

- Requiring the CAISO to implement a “long-term solution” to the problem of overlapping intertie bids by September 30, 2005, and requiring the CAISO to reinstate the “bid or better” methodology for settling intertie transactions unless such a solution is filed to become effective by September 30, 2005.

II. BACKGROUND

On March 23, 2005, the CAISO filed with the Commission Amendment No. 66 to the CAISO Tariff. Therein, the CAISO requested Commission approval of an interim solution to a problem of excessive costs incurred by CAISO Market Participants as a result of the manner in which bids for incremental and decremental energy from System Resources were cleared and settled under Phase 1B of the CAISO’s Market Redesign and Technology Upgrade (“MRTU”). The CAISO explained that the combination of the pre-dispatching of import/export bids from System Resources and the “bid or better” settlement rule, which ensured that System Resources were paid the higher of their bid cost or the real-time MCP, along with variations between the real-time MCP and the projected price used to clear import/export bids, had created an incentive for Scheduling Coordinators representing System Resources to bid in a manner that increases the uplift costs incurred by the CAISO Market, despite the fact that during many intervals the CAISO has no need for additional energy from System Resources in real-time in order to meet load in the CAISO Control Area. Because of the magnitude of costs being incurred, the CAISO proposed, as an immediate, interim solution, the replacement of the “bid or better” rule with a “pay as bid” methodology, under which System Resources would be compensated according to their bid price, without reference to the final real

time MCP. The CAISO, however, recognized that further analysis and additional stakeholder input would be necessary in order to determine the most appropriate “longer term” solution to this problem.

On April 7, 2005, the Commission issued an order approving Amendment No. 66, effective as of March 24, 2005. The Commission stated that in light of the fact that the “bid or better” settlement rule may have been causing excessive amounts of uplift costs, it was just and reasonable to implement the CAISO’s proposed interim solution to prevent imminent harm to customers. Amendment No. 66 Order at P 15. The Commission noted that the purpose of the Amendment No. 66 filing was not to make tariff changes proposing a long-term solution, and that such a solution would be filed with the Commission once it is developed by the CAISO. *Id.* at P 20. The Commission stated that the Amendment No. 66 provisions would continue in effect until the earlier of September 30, 2005, or the effective date of a tariff filing providing a long-term solution filed by the CAISO and accepted by the Commission. *Id.* at 15. In response to issues raised in comments and protests on the Amendment No. 66 filing, the Commission noted that during the interim period, the CAISO should be alert to any unintended consequences of the “as bid” approach, namely “whether liquidity of bids at the interties will be diminished” and “the extent to which the “as bid” policy may cause bidders to change the level of their bids to the expected clearing price, and the resulting effect on the overall costs to customers from both of these possible problems.” *Id.* at P 21. Accordingly, the Commission ordered the CAISO’s Department of Market Analysis (“DMA”) to provide it with weekly reports on the effects of this interim solution with regard to these two concerns, as well as any other issues of concern to the DMA.

III. REQUEST FOR REHEARING AND CLARIFICATION

A. **The Commission Should Grant Rehearing and Find That the CAISO Will, if Necessary, Be Afforded Additional Time to Implement a “Longer Term” Solution to the Problem of Overlapping Intertie Bids, and That the CAISO Will Not Be Required to Reinstate the “Bid or Better” Settlement Rule on October 1, 2005**

In the Amendment No. 66 Order, the Commission indicated that it was accepting the CAISO’s “pay as bid” methodology for settling import transactions until the earlier of (a) September 30, 2005, or (b) the effective date of a tariff filing providing a longer-term solution filed by the CAISO and accepted by the Commission. The Commission stated that if no such tariff amendment was accepted as of September 30, 2005, then, as of October 1, 2005, the Amendment No. 66 provisions would sunset, and the tariff sections modified as a result of Amendment No. 66 would revert to their previous versions (*i.e.*, the “bid or better” methodology).

The CAISO requests rehearing of this ruling, and respectfully asks that the Commission indicate that the CAISO will be afforded additional time, if necessary, to file, and more importantly, implement, a “longer term” solution to the problem of overlapping intertie bids, and that, if such additional time is, in fact, necessary, the provisions of Amendment No. 66 will not sunset on October 1, 2005. The CAISO seeks this relief because the CAISO has recently determined that options, which may theoretically be superior as the “longer-term” solution, cannot be implemented by October 1, 2005. Specifically, the CAISO’s theoretically preferable longer-term solution could not be put in place until March 2006. Moreover, the CAISO believes that reverting to the “bid or better” settlement methodology during the period between October 1,

2005, and the date on which the longer-term solution is implemented would be highly detrimental to Market Participants for the reasons discussed in the CAISO's Amendment No. 66 filing.²

In its "Technical Paper on California CAISO Proposals for Improving Phase 1B Intertie Settlements,"³ the CAISO identified four possible "longer term options" for addressing the problem of high uplift charges being incurred under the "bid or better" settlement methodology. Of these four options, which are all being considered as part of the stakeholder process, the CAISO indicated that it currently preferred Option 1, which consists of a "single pre-dispatch price auction" methodology for settling of import transactions, under which all incremental and decremental bids from System Resources dispatched by the CAISO would be settled at a single pre-dispatch market clearing price that reflects the average of the four 15-minute prices calculated by the CAISO's RTMA software. Such a methodology would also be consistent with the Commission's recommendation in the Amendment No. 66 Order that the CAISO and stakeholders consider "the feasibility of a financially binding hour-ahead market for inc/dec bids from System Resources at the interties under which bids would be settled at the predicted market clearing price rather than the higher of bid or real-time market clearing price." Amendment No. 66 Order at P 22.

As part of this ongoing process, CAISO personnel have investigated the feasibility and timeframe for implementing the various longer-term options. Recently,

² Although the CAISO has not performed a full evaluation of implementation estimates for the other solution options being considered as part of the stakeholder process, the CAISO believes that those options would require a similar amount of time to implement as Option 1 (i.e. 6-8 months).

³ This paper was made available to Market Participants at a stakeholder meeting held on April 28, 2005, and was also included with the Amendment No. 66 filing as Attachment A.

those personnel have concluded that it would require approximately six to eight months to complete the development, testing and deployment of the new software system necessary to implement the “single pre-dispatch price auction” approach embodied in Option 1. This process could not begin until the conclusion of the stakeholder process and receipt of Commission approval. Therefore, if the CAISO concludes, as a result of input received through the stakeholder process and its own analysis, that Option 1 is the most appropriate longer-term solution, the CAISO will be unable to implement this methodology prior to the October 1, 2005 sunset date for Amendment No. 66. Instead, the CAISO estimates that Option 1 could be implemented no sooner than March, 2006.⁴ Under the terms of the Amendment No. 66 Order, the CAISO would either be forced to reinstate the “bid or better” settlement rule during the period between October 1, 2005 and the date on which Option 1 is implemented, which would most likely be at least six months, or abandon Option 1 as a potential longer-term solution.

The CAISO firmly believes that both of these possible outcomes are sub-optimal. First, it would be inappropriate for the CAISO to reinstate the “bid or better” settlement methodology, a settlement methodology that is not just and reasonable. As the CAISO described in its Amendment No. 66 filing, during the period between the implementation of Phase 1B in October of 2004, and the effective date of Amendment No. 66, on March 24, 2005, participants in the CAISO’s markets incurred approximately \$18.5 million in excess costs due to the clearing of overlapping incremental and decremental bids from System Resources. Moreover, data collected since the implementation of Amendment

⁴ This time frame is based on a recent assessment of current CAISO implementation priorities. Thus, while it not impossible for the CAISO to implement a longer-term solution on a more expedited basis, such implementation would, by necessity, come at the expense of the CAISO’s various MRTU-related projects.

No. 66 shows that the change from “bid or better” to “pay as bid” has resulted in a dramatic decrease in the daily costs of clearing incremental and decremental intertie bids.⁵ This data strongly suggests that reverting to the “bid or better” settlement methodology would once again lead to increased, and unwarranted, costs to CAISO Market Participants and California consumers. Such a result would clearly be inconsistent with the Commission’s primary mission of protecting consumers from harm.⁶ On the other hand, the CAISO does not believe that the Commission would wish to foreclose potential options favored by the CAISO and its stakeholders merely because those options cannot be implemented by October 1, 2005. Market Participants would certainly not be well served by the CAISO filing a less than ideal longer-term solution in order to meet the October 1 deadline, which appears to hold no special significance, other than being approximately six months after the implementation of Amendment No. 66.

For these reasons, the CAISO requests rehearing of the Commission’s ruling that the provisions of Amendment No. 66 will only continue in effect until September 30, 2005. The CAISO urges the Commission to reverse this ruling and state that the CAISO will be afforded additional time, if necessary, to file a “longer term” solution to the problem of overlapping intertie bids, and that, if such additional time is, in fact, necessary, that the provisions of Amendment No. 66 will not sunset on October 1, 2005.

⁵ This decrease in costs is detailed in the reports that have been prepared by the CAISO’s Department of Market Analysis (“DMA”) and filed with the Commission each week since the issuance of the Amendment No. 66 Order. See Amendment No. 66 Order at P 21.

⁶ See *Federal Power Comm’n v. Hope Natural Gas. Co.*, 320 U.S. 591, 610-12 (1944); *Pennsylvania Water & Power Co. v. FPC*, 343 U.S. 414, 418 (1952); *Atlantic Refining Co. v. Public Utility Comm’n of the State of New York*, 360 U.S. 378, 388 (1959).

B. The Commission Should Clarify that the CAISO is Not Precluded from Proposing, as the “Longer Term” Solution, a Continuation of the “Pa as Bid” Settlement Methodology

In the Amendment No. 66 filing, although the CAISO recognized that the “pay as bid” methodology might not represent the best longer-term solution, on theoretical grounds, to the problem of overlapping intertie bids, the CAISO did not state that the pay as bid methodology should necessarily be discarded in favor of a different methodology. Indeed, in the technical paper prepared by the CAISO addressing this issue, the CAISO specifically identified “pay as bid” as one of the four possible options for a longer-term solution. Likewise, in the Amendment No. 66 Order, the Commission did not state that the CAISO could not propose the “pay as bid” methodology as its preferred longer-term solution. However, given that the Commission was explicit that the “pay as bid” provisions, as proposed in Amendment No. 66, would only apply on an interim basis, the CAISO respectfully requests that the Commission clarify that the CAISO is not precluded from proposing the adoption of the “pay as bid” methodology on a longer-term basis, if the CAISO concludes, at the close of the stakeholder process, that this methodology is the most suitable longer-term solution.

Although the CAISO has not as of yet reached any conclusions with respect to the best longer-term solution, the “pay as bid” methodology has, to date, worked well in curbing the high uplift costs for import/export transactions observed since MRTU Phase 1B went into operation. Moreover, the potential problems identified with respect to the “pay as bid” methodology prior to the implementation of Amendment No. 66, namely, a decrease in liquidity of bids at the interties and increase in clearing prices for incremental energy, have not, to date, been observed in practice.

Moreover, retaining the “pay as bid” methodology may be attractive given the time constraints associated with this process. First, as discussed above, the longer-term solution that appears to be theoretically superior would take 6-8 months to implement from the time of Commission approval. Also, in February, 2007, the CAISO plans to put in place its new Hour-Ahead Scheduling Process (“HASP”), which will effectively combine the Hour-Ahead Market with the Real Time pre-dispatch process. Hour-Ahead and Real Time bid submissions will be combined into a single bidding and scheduling process that closes at 75 minutes before each operating hour. In developing the HASP proposal, the CAISO, responding to an issue raised by its consultants regarding the pricing of Hour-Ahead intertie schedules,⁷ proposed to use Hour-Ahead prices to settle import and export schedules accepted in the HASP in hours when there is Hour-Ahead congestion on the associated interties. In view of the events leading up to Amendment No. 66 and the present filing, however, the CAISO is considering, as part of the HASP development process, whether the use of Hour-Ahead prices for settling HASP intertie schedules should be extended to all hours, rather than limited to congested hours, or even whether an alternative solution would be superior.⁸ The crucial point is that the CAISO is fully committed to determining and implementing the optimal solution to this problem in the context of the HASP element of the comprehensive MRTU process. Because implementation of HASP will require

⁷ See *Comments on the California ISO MRTU LMP Market Design*, by Scott Harvey, Susan Pope and William Hogan, February 23, 2005, pp. 54-57. This document is available on the CAISO’s Home Page at <http://www.caiso.com/docs/2005/02/23/200502231634265701.pdf>

⁸ See *Comprehensive Market Redesign Update*, California ISO White Paper, revised April 28, 2005, pp.6-7. As noted in the white paper, the CAISO intends to further examine the solution options for settling intertie bids and resolve the details of how the preferred option would be incorporated into HASP through the MRTU stakeholder process. The outcome of this process will be included in the MRTU Tariff filing scheduled for November 30, 2005. The white paper is available on the CAISO’s Home Page at <http://www.caiso.com/docs/09003a6080/35/b5/09003a608035b541.pdf>

replacement of the CAISO's Real Time dispatch and settlement software, it appears that whatever longer-term solution for the pre-HASP period is proposed by the CAISO and approved by the Commission in the context of this proceeding will be superseded by the implementation of HASP in February, 2007. Thus, all modifications made in the CAISO's current dispatch and settlement software that would be necessary to implement Option 1 during the interim period prior to February 2007 would be discarded once the final elements of the CAISO's comprehensive MRTU market redesign, including HASP, are implemented.

Finally, implementing a pre-dispatch price methodology such as Option 1 within the RTMA software (prior to HASP) may involve significant additional complexity and risks than previously anticipated. As explained in detail in the attached "CAISO Plan for Addressing Issues Identified in Amendment No.66 Order," the CAISO is concerned that it may not be feasible to implement a pre-dispatch price methodology using the current RTMA software in a way that appropriately excludes certain "penalty prices" from setting the price, and constrains prices within the allowable economic range (-\$30 to \$250).

Again, the CAISO has not as of yet reached any conclusions with respect to which methodology presents the best longer-term solution. Nevertheless, the CAISO believes that it should have the freedom to explore all of the potential options, including retaining the "pay as bid" methodology, if it determines, at the close of the stakeholder process, that that would be the most appropriate solution all things considered.

Therefore, the CAISO respectfully requests that the Commission clarify that the CAISO is not precluded from proposing, as the "longer-term" solution, until the implementation of HASP, retention of the "pay as bid" methodology.

IV. CONCLUSION

Wherefore, for the reasons discussed above, the CAISO respectfully requests that the Commission clarify and grant rehearing of the Amendment No. 66 Order as requested above.

Respectfully submitted,

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Certificate of Service

I hereby certify that I have this day served a copy of this document upon all parties listed on the official service list compiled by the Secretary in the above-captioned proceedings, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated this 9th day of May, 2005 at Folsom in the State of California.

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CAISO Plan for Addressing Issues Identified in Amendment No.66 Order May 9, 2005

Background

In Amendment No. 66, the California Independent System Operator ("CAISO") proposed to modify the CAISO Tariff so that bids for incremental and decremental energy on inter-ties with neighboring control areas that are pre-dispatched by the CAISO are settled under a "pay as bid" rule. With this modification, bids would be paid (or pay the CAISO) their original bid price, rather than "bid or better," in effect since the implementation of Phase 1B of the CAISO's Market Redesign and Technology Upgrade ("MRTU") on October 1, 2004.¹

In its April 7, 2005 order on Amendment No. 66,² the Federal Regulatory Energy Commission ("Commission") approved the move to a "pay as bid" settlement rule effective as of March 24, 2005. The Commission indicated that its approval of Amendment No. 66 was on an interim basis, until the earlier of September 30, 2005 or the effective date of a long-term solution filed by the CAISO and accepted by FERC. The Commission also ordered the CAISO to monitor and report on the market impacts and effectiveness of the "as-bid" settlement rule, and to file a "plan (including milestones) for addressing the problems identified in this order."

Finally, the Commission indicated that options considered as part of the stakeholder process to develop a longer-term solution should specifically include a "financially binding hour-ahead market for inc/dec bids from System Resources at the interties under which bids would be settled at the predicted market clearing price rather than the higher of bid or real-time market clearing price." Amendment No. 66 Order at P 22. This option appears to correspond to the "single pre-dispatch price auction" option already under consideration by the CAISO, under which all incremental and decremental inter-tie bids dispatched by the CAISO would be settled at a single pre-dispatch market clearing price.

Process in Developing Recommendation

Since the issuance of the Amendment No. 66 Order, the CAISO has monitored and filed weekly reports on market performance under the "as-bid" settlement rule, and has continued to assess various options that might be implemented on a longer-term basis.

On April 28, the CAISO held a stakeholder meeting to discuss various pre-dispatch settlement options under review, update participants on market performance under the "as-bid" settlement rule, and outline potential modifications to settlement provisions relating to how pre-dispatch costs are allocated.

¹ Pursuant to the Amendment No. 66 Order, if no proposed tariff amendment has been filed to become effective by September 30, 2005, then on October 1, 2005, the provisions of Amendment No. 66 will sunset, and the Tariff will revert to the prior "bid or better" settlement provisions.

² *California Independent System Operator Corporation*, 111 FERC ¶ 61,008 (2005) ("Amendment No. 66 Order").

As a result of the April 28, Stakeholder meeting, stakeholders requested additional written information in the form of a whitepaper on four topics:

1. How pre-dispatch prices are determined.
2. How the "deviation credit" (projecting the amount of uninstructed deviations during the next operating hour) is determined within the CAISO's RTMA software.
3. An explanation of uplift allocation issues and proposals.
4. A mathematical proof or explanation of how one of the options for a longer-term solution ("Option 1a") would produce prices that ensure that any pre-dispatched bid will recover its full bid price.

The CAISO is currently developing written information on these topics and expects to release them by May 13, 2005, prior to the next Stakeholder conference call on May 20, 2005.

The CAISO has also discussed the problem and various options with members of the Market Surveillance Committee ("MSC"). Options being developed and assessed will be further discussed at a May 24th meeting of the MSC. Informal feedback and/or a formal option may be provided by the MSC members by late May/early June, prior to development of a final recommendation to the CAISO Board.

Finally, it should be noted that key milestones may be subject to change depending on the Commission's response to the CAISO's Request for Clarification and Rehearing on Amendment 66, filed on today's date.

Update on Assessment of Option 1 (Pre-Dispatch Clearing Price)

As noted above, the Commission's Order indicated that options considered as part of the stakeholder process should specifically include a "financially binding hour-ahead market for inc/dec bids from System Resources at the interties under which bids would be settled at the predicted market clearing price rather than the higher of bid or real-time market clearing price" Amendment No. 66 Order at P 22. This solution appears to correspond to Option 1 of the several options under consideration in the current CAISO stakeholder process.

The CAISO continues to assess the feasibility of and issues with respect to implementing this option with the current RTMA software, as well as in the context of the proposed Hour Ahead Scheduling Protocol ("HASP") that will replace the RTMA pre-dispatch process under MRTU in February 2007. As part of this assessment, several additional issues and options have been identified which may add significant complexity and the risk of additional problems if this options is to be implemented using the existing RTMA software.

As part of the current process for pre-dispatching intertie bids, the RTMA software produces, but does not publish for settlement³, three sets of four 15-minute prices prior to each

³ When first assessing Option 1, the scope of work estimated was based on the assumption that the prices that were already produced by the RTMA software during the pre-dispatch process could be published for settlement purposes. Upon further review, an additional RTMA pricing run appears to be necessary, as explained below.

operating hour. The first set of prices results from a “multi-step” optimization process which identifies the least cost mix of inter-tie bids and bids from internal resources. A second set of prices is generated through a “single step” optimization, in which inter-tie bids selected for pre-dispatch in the multi-step stage run are treated as “fixed” for the entire operating hour, and internal resources are optimized to meet projected demand for each 15-minute interval, subject to various operating and dispatch constraints. In cases of congestion or other binding constraints that cannot be resolved using the available economic bids during these first two optimization runs, the resulting prices would not reflect an economic solution based solely on submitted bids, but rather would reflect dollar amounts that are used by the optimization software to prioritize how those constraints should be relaxed in order to arrive at a solution when economic bids have been exhausted. These soft constraints that are relaxed in order to obtain a solution are called “slack variables”. The dollar amounts used by the software when these slack variable constraints are relaxed are called “penalty prices”. Finally, a third set of prices is generated through a single step “pricing run”, which produces prices reflecting the marginal prices that are based on actual bid prices with no “soft-cap⁴” price constraints enforced. Because inter-tie bids are not allowed to set prices within the ISO System, however, prices produced in this final single step pricing run do not reflect the price of inter-tie bids that will be pre-dispatched at each inter-tie based on this optimization.

Thus, while prices produced during the initial multi-step optimization process determine the price of inter-tie bids that will be pre-dispatched at each inter-tie, if it proves necessary to relax “slack variables,” as described above, then these multi-step prices may reflect “penalty prices” in cases of congestion or other constraints, rather than an economic solution based solely on submitted bids. In order to ensure that these multi-step prices are appropriate for settlement of bids pre-dispatched at the inter-ties they must reflect an economic solution rather than “penalty prices.” As a result some alternative method would need to be implemented that replaces these slack variable penalty prices with prices appropriate for use in settlement. Ideally, these prices should be determined through a separate multi-step pricing run that effectively excludes the penalty prices from setting the price, and constrains the prices within the allowable soft-cap economic range (-\$30 to \$250). However modifying the RTMA software to include a multi-step “pricing run” would require significant additional cost, development time, and potential complexity.⁵

Alternative options for determining settlement prices for hours (and individual branch groups) when RTMA multi-step prices reflect slack variable penalty prices may include settlement on an “as-bid” basis or based on a “hard cap” (e.g. \$250/MWh). While the ISO continues to assess such options, the need to incorporate such features may add significant complexity and risk of additional problems if Option 1 is to be implemented using the RTMA software.

⁴ The “soft-cap” constraint ensures that prices remain between -\$30 and \$250 based on the marginal resource that is at or below the “soft-cap” limits.

⁵ The current HASP proposal makes allowance for both the software and time needed to perform a pricing run for pre-dispatch prices, since the current HASP design contemplates the use of such pre-dispatch prices during hours of congestion.

Development Milestones

- April 28, 2005 Stakeholder Meeting
- May 2-5, 2005 Written Comments from Stakeholders
- May 6, 2005 CAISO Board Update
- May 6, 2005 File Request for Clarification and Rehearing and Milestones
- May 16, 2005 Issue white papers
- May 20, 2005 Stakeholder Conference Call (tentative date)
- May 24, 2005 Market Surveillance Committee Meeting
- June 6, 2005 Recommendation and materials for June 15 CAISO Board meeting due to CAISO management (tentative)
- June 15, 2005 Present recommendation for longer-term solution for approval at CAISO Board Meeting (tentative)
- June 22, 2005 FERC filing (tentative)