

June 18, 1999

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

**Re: California Independent System Operator Corporation,
Docket No. ER99-____-000
Amendments to the ISO Tariff and Request for
Waiver of Notice Requirements**

Dear Secretary Boergers:

Pursuant to Section 205 of the Federal Power Act (AFPA¹), 16 U.S.C. 824d, and Sections 35.11 and 35.13 of the Commission's regulations, 18 C.F.R. 35.11, 35.13, the California Independent System Operator Corporation (AISO¹)¹ respectfully submits for filing an original and six copies of an amendment ("Amendment No. 18") to the ISO Tariff. Amendment No. 18 would modify the Tariff to deal with flaws in the current market rules for managing Intra-Zonal Congestion in real-time.

As explained below, the ISO has identified a flaw in one of the market rules incorporated in the ISO Tariff for managing Intra-Zonal Congestion. This flaw has so narrowly defined the market for bids to manage Intra-Zonal Congestion that a small number of sellers have and are exercising market power. The ISO estimates that unless it expands the market to allow other bidders to compete for this service, consumers face additional costs of up to \$750,000 per day. The issue is

¹ Capitalized terms not otherwise defined herein are defined in the Master Definitions Supplement, ISO Tariff Appendix A, as filed August 15, 1997, and subsequently revised.

particularly acute now, because high hydro run-off and relatively mild temperatures are creating consistent and predictable Intra-Zonal Congestion.

Amendment No. 18 would modify and simplify the ISO's market rule to correct this defect. In order to implement this correction promptly; expand the universe of bidders allowed to compete to alleviate Intra-Zonal Congestion, and thereby avoid additional costs to consumers, the ISO respectfully requests waiver of the prior notice provisions of Section 205(d) of the FPA, 16 U.S.C. § 824d(d), and Section 35.3 of the Commission's regulations, 18 C.F.R. § 35.3, to permit Amendment No. 18 to go into effect for all bids to deliver Energy or Ancillary Services in operating day June 20, 1999. The ISO further requests that the Commission act on Amendment No. 18 in an expedited manner to eliminate any uncertainty about the continued appropriateness of this expedited rule change.

I. BACKGROUND

Section 7.2.6.2 of the ISO Tariff sets forth the market rules under which the ISO is directed to manage Intra-Zonal Congestion. At present, the ISO manages Intra-Zonal Congestion in its real-time operations.² Under Section 7.2.6.2, the ISO is required first to attempt to manage Intra-Zonal Congestion using Adjustment Bids that remain available after Inter-Zonal Congestion has been relieved in forward markets. Only when available Adjustment Bids are exhausted before the congestion is fully resolved may the ISO turn to incremental and decremental bids for real-time Imbalance Energy. Moreover, the ISO is directed first to use Adjustment Bids and Imbalance Energy bids from resources that are within the Zone experiencing Intra-Zonal Congestion before utilizing other options to manage the congestion. See, ISO Tariff Section 7.2.6.2 and Dispatch Protocol section 8.4. Thus, these sections reflect an ordered hierarchy of measures that the ISO must use to manage Intra-Zonal Congestion: Adjustment Bids first; then Imbalance Energy Bids within the Zone; and, finally, other resources, including Imbalance Energy bids from resources outside the Zone. Only if no effective bids exist may the ISO call units out-of-market under the Participating Generator Agreements.

These provisions reflect the original design of the market – under which Intra-Zonal Congestion would be addressed through the Day-Ahead and Hour-Ahead Markets (when Adjustment Bids are submitted), when Inter-Zonal Congestion is also resolved. Due to the staging of software development, the ISO as yet lacks the capability to manage Intra-Zonal Congestion through the Day-

² In contrast, the ISO manages Inter-Zonal Congestion in forward markets, using Adjustments Bids submitted by Scheduling Coordinators to reflect their willingness to adjust the output of their resources.

Ahead and Hour-Ahead Markets. As a result, the ISO currently manages all Intra-Zonal Congestion in real-time. Nonetheless, because of the Tariff provisions, the ISO must continue to rely first on the Adjustment bids, rather than the Imbalance Energy bids submitted in the real-time market. This has produced the anomalous result that the ISO has had to call on a \$250/MW Adjustment Bid, even if significantly lower Imbalance Energy bids are available from the **same unit for the same capacity**. In addition, the ISO must exhaust all bids from within the Zone experiencing congestion, even if a resource outside the Zone with a lower bid could resolve the congestion at lower cost.

This market rule presents the opportunity for strategic bidding, which is now occurring regularly. For example, the limitations embodied in the Tariff have required the ISO to call on high Adjustment Bids on many occasions, when unused Imbalance Energy bids (sometimes from the same unit for the same capacity) are at substantially lower prices.

In circumstances when only one or two units in an area can relieve the problem and they are located in an area on the edge of a zone, the problem is further exacerbated. The ISO may not call on **any bid** outside the zone until **all** bids inside the Zone are exhausted. Yet lower-priced bids just across the **inter-zonal** interface often would solve the **Intra-Zonal** Congestion.

An example illustrating the problem is shown on the diagram contained in **Attachment C**. The diagram reflects a hypothetical system, with two zones and six generating units (represented by the numbered circles). When Path Y within Zone I becomes congested, the current rule embodied in Section 7.2.6.2 and Dispatch Protocol 8.4 require the ISO to look first for Adjustment Bids from Units 1, 3, 4, and 5 (units located in Zone I). Because Unit 1 is the only unit located on one side of the constrained path, there would be no limit on the magnitude of the Adjustment Bids it could submit (other than any applicable price cap), even if adjustments to the output of Unit 2 or Unit 6, which are located in Zone II, could reduce loading on Path Y. The market rule in Section 7.2.6.2 and Dispatch Protocol 8.4 would, under this scenario, give the owner of Unit 1 the opportunity to exercise market power when Path Y is congested.

This is more than a theoretical concern. This bidding behavior is not new, but it has now accelerated to a critical level. Recent bids received by the ISO indicate that additional Market Participants have identified the opportunity that the current market rule presents for them to profit from Intra-Zonal Congestion by submitting high-priced Adjustment Bids. An analysis of the recent bids is contained

in **Attachment D**.³ The ISO estimates that, if all bidders with the ability to exercise market power in this way were to engage in the strategic behavior described above, the ISO would incur additional Intra-Zonal Congestion Management costs of up to \$750,000 each day, compared to the costs it estimates it would incur if it could select the most economical and efficient combination of Adjustment Bids and Imbalance Energy bids to address Intra-Zonal Congestion. These costs are borne by Scheduling Coordinators serving demand within a Zone experiencing Intra-Zonal Congestion through the Grid Operations Charge and ultimately to California end-use consumers.

The ISO identified this problem and developed Tariff revisions which would permit more flexibility in managing Intra-Zonal Congestion in order to address these issues. Tariff revisions were presented to stakeholders for comment and ultimately approved by the ISO Governing Board at its May 27, 1999 meeting, with the plan to file them in the quarterly Tariff filing filed with the Commission yesterday as Amendment No. 17 to the ISO Tariff. As a result of the recent evidence of strategic bidding behavior, the ISO believes a further expansion of the market defined in the rule is required and, more importantly, believes that immediate implementation is necessary.

II. THE PROPOSED AMENDMENTS

As explained above, the current ISO Tariff provisions unnecessarily restrict the market available to the ISO to manage Intra-Zonal Congestion on behalf of Market Participants. The market is limited first to Adjustment Bids in the Zone (see DP 8.4), and once those are exhausted, then to Imbalance Energy bids within the Zone experiencing Intra-Zonal Congestion. These markets are defined in an unnecessarily narrow manner. The proper solution is to expand the market definition to recognize all bids, wherever located, as eligible ones to which the ISO can turn to manage Intra-Zonal Congestion.

Amendment No. 18 would accomplish this by modifying Section 7.2.6.2 (and DP 8.4) to allow the ISO to use Adjustment Bids and Imbalance Energy bids interchangeably and regardless of the location of the resource, to mitigate Intra-Zonal Congestion in real-time, based solely upon the effectiveness (*i.e.*, their ability to mitigate the Intra-Zonal Congestion without increasing Inter-Zonal Congestion)

³ To protect the confidentiality of the anonymous bid data on which **Attachment D** is based, the ISO is submitting **Attachment D** under seal pursuant to Section 388.112 of the Commission's regulations, 18 C.F.R. § 388.112. In accordance with that provision, **Attachment D** is not being provided to parties on whom copies of this filing are being served.

and price of the bids. The ISO would continue to use the same economic resources that it now uses to manage Intra-Zonal Congestion; current limitations on the **order** in which the ISO uses those resources that have submitted Adjustment Bids and/or Imbalance Energy bids would be removed to eliminate opportunities those limitations create for strategic bidding. These changes would not have the ISO select Adjustment Bids and Imbalance Energy bids from outside a Zone to mitigate Intra-Zonal Congestion if that selection would create or exacerbate **Inter-Zonal** Congestion.

Under the existing Tariff provisions, the ISO may exercise its authority to direct redispatch of resources within the Zone that have not submitted Adjustment Bids or Imbalance Energy bids only if there are no available Adjustment or Imbalance Energy bids. Amendment No. 18 would not change the circumstances in which the ISO can exercise its authority to direct out-of-market redispatch of resources.

The proposed revisions reflect the ISO's commitment to increasing efficiency and reducing costs through market mechanisms. It would provide the ISO with the flexibility necessary to reduce the current costs of mitigating Intra-Zonal Congestion without limiting other options for mitigation through the Hour-Ahead and Day-Ahead Markets or through market redesign and would continue to allow the ISO to redispatch resources, only as a last resort.

Amendment No. 18 also includes a number of other elements related to the Intra-Zonal Congestion Management provisions of the ISO Tariff. The amendment would eliminate language in sections 7.2.6.2 and 7.2.6.3 that calls (1) for the use of Adjustment Bids to decrement Generation in order to accommodate Reliability Must-Run Generation dispatched by the ISO and (2) for payment to the Reliability Must-Run Units according to the average of the Adjustment bids used in this manner and to mitigate Intra-Zonal Congestion. These provisions have been displaced by payment provisions in the Reliability Must-Run Contract, according to which the ISO pays Reliability Must-Run Units. The elimination of these provisions will avoid any confusion regarding the payments due.

Amendment No. 18 includes two other clarifying revisions with regard to the management of Intra-Zonal Congestion. First, although the ISO is authorized by various sections of the Tariff to use Generators, Loads, and System Resources to manage Intra-Zonal Congestion, not all of those provisions refer to all three resources. These inconsistencies have been introduced through earlier amendments that revised some, but not all, of the sections. Amendment No. 18 would provide more consistent references to all three resources. Second, several

sections of the Tariff include identical or nearly identical language repeating the same grant of or limit on the ISO's authority regarding the management of Intra-Zonal Congestion. The proposed revisions would replace this identical language with cross-references.

III. REQUESTED EFFECTIVE DATE, REQUEST FOR WAIVER OF 60 DAY PRIOR NOTICE REQUIREMENT, AND REQUEST FOR EXPEDITED CONSIDERATION

The ISO respectfully requests, pursuant to Section 35.11 of the Commission's regulations, 18 C.F.R. § 35.11, that the Commission accept Amendment No. 18 for filing and permit it to become effective for bids to supply in operating day June 20, 1999. For the reasons described above, the ISO believes that immediate implementation of the revised Intra-Zonal Congestion Management rule is necessary. This market rule has unintentionally created the opportunity to exercise substantial market power. A very simple change will allow a more competitive market to operate. To fail to mitigate this unintended creation of market power risks imposing substantial costs on California consumers.

Consistent with this request, and based on the potential for costs of up to three-quarters of a million dollars a day (including weekends), The ISO feels it must, pending Commission action on Amendment No. 18, manage Intra-Zonal Congestion in accordance with the more flexible procedures set forth in Amendment No. 18. The ISO requests that the Commission expedite its consideration of Amendment No. 18 to the extent possible to minimize the extent of any uncertainty created by the ISO's interim implementation of these more flexible procedures.

Good cause exists for the Commission to grant the requested waiver. Amendment No. 18 is intended to eliminate a potential for strategic bidding that could result in millions of dollars of additional costs to California electricity customers. No party is entitled to exercise market power. No change in bidding behavior or bidder procedures is mandated. Bidders may continue to operate exactly as they do now. The ISO will simply be able to select bids from an expanded pool to avoid the current exercise of market power.

This request and the immediate implementation without prior Commission action is not taken lightly. Once the ISO successfully addressed the numerous challenges posed during startup and its initial months of operation, it has endeavored to avoid requesting any waiver of the prior notice requirement and not to implement a change until an order is obtained. Given the extreme circumstances and substantial financial impact at issue in the instant filing, however, the ISO

believes its immediate implementation, the waiver and request for expedited action are in the public interest.

As mentioned earlier, although immediate implementation had not been discussed until now, a filing to eliminate the design flaws in managing Intra-Zonal congestion was to be included in the Amendment No. 17 filing made yesterday. The issues raised in Amendment No. 18 have been reviewed in the ISO stakeholder processes. The ISO has presented the substance of its plan to revise the Tariff to permit it to more economically manage Intra-Zonal Congestion to stakeholders. There were no substantial objections to this plan, which was approved by the ISO Governing Board in May. The only changes are a *further* expansion of the market boundaries and immediate implementation. Both are compelled by the recent bidding behavior experienced and the unnecessary costs already incurred.

In order to ensure that parties are swiftly informed of the ISO's proposal in Amendment No. 18, the ISO commits to take the following steps today. First, the ISO will provide all Market Participants with notice of the filing of Amendment No. 18 with the Commission by e-mail to be sent on this date, with the non-confidential filing attached. The ISO will also e-mail electronic copies of this filing letter and non-confidential attachments to the designated contact in all Scheduling Coordinator Service Agreements. The electronic documents will also be posted on the ISO Home Page.

In addition, the ISO has served copies of this letter, and all non-confidential attachments, on the Public Utilities Commission of the State of California, the California Energy Commission, the California Electricity Oversight Board, and on all parties with effective Scheduling Coordinator Service Agreements under the ISO Tariff.

IV. REQUEST FOR PRIVILEGED TREATMENT

Attachment D is submitted under seal with a request that the Commission grant it confidential treatment pursuant to Section 388.112 of the Commission's regulations, 18 CFR § 388.112 (1998). This request is justified because, under Section 20.3.2 of the ISO Tariff, the ISO is required to treat information about individual bids for Supplemental Energy and individual Adjustment Bids for Congestion Management (which are not designated by a Scheduling Coordinator as available) as confidential. Consistent with the procedures set forth in Section 388.112(b)(ii), the ISO submits one complete original version of *Attachment D* under seal, with a legend on the front page

The Honorable David P. Boergers
June 18, 1999
Page 8

indicating "Contains Privileged information - Do Not Release." The ISO hereby designates the following person to be contacted regarding the request for privileged and confidential treatment of **Attachment D** to this filing:

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IV. NOTICES

Communications regarding this filing should be addressed to the following individuals, whose names should be placed on the official service list established by the Secretary with respect to this submittal:

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IV. SUPPORTING DOCUMENTS

The following documents, in addition to this letter, support this filing:

Attachment A	Revised Tariff Sheets
Attachment B	Black-lined Tariff provisions relating to Intra-Zonal Congestion showing the proposed revisions
Attachment C	Diagram illustrating the potential for strategic bidding behavior and the exercise of market power under current Intra-Zonal Congestion Management rule

The Honorable David P. Boergers
June 18, 1999
Page 9

Attachment D Analysis of recent strategic bidding behavior (submitted under seal with a request for confidential treatment pursuant to Section 388.112)
Attachment E Notice of this filing, suitable for publication in the Federal Register (also provided in electronic format).

An additional copy of this filing is enclosed to be marked with your filing stamp and returned to our messenger. If there are any questions concerning this filing, please contact the undersigned.

Respectfully submitted,

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