

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

California Independent System Operator Corporation)	Docket No. ER02-1656-000
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Investigation of Wholesale Rates of Public Utility Sellers of Energy and Ancillary Services in the Western Systems Coordinating Council)	Docket No. EL01-68-017
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**EMERGENCY REQUEST FOR REHEARING AND MOTION FOR
CLARIFICATION OF THE CALIFORNIA INDEPENDENT SYSTEM
OPERATOR CORPORATION**

Pursuant to section 313(a) of the Federal Power Act, 16 U.S. C. 825l (a), and Rule 713 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (“Commission”), 18 C.F. R. 385.713, the California Independent System Operator Corporation (“CAISO”) hereby requests that the Commission grant rehearing and clarification of its “Order On Rehearing And Compliance Filing” issued on October 11, 2002 (“October 11 Order”). Because the Commission’s October 11 Order has serious ramifications for the rational and effective implementation of the CAISO’s Market Design 2002 (“MD02”) proposal, the CAISO hereby requests that the Commission expeditiously reconsider and vacate its directive that the CAISO implement Phase II Lite by January 31, 2003. In addition, the CAISO requests that the Commissions grant the other rehearing requests and clarifications sought herein.

In support hereof, the CAISO respectfully states as follows:

I. BACKGROUND

A. MD02 Filing

On May 1, 2002, the CAISO filed its comprehensive market redesign proposal (“MD02 Filing”) with the Commission. The CAISO proposed to implement the MD02 proposal in three phases. Phase I, with a proposed effective date of October 1, 2002, included market power mitigation measures designed to prevent physical and economic withholding, an interim residual unit commitment (“RUC”) process, a method to clear the Price Overlap and create a single real-time energy price, and penalties for uninstructed deviations. Phase II, which had an estimated target date of Spring 2003, included, *inter alia*, implementation of an integrated forward market (“IFM”). The ISO’s Phase II IFM proposal involved elimination of the market separation rule and balanced Schedule requirement in conjunction with implementation of simultaneous Congestion Management, Energy market, Ancillary Services procurement and unit commitment on a zonal basis. Phase III, which had an estimated target effective date of Fall 2003, provided for implementation of the full network model, redesigned firm transmission rights (“FTRs”), a resource adequacy obligation for Load Serving Entities (“LSEs”), and an integrated Congestion Management, Energy, Ancillary Services and Unit Commitment Market based on nodal prices developed through locational marginal pricing (“LMP”).

In the MD02 Filing, the CAISO requested that the Commission issue an order by July 1, 2002 accepting the Tariff provisions for the Phase I elements and

granting preliminary conceptual approval of the Phases II and III elements. The CAISO indicated that conceptual approval of the long-term elements by July 1, 2002 was imperative because Phases II and III required extensive software and systems development and testing. The CAISO indicated in its MD02 Filing that it would need a lead-time of approximately 12-18 months to procure, install and adequately test and provide training on the new software and systems before they become fully operational.

B. The July 17 Order And The CAISO's August 16 Request For Rehearing

On July 17, 2002, the Commission issued its "Order on the California Comprehensive Market Design Proposal" ("July 17 Order"). In its July 17 Order, the Commission, *inter alia*, approved, subject to modification, the CAISO's proposed Automatic Mitigation Procedures ("AMP") and penalties for uninstructed deviations and directed the CAISO to expedite implementation of the integrated Day-Ahead Market, Ancillary Services market reforms and proposed reforms to the Hour-Ahead and Real-Time markets.¹ Specifically, the Commission directed the CAISO to implement the Phase II IFM reforms by January 1, 2003 and make a Tariff filing on October 21, 2002 setting forth the CAISO's proposed Phase II market reforms.² The Commission also established technical conferences to address the specifics of the long-term MD02 elements in the July 17 Order.

¹ The Commission also approved the CAISO's proposal to implement software that contains an economic dispatch algorithm to clear continuously overlapping Real-Time Energy bids so that there will be a sin

² The Commission did not approve the CAISO's Phase II proposal in its July 17 Order.

On August 16, 2002, the ISO filed a request for rehearing of the July 17 Order in which the ISO requested, among other things, that the Commission grant rehearing of its requirement that the ISO implement the integrated Day-Ahead market and other Phase II market reforms by January 1, 2003. The CAISO argued that, given the fact that the Phase II market design was not finalized (because it was subject to modification as a result of the Commission-imposed stakeholder process and still required Commission approval), and because of the significant number and extent of the changes to the CAISO's and market participants' software and systems and the scope of testing that must be undertaken to ensure proper functioning, a more prudent and rational approach would be to implement the aforementioned Phase II elements by May 1, 2003.³

C. MD02 Technical Conference Process

Pursuant to the July 17 Order, the Commission Staff convened a technical conference in San Francisco on August 13-15, 2002. Issues discussed at the MD02 Technical Conference included, *inter alia*, implementation of the MD02 Phases II and III proposals. At the MDO2 Technical Conference, the CAISO described the different stages of its MD02 implementation plan and set forth an estimated timeline for implementing the integrated Day-Ahead market and other Phase II market reforms. The parties spent a significant amount of time discussing the appropriate timeline for implementing the Phases II and III proposals and the specific market design elements that might be implemented in each Phase. The CAISO was instructed to determine if it could accelerate the

³ On August 16 and 21, 2002, the CAISO made Tariff filings in compliance with the July 17 Order. The compliance filings reflected the Commission-approved modifications to the CAISO's Phase I proposal.

implementation of some of the Phase II elements. At the end of the MD02 conference, the Commission Staff directed (1) intervenors to file comments regarding the CAISO's implementation proposal and the technical conference process going forward by August 23, 2002 and (2) the ISO to file reply comments by August 27, 2002.

The CAISO filed Reply Comments on August 27, 2002. In its Reply Comments, the CAISO contended that the Phase II implementation timeline originally proposed in the CAISO's May 1, 2002 MD02 filing and the August 16, 2002 request for rehearing was preferable to either accelerated or delayed implementation of Phase II. The CAISO noted that the implementation timeline proposed in its MD02 filing struck the proper balance between (1) moving forward quickly and moving forward carefully, (2) the desire to correct existing market inefficiencies and resolve certain operational problems before Summer 2003, and (3) the desire to minimize the number of times that the CAISO would implement new software modifications so as to accommodate market participants' concerns about having to make changes to their software systems. The CAISO acknowledged, however, that this May 2003 timeline for Phase II would not allow for a complete and deliberative stakeholder process.

In response to the queries of certain market participants whether the CAISO could accelerate implementation of any of the Phase II elements, and at the direction of the Commission's Staff, the CAISO indicated that, from a purely technical perspective, the CAISO possibly could implement an hourly, Day-Ahead energy market on a zonal basis (by eliminating the balanced schedule

requirement and the market separation rule) and move the Hour-Ahead market closer to real time (hereinafter referred to as the “Phase II Lite elements”) by January 31, 2003. However, the CAISO expressly stated that it had not had sufficient time to identify and analyze thoroughly all potential adverse impacts of implementing a Phase II Lite proposal. Further, as recognized by the Commission in the October 11 Order (at ¶ 83), the CAISO did not advocate implementation of a Phase II Lite because, among other reasons, Phase II Lite would not address all of the CAISO’s operational concerns for the Summer of 2003 and would not alleviate the CAISO’s and the market participants’ concerns about implementing two significant market design and software changes in the same year. Specifically, the CAISO indicated that Phase II Lite would not resolve all of the CAISO’s operational concerns because, given the implementation timeline, it would only entail a simple hour-by-hour energy clearing market and congestion management procedure, rather than the 24-hour optimization that would be implemented in the full Phase II. The CAISO identified numerous disadvantages associated with running 24 separate hourly markets (instead of a 24-hour optimization). These problems included, *inter alia*, an inability to provide for inter-hour ramping schedules, failure to accommodate the operating constraints of resources and the lack of a rational mechanism for committing units. Because all of the potential problems associated with Phase II Lite had not been fully identified and explored, the CAISO expressed concern that Phase II Lite would create additional problems for Real Time operators.

The CAISO also noted in its Reply Comments that stakeholders had identified a number of “issues fundamental to Phase II Lite”, and such issues had not yet been resolved. The CAISO indicated that such issues would have to be resolved “immediately” in order for the CAISO to have any possibility of meeting a January 31, 2003 implementation date and to allow adequate time for the CAISO to design, specify, procure and test the new systems and train ISO operations and market participant personnel. The CAISO stated that “it would be next to impossible to resolve the open issues in a timely manner through a deliberative process that provides all concerned parties with a meaningful opportunity to participate and vet the issues fully.”

On September 20, 2002, the CAISO filed “Supplemental Comments Regarding The Market Design 2002 Proposal Implementation Schedule.” In its Supplemental Comments, the CAISO indicated that it would support deferral of Phase II implementation until Fall of 2003 provided that certain operating requirements were satisfied prior to Summer of 2003, *i.e.*, mechanisms were in place that would ensure feasible inter-hour ramping schedules, accommodate resources’ technical constraints and permit the forward commitment of resources. The CAISO acknowledged that deferral of Phase II would (1) allow for a sufficiently deliberative and meaningful stakeholder process whereby Phase II design issues could be fully vetted and possibly resolved, (2) allow the CAISO to issue a Request For Bids (“RFB”) for the Phase II elements of the MD02 proposal, and (3) permit adequate CAISO and Market Participant testing of the new market design elements. The CAISO proposed that under such a schedule,

the CAISO might be able to implement Phase II by October 1, 2003 and LMP in January 2004.

D. The October 11, 2002 Order

In its October 11 Order, the Commission issued a number of new directives and provided several clarifications of its July 17 Order. The Commission reversed its decision in the July 17 Order and found that AMP should not apply to imports, and imports must bid \$0/MWh and be price takers. *Id.* at ¶ 20. In response to complaints by suppliers that AMP might not permit them to recover their costs, the Commission stated that suppliers should seek CAISO consent to enter into Reliability Must-Run (“RMR”) contracts under such circumstances. *Id.* at ¶ 36. The Commission also accepted the CAISO’s proposal to delay implementing clearance of the price overlap using Real-Time economic dispatch until the CAISO completes the software improvements necessary for implementation of the uninstructed deviation penalties. *Id.* at ¶ 68. The Commission also ruled that the CAISO should implement Phase II Lite by January 31, 2003, and stated that the CAISO should defer the implementation of the remainder of Phase II until implementation of Phase III in the Fall of 2003. *Id.* at ¶ 85.

II. GROUNDS FOR REHEARING AND SPECIFICATIONS OF ERROR

The CAISO submits that the Commission erred in making the following determinations in its October 11 Order:

- (1) Phase II Lite should be implemented effective January 31, 2002
and the CAISO should implement the remainder of Phase II and all
of Phase III in the Fall of 2003;
- (2) Imports must bid \$0/MWh; and
- (3) Suppliers can enter into RMR contracts if they believe that AMP will
not permit them to recover their costs.

The CAISO will discuss these issues *seriatim*. The CAISO requests that the Commission grant the instant request for rehearing and vacate the foregoing determinations consistent with the discussion below. The CAISO also requests that the Commission grant the requested clarifications of its October 11 Order.

A. The Commission Should Vacate Its Directive That The CAISO Implement Phase II Lite By January 31, 2003

1. The Commission Should Not Require The CAISO To Implement Phase II Lite

In its October 11 Order, the Commission found reasonable the CAISO's "proposal" to implement Phase II Lite by January 31, 2003. October 11 Order at ¶ 85. The Commission also accepted the postponement of the remaining Phase II elements until implementation of Phase III in the Fall of 2003. *Id.*

The CAISO notes that the MD02 comprehensive market redesign proposal filed on May 1, 2002 did not contain a Phase II Lite. As part of Phase II of its MD02 proposal, the CAISO proposed to establish an integrated Day-Ahead market and replace the existing sequential Congestion Management and Ancillary Services procurement processes with a simultaneous process that procured Energy and Ancillary Services and performed Congestion Management

– a process referred to as the integrated forward market (“IFM”). The CAISO proposed relaxation of the market separation rule and elimination of the balanced schedule requirement as two components of the IFM. The CAISO did not propose – and did not contemplate – implementation of these two elements of the comprehensive IFM proposal on a stand-alone basis.

At the August 13-15, 2002 MD02 Technical Conference, market participants’ questioned whether the CAISO could accelerate any of the proposed Phase II elements, and the Commission Staff requested that the CAISO address the issue. As indicated above, on short notice, and without having fully analyzed the concept internally, the CAISO “floated” Phase II Lite as a “trial” concept in its August 27, 2002 Reply Comments. The CAISO stated that, from a purely technical perspective, it might be able to implement Phase II Lite by January 31, 2003. While speculating that it could possibly implement Phase II Lite by January 31, 2003, the CAISO strongly discouraged the idea of implementing Phase II Lite, noting the following: (1) a January 31, 2003 implementation date would not allow any opportunity for a stakeholder process to resolve issues, and the design of Phase II Lite would have to be set “immediately”; (2) Phase II Lite would require two major market structure changes and corresponding software systems changes in the same year, a result opposed by many market participants; and (3) Phase II Lite would be a sub-optimal Day-Ahead market that would not address, and might exacerbate, the problem of infeasible inter-hour Schedule changes. Reply Comments at 7. The CAISO also indicated that Phase II Lite was merely a concept, and the CAISO

had not had sufficient time to design a well-thought-through Phase II Lite and identify and analyze thoroughly all of the potential adverse impacts associated with implementation of Phase II Lite.

Because the CAISO did not propose implementing Phase II Lite as a stand-alone proposal in its MD02 Filing, in order to implement Phase II Lite, the CAISO would need to design the Phase II Lite elements from “scratch” as a stand-alone proposal, evaluate all of the requirements for and ramifications of a Phase II Lite, and then draft and file tariff language. The CAISO cannot simply cull the Phase II Lite elements from the Phase II IFM proposal and immediately construct a simple Day-Ahead market. Rather, the Phase II Lite elements, as briefly laid out in the October 11 Order, were part and parcel of the IFM. While the software modifications necessary to eliminate the balanced Schedule requirement and market separation rule by themselves may be modest, the resulting effects on the CAISO’s settlements systems are significant. If the balanced Schedule requirement and market separation rule are eliminated, the CAISO will have to create a brand new settlements process to settle the forward energy market, an element that the CAISO heretofore has never had to settle. The changes to the CAISO settlements systems needed for Phase II Lite energy settlement constitute a large part the changes needed to implement energy settlement in the full Phase II.⁴

In addition to these significant settlements systems changes, a number of Phase II Lite issues and operational concerns have yet to be fully addressed.

⁴ Thus, as with the originally proposed Phase II IFM, it would be more efficient for the CAISO will have to design a Phase II Lite forward energy settlement from “scratch” so that it can be carried forward for Phase II IFM, rather than creating a throw away settlement change.

These include, but are not limited to, the following: (1) inter-hour schedule feasibility; (2) acknowledgement of generator ramping rates; (3) whether to retain the hour-ahead market; (4) whether and how to protect bilateral schedules in the new Energy market; (5) whether the new market should allow purely financial supply and demand bids; (6) how to address the exacerbation of local market power in generation pockets; (7) application of AMP to the day-ahead market; and (8) how to accommodate use-limited supply resources.

The CAISO acknowledges that it had not examined thoroughly the feasibility of implementing Phase II Lite by January 31, 2003 when it submitted its Reply Comments.⁵ For example, the CAISO did not (1) have a commitment from a vendor as to when the necessary software and systems modifications could be delivered and (2) fully develop a project schedule that would provide for a commercially prudent implementation schedule with sufficient testing (in particular joint testing with market participants). Accordingly, the Commission took action in the October 11 Order based on a record that was inaccurate and incomplete. The CAISO takes full responsibility for this.

Subsequent to the October 11 Order, the CAISO has expended significant effort to examine the feasibility of implementing Phase II Lite. The CAISO has examined the issues, identified potential problems with and the design elements that might be a part of Phase II Lite, and developed a feasible (yet aggressive by industry standards) implementation schedule (which implementation schedule is

⁵ In attempting to remedy deficiencies in the CAISO's markets and create a foundation for future investment in California's energy infrastructure in an expeditious manner, the CAISO has proposed extremely aggressive timelines for implementing many of the market redesign features. Many of these proposed implementation dates did not reflect a "best practices" approach to system design and testing.

set forth in Section II.A.2 below).⁶ Based on the CAISO's analysis, the CAISO has concluded that it would be impossible to implement Phase II Lite by January 31, 2003. Under the implementation schedule developed by the CAISO, Phase II Lite cannot be implemented prior to the Summer of 2003.

Given the significant problems associated with Phase II Lite – which are discussed in detail below – the CAISO is seeking rehearing of the Commission's directive that the CAISO implement Phase II Lite. The CAISO respectfully requests that the Commission promptly address this rehearing request because of the significant impact that Phase II Lite will have on the CAISO's MD02 implementation process. For example, in the October 11 Order, the Commission directs the CAISO to implement Phase II Lite, but the Commission also indicates that the CAISO should implement Phase II in the Fall of 2003. The CAISO probably cannot implement Phase II in the Fall of 2003 if it is required to implement Phase II Lite. Thus, the CAISO is in somewhat of a quandary. At this time, the CAISO is not proceeding further with Phase II Lite implementation until it gets clearer direction from the Commission regarding implementation of the MD02 long-term market design elements. To that end, on October 29, 2002, the CAISO filed a "Request For Technical Conference Regarding The Market Design 2002 Proposal Implementation Plan and Schedule and Discussion Of Related Western Market Design And Implementation Issues". The CAISO again urges

⁶ Keenly aware of the Commission's and certain market participants' desire for a Day-Ahead market, the CAISO even explored the idea of outsourcing the operation of a simple Day-Ahead market to a third party pending implementation of the IFM. The CAISO stopped pursuing this idea because (1) it would still require significant CAISO oversight and the dedication of CAISO Staff resources, (2) such a Day-Ahead market would not technically be in compliance with the directives of the October 11 Order, and (3) potential cost issues.

the Commission to schedule a technical conference so that the CAISO can discuss the MD02 implementation process and the hurdles that it is currently facing, as well as provide the Commission with a record pursuant to which the Commission can approve a measured, cost-effective and rational MD02 implementation schedule that provides sufficient time for design, coordination, system integration and testing.

For the reasons set forth below, the CAISO submits that, on rehearing, the Commission should vacate the requirement that the CAISO implement Phase II Lite. As discussed in greater detail below, Phase II Lite is inconsistent with the rational, integrated approach that the CAISO had proposed and is pursuing with respect to MD02 market redesign. In that regard, the CAISO initiated the MD02 process to take a comprehensive view of the changes needed in the structure of California's electricity markets and develop an integrated program of proposed market design changes that would address existing deficiencies in a systematic fashion and create a framework for a sustainable, workably competitive electricity infrastructure in California. The long-term market redesign elements have received a full vetting both internally at the CAISO (and continue to be reviewed and refined as required) and with stakeholders through the working group process that has been established. With respect to the infrastructure necessary to implement MD02, the CAISO intends to construct a new comprehensive open software architecture that will accommodate the development and deployment of new market functions in a manner that conforms with accepted and emerging industry standards. The architecture that the CAISO would utilize in connection

with MD02 generally is consistent with the guidelines for software design set forth by the Commission in its Standard Market Design (“SMD”) “ Notice of Proposed Rulemaking”. See “*Notice of Proposed Rulemaking*”, Docket No. RM01-12-000 at ¶¶ 351-58 (July 31, 2002). This comprehensive, integrated approach should help to minimize the number of problems that arise in the future and enable the CAISO to implement the new market design both efficiently and effectively.

On the other hand, Phase II Lite constitutes a piecemeal approach to market design that represents a significant “detour” from the CAISO’s rational market redesign process and detracts from the CAISO’s efforts to implement the MD02 long-term market redesign in a rational and efficient manner. If the Commission does not vacate its directive regarding Phase II Lite, the CAISO will be forced to hastily design a sub-optimal Day-Ahead market without having the opportunity to analyze thoroughly all design issues and vet such issues in a meaningful and deliberative stakeholder process. Further, to implement Phase II Lite quickly, the CAISO would be required to add this functionality to the CAISO’s existing outdated and proprietary systems which will not be used as the future platform to implement the MD02 long-term market redesign elements. In other words, the Commission is essentially asking the CAISO to add a room to a dilapidated, condemned house when the CAISO is already in the process of constructing a new house into which the CAISO will move – a house being built according to the Commission’s own proposed SMD blueprint.⁷ This is not consistent with the Commission’s prior (and appropriate) reasoning regarding the

⁷ In addition, the CAISO settlements system will require modifications that are independent from market systems in order to settle a forward energy market. This function is not currently in place.

implementation of piecemeal market design changes. In that regard, earlier this year, the Commission rejected certain CAISO market design changes on the grounds that “another piecemeal approach presented in isolation from other respects of the California market design is [not] just and reasonable.” *California Independent System Operator Corporation*, 98 FERC ¶ 61,327 (1992). Yet that is exactly what the Commission is doing here by ordering the CAISO to implement Phase II Lite. The Commission should follow its prior guidance and not require the CAISO to implement a piecemeal, temporary element of market functionality such as Phase II Lite. The short cuts and lack of an opportunity for meaningful consideration inevitably could lead to mistakes, design flaws and higher costs for consumers. As the Commission is well aware, the CAISO market has already been hounded by design flaws. The Commission should not require the CAISO to proceed down a path that could create additional problems.

The CAISO’s specific objections to Phase II Lite are set forth below. First, a significant portion of the work necessary to implement Phase II Lite – modifications to the Scheduling Applications Congestion management software (“SA CONG”) -- are “throwaway”, *i.e.*, the CAISO will not continue to utilize that software when the CAISO implements the full IFM because the CAISO will be developing new open modular systems on which to implement the long-term market design. In other words, the CAISO would be spending a significant amount of money for modifications to systems that are not compatible with common architecture and design standards and which will be scrapped once the

IFM is implemented.⁸ This runs afoul of the Commission’s requirement that the CAISO’s software “must be able to accommodate change” for evolving wholesale markets.⁹ October 11 Order at ¶ 49.

Second, the CAISO estimates that the modifications to its existing system necessary to implement Phase II Lite will cost several hundred thousand dollars. Further, if the CAISO is required to expedite implementation of Phase II Lite (and because of the “closed” proprietary nature of the CAISO’s existing software systems), the CAISO would have to “sole source” the project to the CAISO’s existing vendor (as opposed to bidding out the project). This runs counter to the CAISO’s long-term objective of following “best practices” procurement procedures and could result in increased costs. As the Commission will recall, the CAISO was required to implement its markets through these single-vendor, closed systems at start-up in 1998 in order to meet aggressive in-service timelines driven by external expectations, not by rational business practices. Since then, the limitations of the CAISO’s systems and the problems associated with implementing changes to such systems have been an

⁸ Phase II Lite increases the risks associated with the Commission-approved, MD02 Phase 1B (implementation of uninstructed deviation penalties and clearance of the price overlap) because Phase 1B is being implemented on the new, more open architecture/platform; whereas, Phase II Lite is utilizing the old proprietary platform.

⁹ The Commission noted in the October 11 Order that its Standard Market Design proposes modular software development, *i.e.*, the ability to change software modules without changing other software or the entire program. October 11 Order at n. 18. The Commission stated that through “this type of flexible software development, [it] can allow the initial expenditure of funds [by the CAISO] on software development and the CAISO can implement Commission-approved changes to the market design at a later time without completely revising the software. *Id.* By requiring the CAISO to expend funds on software for Phase II Lite that cannot be used or built upon in the future, the Commission is violating its own directives in the October 11 Order.

ongoing concern for the CAISO, the Commission and market participants.¹⁰

Such mistakes must not be repeated.

Third, requiring the CAISO to implement Phase II Lite would divert limited CAISO Staff resources away from implementation of MD02 Phases 1B, II and III. The CAISO has already dedicated Staff to implementation of these MD02 phases and developed an implementation schedule for each of the phases. If the CAISO is required to implement Phase II Lite, the CAISO would have to remove Staff from the MD02 Phases 1B, II and III implementation teams and assign them to Phase II Lite implementation. Thus, if CAISO Staff are required to dedicate their efforts to Phase II Lite implementation, there would be a resulting several month delay in the CAISO's implementation schedule for the long-term market redesign elements, including the full IFM and LMP. In other words, if the CAISO is required to implement Phase II Lite, it will not be able to implement the Phase II IFM in a prudent manner until some time in 2004.

Fourth, Phase II Lite is a sub-optimal Day-Ahead market that could exacerbate certain operational and market power problems for the CAISO. For example, a simple Phase II Lite would not provide for feasible inter-hour ramping schedules because each hour would be cleared independently of all others, as opposed to the 24-hour optimization that exists under the full IFM (*i.e.*, it could create an hourly Schedule which a generator cannot meet because it would

¹⁰ For example, in the CAISO's July 10, 2001 compliance filing to the Commission's June 19, 2001 "Order on Rehearing of Monitoring and Mitigation Plan for the California Wholesale Electric Markets, Establishing West-Wide Mitigation, and Establishing Settlement Conference", 95 FERC ¶61,418 (2001), the CAISO indicated that proxy prices must be implemented an hour at a time because the CAISO's software systems only allow one set of bids (either market or proxy) to be used in a single hour.

require too great a ramp from the previous hour). Further, a simple Phase II Lite would not address the concern about accommodating the technical constraints of resources, such as energy and emissions limitations and minimum run times. Thus, Phase II Lite Day-Ahead schedules might not be a reliable predictor of actual Real-Time energy flows.

Fifth, a non-integrated forward market would make it much easier for suppliers to exercise local market power via the “DEC” game because all they will have to do in order to over-schedule is bid into the forward market as a price-taker, collect the forward market MCP, and then be paid to back down in Real Time, thereby further exacerbating a known deficiency in the CAISO’s existing market design. To play the DEC game effectively under the current market design, a supplier must secure a forward market position through the more arduous process of negotiating a balanced bilateral schedule. Without adequate mitigation to address the DEC game, Phase II Lite will make playing the DEC game an effortless and no-risk process. Adequate mitigation measures must be implemented in order to address the “DEC” game under these circumstances.

In addition, as part of Phase II of the MD02 Filing, the CAISO included AMP provisions to address system-wide market power in the forward markets. To ensure adequate market power protection, Phase II Lite would need to include an AMP process.

Each of the aforementioned problems would need to be addressed in order to ensure that a Phase II Lite market operates effectively and efficiently and does not exacerbate operational problems and market power concerns.

Moreover, as indicated above, the CAISO has not had the opportunity to evaluate thoroughly all of the potential problems that might result from Phase II Lite. Accordingly, the possibility exists that other problems could arise from implementation of Phase II Lite.

Sixth, it is uncertain that load will actively participate in the market. In that regard, California's three investor owned utilities ("IOUs") will inherit the CERS long-term contracts effective January 1, 2003. These contracts cover a large portion of the IOUs' net short. Under these circumstances, it is not clear how liquid a Phase II Lite market will be. Further, because two of the three IOUs are still not creditworthy, it is unclear to what extent they will be able to participate in a Day-Ahead market. It is the CAISO's understanding that the Automated Power Exchange ("APX") previously explored the idea of implementing a forward market in California but did not proceed with it because there was no guarantee of market volumes to make it commercially feasible. The CAISO will expend significant monies and Staff resources to implement Phase II Lite. If load does not participate, such expenditures will be in vain.

Finally, even if the CAISO were to follow a reasonably aggressive schedule for implementing Phase II Lite --a schedule that would not follow all of the "best practices"¹¹ procedures --it would not be feasible for the CAISO to implement Phase II Lite before the Summer of 2003. The CAISO is providing its schedule for Phase II Lite implementation *infra* in Section II.A.2. As discussed in greater detail below, and dependent on certain factors identified in

¹¹ "Best practices" means a commercially acceptable, thorough and deliberate process for the Initiation, Elaboration, Construction and Implementation of new software systems to ensure the maximum likelihood of success and to minimize the risks to the market.

such discussion, the CAISO likely would not be able to implement Phase II Lite until the late Summer or Fall of 2003.¹² However, following the commercially acceptable “best practices” procedures that the CAISO has established for implementation of the long-term elements of the MD02 market design (which procedures also are set forth in Section II.A.2), the CAISO anticipates that it would be able to implement the full IFM sometime in the Fall of 2003 or the first quarter of 2004 (assuming that the CAISO does not have to implement Phase II Lite which would result in additional delays).¹³ The estimated timelines for implementation of both Phase II Lite and Phase II are based on the following assumptions: (1) timely processing of the CAISO’s Tariff filings and issuance of orders by the Commission; (2) complete approval of all of the substantive elements of the CAISO’s filings; and (3) an estimate of the amount of time that it will take for the vendor to deliver the necessary software/systems, which estimate is based on the CAISO’s experience and general industry practice.¹⁴ One variable in the Phase II Lite and Phase II timelines that is completely outside

¹² The CAISO submits that it would not be prudent for the CAISO to implement significant software and systems modifications during the Summer. Historically, the CAISO has avoided implementing major market changes and software/systems modifications during the Summer to avoid potential system unavailability during the peak season and the adverse impacts that would have.

¹³ The CAISO can only estimate a timeline for implementation of Phase II because, *inter alia*, the CAISO has not yet issued a Phase II RFP and, as such, does not have commitments from vendors as to the amount of time it would take to develop and deliver the necessary software/systems. Further, the stakeholder process is ongoing, and the Commission has not finally approved the Phase II market design. Following the procedures that the CAISO has established for implementation of the long-term MD02 elements, and assuming reasonable software/systems development timelines and timely processing and approval of the CAISO’s proposal, the CAISO anticipates that it will not be able to implement Phase III until some time in 2004.

¹⁴ Modifications of substantive elements of the design could impact the scope, schedule and cost of implementation. The CAISO would need to evaluate the modification to determine the specific impact that it would have.

of the CAISO's control is the **actual** amount of time that the vendor will need to develop the necessary software and systems.

It simply does not make sense for the CAISO to expend significant resources and funds to implement a temporary and piecemeal market design that might only be in effect for a few months until it is replaced by the comprehensive IFM. Accordingly, the Commission should rescind its directive that the CAISO implement Phase II Lite.

2. Even Under A Fairly Aggressive Implementation Schedule, The CAISO Cannot Implement Phase II Lite Prior To Summer of 2003

The CAISO has established a Project Management Office ("PMO") to oversee MD02 implementation. The PMO has developed "best practices" procedures to govern implementation of the Phases II and III elements of the comprehensive, integrated MD02 proposal. This "best practices" process follows a commercially acceptable Systems Development Lifecycle. There are four steps for implementation of each of the MD02 phases – Initiation, Elaboration, Construction and Implementation.

The PMO has developed a fairly aggressive draft Phase II Lite project plan that follows these four steps. However, as discussed below, the implementation plan does not follow all of the "best practices" procedures. The Phase II Lite plan involves a rational systems change process that attempts to minimize risk both to the CAISO and to Market Participants, yet respects the Commission's desire to eliminate both the balanced schedule requirement and the market separation rule as quickly as reasonably possible. The draft Phase II

Lite project plan developed by the CAISO and reviewed by the CAISO's external project management consultants for the MD02 Project --is fairly aggressive and does not reflect a "best-practices" process that would otherwise be followed if the Commission were not requiring expedited implementation.¹⁵ The draft project plan for Phase II Lite also provides reasonably adequate time to (1) design all of the software modifications that are necessary to relax the balanced schedule requirement and the market separation rule; (2) prepare a Detailed Scope of Work Statement ("DSOW") to govern the preparation of the new software modifications; (3) code the modifications; and (4) test the new modifications, first in isolation, then integrated with other ISO systems and, finally, jointly with market participants in market simulation. However, the draft project plan allows only minimal time for market participant review of and input into the design and does not allow time for the CAISO to issue a Request for Bids to minimize the implementation costs by seeking competing vendors. Rather, the CAISO would be forced to source the project to its current software vendor and utilize an incremental DSOW rather than a global DSOW, *i.e.*, the CAISO would add elements to its existing system (which will be replaced upon implementation of the IFM) rather than develop a new system.¹⁶ As discussed in greater detail below, under this schedule, Phase II Lite would not be implemented until

¹⁵ In implementing Phases II and III of the comprehensive market redesign, the CAISO intends to follow the "best practices" procedures.

¹⁶ Good commercial practice would require that the CAISO establish the requirements for the project and then bid out the project.

approximately seven to eight months after the Commission issues an order approving the CAISO's Tariff filing for a specified Phase II Lite design.¹⁷

The Initiation stage involves identifying options, the issues that need to be resolved, and the necessary software changes, as well as developing a realistic implementation timeline. The Initiation stage for Phase II Lite is approximately one-to-two weeks.

The Elaboration Stage involves resolving all policy and design issues, developing the design of the project (including IT design), drafting Tariff language and a Section 205 filing, conducting a stakeholder process to address policy issues, holding Joint Application Design ("JAD") group sessions (with stakeholder representation) to create the actual design, "gathering" the business and functional requirements and preparing a Detailed Scope of Work to govern the work associated with the new software modifications. The CAISO has estimated a six-to-ten week Elaboration stage for Phase II Lite. This timeline is fairly aggressive given that the Phase II Lite proposal is a recent concept, and the CAISO has not identified and analyzed thoroughly all of the possible design elements and potential operational impacts associated with Phase II Lite

¹⁷ Appendix A hereto contains a letter from the CAISO's external project management consultants setting forth their preliminary analysis of the CAISO's schedule for implementing Phase II Lite. They concur with the CAISO that the Phase II Lite cannot be implemented by January 31, 2002. They indicate that, under a reasonably aggressive schedule, Phase II Lite could be implemented in late-July of 2003. However, it must be noted that the timeline laid out in the letter does not reflect any time attributable to the processing and approval of the CAISO's Phase II Lite proposal. Because the CAISO has not filed – and the Commission has not approved – a specific Phase II Lite proposal and corresponding tariff language, the timeline must be extended to account for the requisite regulatory process.

implementation. The CAISO's aggressive timeline would accommodate only a truncated one- or two-week stakeholder process.¹⁸

After the CAISO finalizes the Tariff language, the CAISO must file such Tariff language with the Commission and obtain Commission approval for such Tariff language. As indicated above, the CAISO has never filed a detailed Phase II Lite proposal with the Commission. Accordingly, the CAISO must make a Section 205 Tariff filing and obtain Commission approval of a specific Phase II Lite proposal. The Tariff approval process could add two months to the implementation timeline – assuming that the Commission approves the CAISO's filed proposal without modification within the standard 60-day window. If the Commission were to modify the CAISO's filed Phase II Lite proposal, the CAISO might then have to modify the specifications, thereby resulting in additional delays.

Following Commission approval of a Phase II Lite proposal, the CAISO will contract with the software vendor. The CAISO's implementation schedule allows approximately one-to-two weeks for this process. Under a "best practices" approach – which the CAISO believes must be used for Phases II and III -- the CAISO would issue a Request for Proposals, evaluate the responses of various vendors and negotiate with potential vendors.

The third stage of the MD02 implementation process is the Construction stage. This stage involves the development of the various systems and software

¹⁸ Under a "best practices" approach, the CAISO would conduct a full and deliberate stakeholder process that would fully address all policy and design issues and develop the actual design through multiple JAD sessions. In order to accelerate implementation of Phase II Lite, the CAISO cannot follow such a process.

that are required to effectuate the market design change(s). Phase II Lite would require modifications to SA CONG as well as development of a new process in the Settlements (“BBS”) system. The CAISO has estimated that software and systems development will require approximately three to three-and-one-half months. This estimate is based on normal industry practice and the CAISO’s experience with respect to modifications of this nature. However, the actual timeline for the development and delivery of the Phase II Lite systems/software is solely in the hands of the vendor; the CAISO’s timeline is merely an estimate. Because the ISO’s market systems have never included a forward auction-based energy market, the required software changes are significant, especially the settlements-related software changes. It should be noted that, although the CAISO would pursue an abbreviated, fairly aggressive PMO process for Phase II Lite, the CAISO will design and implement settlement changes that can be carried over to the comprehensive IFM. This is reasonable and prudent because it will minimize the amount of temporary or “throwaway” changes.¹⁹

Under the PMO approach, testing is also included in the Construction stage, although testing is often considered a separate stage. The testing phase includes systems, integration, end-to-end, load and performance and user access testing, as well as market simulation. The CAISO estimates that approximately four to four-and one-half months of systems integration and testing will be necessary for Phase II Lite. However, some of the SA CONG unit testing will occur parallel to the development of the settlement systems; therefore, the

¹⁹ The settlement software changes necessary to implement Phase II Lite would be the only software modifications that would not be “throwaway”.

testing stage should conclude approximately three-and-one-half to four months after the conclusion of the development stage.

The Phase II Lite modifications represent a complete paradigm shift in the way the CAISO and market participants do business. Upon relaxation of the existing market separation rule and elimination of the balanced schedule requirement, and introduction of a day-ahead energy market, the fundamental structure of the bidding, scheduling, pricing, and settlement of the market will change. It will necessarily take the CAISO and market participants time to correct problems with and acclimate to the new system. Given the scope and complexity of the changes, adequate testing by both the CAISO and market participants is necessary.

Thus, the CAISO's projected timeline includes CAISO testing and joint CAISO-market testing (*i.e.* market simulation). CAISO testing includes integration testing, technical testing, and acceptance testing. The purpose of CAISO testing is to ensure that the delivered product matches the specifications. As indicated above, the ISO will be changing two major systems – SA CONG and settlements. All integration and external testing will have to wait for completion of the settlements systems (which likely will not be completed until at least one month after completion of the SA CONG modifications). The CAISO's timeline for testing is reasonable given the extensive scope and complexity of the changes.

The final stage is the Implementation stage. The Implementation stage involves closing down the old systems and starting up the new systems. The

CAISO estimates that the Implementation stage for Phase II Lite would last approximately one week.

In conclusion, the CAISO's abbreviated timeline for implementation of Phase II Lite is reasonable, although it does not allow sufficient time for each stage to be considered a "best practices" implementation. As discussed above, it is anticipated that the ISO would need approximately seven to eight months to implement Phase II Lite after the Commission issues an order approving the ISO's specific Phase II Lite proposal, including the implementing Tariff language. Thus, a January 31, 2003 implementation date for Phase II Lite is not feasible.²⁰

B. The Commission Erred In Finding That Imports Must Bid \$0/MWh

In the July 17 Order, the Commission found that AMP should apply to imports because "imports constitute a significant portion of California energy supply" and "[w]ithout AMP applied to imports...concerns with megawatt laundering arise." July 17 Order at ¶ 71. However, in the October 11 Order, the Commission reversed its prior determination and concluded that AMP should not apply to imports. October 11 Order at ¶ 20. The Commission also found that imports must submit \$0/MWh bids into the California markets and be price takers. *Id.* In reaching its decision, the Commission rationalized that "establishing a different set of rules for imports (*i.e.*, not permitting imports to set the market clearing price yet subjecting such bids to AMP) may continue incentives for

²⁰ The CAISO notes that it took the CAISO approximately three-and-one-half months to implement AMP after the Commission approved AMP in the July 17 Order. Unlike Phase II Lite, AMP did not change the basic structure of the CAISO's market and did not implicate significant modifications to the CAISO's settlements systems. Stated differently, AMP was a minor change compared to Phase II Lite.

megawatt laundering or other gaming strategies.” *Id.* The Commission also found that implementation of AMP only in California and not west-wide would create disincentives to bid into CAISO markets. *Id.* The Commission stated that in order to avoid supply disincentives and to address megawatt laundering concerns it was necessary to exempt imports from AMP. *Id.*

The CAISO submits that the Commission erred in requiring imports to bid \$0/MWh. On rehearing, the Commission should vacate this requirement and, instead, find that imports can bid prices other than \$0M/Wh and be paid the market clearing price (“MCP”), but must remain price-takers and cannot set the MCP. This alternative is consistent with the Commission’s stated objectives that California’s market rules should not create supply disincentives for imports and opportunities for “megawatt laundering”. On the other hand, the imposition of a \$0/MWh bidding requirement creates a significant supply disincentive for imports and, when the CAISO eliminates the Target Price and creates a single clearing price, will complicate clearing the Price Overlap.²¹

As the Commission is well aware, the CAISO relies extensively on imported energy to maintain the reliability of the CAISO Control Area. Accordingly, it is extremely important that the CAISO have market rules in place that encourage the participation of imports in California’s markets. In particular, the CAISO desires, to the maximum extent possible, to accommodate out-of-state suppliers’ reasonable expectations that they should earn a price no lower than their bid, which, in the real-time market, should represent their marginal

²¹ As indicated above, the Commission approved clearance of the price overlap in its July 17 Order.

costs. If marketers seeking to import energy into the CAISO Control Area bid \$0/MWh, the CAISO is obligated to dispatch those bids first, thereby depressing the real time Imbalance Energy price.²² This in turn discourages out-of-state suppliers from offering supplies to the CAISO. Since the Commission imposed the \$0/MWh bid requirement in its December 19, 2001 Order in Docket Nos. EL00-95, *et al.*,²³ imports from most Scheduling Coordinators have diminished significantly.²⁴ Given the CAISO's dependence on imports, it is imperative that this trend change. Permitting imports to bid prices other than \$0/MWh will help encourage imports to participate in the CAISO's markets.²⁵ In that regard, if imports are permitted to bid prices other than \$0/MWh, they are more likely to be paid an MCP that is closer to their bid price than if they are required to bid \$0/MWh because the CAISO will consider their bid price in dispatching resources in economic merit order.

The \$0/MWh bidding requirement also needs to be eliminated to clear the Price Overlap properly. In that regard, in the July 17 Order, the Commission approved the CAISO's proposal to implement software that contains an

²² While this might sound good, such a result would not be beneficial in the long-run if it discourages imports from participating in the CAISO's markets.

²³ *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services into Markets Operated By the California Independent System Operator and the California Power Exchange*, 97 FERC ¶ 61,275 (2001).

²⁴ The CAISO has notified the Commission previously about the reduction in imports into the CAISO's market. See Fourth Quarterly Report of the California Independent System Operator Corporation, Docket Nos. EL00-95-000, *et al.*, p10 (June 14, 2002); Third Quarterly Report of the California Independent System Operator Corporation, Docket Nos. EL00-95-000, *et al.*, pp. 22-23 (March 26, 2002).

²⁵ In the October 11 Order, the Commission declined to apply AMP to imports because it would create a disincentive for imports to offer supplies into the CAISO's imbalance market. However, the \$0/MWh bid requirement constitutes a far greater supply disincentive than the imposition of AMP. Thus, retention of the \$0/MWh bid requirement is inconsistent with the Commission's logic for rejecting the application of AMP to imports.

economic dispatch algorithm to continuously clear overlapping real-time Energy bids so that there will be a single price in each ten-minute interval.²⁶ July 17 Order at ¶ 128. As the CAISO requested, and as the Commission approved in the October 11 Order, the CAISO will not implement such software until it can simultaneously begin applying uninstructed deviation penalties. The CAISO estimates that it will implement this new software in mid-2003. Under the current Target Price methodology used to resolve the Price Overlap, the Target Price will be set at the lower of the lowest available proxy bid and the clearing price of feasible incremental and decremental bids available based on a 10-minute capability assuming such bids were cleared. This results in a settlement price for imports that is unlikely to be \$0/MWh. Therefore, currently there is little risk that an import required to bid \$0/MWh will actually be settled at \$0/MWh. However, once the new economic dispatch software is implemented, forcing imports to bid at \$0/MWh and be price takers will cause a Price Overlap with any DEC bid that is greater than zero. As a result, import bids will likely end up clearing at \$0/MWh. In other words, imports would be paid \$0/MWh for their energy. This unreasonable outcome could cause imports to flee from the CAISO's markets. On the other hand, if imports are permitted to bid non-\$0MWh, this problem will not arise when the CAISO implements its software to clear the Price Overlap. Imports will be paid their bid price when they are dispatched to clear the Price Overlap, although that bid price will not set the market clearing price. The

²⁶ The CAISO proposed to issue Dispatch instructions to all overlapping bidders, thereby requiring bidders to buy Energy (*i.e.* reduce Generation) or sell Energy (*i.e.* increase Generation) at the applicable 10-minute price. By clearing the price overlap for each 10-minute interval, the separate incremental and decremental prices converge to a single market clearing price.

CAISO recognizes that the Commission is concerned about “megawatt laundering” and has imposed the \$0/MWh bid and price-taker requirement on imports in order to prevent “megawatt laundering”. However, it is not necessary for the Commission to impose a \$0/MWh bid requirement to prevent megawatt laundering; all that is necessary is that the Commission maintain the price-taker requirement and not permit imports to set the MCP. Under these circumstances, if imports were permitted to bid above \$0/MWh, there would not be any “megawatt laundering” concerns because imports could not set the MCP. Internal resources would continue to set the MCP just as is the case today. Thus, there would be absolutely no incentive for internal resources to “megawatt launder”. Given that eliminating the \$0/MWh bid requirement would not create any new gaming opportunities, but would create some additional supply incentives for imports, there is no logical reason why the Commission should require imports to bid \$0/MWh.

If the Commission does not approve the CAISO’s recommendation discussed above, then the CAISO requests that the Commission revert back to its determination in the July 17 Order that import bids can exceed more than \$0/MWh and would be subject to AMP. The CAISO respectfully disagrees with the Commission’s finding that “not permitting imports to set the market clearing price yet subjecting such bids to AMP” would create “incentives for MW laundering or other gaming strategies”. Under this approach, although import bids would be not eligible to set the MCP and would be paid an uplift if dispatched at a bid price that is above the MCP, for the purposes of AMP, import

bids would be treated identically to bids from internal resources. Specifically, the CAISO would assume that import bids are eligible to set the MCP for the purposes of conducting the market impact test under AMP, similar to the treatment the CAISO accords bids above \$250/MWh from internal resources. Given the symmetric treatment accorded import bids, the CAISO does not believe that “megawatt laundering” or gaming would be facilitated.

C. The Commission Erred In Stating That Suppliers Who Believe That AMP Prevents Them From Recovering Their Costs Can Simply Execute RMR Contracts

In response to the Commission’s approval of AMP in the July 17 Order, numerous suppliers filed requests for rehearing alleging that AMP would suppress prices in the California market, thereby undermining the development of a viable market and possibly precluding suppliers from recovering their costs. In its October 11 Order, the Commission stated that “if a supplier believes that AMP procedures and associated reference prices do not allow for recovery of all of their relevant costs for a specific unit, then the supplier should seek CAISO consent to enter into an RMR agreement. If such agreement cannot be negotiated, the generator may file a complaint with the Commission concerning this matter.” October 11 Order at ¶ 36.

The Commission’s statement implies a misunderstanding of the California market. The Commission itself has recognized on numerous occasions that an RMR unit “is a generating facility that the ISO can call upon when necessary to provide energy and ancillary service essential to the reliability of the California transmission network.” *AES Southland, Inc. et al.*, 94 FERC ¶ 61,248 at 61,871

(2001) (“AES”); see also *Duke Energy Oakland, L.L.C.*, 85 FERC ¶ 61,047 at 61,141-42, n.1 (1998) (RMR units are units that the CAISO must dispatch at the CAISO’s request in order to ensure the reliability of the transmission network). Stated differently, an RMR unit “is a generating unit, the absence of which could compromise reliability.” *AES* at 61,871, n.2. The primary purpose of RMR units is to ensure local reliability, and the CAISO has the ability to schedule and dispatch such units during certain hours at a cost-based rate because of physical limitations on the supply grid. *California Independent System Operator Corporation*, 90 FERC ¶ 61,345 at 62,135 (2000). Pursuant to Section 5.2.5 of the CAISO’s Tariff, the CAISO annually conducts technical evaluations based on expected load and generation patterns for the CAISO Controlled Grid and the CAISO’s approved reliability criteria for designating RMR units. Based on these studies, the CAISO then determines which generating units the CAISO requires to be RMR units for the upcoming year. Thus, under the CAISO’s Commission-approved Tariff, units must satisfy applicable reliability criteria in order to become RMR units. Units cannot become RMR units simply because the owner of the unit has determined that participating in the market will not assure adequate cost recovery.

Accordingly, on rehearing, the Commission should rescind its statement that suppliers can seek RMR status for their units if they believe that the application of AMP will preclude them from recovering their costs. Units can qualify for RMR status only if they are required to satisfy applicable reliability criteria. The Commission should indicate that, if suppliers are concerned about

cost recovery due to AMP, they should file for cost-based rates (instead of the market-based rates they currently have). That would be consistent with the position the Commission has taken in every other instance in which generators in the California market have complained that Commission-approved price mitigation measures might jeopardize fixed cost recovery. *See, e.g., San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services into Markets Operated by the California Independent System Operator and California Power Exchange*, 97 FERC ¶ 61,275 at 62,204 (2001); 95 FERC ¶ 61,418 at 62,564 (2001).

III. REQUEST FOR CLARIFICATION

A. **The Commission Should Clarify That Intertie Schedules Are Excused From Uninstructed Deviation Penalties Only When The CAISO Makes Inter-Hour Changes To Dispatch Instructions**

Certain parties noted that a sentence in Section 11.2.4.1.2 of the proposed Tariff language that was submitted on May 1, 2002 was missing from the CAISO's June 17 Tariff filing. The Commission directed the CAISO to re-file proposed Tariff Section 11.2.4.1.2 and include the following sentence in Section 11.2.4.1.2(c): "Uninstructed energy resulting from declining intra-hour Instructions will not be subject to the uninstructed Deviations Penalty." October 11 Order at ¶ 66.

The CAISO notes that the aforementioned sentence was included in Section 11.2.4.1.2(b) in the Tariff language filed on May 1, 2002. In the June 17 filing, the CAISO created a new section 11.2.4.1.2(b) and the sentence was

moved to Section 11.2.4.1.2 (c). The CAISO requested that the revised language submitted on June 17, 2002 not be made effective until May 1, 2003. However, the CAISO inadvertently omitted the sentence when it made its August 16, 2002 compliance filing.

The CAISO notes that in its Request for Rehearing filed on August 16, 2002, the CAISO sought clarification of the Commission's interpretation of this sentence in the July 17 Order. In that regard, in its protest of the MD02 Filing, the Bonneville Power Administration argued that the CAISO should limit the application of uninstructed deviation penalties to Market Participants with the ability to respond to the CAISO's 10-minute instructions. In its July 17 Order, the Commission noted that Section 11.2.4.1.2(b) of the proposed tariff language – which the Commission approved – provides an exemption for such cases. July 17 Order at ¶ 143. Although in its October 11 Order the Commission directed the CAISO to reinsert the sentence into the Tariff, the Commission did not address the CAISO's requested clarification.

The CAISO again seeks to clarify how uninstructed deviation penalties will apply to intertie schedules. Section 11.2.4.1.2(b) provides that uninstructed deviation penalties will apply to intertie schedules if a pre-Dispatch instruction (i.e., a Dispatch instruction issued for the next hour, not for immediate Dispatch) is declined or not delivered. However, Uninstructed Imbalance Energy resulting from declining intra-hour instructions will not be subject to uninstructed deviation penalties. Thus, if the CAISO pre-Dispatches an intertie bid, and the pre-Dispatch instruction is declined or the Energy is not delivered, an uninstructed

deviation penalty will apply. However, if the CAISO makes an intra-hour change by issuing a new Dispatch instruction for an intertie schedule, the CAISO would not impose an uninstructed deviation penalty.

Thus, the Commission should clarify that intertie schedules are not subject to uninstructed deviation penalties only in the context of intra-hour Dispatch instructions. This position is consistent with current Western Electricity Coordinating Council practice in which changes are made to hourly inter-control area interchange schedules for emergency reasons only (*i.e.*, not for economic reasons), and therefore interchange schedules are not expected to respond to 10-minute Dispatch instructions. It is not appropriate to forgive uninstructed deviation penalties when an intertie supplier declines a pre-Dispatch instruction or otherwise fails to deliver Energy because such action cannot be excused on the basis that the tie is unable to react in a timely manner.

B. The Commission Should Clarify That The CAISO Is Permitted To Impose A Proxy Bid When A Supplier Is Subject To The Must-Offer Obligation And Does Not Submit A Bid

In the October 11 Order, the Commission stated that “[t]he market-oriented rules in the July 17 Order remove the ability of the CAISO to impose proxy prices to replace a supplier’s bid.” October 11 Order at ¶ 87. The CAISO requests that the Commission clarify that, in instances where a supplier is subject to the Must-Offer Obligation and does not submit a bid, the CAISO is permitted to impose a proxy bid. If the CAISO were not permitted to impose a proxy bid in such circumstances, the efficacy of the Must-Offer Obligation would be undermined because suppliers could avoid the obligation by simply not

submitting a bid. Some form of default bid, *i.e.*, a CAISO-imposed proxy price, is necessary in order to maintain the effectiveness of the Must-Offer Obligation.

Thus, the CAISO should not be permitted to impose a proxy bid only in circumstances where the supplier has in fact submitted a bid.

IV. CONCLUSION

Wherefore, for the foregoing reasons, the CAISO requests that the Commission grant the instant request for rehearing and vacate the following determinations made in the Commission's October 11 Order: (1) the requirement that the CAISO implement Phase II Lite by January 31, 2003; (2) the requirement that imports bid \$0/MWh; and (3) the statement that if generators believe that AMP jeopardizes cost recovery they can enter into an RMR contract. On rehearing, the Commission should rescind the directive that the CAISO implement Phase II Lite. Further the Commission should require imports to be price-takers, but permit imports to bid other than \$0/MWh and be paid the MCP.

The Commission also should state that if generators believe that AMP precludes them from recovering their costs, they should file for cost-based rates. Finally, the CAISO requests that the Commission grant the clarifications requested herein.

Respectfully submitted,

Charles F. Robinson,
General Counsel
Anthony J. Ivancovich,
Senior Regulatory Counsel
California Independent System
Operator Corporation
151 Blue Ravine Road
Folsom, CA 95630
(916) 608-7135

Filed: November 8, 2002

APPENDIX A



*Business Consulting Services
IBM Global Services*

*199 Fremont Street
San Francisco, CA 94105*

November 7, 2002

Mr. Spence Gerber
California ISO
151 Blue Ravine Rd.
Folsom, CA 95630

Dear Mr. Spence Gerber:

IBM Business Consulting Services is providing external project management consulting with respect to the California ISO's (CAISO) MD02 project. In that role we have completed a preliminary analysis of the required elements of a Phase 2 Lite (P2L) implementation. This was completed under the premise that implementation of P2L should, to the extent possible, be completed in a manner consistent with industry accepted practices for systems implementation, that the implementation would start on October 24, 2002 and that the required CAISO resources to implement P2L were ready and available to complete the required tasks. We based the analysis on project timelines developed within the CAISO by CAISO subject matter experts, through consultation with the prospective vendor for the required software modifications and other information provided by CAISO. In general, the broad timeline that results from this analysis is:

- 1) Business and technical design including an extremely abbreviated stakeholder process can reasonably be completed by early December 2002.
- 2) External CASIO Vendor delivery of systems can reasonably be completed by mid February. Internal CAISO modification to settlement systems can be completed the first of April.
- 3) Testing, both internally and externally to the CAISO can reasonably be completed by the end of July 2003.

It is my understanding from CAISO staff that CAISO would have to make a tariff filing and obtain Federal Energy Regulatory Commission (FERC) approval of its P2L proposal. I have been advised that the tariff filing would occur after the completion of 1) and prior to the start of 2) above. The above timeline does not reflect any time attributable to the processing and approval of the CAISO filing because this is outside our area of expertise.

Although preliminary design work for implementation has been undertaken by the CASIO, the ability to further progress on implementation is limited prior to the approval by FERC of CAISO's P2L proposal. Thus, time must be added to the above outlined timeframes as appropriate dependent on the duration of the time required to obtain such FERC approval.

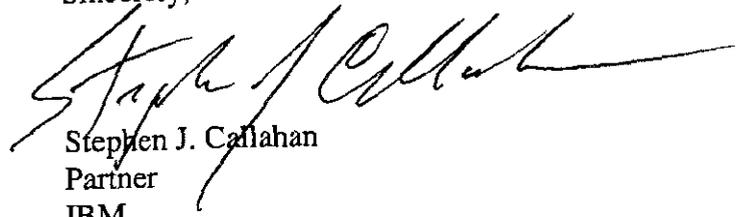
The above timeframes are reasonably aggressive due the existence of significant aggravating factors:

- First, implementing Phase 2 Lite (P2L) is only achievable by modifying the current ABB systems at CASIO. Since P2L is incremental to current systems, significant technical and IT design considerations must be fully analyzed to verify any changes to the systems as a result of P2L work as designed and do not negatively impact systems currently in production.. Given the complexity of the current CAISO systems, this task must be thorough and detailed.
- Second, the timeline assumes that ABB will deliver the required systems modification in a 10 to 12 week timeframe and the code would be fully acceptable to the CAISO relative to specification in that time frame. Any delay by the vendor or the uncovering of any substantial bugs during testing will add to this timeframe.
- Third, a four month testing window to complete all internal and external testing of this system is viewed as significantly aggressive in terms of the contemplated changes to CAISO systems and market participant operations. Considering the degree of change and the abbreviated design timeframe outlined above, expecting not to have significant testing variances is aggressively optimistic. Compounding this issue is the requirement that this testing be completed not only on the new functions but also regression tested across current CAISO systems. To the extent that such optimism is not born out in actual testing, the proposed completion of testing will not be achieved on schedule.

There are a couple of unfortunate consequences of the proposed timeframe that should also be considered. First, the proposed approach continues to promulgate the substantially single vendor situation at the CAISO. This is a situation that I have been informed, by the management of the CAISO and by FERC through the SMD NOPR, as inconsistent with the desire or the intent of future market systems design and implementation. Second, although best practices were considered in constructing this timeframe, the fact is that a number of the required steps have been abbreviated significantly. Such abbreviating of the process increases the risk that either an error of omission or an error of commission will arise during design or implementation and be discovered in testing. If such errors arise, remediation will certainly threaten the July 03 implementation timeline.

Considering the aforementioned factors and circumstances, we believe the July 03 timeline for implementation of P2L is reasonably aggressive. Additionally, we see no viable or prudent scenario in which P2L could be achieved by January 31, 2002.

Sincerely,

A handwritten signature in black ink, appearing to read "Stephen J. Callahan". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Stephen J. Callahan
Partner
IBM



November 8, 2002

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

**Re: California Independent System Operator Corporation
Docket No. ER02-1656-000**

**Investigation of Wholesale Rates of Public Utility Sellers of Energy
and Ancillary Services in the Western Systems Coordinating Council
Docket No. EL01-68-017**

Dear Secretary Salas:

Enclosed for electronic filing please find the Emergency Request For Rehearing And Motion For Clarification of the California Independent System Operator Corporation in the above captioned dockets.

Thank you for your assistance in this matter.

Respectfully submitted,

Anthony J. Ivancovich
Counsel for The California Independent
System Operator Corporation

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in the above-captioned dockets.

Dated at Folsom, CA, on this 8th day of November, 2002.

Anthony Ivancovich