UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

California Independent System Operator Corporation	)	Docket No. ER99-4462-000

ANSWER OF
CALIFORNIA INDEPENDENT SYSTEM OPERATOR
CORPORATION TO MOTIONS TO INTERVENE,
COMMENTS, AND PROTESTS

I. INTRODUCTION AND SUMMARY

On September 17, 1999, the California Independent System Operator Corporation ("ISO") filed Amendment No. 21 to the ISO Tariff ("September 17 Filing").[1] Amendment No. 21 modifies the ISO Tariff to implement a decision by the ISO Board of Governors ("Governing Board") to extend for one year the authority of the ISO to disqualify Imbalance Energy and Ancillary Service bids that exceed levels specified by the Board in recognition of the delay in implementing reforms of the ISO's Ancillary Service markets. As part of that decision, the Governing Board approved a three-fold increase in the price caps, from $250 to $750 (per MWh or MW, respectively) effective September 30, 1999. The Governing Board's decision to implement an immediate and substantial increase in price caps and to apply for an extension of the ISO's authority

[1] Capitalized terms not otherwise defined herein are used in the sense given in the Master Definitions Supplement, Appendix A to the ISO Tariff.

represents a compromise that was supported by an overwhelming majority of Governing Board members.

Pursuant to Rule 213 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213, the ISO submits its Answer to the Motions to Intervene, Comments, and Protests submitted in the above-captioned docket. The ISO does not oppose the intervention of any of the parties that have sought leave to intervene in this proceeding.

The ISO notes that the extension of the ISO's price cap authority, as proposed in Amendment No. 21, has broad support among the intervenors. Intervenors representing generators and other sellers, as well as those representing market buyers and the California Public Utilities Commission ("CPUC") and other state agencies, support the extension of that authority. May intervenors support the compromise approach to price caps reflected in the ISO Governing Board's resolution.

Some intervenors, however, protest Amendment No. 21. One group argues that any extension of the ISO's price cap authority is unwarranted or should be limited; the other contends that price caps should not be increased above $250. Neither position is well-founded.

There is no substance to certain intervenors' objections to the limited extension of the ISO's price cap authority proposed in Amendment No. 21. As the Commission has recognized, the ISO has every right to establish maximum prices it is willing to pay on behalf of buyers in its Imbalance Energy and Ancillary Service markets. The Commission's approval of market rate authority for sellers

in California energy markets is not equivalent to a requirement that buyers pay whatever prices those sellers choose to demand in their bids to the ISO.

The ISO would nevertheless prefer to eliminate price caps, if it could be confident that the Ancillary Service and Imbalance Energy markets were workably competitive. The need at the present time for continued upper bounds on prices in the ISO's markets, however, is clear. The Commission has recognized that the Ancillary Service markets, and the Imbalance Energy market to which they are linked, suffer from a number of serious flaws. Only some of the reforms that were developed to address those flaws have been implemented, and their effectiveness has not been tested under summer peak load conditions. The ISO's Market Surveillance Committee, moreover, has concluded in a recently issued report that market power continues to be exercised in California wholesale electricity markets during certain market conditions. It would therefore be premature to conclude that the ISO's purchase price caps are now unneeded.

Further, the ISO Governing Board's resolution reflects a reasonable and measured approach to the extension and exercise of the ISO's price cap authority. The immediate three-fold increase in the price caps ensures that the markets will send strong signals when shortages require the introduction of additional supplies, while enabling buyers to protect themselves against the continuing exercise of market power, which analyses by the independent ISO Market Surveillance Committee ("MSC") found still to be present in California markets. The Governing Board's resolution also requires the ISO to evaluate and report back to the Board on progress toward mitigating specific factors that

are recognized to impair the competitiveness of those markets. The first such report, due prior to the summer of 2000, will enable the Governing Board to adjust the level of the cap before the peak season, if necessary. The second report, due after summer 2000, will enable the Governing Board to determine whether there is any further need for price caps. By the terms of Amendment No. 21, the ISO's price cap authority would expire on November 15, 2000, unless the Governing Board makes a further decision and the Commission concurs that a further extension is warranted.

There is no better basis for the arguments of other intervenors, who assert that any increase in the purchase price caps in the ISO's markets is premature. These objections do not take issue with Amendment No. 21 which, consistent with the Commission's direction in an earlier order, does not specify a particular price cap level, but authorizes the ISO to cap purchase prices at levels determined in accordance with the policies adopted by the Governing Board. The Governing Board determined that the importance of giving better price signals to encourage entry of new supplies, together with the expectation that the Ancillary Service reforms would improve the competitiveness of the ISO's markets, warranted a substantial increase in price cap levels, but not their elimination. That conclusion represents a reasonable balance of the interests of sellers and buyers participating in the ISO's markets.

The Commission should accordingly accept Amendment No. 21 without substantive modification. The Commission should also grant the requested waiver to permit the relevant portions of Amendment No. 21 to take effect as of

November 15, 1999 (and in the case of the modification to the Schedules and Bids Protocol, September 30, 1999), to ensure there is no interruption of the ISO's authority to reject bids that exceed the increased price ceilings.

II. BACKGROUND

A. Amendment No. 21

Since the ISO commenced operations on March 31, 1998, it has had the authority to reject bids in its real-time Energy market that exceed a ceiling price level established by the ISO. During the summer of 1998, when the partial lifting of cost-based pricing restrictions on sales of Ancillary Service capacity led to extremely high prices in those markets, and the ISO's analysis revealed that they were not workably competitive, the Commission approved the ISO's request to extend its price cap authority to Ancillary Service markets. The Commission based its conclusion that price caps were needed on studies by the ISO's Market Surveillance Committee ("MSC") and by the California Power Exchange's Market Monitoring Committee ("MMC") identifying "numerous factors limiting competition in the Ancillary Services markets."[2] The Commission determined that price caps are consistent with the authorizations for sellers to transact at market-based rates because, "as the purchaser of Ancillary Services and Replacement Reserves, the ISO has the discretion to reject excessive bids."[3]

In its May 26, 1999 Order in Docket Nos. ER98-2843-005, *et al.*, the Commission substantially approved proposed reforms to the ISO's Ancillary

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[2] *AES Redondo Beach, et al.,* 85 FERC ¶ 61,123 at 61,462 (1998) ("October 28 Order").

[3] *Id.* at 61,463.

Service markets and confirmed the ISO's authority to impose caps on the prices it would pay for Ancillary Service and Imbalance Energy, but limited the duration of that authority to November 15, 1999.[4] The Commission reasoned that, by that date, the Ancillary Service market reforms would have been implemented prior to, and tested over, the full summer 1999 peak season, and their efficacy would have been reviewed in reports that the Commission ordered to be submitted by the ISO's MSC and the PX's MMC. The Commission stated that the ISO could file to extend that authority if it found "that price caps continue to be necessary" based on the summer's experience with the reforms in the Ancillary Service markets implemented by Amendment No. 13 and Amendment No. 14.[5] It anticipated that the ISO's decision would be informed by reports prepared by the MSC and the MMC, which were due on October 15, 1999.

Throughout the summer of 1999, the Governing Board evaluated the continued need for price cap authority, in light of the delay in implementing Ancillary Service market reforms due to the time required to develop, install, and test the necessary software. The ISO considered various price cap alternatives and discussed these alternatives during stakeholder meetings, including two public sessions of the MSC. The ISO then implemented many of its Ancillary Service reforms in mid-August. As a result of the late-summer implementation, and also due to relatively moderate summer weather conditions, the ISO has not had the opportunity to confirm the efficacy of those reforms to maintain competitive conditions during an entire summer peak season. Other market

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4 *AES Redondo Beach, et al.,* 87 FERC ¶ 61,208 at 61,818-19 (1999) ("May 26 Order").

5 *Id.* at 61,818.

reforms, including a critical reform relating to the scheduling of energy procured under contracts for Reliability Must-Run ("RMR") Generation and the automation of real-time dispatch instructions, have not been implemented yet due to software development problems and restrictions in settlement agreements.

While the ISO's strong preference would have been to eliminate price caps completely in its Energy and Ancillary Service markets, the ISO and the Governing Board recognized the still incomplete nature of the Ancillary Service market reforms, the fact that the effectiveness of those reforms that had been implemented remained untested, and the additional fact that the RMR Contracts had not yet been reformed in accordance with the recommendations of the MSC. The ISO and the Governing Board also recognized that, in light of the impending expiration of its price cap authority on November 15, 1999, the ISO could not wait for the report of the MSC before deciding whether to apply for an extension of that authority.

Taking these considerations into account, and weighing the positions of stakeholders in favor of and against the continuation of price caps, the Governing Board ultimately adopted a resolution that balances the ISO's preference for relying on markets to the greatest extent possible against the need to protect consumers against the exercise the market power, while making it clear to the market that such protection will be a temporary feature only. The Governing Board's resolution directed the ISO to file for an extension of price cap authority, while raising the price caps in Ancillary Service and Imbalance Energy markets from $250 to $750 (per MW or MWh, respectively), effective September 30,

1999. ISO management was directed to report to the Governing Board, before the next summer season, on the competitiveness of the markets and on the development of demand-side management and hedging options, with the price caps to be reduced to $500 if that report was negative. ISO management was directed to submit a further report after the summer 2000 season, analyzing the results and recommending a plan to eliminate price caps. The Governing Board also authorized management to reduce price caps on a "safety net" basis, upon a determination that markets are not workably competitive. The ISO has already implemented the portion of the Governing Board's resolution raising the price caps on September 30, 1999.

Other components of the Governing Board's resolution, which relate to the manner in which price caps would operate after November 15, 1999, require the Commission's approval. The ISO accordingly proposed in Amendment No. 21 to modify Section 28 of the ISO Tariff to extend its authority to establish maximum price levels for Energy and Ancillary Service bids, in conformance with any limitations and conditions adopted by the Governing Board, through November 15, 2000.[6]

Amendment No. 21 also modifies SBP 4.6, eliminating a table specifying ranges for Adjustment Bids, which are affected by alterations in permissible bid

[6] Rather than expressly incorporating the limitations reflected in the Governing Board's resolution into the ISO Tariff, Amendment No. 21 specifies that any price caps imposed by the ISO must be consistent with the criteria adopted by the Governing Board and must be published on the ISO Home Page or WEnet. This approach is consistent with the Commission's order on Amendment No. 12 to the ISO Tariff, in which it rejected a tariff amendment that would have incorporated into the ISO Tariff limitations on the ISO's authority to cap prices, while confirming the ISO's authority to cap prices at levels it deems appropriate. *California Independent System Operator Corp.*, 86 FERC ¶ 61,059 at 61,201-02 (1999) ("January 27 Order"). It also reflects the potential for changes to price cap levels that is incorporated in the Governing Board's resolution.

ranges.[7] The ISO explained that the specification of bid ranges in the SBP is inconsistent with the flexible price cap policy adopted by the Governing Board as well as unnecessary, because the ranges are to be assigned automatically by the ISO's scheduling software. The ISO also explained that these modifications are necessary to accommodate the higher price caps that the ISO implemented on September 30, 1999, under its existing price cap authority.

B. Interventions

A notice of intervention was filed by the CPUC and motions to intervene were filed by a number of parties.[8]

Most intervenors support the extension of the ISO's authority to cap purchase prices, as proposed in Amendment No. 21, either explicitly or by filing interventions that do not protest the amendment. That support is not limited to representatives of market buyers, but also includes power marketers (Duke,

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[7] Permissible Adjustment Bids are constrained by caps on Imbalance Energy bids.

[8] Timely motions to intervene were filed by the California Department of Water Resources ("DWR"); the California Municipal Utilities Association ("CMUA"); the California Electricity Oversight Board ("Oversight Board"); the Cities of Anaheim, Azusa, Banning, Colton, and Riverside, California ("Southern Cities"); the Cities of Redding and Santa Clara, California, and the M-S-R Public Power Agency ("Cities/M-S-R"); the City and County of San Francisco ("San Francisco"); Coral Power, L.L.C. ("Coral"); Duke Energy North America LLC ("Duke North America"); Duke Energy Trading and Marketing, L.L.C. ("Duke"); Dynegy Power Marketing, Inc. ("Dynegy"); the Electric Power Supply Association ("EPSA"); Engage Energy US, L.P. ("Engage"); the Metropolitan Water District of Southern California ("Metropolitan"); the Modesto Irrigation District ("MID"); the Northern California Power Agency ("NCPA"); Pacific Gas and Electric Company ("PG&E"); Reliant Energy Power Generation, Inc. ("Reliant"); the Sacramento Municipal Utility District ("SMUD"); San Diego Gas & Electric Company ("SDG&E"); Southern California Edison Company ("SoCal Edison"); Southern Energy California, L.L.C., Southern Energy Delta, L.L.C., and Southern Energy Potrero, L.L.C. ("Southern Parties"); Statoil Energy, Inc. ("Statoil Energy"); the Transmission Agency of Northern California ("TANC"); Turlock Irrigation District ("Turlock"); the Western Area Power Administration ("WAPA"); the Western Power Trading Forum ("WPTF"); and Williams Energy Marketing & Trading Company ("Williams"). The Los Angeles Department of Water and Power submitted a letter supporting Amendment No. 21. In addition, a filing was made in another docket that relates in part to proceedings in the present docket: the *Supplemental Protest of the Metropolitan Water District of Southern California Regarding Amendment No. 22 to the ISO Tariff*, Docket No. ER99-4545-000 (filed Oct. 22, 1999) ("*Metropolitan Supp.*").

Coral), municipal utilities (Southern Cities, Metropolitan), a municipal joint action agency (NCPA), and the state's investor-owned utilities. The CPUC and the Oversight Board also support the extension of the ISO's price cap authority. These intervenors recognize that Amendment No. 21 and the ISO Governing Board decision that it implements represent a compromise among the various interests affected by prices in the ISO's markets.

A number of intervenors, though, accompanied their interventions with comments and/or protests. Some of them argue that price caps should be eliminated or approved only for a shorter period. Others argue that price caps should be maintained at the former $250 level. A few complain about the elimination of SBP 4.6. The ISO does not oppose the intervention of any of the parties that have sought leave to intervene. The ISO does not believe, however, that any of the challenges to Amendment No. 21 has merit.

C. Market Surveillance Committee Report

As explained above, the impending expiration of the ISO's price cap authority on November 15, 1999 made it infeasible for the ISO to await the issuance of the Market Surveillance Committee's report on conditions during the summer before deciding whether to apply to the Commission for an extension of its price cap authority.

The *Report on Redesign of California Real-Time Energy and Ancillary Service Markets* (*"MSC Report"*) prepared by the Chairman of the MSC was filed with the Commission on October 19, 1999 (after Amendment No. 21 was filed).[9]

[9] The other members of the MSC advised the Chairman of the ISO's Board of Governors, in a letter submitted to the Commission with the *MSC Report*, that, while they were unable to

The *MSC Report* found that, due to the delay in implementing some components of the Ancillary Service market reforms and the moderate load conditions during the summer, there were insufficient data "to provide any definitive assessment of the success of the ancillary services market redesign process."[10] The *MSC Report* also found that, while the performance of the ISO's Ancillary Service markets seems to have improved significantly, "significant market power remains in California's wholesale energy markets during periods of high total system load."[11] The *MSC Report* recommended that the ISO continue to have "the authority to impose a purchase price cap in its energy and ancillary services markets, at least until all remaining market design flaws are eliminated."[12] The evidence forming the basis for this conclusion is discussed below.

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participate fully in the drafting of the report, they concurred with the report's findings and conclusions with respect to the design and operation of the ISO's Ancillary Service and real-time energy markets, including, in particular, the need for the ISO to retain price cap authority at least through summer 2000, so that the efficacy of the market redesign and RMR reforms can be tested under high demand conditions. A copy of the *MSC Report* is attached to this Answer.

[10] *MSC Report* at 6. As the MSC notes, a number of the elements of the redesign will not be ready or cannot be properly tested until next year. *See id.* at 5-9.

[11] *Id.* at 1.

[12] *Id.* at 2.

III. ANSWER TO COMMENTS AND PROTESTS[13]

A. The Continuation of the ISO's Price Cap Authority is Justified and Necessary

1. Claims that the ISO must meet a heavy burden to justify the continuation of its authority to limit purchase prices are unfounded

Some intervenors assert that to extend its authority to establish maximum prices in its markets, the ISO must meet a heavy burden, submitting evidence, based on experience gained during the summer of 1999, that significant market design flaws remain.[14] As we will explain below, there is ample evidence that price caps remain needed, including the analyses submitted in the *MSC Report*. Separate and apart from this evidence, moreover, these intervenors' claims are legally flawed in at least three respects.

First, these intervenors would put a heavier burden on the ISO than the Commission itself required: the May 26 Order did not establish a presumption that the Ancillary Service and Imbalance Energy markets would be competitive by November 15, 1999 or require the ISO to prove the contrary in order to extend its price cap authority. Indeed, the Commission would have had no basis for establishing such a presumption, since it could not predict what supply and conditions would prevail, when the Ancillary Service market reforms would be

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[13] Some of the intervenors commenting on Amendment No. 21 do so in portions of their pleadings that are variously styled, without differentiation. Intervenors also request affirmative relief in pleading styled as protests. There is no prohibition on the ISO's responding to the comments in these pleadings. The ISO is entitled to respond to these pleadings and requests notwithstanding the labels applied to them. *Florida Power & Light Co.*, 67 FERC ¶ 61,315 (1994). In the event that any portion of this answer is deemed an answer to protests, the ISO requests waiver of Rule 213 (18 C.F.R. § 385.213) to permit it to make this answer. Good cause for this waiver exists here given the nature and complexity of this proceeding and the usefulness of this answer in ensuring the development of a complete record. *See, e.g., Enron Corp.*, 78 FERC ¶ 61,179, at 61,733, 61,741 (1997); *El Paso Elec. Co.*, 68 FERC ¶ 61,181, at 61,899 & n.57 (1994).

[14] *See, e.g.*, Williams at 4-7 (citing May 26 Order at 61,818); Reliant at 5-11.

implemented, or how effective they would be. Accordingly, instead of establishing specific preconditions for the extension of the ISO's price cap authority, the Commission stated: "After this summer's experience under its proposed market reforms, if the ISO believes that price caps continue to be necessary for an additional period of time, it may file at that time to continue them."[15] The Commission did *not* require the ISO to support its belief that "price caps continue to be necessary" with any particular type of evidence or signify that a proposal to continue price caps would be subject to any burden other than the burden that would normally apply under section 205 of the Federal Power Act ("FPA"), 16 U.S.C. § 824d.

Second, the intervenors' argument is contrary to the Commission's consistent recognition that a cap on acceptable bids is a perfectly normal and acceptable mechanism through which the ISO may set maximum limits on the prices it is willing to pay. In the October 28 Order, the Commission stated that its approval of price caps in July 1998 "simply acknowledged that, as the purchaser of Ancillary Services . . . the ISO has the discretion to reject excessive bids."[16] Similarly, in confirming the ISO's authority to cap Imbalance Energy bids, the Commission stated, "We reject the arguments that it exceeds our statutory authority to authorize the ISO to impose purchase price caps. As we held in [the October 28 Order], the purchaser has the discretion to reject excessive bids."[17]

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[15] May 26 Order at 61,818-19.

[16] October 28 Order at 61,463 (referring to *California Independent System Operator Corp.,* 84 FERC ¶ 61,046 (1998)).

[17] January 27 Order at 61,202.

Permitting the ISO to establish such purchase price caps is entirely consistent with the Commission's orders authorizing sellers to transact at market-based rates.[18] Those authorizations apply to voluntary transactions between willing buyers and sellers; they cannot be transformed into requirements that buyers pay whatever price the seller chooses to bid. A generator is always free to sell real-time energy or ancillary services at a higher price if it can find a willing buyer, such as a self-providing Scheduling Coordinator or an out-of-state purchaser.[19] In contrast, the ISO's responsibility for reliable operation of the grid requires it to purchase adequate quantities of Ancillary Service capacity and Imbalance Energy. The ISO Governing Board's resolution makes it clear that, for the present, the ISO is not a willing buyer when prices exceed $750.

Third, the attempt to erect obstacles in the way of an extension of the ISO's price cap authority and thereby to compel the ISO to purchase Imbalance Energy and Ancillary Service capacity at prices exceeding the levels determined by its Governing Board would turn the Federal Power Act's regulatory scheme on its head. The Supreme Court long ago recognized that the FPA authorizes wholesale power market participants to determine on a mutually agreeable basis the prices and other terms at which they will transact, subject to the Commission's oversight to ensure the justness and reasonableness of those terms. In *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.,* the Court stated:

> [The Act] permits the relations between the parties to be established initially by contract, the protection of the public interest

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18 October 28 Order at 61,463.

19 *See MSC Report* at 125 n.19.

> being afforded by supervision of the individual contracts, which to that end must be filed with the Commission and made public.[20]

The specification by the ISO of maximum prices for its purchases of Imbalance Energy and Ancillary Service capacity is entirely consistent with this regulatory paradigm; tying the ability of the ISO to establish such purchase price caps to the identification of particular market design flaws, in contrast, would convert the ISO into an involuntary purchaser, at prices it considers excessive. The intervenors' proposed restrictions on the ISO's ability to specify in the ISO Tariff that it will not pay unreasonable prices for Ancillary Services and Imbalance Energy are inconsistent with the FPA and, in particular, antithetical to the FPA's requirement of just and reasonable rates. *See* FPA §§ 205 and 206, 16 U.S.C. §§ 824d and 824e.

2. Purchase price caps continue to be necessary

The ISO's decision to apply for a one-year extension of its price cap authority was not taken lightly. It was based on a number of factors pointing to the continued need for price caps in the Ancillary Service and Imbalance Energy market and was tempered by the decision to increase the level of the price caps by a factor of three. That decision was recently endorsed in the *MSC Report*, which presents analyses confirming the continued presence of market power in the California electricity markets.

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[20] 350 U.S. 332, 339 (1956); *see also, e.g.*, *Union Electric Co. v. FERC*, 890 F.2d 1193, 1194-95 (D.C. Cir. 1989); *Cities of Bethany v. FERC*, 727 F.2d 1131, 1139 (D.C. Cir. 1984). The Court in *Mobile* was discussing the Natural Gas Act. In the companion *Sierra Pacific* case, the Court stated that its analysis was equally applicable to the corresponding provisions of the FPA. *FPC v. Sierra Pac. Power Co.*, 350 U.S. 348, 352-53 (1956).

First, as noted earlier, in the October 28 Order the Commission concurred in the conclusions of the MSC and the MMC that significant market design flaws created opportunities for the exercise of market power in the Ancillary Service markets and in the Imbalance Energy market that is closely linked to them.[21] The May 26 Order substantially approved a package of market reforms to designed to correct these flaws. The software to implement these reforms could not, however, be completed in time for them to be in place throughout the summer season. Some of the Ancillary Service market redesign measures were implemented in mid-August 1999, others were implemented in September, and still others will be further delayed due in part to the need to delay substantial new software changes until after the beginning of the year due to Y2K concerns.[22] The reform of the manner in which energy obtained under RMR contracts is dispatched, which the *MSC Report* identifies as a particular ongoing concern, also cannot be implemented before next year, due both to software issues and to settlement agreement restrictions.[23]

As a consequence of these delays and of the moderate weather experienced this summer, there is no basis for the ISO or the Commission to conclude that the market redesign measures will be effective in correcting the market design flaws that were identified last year and in eliminating opportunities for the exercise of market power. The *MSC Report* found the limited data available insufficient to support any definitive assessment of the effectiveness of

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[21] October 28 Order at 61,462.

[22] The automation of the Imbalance Energy instructions and the withholding of payments attributable to Ancillary Service capacity that is not available in real time, which depends upon such automation, will be delayed until February 2000. *See MSC Report* at 5.

these reforms "so that the ISO's markets cannot yet be relied upon to be workably competitive."[24]

Second, the *MSC Report* analyzed the data available through July 1999 to compare prices in the California wholesale energy market with those that would have prevailed under pure competitive conditions:

> According to our calculations, the total wholesale energy costs, excluding energy produced under must-take arrangements, were 20% above those that would have resulted from the pure competitive market benchmark for the period July 1 to July 26, 1999.[25]

While the extent to which energy costs exceeded the competitive benchmark was considerably less than prevailed in July 1998, the *MSC Report* found that a significant portion of the improvement was attributable to milder weather conditions in 1999, and concluded that "during periods of high total ISO load there appears to be a significant amount of market power exercised in the California wholesale electricity market."[26] The *MSC Report* thus confirmed the ISO's observation that prices reaching the $250 caps in the Ancillary Service and Imbalance Energy markets during a number of hours this summer, despite the relatively moderate weather conditions and improvements in the markets, case doubt on the competitiveness of the markets.

The *MSC Report* also analyzed the ISO's recent experience following the rise in the price caps to $750, effective September 30, 1999. It noted that congestion on a major transmission path in California led to prices for day-ahead

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23 *Id.* at 67-68.
24 *Id.* at 10.
25 *Id.* at 64.
26 *Id.*; *see also id.* at 65.

Congestion relief and energy in northern California approaching the new caps, and prices for Ancillary Services well in excess of the former $250 caps.[27] The *MSC Report* concluded, based on this experience, that "significant market power remains in the California electricity market, particularly when there is limited transmission capacity into the ISO control area and across congestion zones."[28]

Third, the demand side of the California market continues to have an extremely limited ability to respond to higher prices. As described in the *MSC Report*, final hourly retail demand is virtually price inelastic, due in large part to effect of California's retail rate freeze, which severs the link between wholesale energy costs and prices paid for electricity consumed at retail.[29] Neither retail consumers nor the energy service providers that serve them have an incentive to install the metering and other infrastructure necessary to create rates that respond to hourly energy and Ancillary Service prices. However, "a price-responsive hourly wholesale demand is essential to limit the exercise of market power by generators during periods expected to have high system loads."[30]

Although the analyses presented in the *MSC Report* were not available when the ISO and its Governing Board had to decide whether to apply for an extension of the ISO's price cap authority, the incomplete status of the reform of the Ancillary Service markets, the continued inability of demand to respond to hourly increases in Ancillary Service and Imbalance Energy prices, and repeated

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27 *Id.* at 60-61. The hour-ahead price for Regulation Up actually hit the $750 cap for one hour on October 1, contrary to the assertion of Southern Parties that "no transactions reached the price cap." Southern Parties at 20.

28 *MSC Report* at 63.

29 *Id.* at 8; *see also id.* at 135.

30 *Id.* at 10; *see also id.* at 128.

instances of high prices in those markets persuaded a large majority of the Governing Board's members to conclude that a continuation of the ISO's price cap authority was warranted. The *MSC Report* endorses this conclusion:

> The MSC has been extremely reluctant to recommend imposing purchase-price caps on the energy and ancillary-services markets in California. However, we continue to have concerns about the competitiveness of the California energy and ancillary-services markets, as we have detailed in Sections 3 and 4 of this report. For that reason, we believe that until the market-design problems identified in our prior reports are remedied and it is made clear that any remaining generator market power has been mitigated, purchase-price limits should be retained on the imbalance-energy and ancillary-services markets. The Committee also believes that until there is sufficient confidence that the structure of the California wholesale electricity market allows unrestricted market forces to yield efficient results, there will still be a need for a maximum purchase price limitation or other mechanism by which the ISO and the PX can facilitate the smooth functioning of the market and protect California consumers from inefficiently high prices for energy and ancillary services.[31]

The MSC warned that "[i]f the ISO lacks the authority to limit the prices at which it purchases energy or ancillary services, it will be forced as it was in July 1998 to accept bids of $5,000 or $9,999 per MWh for ancillary service, *even in times of moderate demand and ample supply*," and that "[a] market perturbation in thin ancillary services markets . . . could have extraordinary impacts on prices and costs."[32]

There is accordingly ample evidence supporting the ISO's conclusion that price caps continue to be needed for the Ancillary Service and Imbalance Energy markets. The reforms necessary to eliminate the potential for the exercise of market power in those markets have not yet been implemented and shown to be

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31 *Id.* at 126.

32 *Id.* at 127 (emphasis added).

effective, and the *MSC Report* concludes, based on its analysis of prices, that market power in fact is being exercised during certain market conditions.

B. The ISO Governing Board Adopted a Reasonable Policy for the Implementation of Price Caps

1. The Governing Board's Policy Represents a Reasonable Compromise and a Transition Toward Uncapped Market Prices

As many intervenors recognized – including intervenors who filed protests – Amendment No. 21 and the price cap policy it implements represent a compromise among stakeholders taking opposing positions on the continued need for price caps and the appropriate levels of price caps if they are retained. The resulting compromise policy was approved almost unanimously by the ISO's Governing Board.[33] The ISO's strong preference would be to eliminate price caps completely in the Energy and Ancillary Service markets, so that market participants could receive undiluted price signals that would provide incentives for investment in new generation resources, as well as in enhanced capability of Demand to respond to prices. However, for the reasons described above, the present circumstances do not allow price caps to be eliminated.

Under the policy adopted by the Governing Board, the price caps have been raised from $250 to $750 effective September 30, 1999. As the ISO's Department of Market Analysis notes, this increase "expands by a factor of three the potential range of price movement . . . to provide stronger market price signals for new generation to enter the market and for the demand side to

[33] *See, e.g.*, Cities/M-S-R at 7-8; CPUC at 3-4; Oversight Board at 5; SoCal Edison at 1; SMUD at 4; TANC at 9-10.

develop greater capability to respond to price movements."[34] Even intervenors that oppose price caps concede that the $750 caps are less likely than $250 caps to dilute market signals to existing and potential market participants.[35] It is a *non sequitur* for those intervenors to say, in their next breath, that the $750 and $250 caps are equally "arbitrary."[36] The $750 price caps plainly provide substantially stronger price signals than the lower caps they replaced, as well as a strong signal to the market of the ISO's intention to eliminate the price caps when conditions warrant.

The Governing Board's resolution provides for repeated reviews of the market situation. The Governing Board required the ISO to report, prior to June 1, 2000, on whether market conditions and demand responsiveness have improved sufficiently to retain the price caps at the $750 level during the following summer. The ISO is also required to report to the Governing Board after the summer of 2000, regarding market conditions during the summer and to present an implementation plan to eliminate price caps. If that plan calls for the continuation of price caps beyond November 15, 2000, a further filing with the Commission will be required. Further, Amendment No. 21 contains a "safety net" provision that permits the ISO to lower price caps in a market whenever it determines that the affected market is not workably competitive, as long as the Governing Board is promptly notified and presented with supporting analysis. Thus, the amendment both requires reviews at specified times and also provides the ISO flexibility to address unanticipated developments.

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[34] September 17 Filing at Attachment C.

[35] Williams at 10.

2. Maintaining price caps at the former $250 level or replacing them with other mechanisms would upset the Governing Board compromise and would ignore improvements in the Ancillary Service markets

Some intervenors argue that price caps should be maintained at the $250 level.[37] These arguments are misplaced. First, maintaining a $250 price cap would overturn the compromise that the Governing Board has carefully crafted. That compromise involves both an extension of the ISO's price cap authority and an immediate increase in the price caps to improve price signals to suppliers. Keeping the price caps at $250 would deter entry by new suppliers, to the detriment of buyers and the consumers they serve. It would also ignore the progress that has been made in addressing Ancillary Service market design flaws. Although the *MSC Report* noted that the process of correcting market flaws remains incomplete and that prices during certain market conditions reflect the exercise of market power, it also identifies substantial improvements in the functioning of the ISO's Ancillary Service and real-time energy markets. The Governing Board appropriately took those improvements into account in adopting higher price cap levels. Moreover, keeping price caps at $250 would deny the ISO and the Commission the opportunity to assess the performance of the 1999 market redesign elements during the relatively low-risk off-peak seasons. This would bring the ISO to summer 2000 with much less experience, under less-constrained market conditions, and hence less confidence that caps could be raised next summer. Finally, the ISO notes that these objections to the Governing Board's decision to increase the price caps do not go to anything in

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[36] *See id.*

Amendment No. 21. Consistent with the Commission's direction on Amendment No. 12 in the January 27 Order, Amendment No. 21 would not specify the level of price caps in the ISO Tariff. As described above, if circumstances warrant a reduction or in increase in price caps, the caps can be adjusted by the ISO, subject to the approval of the Governing Board.[38]

Other intervenors suggest that the ISO should use the price volatility limiting mechanism ("PVLM") that was considered, but rejected, as an alternative to price caps.[39] This step, too, would overturn the Governing Board's compromise, which rejected the PVLM proposal on practical grounds.[40] In comparing some PVLM designs against some of the possible fixed-price-cap alternatives, the ISO and the market participants realized that the desirable features of the PVLM (*e.g.*, responsiveness to supply and demand conditions and elimination of an absolute cap) would come at a significant cost to simplicity and predictability. Ultimately, the ISO and the Governing Board opted for simplicity and decided to recommend that the Governing Board adopt fixed the fixed price cap proposal contained in Amendment No. 21. That decision is reasonable and should not be overturned at the insistence of a single stakeholder, who participated in the process.

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[37] *See, e.g.*, Metropolitan at 10-12.

[38] The last point also refutes the proposals that the Commission should impose a cap no lower than $2,500 if the ISO's rate cap authority is extended at all (*see* Southern Parties at 26), and that any reduction of the cap below $750 should be conditioned on a further Commission approval (*see* Duke at 3).

[39] SoCal Edison at 17.

[40] Under Section 28 of the ISO Tariff, as it is proposed to be revised in Amendment No. 21, the ISO Governing Board could adopt a PVLM if it were to decide that the compromise resolution is no longer appropriate.

C. The Elimination of SBP 4.6 is Appropriate

Amendment No. 21 would eliminate the table in SBP 4.6, which specifies permissible ranges of Adjustment Bids that would be used by the ISO's congestion management software to protect the priority of different schedules. The adjustment of the price cap levels required modification of those ranges, and the ISO determined that the more appropriate course was to eliminate the table. Some intervenors challenge this modification, but their objections are unfounded.[41]

Under the Commission's "rule of reason," any rate schedule, including the ISO Tariff, need only contain provisions sufficient to notify customers of rates and other terms of service.[42] SBP 4.6 is simply a description of how the ISO's software assigns Adjustment Bid values. Due to software modifications related to the scheduling templates for Existing Contracts and Firm Transmission Rights (as described in Amendment No. 22, pending in Docket No. ER99-4545-000), all values set forth in SBP 4.6 are assigned by the ISO's software automatically. Scheduling Coordinators are no longer required to submit any of the Adjustment Bid values set forth in SBP 4.6.

The table eliminated from SBP 4.6 thus does not affect the rates paid by customers using the ISO Controlled Grid and does not inform them of choices they need to make to schedule their transactions. It accordingly contains a level of detail that is unnecessary and inappropriate for the ISO Tariff. It is a

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41 *See, e.g.*, SMUD at 4-5; TANC at 6-8.

42 *Pacific Gas and Elec. Co., et al.*, 81 FERC ¶ 61,320, at 62,470 (1999); *cf. Commonwealth Edison Co.*, 21 FERC ¶ 61,096 (1982) (holding that the Commission would

quintessential example of the type of "'operator guidelines' that simply add details or procedures necessary to implement tariff provisions" which the Commission invited the ISO to file to remove from the ISO Tariff in its December 17, 1997 Order that incorporated the Protocols into the filed tariff.[43]

Further, retaining the table now included in SBP 4.6 would be inconsistent with the Commission's direction in the January 27 Order to exclude specific limitations of price cap levels from the ISO Tariff. As explained above, the ISO has followed that direction in the proposed revisions to Section 28. Leaving the table in SBP 4.6 in place would create the anomalous situation in which a Protocol section, but not the ISO Tariff, would have to be changed when and if the Governing Board modifies the price cap levels.

Finally, the elimination of SBP 4.6 would not affect the relative priorities of transmission service under Existing Contracts or priorities associated with RMR Generation. Other provisions of the ISO Tariff require the ISO to honor Existing Contracts.[44] SBP 4.6, in contrast, provides details about the *internal* software code the ISO uses to implement its commitment. The elimination of that provision in no way weakens the ISO's obligation or commitment to honoring Existing Contracts. Likewise, the elimination of SBP 4.6 would not require the addition of a provision to the ISO Tariff guaranteeing that customers holding Existing Contracts would incur no additional charges as a result.[45]

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deprive a utility of needed flexibility in providing "economy energy" if it required the submission of additional detail on the exercise of the utility's authority to offer such service).

43 *Pacific Gas and Elec.*, 81 FERC at 62,471.

44 *See* ISO Tariff Section 2.4.4.1.

45 *Cf. Metropolitan Supp.* at 5-6.

IV. CONCLUSION

For the foregoing reasons, the Commission should accept Amendment No. 21 to the ISO Tariff without modification.

Respectfully submitted,

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Dated: October 29, 1999

CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing document upon all parties on the official service list compiled by the Secretary in the above-captioned proceeding, 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 29th day of October, 1999.

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Bradley R. Miliauskas