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October 20, 2000

The Honorable David B. Boergers
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Room 1A
Washington, D.C. 20426

Re: *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,* Docket No. EL00-95-000; and *Investigation of Practices of the California Independent System Operator and the California Power Exchange,* Docket No. EL00-98-000

Dear Secretary Boergers:

By this submission, the California Independent System Operator Corporation ("ISO")[1] is tendering the specifics of a proposed Offer of Settlement addressed to a core issue in the pending dockets – the need to have in place as soon as is practicable a system-wide market power mitigation regime. This submission is not intended to displace the important Congestion Management and market redesign efforts that now are nearing completion. Rather, it is complementary to those initiatives and addressed to issues that cannot be ignored in the interim and that are likely to persist even with market reformation, for they are attributable not to design inadequacies, but to infrastructure insufficiency.

[1] Capitalized terms are used as defined in Appendix A of the ISO Tariff.

The proposal is submitted as a statement of principles and in settlement format, both so that it may serve as a vehicle for constructive interchange among interested participants and so that it may result in corrective action on a schedule that is consistent with the gravity of the underlying problems. Because it is submitted in response to litigation already initiated, and for the sole purpose of providing a platform for the development of a consensual resolution, ISO management has not submitted the proposal to its Governing Board for its consideration.

Shortly before the filing of this submission, the ISO became aware of the Order issued by the Commission on October 19th. The Commission's order calls for a special meeting on November 1, 2000, a three-week comment period, and a public conference on November 9, 2000. The Commission indicates that it anticipates issuing an order adopting and directing remedies by December 31, 2000. The ISO believes that the procedural format laid out in this proposal can accommodate the Commission's procedural order and proposed schedule.

To facilitate achievement of an expedited consensual resolution, the ISO urges the immediate appointment of a Settlement Judge under direction to convene a technical conference after the Commission's November 1, 2000 meeting and before the public conference on November 9, 2000. Having corrective action in place at the earliest date practicable can best be achieved through a consensual resolution among all affected participants. The ISO urges that the parties to these proceedings be directed to appear at that conference, accompanied by a principal empowered to make commitments, and that each be required to indicate its acceptance of the settlement principles or, failing that, its specific objections to any of its provisions together with suggested modifications that would be acceptable. If a consensual resolution is achieved, it would be the focus of the public conference on the November 9, 2000. If a resolution is not achieved, the settlement effort will nonetheless assist in the public discussion that takes place on November 9, 2000. The ISO agrees with the need for a Commission order to be issued before the end of the calendar year, so that the ISO will be able to have the relief in place by the Spring of 2001.

California's restructured electric power market unquestionably is experiencing severe difficulties, difficulties that largely were camouflaged while retail consumers were insulated from wholesale price spikes. But with the temporary lifting of price caps in the service territory of San Diego Gas & Electric Company, the gravity of the problems has become apparent and has provoked an outcry from all quarters. Understandably, this Commission initiated both a broad investigation of power markets generally and a more specific expedited investigation of the California markets. Equally understandably, constituent groups have filed a series of complaints bringing to the fore more specific grievances and proposed solutions.

It perhaps also is understandable that much of the criticism has been focused on the markets administered by the ISO. The ISO's markets are, after all, visible and, as a result of a distortion of the intended market design, have been called upon to discharge responsibilities that never were intended to fall to the ISO. This is said not as a matter of exculpation, but as a fact.

The principal responsibility of the ISO, a responsibility that it has discharged admirably under exceedingly trying circumstances this past summer, is to keep the lights on and to operate the ISO Controlled Grid and its Interconnections with neighboring Control Areas reliably. This was accomplished notwithstanding the failure of Supply indigenous to California to keep pace with Load growth (for much of the decade preceding restructuring, infrastructure investment in Generation and transmission largely was ignored) and notwithstanding the diminished availability of imports to a State that historically has been import dependent.

When the California model was developed, it was recognized that the ISO, to meet its reliability responsibilities, would have to operate, in real-time, an Imbalance Energy market. However, it was always assumed (and intended) that no more than 5%, at the very outside, of the Load within the Control Area would be satisfied in that market. It was intended to be a fine-tuning mechanism, meeting Load that could not reasonably have been forecast in time to be balanced with Supply in a forward market.

In sharp contrast to the intended market design, the ISO real-time imbalance market regularly has been called upon to satisfy 20% of actual Load and on occasion as much as 30% or more. This is intolerable from both a reliability and cost standpoint. This shift of responsibility has placed an enormous added burden on the ISO's Operations staff.[2] Even though the challenges have been of unprecedented proportions, they were and are being met successfully. However, an inevitable consequence of this shift in Load-satisfying responsibility from the Power Exchange ("PX") and bilateral forward markets to the ISO's Real Time Market, apart from testing reliability in the extreme, was to focus attention on the wholesale prices that emerged when Supply had to be accepted because Demand (and the ISO) lacked the ability to say "no."

It is, quite frankly, tempting to provoke an analysis of where responsibility for current difficulties properly should be assigned. That, however, would not be productive. Nor, we submit, would it be productive to call for a reversal of restructuring. It was the failure of the regulatory paradigm to bring forth sufficient, reasonably priced Generation that was a principal impetus for restructuring. During the prior decade, virtually nothing was done to supplement California's aged Supply inventory; in the few years since,

[2] The ISO recognizes that its own policies may have contributed to underscheduling, and it already has taken corrective action. However, much more needs to be done.

independent Generators have proposed approximately 40 new, efficient, and environmentally-preferential projects, requiring an investment of over $10 billion.

Instead of focusing on the assignment of blame, it is imperative that we reach agreement on the underlying problems and on their solutions. In the judgment of the ISO, and without in any way diminishing the significance of the need to reevaluate Congestion Management and market design, the core problems are:

- infrastructure insufficiency, both Generation and transmission;
- inadequate Demand-side price responsiveness;
- insufficient forward contracting;
- inadequate forward scheduling; and
- the need for market power mitigation – system-wide and local.

It is important to note that there is widespread agreement on the core problems identified above, including among the FERC, State regulators, and the market monitoring entities of the ISO and the PX (both the internal market analysis units and the external market monitoring committees). In various orders and reports, these entities have acknowledged the need (a) to site and build new generating and new transmission facilities, (b) to address the lack of retail Demand responsiveness, (c) for forward contracting, (d) to reduce the amount of Load being served in the ISO's Real Time Market through more forward scheduling, and (e) for market power mitigation.[3]

The proposal that comprises this submission addresses system-wide market power mitigation and includes provisions regarding forward contracting and forward scheduling. The core problems regarding the investment needed for new generation facilities, new transmission facilities, and retail Demand response (e.g., end-use metering equipment) require significant action by state regulatory bodies as well as actions by the ISO and others,[4] and are not specifically addressed in this proposal. Preliminarily, however, it may

[3] See, e.g., *San Diego Gas & Electric v. Sellers of Energy and Ancillary Services Into Markets Operated by the California Power Exchange and California Independent System Operator* 92 FERC ¶ 61,172 at 61,605; August 2, 2000 Report to Governor Gray Davis by the President of the California Public Utilities Commission and the Chairman of Electricity Oversight Board, Executive Summary; September 6, 2000 Report of the ISO's Market Surveillance Committee; and the August 10, 2000 Report of the ISO Department of Market Analysis to the EOB.

[4] For example, State regulators must approve the siting, the construction, and the environmental review of new Generation and transmission facilities. The ISO, in consultation with State regulators and Market Participants, must develop and implement policies concerning Interconnection and long-term grid planning

be instructive to summarize the initiatives that the ISO has underway to make the contribution it is able to make to the resolution of these issues.

"Local" market power mitigation is part of the Congestion Management redesign effort, the results of which soon will be considered by the ISO Governing Board and then presented to the Commission. The stimulation of infrastructure development has been a principal focus of the ISO. Each year the ISO technical staff analyzes the improvements that can be made to the backbone transmission system – from major new installations to rather minor, but still helpful, local modifications. To date, over $800 million in new transmission investments have been approved by the ISO as needed, and hundreds of millions of dollars of additional transmission investments are undergoing analysis.

On the Generation side, the ISO has, where appropriate, utilized its contracting authority to support new Supply additions. And, in response to the "needle" peak issue that complicates significantly California's Supply situation (Load typically is below 35,000 MW but can spike to as high as 44,000 MW for a few hours on relatively few days), the ISO has issued a Request for Bids soliciting incremental peaking resources. The primary objective of this measure is to assure the availability of critical peaking resources; resources necessary to maintain reliable operation of the system. The objective is to assure availability of critical peaking resources, but under a pricing regime that allows adequate compensation for those high cost units without distorting the Market Clearing Price that should pertain in a competitive baseload market. The bifurcation of the capacity required to address peak Demands from the majority of hours of the year in which the market is competitive is a practical recognition that, at least for the immediate future, there may not be a competitive market for peak needs absent significant participation by wholesale and retail Demand. The ISO, therefore, is endeavoring to obtain peaking resources through an alternative competitive regime. The success of this measure in addressing these non-competitive circumstances will ultimately depend on the amount of peaking resources the ISO is able to procure. The ISO's Demand Relief programs also can make a significant contribution to peak management. Accordingly, the ISO again intends to issue a Request for Demand Relief proposals in time to assure the availability of those tools for the Spring and Summer of 2001.

These peak management resources – both Supply enhancement and Demand reduction – are being acquired competitively, but under a pricing mechanism that will not impact Market Clearing Prices in the markets traditionally administered by the PX and the ISO. Peaking units that can and should run only a few hundred hours a year must be assured of the opportunity to achieve full cost recovery over those limited operating hours. If required to obtain that recovery in the traditional second-auction markets, clearing prices would be driven far above the competitive prices to be expected from non-peaking units.

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matters.

By establishing a differentiated pricing regime for peaking resources, the goals of assuring those units a fair opportunity of cost recovery, while insulating the traditional markets from inappropriate upward price pressure, can be realized. While peaking capacity and the ISO's Demand Relief programs are important elements in managing peak Demands, fully competitive retail markets require retail Demand that is able effectively to respond to price signals. The development of technical standards for, and the investment in, metering capability must be addressed in order to have effective Demand response by retail customers.

Finally, the ISO has been endeavoring to stimulate forward contracting and to encourage forward scheduling. As to the latter, tariff changes already have been adopted and more are under consideration. As to the former, the ISO has begun both to explore long-term Supply availability and, because it firmly is of the view that its market intervention should be minimized and that forward contracting more properly is the responsibility of load-serving entities, it has called upon the California Public Utilities Commission to empower and encourage utility distribution companies to forward contract.

These efforts must and will continue. But parallel action to protect against the potential for the system-wide exercise of market power – that is, market power that is not the result of a locational advantage – must be put in place as soon as is practicable. The ISO intends, by this submission, to facilitate achievement of that goal, hopefully through a consensual process. The proposal that is outlined in the enclosed Offer of Settlement and summarized below was designed as a comprehensive, implementable package. It is not presented, however, as a *fait accompli* but, rather, as a basis for considered deliberations. If the parties have suggestions for refinements or even for modifications, the ISO is prepared to explore them fully. What the ISO seeks to avoid is the squandering of time, prejudicing the pursuit, if necessary, of more action-forcing steps. The time-imperative does not permit anything short of the full commitment of all affected constituencies. That is why we call for the immediate appointment of a Settlement Judge and for direction from the Commission that all parties be required, expeditiously, to respond with specificity.

The proposal that is attached is bottomed on the analyses undertaken independently by the Market Surveillance Committee and the Department of Market Analysis ("DMA"), each of which indicates that, while the markets are competitive for many hours of the year, market power is evident when available Supply is only moderately sufficient to meet Demand. *See* the attached Declaration of Dr. Eric Hildebrandt. In response to these analyses, the ISO initially endeavored to develop a process that would allow for the bifurcation of the market between "competitive" and "non-competitive" hours. However, bifurcation of the markets in this fashion would present issues of practicality and predictability. Accordingly, while willing to discuss any and all options in settlement negotiations (including bifurcation of markets into competitive and non-competitive periods), the ISO is proposing a simpler approach. Namely, the ISO proposes that the price cap be established at $100/Mwhr with the following exemptions:[5] (1) if an owner demonstrates that a payment of $100/Mwhr would be insufficient to cover the variable operating cost of a unit and make some reasonable contribution to fixed cost recovery, a higher cap would be fixed for that unit but that price would not establish the Market Clearing Price; (2) Generation fired by renewables would be exempt; (3) owners and operators whose units do not exceed 50 MW would be exempt; (4) incremental Generation (additions to existing units and new units) would be exempt; (5) any owner or marketer who demonstrates that it has committed 70% or more of the availability of its in-State portfolio to an in-State Load-serving entity for a term extending at least through October 15, 2002, would be exempt, and (6) imports would be exempt.[6] Exempt units would be subject to whatever higher damage-control price cap is in place.[7] It is the ISO's expectation that the combined effect of the $100/Mwhr price cap with the availability of an exemption from that limitation will incline those that own or control Generation resources to forward contract.

As a corollary measure, it is proposed that Load be required to forward contract for no less than 85% of projected requirements, as adjusted by season and time-of-day. Generation currently owned by Load-serving entities would be counted in satisfaction of the 85% requirement. Finally, while forward contracting should go a long way toward resolution of the underscheduling problem, Scheduling Coordinators would be required to schedule no less than 90% of Load in the Day-Ahead Market and no less than 95% in the Hour-Ahead Market. A charge would be assessed against Load and Generation that appears in real-time and that exceeds 1.10 and 1.05 times the balanced schedules submitted, respectively, in the Day-Ahead and Hour-Ahead Markets, and out-of-market costs would be charged to underscheduled Load and to Generation appearing in real-time in excess of balanced schedules.

By requiring forward contracting to the extent proposed, Utility Distribution Companies, with the concurrence of the Public Utilities Commission, should be in a

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[5]A price cap ceiling of $100/Mwhr was selected because the analysis undertaken by the DMA indicates that during times when the market is workably competitive, it clears at prices below $100/Mwhr. *See* Hildebrandt Declaration at 3,7,9. The ISO would propose to peg that ceiling price to an assumed monthly average burner tip price of natural gas at $7/MMBtu. To the extent that the price of natural gas deviates from this assumed cost by more than a threshold level, say 5%, it would be the ISO's intention that the ceiling price be adjusted to reflect that cost change. Application of that standard today might require a price higher than $100/Mwhr in light of recent escalations in natural gas prices. It is proposed that the base price be established by reference to the most current natural gas information available at the time that the Commission approves the settlement.

[6]Imports present an especially vexing problem. A suggested solution is offered but on this issue in particular, we encourage the parties to engage in frank discussions toward the end of developing a satisfactory compromise.

[7] Demand-side programs would not be subject to any payment cap.

position to secure for their customers with the most inelastic Loads – residential and small commercial – adequate supplies at fixed rates. The ISO urges the participation of the Public Utilities Commission in this settlement effort so that the objective of consumer protection may best be realized.

The ISO does not presume that its proposal is free of difficulties for either Generators or marketers or for Load-serving entities. The ISO does urge, however, that interested parties resist the inclination to dwell on shortcomings, on the inclination to be critical. If the proposal were being offered as a final resolution, criticism might be appropriate. It is offered, instead, as a good faith basis for beginning a dialogue that no longer can be postponed. Development of an acceptable solution will require the cooperation of the ISO, of Market Participants, of Load-serving entities and their consumers, and of regulators. That is precisely what is so desperately needed at this critical juncture – cooperation and the cessation of finger-pointing. Nothing less is tolerable; nothing less will discharge the responsibility which each bears to ensure that restructuring works for the consumers who are to be its principal beneficiaries.

Copies of this submission are being served on all parties to these consolidated proceedings and Docket Nos. Docket Nos. EL00-104-000, EL01-1-000, EL01-2-000 and ER00-3673.

Sincerely,

Edward Berlin

Attachments: Offer of Settlement
Declaration of Dr. Eric Hildebrandt, Ph.D.

cc: All Parties

The Honorable James J. Hoecker
The Honorable Linda K. Breathitt
The Honorable Curtis L. Hèbert, Jr.
The Honorable William L. Massey
Chairman Michael A. Kahn
California Electricity Oversight Board
President Loretta Lynch
California Public Utility Commission

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all parties on the official service lists compiled by the Secretary in the above-captioned proceeding and Docket Nos. EL00-104-000, EL01-1-000, EL01-2-000 and ER00-3673 in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated at Washington, D.C. this 20th day of October, 2000.

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Michael E. Ward