CALIFORNIA ISO

California Independent
System Operator

May 15, 2002

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

Re: San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services in Markets Operated by the California Independent System Operator and California Power Exchange, et al., Docket Nos. EL00-95-001, ER02-1656-000 and EL00-98-000

Dear Secretary Salas:

Enclosed for electronic filing please find the Motion of the California Independent System Operator Corporation for Rejection or, in the Alternative, Answer to Motion of Reliant Companies for Establishment of a Capacity Market, Etc., submitted 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

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

San Diego Gas & Electric Company	)	**Docket No. EL00-95-001**
v.	)	
Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and the California Power Exchange	)	
Investigation of Practices of the California Independent System Operator and the California Power Exchange	)	**Docket No. EL00-98-000**
California Independent System Operator (MD02)	)	**Docket No. ER02-1656-000**

MOTION OF THE CALIFORNIA ISO FOR REJECTION OF OR, IN THE ALTERNATIVE, ANSWER TO, MOTION OF RELIANT COMPANIES FOR ESTABLISHMENT OF A CAPACITY MARKET, ETC.

Pursuant to Rules 212 and 213 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §§ 385.212 & 385.213 (2002), the California Independent System Operator Corporation ("California ISO") hereby moves for the Commission to reject, or, in the alternative, to deny as moot the Motion for Establishment of a Capacity Market in California with Associated Must Offer Obligations and Price Mitigation Measures ("Capacity Market Motion") filed in the above indicated dockets. The Capacity Market Motion was filed on April 30, 2002 by Reliant Energy Power Generation, Inc. and Reliant Energy Services, Inc. (collectively "Reliant Companies").

For the reasons discussed below the Commission should reject the Capacity Market Motion because it does not comply with the Commission's Rules for filings of this nature. If the

Commission does not reject the Capacity Market Motion, it should deny the Motion because subsequent events have rendered the Capacity Market Motion moot. Nothing prevents Reliant Companies from submitting their proposal through the procedurally appropriate avenues available to them.

I. Background

In its Capacity Market Motion, the Reliant Companies request that the Commission require establishment of a capacity commitment market, along with associated must offer obligations and price mitigation measures upon expiration of the west-wide mitigation scheme on September 30, 2002. Reliant Companies propose to establish a temporary Available Capacity market that would begin on October 1, 2002 and terminate on December 31, 2004. Load Serving Entities (LSEs) would be required to obtain sufficient capacity to meet their ISO-forecast load requirement plus their Reserve Margin. For those LSEs that fail to self-arrange the requisite amount of capacity, the ISO would acquire such capacity on the LSEs' behalf in an ACAP market. Generators with Participating Generator Agreements would be obligated to offer available and uncommitted capacity in the ACAP auction, and generators selected as ACAP resources would be obligated to submit bids for the committed capacity in the ISO's Day Ahead Market. ACAP resources would be required to post a credit in an amount equal to 10 percent of the monthly contract value. If the resource is unable to provide the committed capacity, it will lose a part of its payment in proportion to its level of non-performance and also forfeit as a penalty a pro rata portion of the 10 percent credit posted. There would be a cap on payments to ACAP resources equal to the higher of $250/MWh or an index price set by a high heat rate unit and a gas index. For non-ACAP resources, Reliant Companies propose a damage control bid cap of $1,000/MWh. However, Reliant Companies propose that there would be no after-the-fact

mitigation for accepted bids (1) at prices of $250/MWh or less, or (2) that are within 300 percent of a ninety-day rolling average of a resource's bidding history. For the long term, Reliant Companies propose establishment of a forward capacity market in the form of an annual Regional Reliability Commitment ("RRC"). The RRC would be structured in a manner similar to the interim ACAP, but would operate on a three- year forward-looking basis. However, there would be no price mitigation measures in place.

The California ISO agrees with the Reliant Companies that imposition of a capacity obligation on LSEs is both appropriate and necessary. In that regard, such a capacity obligation will help (1) ensure the operational integrity of the California ISO-controlled grid, (2) promote stability in California's wholesale energy markets and (3) promote the development of new generation in California. These are some of the reasons why the California ISO proposed an ACAP obligation for LSEs in its Comprehensive Market Design Filing on May 1, 2002 ("May 1 Filing"). The California ISO commends Reliant Companies for recognizing the clear benefits of imposing a capacity obligation on LSEs. However, the California ISO submits that Reliant Companies' specific proposal is seriously flawed both procedurally and substantively and, as such, must be rejected by the Commission.

II. The Motion Fails to Comply with Rule 205

The Reliant Companies have submitted their Capacity Market Motion as a "motion" filed pursuant to Rule 212 in this proceeding. The Commission should recognize that this Motion is not appropriately characterized and does not conform to the Commission Rule applicable to its stated purpose. The Commission should therefore reject it.

A "motion" ordinarily provides a means for a party to request that the Commission take some procedural action in an on-going proceeding. The Rules make other provision for more

complex issues and proposals, such as tariff or tariff-related filings. Indeed, the Commission specifically provides in Rule 205 that where a person seeks to "establish or change any specific rate, rate schedule, tariff, tariff schedule, fare, charge, or term or condition of service, or any classification, contract, practice, or any related regulation," such person "must make a tariff or rate filing." 18 C.F.R. § 385.205 (emphasis added). Rule 205 makes a tariff or rate filing (which are subject to all of the requirements of Part 35, including a fee) the exclusive procedural course for filings seeking to establish or modify tariffs or rates. *See* 18 C.F.R. Part 35.

The Capacity Market Motion inherently involves the establishment of any or all of rates, schedules, fares, charges, and terms or conditions of service in the course of setting up a market in California for available capacity. For example, the Reliant Companies allege that "the market receives an availability benefit for which generators are not compensated." Motion at 4. Consequently, Reliant Companies introduce a framework that would provide compensation to suppliers of capacity (such as themselves). Thus, the Capacity Market Motion purports to seek the establishment or change of a tariff in contravention of Rule 205. The Commission should therefore reject it.

Another defect in the procedural course adopted by the Reliant Companies in presenting their Capacity Market Motion is their lack of standing to file it in its current form. Rule 205 provides for a person to file tariffs and associated practices that are "by and for the applicant." 18 C.F.R. § 385.205. Recognition that the Capacity Market Motion constitutes a tariff filing does not mean that the California ISO agrees that the Reliant Companies or any other person, has standing, at their own initiative, to amend or supplement the California ISO FERC Tariff, or to establish a new tariff subject to the California ISO's administration. The California ISO has the exclusive right under both Section 205 of the Federal Power Act, as reaffirmed in Rule 205, to

file tariffs and associated practices "by and for" itself. 16 U.S.C. § 824d (1992). The Reliant Companies may seek Commission authorization to establish their own capacity market, but not one "by and for" the California ISO or any other person.

III. The Motion is Moot

In addition to its procedural infirmity, subsequent events render the Motion moot. The Reliant Companies state that they submitted the Reliant Proposal based upon the belief that the filing scheduled to be submitted by the California ISO, as required by the Commission in its Order on Clarification and Rehearing issued in this docket on December 19, 2001,[1] would not "propose actual changes, but rather [would] make 'hypothetical' observations about possible market redesign." Motion at 5.

Since that time the California ISO timely filed in this docket its Comprehensive Market Design Proposal and supporting documents on May 1, 2002. Contrary to the expectations of the Reliant Companies, this filing contains numerous and specific proposals about the redesign of California's energy markets, including a specific proposal to establish an available capacity obligation on load-serving entities in California. Moreover, the California ISO indicates (at 47) in its cover letter to the May 1 Filing that the California ISO will make a second filing in this docket in mid-June, 2002 ("June Filing"). This filing will include proposed amendments and revisions to the California ISO's FERC Electric Tariff to establish an available capacity framework. Because the Reliant Companies predicated their Capacity Market Motion on the assumption that the California ISO would take no action, and the California ISO has in fact submitted its own proposal and, indeed, will imminently submit in the June Filing tariff sheets designed to create an available capacity framework for California, the Commission should find

[1] *San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Services, etc.. et al.*, 97 F.E.R.C. ¶61,275.

that the Capacity Market Motion is moot. The Reliant Companies will, of course, have an opportunity to file a protest along with other parties in this proceeding commenting on any aspects of California ISO's proposal.

IV. There Are Procedurally Proper Alternatives

If the Reliant Companies desire to have their proposed capacity market framework considered, they have alternative --and appropriate-- procedural avenues available. First, where relevant, the Reliant Companies are welcome to reformulate aspects of their proposal in protests to or comments on the California ISO's May 1 Filing and/or June Filing. The California ISO welcomes, and will continue to welcome, input from all affected parties on the development of available capacity markets for Californians. However, the California ISO notes that to the extent that the Reliant Companies seek to impose their model, they must affirmatively demonstrate that the California ISO's proposal is "unjust, unreasonable, or unduly discriminatory or preferential," not merely "not as good" as the Reliant Companies' proposal. Federal Power Act § 206; 16 U.S.C. § 824e.

Provided that Reliant Companies meet the procedural requirements and submit any necessary fees, the Reliant Companies may also attempt to reformulate the Capacity Market Motion into a complaint filed pursuant Rule 206 or a petition for a declaratory order filed pursuant to Rule 207. *See* 18 C.F.R. §§ 385.206 & 385.207. However, the Commission itself should not attempt to recast the Motion into such a format, and thereby excuse Reliant Companies from its generally applicable Rules and force the California ISO and other affected parties to address this proposal in a procedurally awkward manner.

V. Reliant Companies' Proposal Has Numerous Substantive Flaws

Although the California ISO believes that the Commission must reject Reliant Companies' Capacity Market Motion for procedural reasons, the California ISO will briefly identify some of the specific flaws with Reliant Companies' ACAP/RRC proposal. In the event Reliant Companies include their ACAP/RRC proposal in a protest to the ISO's May 1 Filing, the California ISO will address such proposal in greater detail in any answer to protests. Based on a cursory review of Reliant Companies' ACAP/RRC proposal, the California ISO has identified the following problems with such proposal:

- ?? Implementing an interim ACAP market effective October 1, 2002 will provide too short of a procurement window to mitigate the market power that existing generation likely would have in an ACAP market. As a consequence, the proposed $6/KW-month cap would likely be hit in most months. A capacity obligation should not be imposed without allowing sufficient time for new generation development and demand response programs to compete with existing resources in providing ACAP.

- ?? The continued uncertainty of the utilities' financial status makes imposition of an ACAP requirement on October 1, 2002 problematic. The California ISO does not believe it is appropriate or practical to impose an ACAP obligation on LSEs until such entities are creditworthy and have substantial lead- time to meet such an obligation. In that regard, ACAP essentially is a long term planning tool for utilities. ACAP is not intended for an entity like CERS that has stepped in only on a temporary basis in order to backstop purchases in the absence of non-creditworthy utilities.

- ?? The California ISO does not desire to establish and operate a formal ACAP market. The California ISO believes that an ACAP obligation can be met adequately through bilateral arrangements.

- ?? A major conceptual flaw is that the proposal appears to be a hybrid of an eastern-ISO installed capacity ("ICAP") regime and the California ISO's ACAP proposal. Reliant Companies' proposed combination of ICAP and ACAP features will maximize payments to suppliers and, correspondingly, costs to consumers. Under the California ISO's ACAP proposal, the strong availability aspect is combined with a monthly adjustment of LSEs' obligations, thereby resulting in resource procurement that matches the California ISO's operating needs. In contrast, an ICAP-type obligation typically is intended for a longer time horizon but with

weaker availability provisions. Under Reliant Companies' proposal, the combination of strong availability provisions with an obligation that is established years in the future seriously diminishes LSE flexibility in procurement and increases the risk of costly over-procurement.

?? However, this can occur only after the fact, not through active participation in the market. Because the demand in the market would be inelastic, suppliers would have the opportunity to spike prices in the market.

?? A $1000/MWh damage control bid cap is wholly inappropriate in the California market where a robust and competitive market does not exist. In addition, it is absurd to apply a gas price index to a $1,000/MWh cap.

?? The safe harbor provisions are overly generous and will not provide sufficient protection against market power. They essentially constitute an advance determination that any price below $250/MWh is just and reasonable, even if such price is the product of anticompetitive bidding behavior or market manipulation. This is wholly inappropriate. With respect to bids in excess of the safe harbor level, Reliant Companies' proposal is inconsistent with the Commission's view that prospective mitigation after certain thresholds are met is better than after-the-fact mitigation.

?? It is not entirely clear how the real time price will be established. It appears that the market could be bifurcated if ACAP resources are capped at $250 and non-ACAP resources can receive a price higher than $250. This is inefficient and reduces transparency. If non-ACAP resources can set the price, it provides incentive to keep non-ACAP resources.

?? The non-availability proposal for ACAP resources will not be significant enough to deter physical withholding during critical peak periods. When a supplier withholds capacity from a particular unit, it only forfeits the availability payment and a pro rata share of the guarantee for that unit. However, the supplier may be able to drive up the energy price that the supplier's entire portfolio would then earn. As the California ISO indicated in its May 1 Filing, when suppliers under-deliver energy, prices generally rise. Under these circumstances, the supplier could earn increased revenues that would more than offset the lost revenues due to the non-availability penalty.

?? The proposed reporting of availability is similar to that for Reliability Must Run units. Such reporting has led to contentious disputes. At a minimum, the California ISO should have the right, without advance notice, to test unavailability and rescind capacity payments retroactively if the unit does not respond.

?? The RRC allows for trading of an RRC obligation. Given that ACAP capacity has a necessary locational aspect to it due to network constraints, a supplier may not simply substitute one capacity obligation for another.

?? Reliant Companies' proposal appears to build in a 7% forced outage rate for all units. There is no incentive to improve a generator's availability beyond 93%.

In addition to pointing out the aforementioned defects with Reliant Companies' proposal, the California ISO feels compelled to clarify a couple of misconceptions in Reliant Companies Capacity Market Motion. First, Reliant Companies assert that the ISO uses the must-offer obligation to require generators to run at minimum load even when they are not needed. Motion at 4. To the contrary, the ISO recognized long ago that the must-offer commitment could lead to over-commitment. The Commission accepted the California ISO's use of "waivers" from the must-offer obligation to address this problem. *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services In Markets Operated by the California Independent System Operator and California Power Exchange,* 97 FERC ¶61,293 at 62,362-63 (2001). Second, Reliant asserts that the California ISO uses the must-offer obligation to get "free" operating reserves. Contrary to Reliant Companies' claim, the California ISO does not count unloaded capacity from the units for which it revokes "waivers" or from self-committed units such as Ancillary Services. In California ISO markets, unloaded capacity is not equivalent to reserves. Units that provide reserves to the California ISO through California ISO markets are compensated for such reserves. The California ISO notes that, under its Residual Unit Commitment "(RUC") proposal in the May 1 Filing, RUC units would be guaranteed - recovery of start-up and minimum load costs, and would receive a capacity payment for each MW of capacity above minimum load that was selected in the RUC process and was not dispatched to provide energy. . Reliant Companies are incorrect in claiming that RUC is entirely cost-based because the energy bid curve is market-based.

VI. Conclusion

WHEREFORE, for the foregoing reasons, the California ISO requests that the Commission reject the Capacity Market Motion or, in the alternative, deny it as moot.

Respectfully submitted

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Dated: May 15, 2002

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, California, on this 15th day of May, 2002.

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Anthony J. Ivancovich