers instances of misconduct by the CA ISO, in which case it must, and does, have the authority and obligation to report these discoveries outside the organization. A contrary conclusion would leave Management powerless or at least severely disabled in its efforts to develop and advocate policies it believes are necessary to the proper functioning of the systems and markets under its care. Moreover, the CA ISO is unaware of any instance where CA ISO Management, or the Board, has prohibited the DMA from issuing a report or finding on a matter. Thus, while perception is important, the CA ISO's DMA has and continues to function "independently" and without restraint from CA ISO Management.

In addition, the Audit raises concerns regarding the "ease" (or lack thereof) with which the members of DMA can circumvent their immediate reporting relationship with the General Counsel and present their concerns to the CEO, the Board, and the Commission. However, the Audit fails to reference a single instance in which the

concerns cited have ever emerged under the current reporting relationship.<sup>3</sup> Nor could it, since the facts are to the contrary. In fact, the Director of Market Analysis speaks directly with the CEO (with or without the knowledge of the General Counsel) on average twice a week. In addition, she reports directly to members of the Board at virtually every Board meeting. DMA staff, like the rest of CA ISO staff, remains available to address any questions or concerns raised by Board members between meetings (and a number of Board members have availed themselves of this opportunity). Additionally, DMA staff regularly raises issues with FERC staff, on an as-needed basis, without having the information filtered by the General Counsel. There has not been a single instance in which the current General Counsel has made substantive changes to any proposal by DMA or prohibited a report from being made. In short, the concern with the current organization cited by the Audit is at best theoretical and is at odds with the facts. However, that being said, the CA ISO is not opposed to adding additional clarification to DMA's reporting relationships, as currently defined in the CA ISO Tariff, to provide confidence that DMA can report directly on a matter to the CEO, the Board, and the Commission.

The CA ISO also disagrees with the implication in the Audit, based on comments by market participants, that DMA's involvement in the Commission's refund case is somehow at odds with its core mission and independence. In fact, analysis of and determinations regarding the exercise of market power are clearly within DMA's purview. The exigent circumstances of the California electricity crisis have quite predictably fostered an atmosphere of mistrust – that should be no surprise when

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<sup>3</sup> The Audit erroneously asserts that DMA, until mid-2000, reported to the Vice President of Grid Operations. In fact, DMA, from the CA ISO's inception, has always reported to the General Counsel.

billions of dollars are at stake. However, to think that DMA, or any other market monitoring body, could somehow avoid or disengage from the ongoing fact-finding/litigation process is unrealistic and at odds with the market monitoring function defined for RTOs in the Commission's Order 2000. If the DMA had failed to express an opinion on these matters, it would have failed to do its job.

### ***Findings and Recommendations Regarding the Market Surveillance Committee***

The CA ISO Tariff currently provides for the establishment of a "Market Surveillance Committee" ("MSC"). As stated in the CA ISO Tariff, the purpose of the MSC is to provide independent external expertise on the CA ISO market monitoring process and to provide independent expert advice and recommendations to the CEO and Governing Board. The members of the MSC fall outside any internal CA ISO reporting relationships and have access to the same set of data that is available to DMA. Until recently (see discussion below), the MSC has been quite active in analyzing data and publishing reports. When possible given the content of the discussion, it traditionally has opened its meetings to the public and made itself available to receive comments, concerns and requests from market participants and other interested parties (as well as the Commission).

### ***CA ISO Comments***

The CA ISO agrees with the Audit's finding that the MSC's effectiveness has been weakened lately due to current vacancies. At the behest of the Board, management is in the final stages of screening additional candidates and anticipates that appointment(s) to the MSC will be made at an upcoming Board meeting. The CA ISO believes that once the MSC is again fully constituted, it will be in a position to meet



stakeholders' and the Commission's demand for "independent" (external) oversight of the CA ISO's markets.

### ***Findings Regarding Communication Between DMA and the Commission***

#### ***CA ISO Comments***

The CA ISO concurs with the Audit's finding that communications between DMA and Commission staff could benefit from a more formal structure. Currently, when DMA identifies an issue, it is not always clear to whom at the Commission the issue should be referred. Additionally, despite increased reporting obligations to the Commission in recent months, DMA has received few inquiries and very little feedback from Commission staff concerning its reports. DMA would appreciate, and the CA ISO recommends, the assignment of one or more Commission staff members to serve as a primary contact (or contacts) for receiving and responding to communications received from DMA staff. Additionally, DMA believes that the scheduling of regular conference calls and meetings among its members and Commission staff would be beneficial.

### ***Findings Regarding Regional Scope***

The Audit also finds that the scope and function of both the DMA and MSC should be reexamined to determine if the scope of market monitoring should be extended to the entire West.

#### ***CA ISO Comments***

The CA ISO supports this finding and recommendation. First, as was clearly evident from the 2000-2001 electricity crisis, the entire West functions as one market and effective monitoring and oversight requires analyzing the entire Western market. Second, the CA ISO has been engaged in active discussions with representatives of

RTO West, WestConnect, and other market participants regarding the appropriate level of West-wide market monitoring activities.

### ***Findings Regarding ISO Mission***

The Audit found that the CA ISO's mission statement fails to reflect an appropriate role for the CA ISO. Specifically, the Audit found that:

*The current mission of the CAISO does not meet the requirements of the current California energy markets. (Finding III-F17).*

The Audit stated that:

*With the arrival of the current Board of Governors, the mission of the California ISO was modified "to provide safe, reliable electric transmission services to all Californians within its control at the lowest reasonable cost." Put simply, while the role of a system operator should be to maintain reliability and to facilitate functional, competitive markets, the current California ISO mission statement, which emphasizes 'least cost,' smacks of command and control approach more akin to a regulatory body operating in a regulated industry than an independent system operator.*

Based on those findings and observations, the Audit recommended that:

*Modify the mission of the CAISO to reflect an appropriate role in the electric market of California and the west. The CAISO should have a broader and clearer vision. The previous vision's vague reference of reliability through markets does not clearly articulate the role of the CAISO in developing and maintaining a robust, transparent market for electricity. (Recommendation III-R5).*

### ***CA ISO Comments***

The CA ISO agrees to reexamine its mission statement and to identify modifications that may better reflect the CA ISO's role in the Western electricity market. The CA ISO believes, however, that cost considerations are appropriately reflected in the CA ISO's mission statement. The CA ISO is a public utility under the Federal Power Act and therefore functions within a public interest paradigm. In addition, the CA ISO, as a California not-for-profit

corporation, was created to foster a “public purpose”, with the additional requirements as a 501(c)(3) organization under federal law to “reduce the burdens of state government” and, thereby, has a legitimate role with respect to the efficient functioning of the electric markets and an obligation to create an environment that promotes just and reasonable prices.

### ***Findings and Recommendations Regarding Process and Culture***

The Audit made a number of findings with regard to the CA ISO’s internal and external processes. Specifically, the Audit found that:

*Operation of the California electric system and the associated markets has, in many cases, become an elaborate legal process rather than a business and electric utility operations process. (Finding III-F18);*

*The problems of the past two years have contributed to an internal culture within the CAISO that is not fully compatible with the effective execution of its mission. (Finding III-F19);*

*The CAISO’s relations with SCs are such that many would rather not do business with the CAISO, and those with a choice have indeed withdrawn. (Finding III-F20); and*

*The CAISO does not provide sufficient visibility and transparency with respect to much of its workings, including market decisions, operations and market analyses. (Finding III-F21).*

Based on these findings, the Audit recommended that the CA ISO:

*Implement specific management programs to change the culture and processes at the CAISO so that they address the needs of stakeholders. (Recommendation III-R6).*

*Improve communication between FERC and CAISO by increasing on-site presence and facilitation of communications with stakeholders. (Recommendation III-R7).*

*Establish formal procedures for following up on the findings and recommendations from the operational audits and other formal audits and reviews. (Recommendation IV-R1).*

*Conduct further analysis into the benchmarking data and develop specific action plans to address those areas of high cost (Recommendation IV-R2).*

*In concert with users and in coordination with overall corporate business plans, develop a formal strategic IT plan. (Recommendation IV-R3).*

### **CA ISO Comments**

As noted earlier in these comments, the electricity crisis of 2000-2001 and its aftermath has certainly lead to an erosion of trust between the CA ISO and its market participants. The CA ISO recognizes that there is a need to rebuild the relationship between the CA ISO and its customers. However, the fact that the CA ISO operations have become a “complex legal process”, as stated by the Audit, is more a consequence, or symptom, of the market failing than a flaw in the CA ISO’s processes. More than anything, the fact that market participants were not getting paid and that price signals and CA ISO operations were opaque, at best, are the reasons for the dissonance cited. However, that being said, the CA ISO clearly recognizes that better price and operational transparency will increase confidence in the CA ISO’s operating actions and instructions and remove the need for legal maneuvering on the dispatch floor. That is, the challenge for the CA ISO is to send more accurate and meaningful real-time price signals so that market participants will have confidence that the price signals established by the CA ISO are fully consistent with the operating instructions given by its operators. The CA ISO recognizes that, at times, the operating instructions given by the CA ISO are at odds with the price signals because of the state of the California market. The CA ISO believes that this disconnect is in part a consequence of

the CA ISO's complex market design, rules and mechanisms. The CA ISO is committed to resolving these issues as part of its MD02 effort.

In addition, in order to ensure clearer communications between the CA ISO and its market participants, the CA ISO has initiated the following activities:

- In the Fall of 2001, the CA ISO initiated visits with all major generators to improve communications and understanding of certain issues. Moreover, Market Operations personnel attended these meetings in order to further internal understanding of market participant issues;
- The CA ISO is establishing a more structured informal communications process with market participants. The purpose of this effort is to attempt to discuss compliance issues directly with generators (and to understand them better) before notifying FERC. This will be enhanced during 2002 with weekly discussions with generators regarding performance issues and market issues.
- As part of its MD02 stakeholder process, the CA ISO unveiled a new approach that it hopes will facilitate meaningful discussions with market participants. On January 14-17, the CA ISO sponsored four targeted meetings to allow stakeholders to review the Preliminary MD02 proposal. Targeted audiences included Load Serving Entities (LSEs), Generators and Marketers (G&M), Vertically-Integrated Utilities (VIUs) and Importers and Other Control Areas (I&OCA). Over 100 persons from about 75 organizations (in addition to CA ISO personnel) attended these meetings in person while another 120 participants from over 75 organizations participated by conference call. Participants included the targeted Focus Group market sectors as well as State regulatory personnel, State legislative staff and FERC staff. In addition, the CA ISO has received written comments from over 30 organizations.

The CA ISO is committed to undertaking a major initiative in 2002 to improve relationships and communications with stakeholders. As part of the CA ISO's annual customer satisfaction survey process, a specific action plan will be finalized by April 15, 2002. The CA ISO believes that the subject of culture change is one of better communication and mutual understanding.

With respect to the Audit recommendation that the CA ISO increase on-site facilitation by FERC, the CA ISO recognizes that stakeholders viewed the September 24-25, 2001 FERC technical workshop in Folsom as a constructive forum, and that the

commitment of FERC staff improved the understanding of certain contentious issues. Moreover, the CA ISO takes seriously the admonition of market participants to work with Commission staff to arrange similar sessions. The CA ISO agrees and will pursue such discussions with Commission staff. The CA ISO is concerned however that market participants not rely exclusively on these types of forums to address concerns and that they maintain an active dialogue with the CA ISO. The CA ISO recognizes that Commission staff's resources are limited and that their time is valuable.

The Audit recommends that the CA ISO implement more formal procedures to follow up on the findings and recommendations of formal operational and other audits. The CA ISO believes that such procedures are already informally in place. The CA ISO agrees to more formally codify in its procedures the process for ensuring that the results and recommendations of its established audits are addressed.

The Audit also recommends that the CA ISO conduct further benchmarking studies and analysis and to develop action plans to address areas of high cost. The CA ISO is in the process of conducting additional benchmarking analysis. The CA ISO regularly participates in coordinated benchmarking efforts among established ISOs and grid operators worldwide. While the CA ISO believes that these efforts are worthwhile, the CA ISO cautions that often direct comparisons are difficult, if not impossible, in light of the different functions/services that each organization provides. However, the CA ISO is extremely sensitive to the perception that it is a high-cost organization and continually implements efforts to address these legitimate cost concerns. As an organization, the CA ISO has identified cost reduction as a primary going-forward objective and has proposed to explicitly incorporate that goal into its corporate goals for

2002. Last year the organization was successful in saving approximately \$13 million from its projected budget.

Finally, the Audit recommends that the CA ISO develop, in concert with users, a formal IT strategic plan. As the Audit recognizes, the existing IS department has been reorganized to better align its services with the needs of the CA ISO's business units. As part of that reorganization, the IS department intends to develop a formal strategic plan by the end of the second quarter on this year.

### ***Findings Regarding Market Design Issues***

The Audit made a number of findings and recommendations regarding necessary reforms to the CA ISO's markets. The Audit found that:

*The operational and Market Issues identified [in the Audit] should be given careful consideration in efforts to redesign markets. (Finding IV-F31);*

*Comprehensive market reform is necessary to restore viable, transparent electricity markets in California. (Finding IV-F30);*

*To develop a viable comprehensive market reform, it will be necessary to first revitalize an effective stakeholder process. (Finding IV-F31);*

*There is broad agreement that CAISO would be better served if all LSEs were required to procure adequate capacity reserves. (Finding IV-F32); and*

*The structure of the current market design is overly complex and leads to many operational, communications and cost issues. (Finding IV-F33).*

The Audit stated that:

*There is broad support for the notion that market redesign is a high priority problem in California and is deserving of immediate attention. The efforts of the CAISO are, therefore, to be applauded, yet the success of the effort faces significant challenges. Consider the dysfunctional processes now in place for stakeholder input; the lack of trust and credibility in the CAISO by its stakeholders; continued disagreement on the fundamental principles of market design; the overwhelming complexity of the current design and the perception that any changes are merely band-aids that increase complexity even more; and legitimate questions on the roles of various*

*players. These challenges to the successful implementation of a new market design should not be underestimated. It is for this reason that we suggest that the market redesign, although of high priority, may nonetheless be somewhat premature. A stronger foundation needs to be in place before the sweeping changes needed in the design of the market can be effectively developed and implemented. This foundation must include the restoration of the CAISO's credibility, a renewed stakeholder process and agreement on fundamental design principles. To proceed with the proposed aggressive schedule without the proper foundation has a strong potential for stakeholders to feel as if the process has been forced on them. Their likely recourse will be a legal reaction, further delay, and another setback to re-establishing an effective stakeholder process and CAISO credibility. To the extent the aggressive schedule is driven by regulatory deadlines, reasonable extensions should be pursued which permit a reasonable stakeholder process.*

As a result of these findings and observations, the Audit recommended that the CA ISO should:

*Develop an approach to accomplish a comprehensive market reform that includes effective input from stakeholders. (Recommendation: IV-R10).*

### **CA ISO Comments**

The CA ISO generally agrees with the Audit's findings and recommendation. Most importantly, the CA ISO agrees that any market reform effort must be built upon a strong foundation and include effective input from stakeholders. While the Audit references the need for restoring CA ISO credibility and a renewed stakeholder process, with which the CA ISO agrees, the CA ISO also believes that more fundamental issues must first be resolved. As noted above, a comprehensive and highly-coordinated effort must be undertaken by state and federal policymakers to ensure that the fundamental failings – lack of generation, transmission and price responsive demand – are addressed. Only then can California's investor-owned utilities return to financial health. Finally, the Commission must ensure that adequate market power mitigation measures are in place throughout the transition to a stable market.



The CA ISO is concerned that too much emphasis has been placed on its own market redesign effort and that there has not been sufficient recognition that many parties must and will have a role in implementing necessary and effective reforms in the California electricity market. Therefore, the CA ISO agrees with the Audit's recommendation that reasonable extensions of regulatory deadlines may be necessary.

As noted above, the CA ISO has initiated a MD02 effort to redesign its markets. Many, if not all, of the findings and recommendations contained in the Audit have been incorporated into the MD02 effort and identified as goals. As part of the MD02 effort, the CA ISO will employ the new, more focused, stakeholder process and will shortly initiate other efforts to improve communication between the CA ISO and its stakeholders.

Moreover, the CA ISO has identified as an objective of its MD02 effort the need to simplify the CA ISO's markets and make them more transparent. As part of that effort, the CA ISO has examined practices and methods successfully used in other ISOs. The CA ISO also plans to address and fix certain of the market design flaws previously identified, but left unaddressed, that contributed to the recent crisis. Specifically, the CA ISO proposes to develop and implement a congestion management system that utilizes a full (detailed) network model and security-constrained economic dispatch with locational marginal pricing. The CA ISO believes that use of such a model and pricing will greatly enhance both market and operational transparency by revealing previously masked transmission congestion and reducing the need of operators to dispatch resources "out of sequence" to address such congestion. Finally, the CA ISO has included, as a critical feature of its draft market design proposal, a requirement for

load serving entities to procure and make available to the CA ISO adequate capacity (See Audit Finding IV-F32).

### ***Findings Regarding Generator Conduct***

The Audit found that the 2000-2001 electricity crisis not only damaged the perception of the CA ISO, but also found that other parties were equally affected.

Specifically, the Audit found that:

*Public perceptions have damaged the image of the generators and, therefore, the public's confidence in the market as a whole. (Finding IV-F34).*

The Audit stated that:

*In a mature industry, firms can make a great deal of money in times of scarcity or stress; indeed, scarcity pricing, driven by a shortage of supply and/or excess of demand, can provide the economic signal for new investment which can alleviate supply shortages over the long haul. Yet, in a mature industry, firms are also prudent enough to apply a degree of self-discipline. This line of thinking is prevalent on several levels. First, and most simply, it makes little sense to "kill the goose that lays the golden eggs" (and many would argue that is precisely what has happened in California). Second, the players, both consumers and otherwise, have a long memory. When offending firms need help in the future, they would like to get a sympathetic ear. And finally, all firms want a positive image with the public, recognizing that long-term success and a negative public image simply do not go together.*

The Audit recommended that the CA ISO:

*Pursue additional steps at FERC to prohibit generating companies from engaging in any anticompetitive behavior. (Recommendation IV-R11).*

### ***CA ISO Comments***

The CA ISO agrees with the Audit recommendation. The CA ISO firmly believes that a necessary and critical overlay to any market redesign effort is effective market power mitigation measures. As part of its Market Redesign 2002 effort, the CA ISO is placing primary emphasis on the identification and development of effective market power mitigation tools. As noted earlier in these comments, the CA ISO believes that

the Commission must ensure that adequate market power mitigation measures are in place at all times.

### ***Findings Regarding Public Power Issues***

The Audit included a number of findings with regard to public power participation in the CA ISO's markets.

*The public power sector, which represents a substantial amount of California supply, load, and transmission, should be an integral part of any industry design that purports to optimize California's resources. (Finding IV-F35).*

The Audit stated that:

*In past years, extensive discussions have taken place to accommodate public power as a part of the CAISO grid, but all have failed. Varying reasons for this failure have been offered, including private use restrictions, local control issues, turf and philosophical issues, load curtailment policies, and compensation for transmission. On balance, however, it appears that the economic incentive for broad municipal participation in the CAISO has simply not been there. It will be noted that other jurisdictions included within the western markets enjoy strong public power participation in their regional activities. This, combined with positive feedback from public power people, lends encouragement that a California solution can be found that will adequately compensate the municipals, protect their customers, and improve the overall effectiveness of California's electric system. In the meantime, the gulf between the CAISO and the municipals should be considered a serious flaw in the California system.*

Based on these findings, the Audit concluded that the CA ISO should:

*Re-initiate efforts in future market design to bring public power into the fold of an integrated California solution. (Recommendation IV-R12).*

### ***CA ISO Comments***

The CA ISO agrees with the Audit recommendation. First, the CA ISO notes that a number of municipal utilities, and governmental and federal agencies already participate in the CA ISO structure as Scheduling Coordinators, Participating Transmission Owners, Utility Distribution Companies, and

Participating Generators. However, from a market design perspective, the CA ISO recognizes the importance of designing a system that accommodates the needs of municipal customers, as well as all vertically integrated utilities. As part of its MD02 effort, the CA ISO has expressly adopted as an objective of that effort to create a menu of services that recognizes the unique requirements and needs of each of the CA ISO's customers. In addition, the CA ISO has already engaged the municipal utilities in discussions whose purpose is to develop a comprehensive proposal that will provide the municipals the "tools" they need to function as part of the CA ISO's markets.

### ***Findings and Recommendations Regarding Financial Stability***

The Audit made a number of findings regarding the financial state of the CA ISO, the IOUs and the market as a whole. Specifically, the Audit found that:

*Since the appointment of the current Board of Governors, the CAISO has not had a CA ISO Audit Committee in place, and there is currently no direct reporting mechanism between the Controller's office and the Board (Finding IV-F25);*

Based on these findings, the Audit concluded that the CA ISO should:

*Implement efforts to return the CA ISO to a creditworthy level (Recommendation IV-R4);*

*Support financial and creditworthiness restructuring activities vis-à-vis SCE (Recommendation IV-R5);*

*Implement a short term means for PG&E to return to creditworthiness (Recommendation IV-R6); and*

*Establish a direct reporting relationship between the Controller's office and the Board of Governors (Recommendation IV-R8).*

### ***CA ISO Comments***

The CA ISO agrees that the CA ISO's, PG&E's, and SCE's return to creditworthy status is a necessary predicate to restoring confidence in and stabilizing the market.

However, while the CA ISO is committed to expending every effort to contain its own costs and support the IOU's return to creditworthy status, the CA ISO does not believe that it can greatly influence or affect the outcome of this process. The CA ISO's ability to conduct its markets/operations is directly related to California Energy Resource Scheduling's (CERS) ability to fund or back IOU activities in the CA ISO markets.

It is unfortunate that the CA ISO, despite meeting all of its corporate and financial obligations in full and on-time throughout the crisis, has been subject to the same compromised credit rating impact as the defaulting IOUs. On a long-term basis, however, the CA ISO's creditworthiness is directly tied to that of the IOUs. Thus, re-establishment of the long-term creditworthiness of the IOUs is an essential step for the CA ISO to again be viewed as creditworthy. The CA ISO can and will work with all parties, including the financial agencies, to develop and maintain long-term liquidity in the California electrical markets.

In addition, while it is important to focus on the return of the IOUs to financial health, the CA ISO believes that going forward, it is necessary to ensure that the new market structure never exposes large quantities of load to the volatility of spot market electricity prices. Moreover, the CA ISO has also begun to explore the use of higher credit standards and increased use of security deposits as measures to ensure creditworthiness in the CA ISO's markets.

Although the Controller presents information at each monthly Board meeting, the CA ISO acknowledges that a more formal process should be established between the Controller and the Board. However, the CA ISO notes that the findings indicate that all required audits were completed under the current Board.

## ***Findings and Recommendations Regarding CA ISO Settlements***

Based on market participants concerns regarding the complexity of the CA ISO's settlements system, the Audit made the following findings:

*The volume of transactions has resulted in a higher level of staffing for client services, including the settlement function, than at other ISOs. (Finding IV-F20);*

*Manual settlement transactions add a level of vulnerability to the settlement process. (Finding IV-F21).*

Based on these findings, the Audit concluded that the CA ISO should:

*Simplify the settlements process as part of an overall market redesign. (Recommendation IV-R7).*

*Enhance control over off-line calculations in the settlements process. (Recommendation IV-R9).*

### ***CA ISO Comments***

The CA ISO believes that the findings of the Audit are, for the most part, valid and correct and that the recommendations are appropriate. A primary objective of the CA ISO's MD02 effort is to make the markets more predictable and transparent and thereby provide transparency to the settlement process. The CA ISO believes that by increasing both price and operational transparency as part of its MD02 effort, the CA ISO will eliminate certain of the confusion and concern over CA ISO operations and settlements.

The CA ISO is unclear as to what is meant by the statements attributed to participants that the CA ISO "refuse(s) to share metrics." Other statements in the Audit allege that the CA ISO continuously changes its rules, that changes are implemented too fast and retroactively, without publication. The CA ISO is concerned about these

statements. The CA ISO generally notifies the market, via a market notice, in advance of bringing settlement changes into production.

In terms of the number of manual workarounds, the CA ISO has already begun to address that issue by following the recommendation of the CA ISO's SAS 70 audit to put additional controls on our manual work-arounds. Further, two teams have been established to study settlements simplification, one as part of the MD02 effort and another reviewing the current settlements operation. Both of the settlements simplification efforts are designed to work in concert with the market redesign to identify areas where the market design creates settlement complexity and to determine if the complexity is necessary. Furthermore, there is approved capital in the 2002 budget to automate manual work-arounds, which should serve to reduce the "level of vulnerability to the settlement process." Finally, it should be noted that while the CA ISO can and will take steps to significantly reduce the number of manual workarounds, manual workarounds are a necessary consequence of unanticipated changes in design, or to accommodate the requirements of entities within California that are not part of the system under the CA ISO's control.

### **Conclusion**

The CA ISO acknowledges and appreciates the tremendous effort and resources expended by the Commission and its staff over the past several years in addressing matters regarding the California energy market. Without question there is much work still to be done – both to address the issues raised in the Audit and, more importantly, to address the root causes of the recent crisis. The CA ISO firmly believes that if those efforts are to be successful, the Commission must quickly establish a deliberate plan of

action and schedule that systematically addresses the core deficiencies of the California market. Of equal importance, the Commission must ensure that fail-safe market power mitigation measures are in place in the California market until there is a demonstrably competitive market. The CA ISO beseeches all parties to work together to forge a partnership built upon trust and the belief that we are all working towards a common vision – that of an electricity market that delivers dependable and affordable power for all consumers. The CA ISO accepts that challenge and stands ready to do its part. The CA ISO appeals to the Commission for continued leadership on this most Herculean endeavor.

Respectfully submitted by:

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Terry M. Winter  
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151 Blue Ravine Road  
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(916) 608-7147

Dated: February 15, 2002





February 15, 2002

The Honorable Magalie Roman Salas  
Secretary  
Federal Energy Regulatory Commission  
888 First Street, N.E.  
Washington, DC 20426

**Re: Operational Audit of the California Independent System Operator  
Corporation  
Docket No. PA02-1-000**

Dear Secretary Salas:

Enclosed for electronic filing please find The California Independent System Operator Corporation's Comments on the Commission's Operational Audit of the CA ISO in the above-captioned docket.

Thank you for your assistance in this matter.

Respectfully submitted,

Margaret A. Rostker  
Counsel for The California Independent  
System Operator Corporation  
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## **CERTIFICATE OF SERVICE**

I hereby certify that I have this day served the California Independent System Operator Corporation's Comments on the Commission's Operational Audit of the CA ISO upon each person designated on the official service list compiled by the Secretary in the above-captioned dockets.

Dated at Folsom, California, on this 15<sup>th</sup> day of February, 2002.

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