THE UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

San Diego Gas & Electric Company, Complainant,	)	
v.	)	**Docket No. EL00-95-045**
Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and the California Power Exchange, Respondents.	)	
Investigation of Practices of the California Independent System Operator and the California Power Exchange	)	**Docket No. EL00-98-042**

REQUEST FOR REHEARING AND/OR CLARIFICATION OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION

Pursuant to Rule 713 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.212, the California Independent System Operator Corporation ("ISO")[1] submits this request for clarification and rehearing in the above-captioned dockets. The ISO respectfully requests that the Commission clarify and or revise a limited number of items in its March 26, 2002, Order on Proposed Findings on Refund Liability, 102 FERC ¶ 61,317 ("March 26 Order").

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

I. BACKGROUND

On August 2, 2000, San Diego Gas & Electric Company filed a complaint in Docket No. EL00-95 against all sellers of energy and ancillary services into the ISO and California Power Exchange ("PX") markets. In response, the Commission issued an order on August 23, 2000, in which it instituted formal hearing proceedings under Section 206 of the Federal Power Act to investigate the justness and reasonableness of the rates of public utility sellers in the California ISO and PX markets, and established a refund effective date for spot sales made into the California marketplace of October 20, 2000. *San Diego Gas & Electric Co.*, et al., 92 FERC ¶ 61,172 (2000) ("August 23 Order"). As a result of this investigation, the Commission issued orders on November 1, 2000 and December 15, 2000, in which it adopted prospective price mitigation for the California marketplace in the form of a soft-cap breakpoint. *See San Diego Gas & Electric Co.*, et al., 93 FERC ¶ 61,121 (2000) ("November 1 Order"); *San Diego Gas & Electric Co.*, et al., 93 FERC ¶ 61,294 (2000) ("December 15 Order"). In addressing the question of refunds, the Commission emphasized that sellers into ISO and PX markets would continue to remain subject to refund liability, noting that, if the Commission found "that the wholesale markets in California are unable to produce competitive, just and reasonable prices, or that market power or other individual seller conduct is exercised to produce an unjust and unreasonable rate, we may require refunds for sales made during the refund effective period." November 1 Order at 61,370.

On April 26, 2001, the Commission issued an order adopting a new prospective price mitigation methodology for California wholesale power markets to replace the soft cap breakpoint mechanism. *San Diego Gas & Electric Co.*, et al., 95 FERC ¶ 61,115

(2001) ("April 26 Order"). Under that methodology, price mitigation would apply to all generators in California, including non-public utility generators, with available capacity during periods of reserve deficiency, defined as emergency situations beginning at stage 1 (*i.e.*, when reserves are 7.5 percent or less). *Id*. at 61,358. The ISO would determine the level of mitigation by calculating a marginal cost for each gas-fired generator in California using heat rate[2] and emissions data provided to the ISO and the Commission by generators, a proxy for gas costs, and a $2.00 adder for operation and maintenance expenses. *Id*. at 61,359. The Commission required the ISO to modify its markets to permit generators to elect the proxy price in lieu of an individual bid above the proxy, and all generators who elected the proxy would be paid a single market clearing price reflecting the highest priced unit dispatched, as determined by calculations using the proxy prices. *Id*.

The Commission expanded this proxy price mitigation methodology to non-reserve deficiency hours and to markets throughout the WSCC in an order issued on June 19, 2001. *San Diego Gas & Electric Co.*, et al., 95 FERC ¶ 61,418 (2001) ("June 19 Order"). In that order, the Commission also required all public utility sellers and buyers in the ISO's markets to participate in a settlement conference "to complete the task of settling past accounts and structuring the new arrangements for California's energy future." *Id*. at 62,570. One of the topics explicitly set for discussion at this conference was the issue of refunds related to past periods. The Commission appointed Chief Judge Wagner as the settlement judge, and required the Chief Judge to

[2] With respect to the heat rates used in this calculation, the Commission noted that they "must reflect operational heat rates that do not include start-up and minimum load fuel costs." *Id*. at 61,359.

provide the Commission with recommendations at the close of the conference if parties did not reach agreement.

After the close of the settlement conference, because no agreement was reached between the parties, Chief Judge Wagner provided recommendations to the Commission on this issue in his July 12, 2001 "Report and Recommendation of Chief Judge and Certification of Record." *San Diego Gas & Electric Co.*, et al., 96 FERC ¶ 63,007 (2001) ("July 12 Report and Recommendation"). Therein, with respect to refunds for past periods, the Chief Judge opined:

> That very large refunds are due is clear. In fact, the Commission so found in its June 19, 2001, Order. While the amount of such refunds is not $8.9 billion as claimed by the State of California, they do amount to hundreds of millions of dollars, probably more than a billion dollars in an aggregate sum.

Id. at 65,038.

In order to determine the amount of refunds due, the Chief Judge recommended using the price mitigation methodology set forth in the June 19 Order, with several modifications. *Id*. at 65,039-40. Specifically, the Chief Judge recommended (1) using actual unit heat rates, rather than hypothetical heat rates; (2) using daily spot gas prices rather than monthly bid-week prices; (3) separating the state's gas market into northern and southern zones; (4) excluding emission costs from the MMCP and treating them as a separate item deductible from total refund liabilities; and (5) not using the June 19 Order's 85 percent price ceiling for non-emergency hours. *Id*. at 65,040-041.

On July 25, 2001, the Commission issued an order addressing the scope and methodology of refunds for sales in the California marketplace. *San Diego Gas & Electric Co.*, et al., 96 FERC ¶ 61,120 (2001) ("July 25 Order"). The

Commission indicated that refunds would be limited to spot market transactions made between October 2, 2000 and June 20, 2001 (the "Refund Period"), and would include sales made by both public and non-public utilities. *Id*. at 61,499. The Commission, however, excluded from refund liability purchases made by the California Department of Water Resources ("CDWR") through bilateral contracts, as well as transactions made under the DOE Orders issued pursuant to Section 202(c) of the Federal Power Act ("FPA"). *Id*. at 61,514-16.

In terms of methodology, the Commission largely adopted the recommendations of the Chief Judge. *Id*. at 61,516-17. The Commission required the ISO to first determine the "marginal unit" in each 10-minute interval by "selecting from the actual units dispatched in real-time the maximum heat rate of any unit dispatched each hour in the real-time imbalance market." *Id*. at 61,517. This heat rate would be multiplied by the simple average daily spot price as reported by Gas Daily, NGI's Daily Gas Price index and Inside FERC's Gas Market Report. *Id*. at 61,517-18. To this result, the Commission required the ISO to add $6/MWh for O&M expenses, and a 10% creditworthiness adder for transactions made after January 5, 2001 to arrive at the final MMCP for each interval *Id*. at 61,518-19. The Commission also required the calculation of interest "on both refunds and receivables past due, pursuant to the methodology for the calculation of interest under Section 35.19a of the Code of Federal Regulations." *Id*. at 61,519. Finally, the Commission established an evidentiary hearing process before Judge Birchman, and directed the Presiding Judge to make findings of fact as to "(1) the mitigated price in each hour of the Refund Period; (2) the amount of refunds owed by each supplier according to the methodology established

herein; and (3) the amount currently owed to each supplier (with separate quantities due from each entity) by the ISO, the investor owned utilities, and the State of California." *Id*. at 61,520. In order to develop the factual record, the Commission ordered the ISO to provide Judge Birchman with a "re-creation of the mitigated prices that result from using the methodology described herein for every hour" during the Refund Period, and directed the ISO and PX to rerun their settlements systems applying the MMCPs and also provide those results to Judge Birchman. *Id*.

As directed by the Commission in the July 25 Order, the ISO calculated mitigated clearing prices for each hour during the Refund Period and submitted those clearing prices to the Presiding Judge and parties in the proceeding. The ISO then used these MMCPs to rerun its settlements and billing system for the Refund Period, and also provided these results to the Presiding Judge and Parties. Because there are relatively discrete sets of issues associated with the calculation of the MMCPs and the determination of what refunds were owed and the resulting current amounts owed to each supplier, it was decided to bifurcate the evidentiary process into two phases in order to address all issues as efficiently as possible. Phase 1 would address the calculation of the MMCPs for each interval and hour during the Refund Period, and Phase 2 would focus on the ISO and PX reruns of their settlement systems, and the issues of what refunds were owed, and, in the end, after taking into account such items as cash positions and interest, "who owed what to whom." The ISO and other parties to the evidentiary proceeding filed testimony and exhibits concerning Phase 1 issues during the fall of 2001.

On December 19, 2001, just prior to the commencement of the hearing on Phase 1 issues, the Commission issued an order addressing requests for rehearing and clarification with respect to a number of issues from the June 19 and July 25 Orders. 97 FERC ¶ 61,275 (2001) ("December 19 Order"). Therein, the Commission modified one aspect of the refund methodology to require the ISO to calculate MMCPs by selecting as the marginal unit that unit with the highest system wide total costs after multiplying heat rates by gas costs for an interval, rather than selecting the unit with the highest overall heat rate. *Id*. at 62,203.

The Phase 1 hearing on MMCP issues commenced on March 11, 2002 and continued through March 15, 2002. A hearing addressing Section 202(c) transactions was held from March 18 through March 22, 2002. Parties filed initial and reply briefs on both of these issues shortly after the conclusion of these hearings.

On May 15, 2002, the Commission issued an order addressing petitions for rehearing and clarification of the December 19 Order. *San Diego Gas & Electric Co.*, et al., 99 FERC ¶ 61,160 (2002) ("May 15 Order"). Therein, the Commission clarified several issues relating to the refund methodology. First, the Commission indicated that out-of-state generators would be eligible to set the MMCP if they could provide the necessary heat rate information to the ISO. *Id*. at 61,656. The Commission also clarified that Out-of-Market ("OOM") transactions were not eligible to set the MMCP, and ordered the Presiding Judge to address suppliers' allegation of mis-logging of Out-of-Sequence ("OOS") transactions by the ISO. *Id*. Finally, the Commission clarified that

the MMCP was to be treated as a cap on historical prices, rather than a substitute clearing price. The Commission explained:

> For accepted bids above the breakpoint, the refund methodology should use the lower of the bid or the MMCP. For accepted bids at or below the breakpoint, the refund methodology should use the lower of the auction price or the MMCP. When the breakpoints were not triggered and there was a single market clearing price, the refund methodology should use the lower of the single market clearing price or the MMCP.

Id. at 61,656.

During the spring and summer of 2002, parties submitted testimony and exhibits addressing Phase 2 issues, and a hearing on those issues was held from August 19 through August 23, 2002. Initial and reply briefs were filed by the parties after the conclusion of the hearing.

The Proposed Findings of Fact

On December 12, 2002, Presiding Judge Birchman issued his Certification of Proposed Findings on California Refund Liability ("Proposed Findings of Fact") addressing all issues in both Phase 1 and Phase 2 of the proceeding. With respect to issues in Phase 1 of the proceeding, the Proposed Findings of Fact address two main issues: (1) how to determine MMCPs for each interval and hour during the Refund Period; and (2) what, if any, transactions were made pursuant to Section 202(c) of the FPA.

One of the larger issues concerning the appropriate calculation of MMCPs has been whether the ISO should use incremental or average heat rates to determine a unit's heat rate for insertion into the Commission's refund formula (Issue I.B). The Presiding Judge found that incremental heat rates "are a just and reasonable means to

set the MMCP" and are "consistent with the Commission's goal of replicating prices in a competitive market." Proposed Findings of Fact at ¶¶ 40, 70. The Proposed Findings of Fact concluded that incremental heat rate curves should not be adjusted to be monotonically non-decreasing. Proposed Findings of Fact at ¶ 83. Also, with respect to the issue of the operating point on a heat rate curve at which a unit's heat rate should be taken for insertion into the refund formula (Issue I.C), the Proposed Findings of Fact found that the ISO's use of an Acknowledged Operating Target ("AOT") adhered to the Commission's orders and that it achieves a result that is just and reasonable. *Id*. at ¶ 84.

The Proposed Findings of Fact next addressed the universe of units eligible to set the MMCP for each interval (Issue I.D). The Proposed Findings of Fact concluded that the eligibility of a unit to set the MMCP during a particular interval is contingent upon that unit having had a bid in the ISO's BEEP stack in that interval. *Id*. at ¶ 94. The Proposed Findings of Fact reasoned that "the BEEP stack represents the best and closest approximation of what the Commission required of the ISO to re-create, or emulate closely, the outcome of a competitive market with actual dispatch data, rather than a hypothetical dispatch of resources." *Id*. at ¶ 101. With respect to the types of energy eligible to set the MMCP (Issue I.D.2), the Proposed Findings of Fact found that several types of energy are eligible: (1) BEEP Supplemental and BEEP Spin, Non-Spin, and Replacement Reserve Ancillary Services, *id*. at ¶ 115; and (2) Out-of-Sequence ("OOS") Non-Congestion Imbalance Energy Supplemental and OOS Non-Congestion Spin, Non-Spin, and Replacement Reserve Ancillary Services that are eligible to set the historical market clearing price under ISO Operating Procedure M-403, *id*. at ¶ 120.

The Proposed Findings of Fact found that the following types of energy are not eligible to set the MMCP: (1) OOS Congestion, *id*. at ¶ 135; (2) Out-of-Market ("OOM") sales, *id*. at ¶ 138; (3) Residual Energy, *id*. at ¶ 152; and (4) Regulation Energy; *id*. at ¶ 158. The Proposed Findings also found that units that did not actually respond to a BEEP dispatch are excluded from eligibility to set the MMCP. *Id*. at ¶ 203.

The final issue relating to unit eligibility addressed by the Proposed Findings of Fact is the issue of whether units outside the ISO control area should be eligible to set the MMCP (Issue I.D.8). The only out-of-state supplier that provided evidence to support a claim that its units should be included in the ISO's MMCP calculations was Arizona Electric Power Cooperative ("AEPCO"). Because the May 15 Order determined that out-of-state suppliers were eligible to set the MMCP if they provided the appropriate heat rate data to the ISO, the issue became whether AEPCO had provided sufficient data such that its units would be eligible to set the MMCP. *Id*. at ¶ 215. The Proposed Findings answered in the affirmative, concluding that the heat rates provided by AEPCO "are adequate and eligible to be included in the ISO's calculations of MMCPs during the refund period." *Id*. at ¶ 216.

Phase 2 of the evidentiary hearing process involved numerous issues relating to the calculation of refund amounts owed by suppliers and the determination of who owes what to whom. The first set of Phase 2 issues addressed by the Proposed Findings of Fact concerns the ISO's rerun of its settlement database (Issue I.A). With respect to the issue of the proper pre-mitigation database to be used by the ISO in its settlement rerun, the Proposed Findings of Fact concluded that the California Generators had failed to show that mislogging of OOS non-congestion transactions resulted in the ISO

establishing incorrect historical market clearing prices, such that the ISO would be required to calculate revised historical market clearing prices pursuant to the Commission's May 15 Order. Proposed Findings of Fact at ¶ 423.

The Proposed Findings of Fact also addressed numerous issues relating to whether the ISO treated certain transactions and charge types improperly as a part of its mitigation. The Proposed Findings next addressed issues relating to the rerun of the PX settlements system (Issue I.B). Then, the Proposed Findings of Fact provided findings concerning what emissions amounts are properly offset against refunds. (Issue II). Issue III of the Proposed Findings of Fact included several items under the heading of what refund amounts are owed by each supplier, and what amounts are currently owed to each supplier by the ISO, PX, the investor-owned utilities, and the State of California. Under this heading, the Proposed Findings of Fact addressed the bilateralization of obligations, the application of refunds as offsets, the accounting for the cash position of parties, the calculation and application of interest, and the results of applying the Commission's refund methodology. *Id*. at ¶¶ 768-822. With respect to interest, the Proposed Findings of Fact found that interest should be assessed on both refunds and amounts past due pursuant to Section 35.19, but declined to address the merits of the ISO's arguments concerning the need for the ISO to remain a cash-neutral entity regardless of the mechanism directed by the Commission for collecting interest on amounts owed and owing during the Refund Period, because, according to the Presiding Judge, concerns relating to cash neutrality do not fall under any of the issues to be addressed in the present proceeding, and instead raise matters with regard to

cash shortfalls which the ISO and other parties have expressly agreed to not adjudicate and to have presented to the Commission at a later date. *Id*. at ¶¶ 806, 819.

Staff Report on Price Manipulation in Western Markets

On the same day as the March 26 Order, Commission Staff issued a report containing its findings with respect to price manipulation in Western energy markets. *Final Report on Price Manipulation in Western Markets*, Docket No. PA02-2-000 (March 26, 2003). Therein, Staff reported its finding that prices established in California gas spot markets during the Refund Period were artificially high due to a number of factors, and were far in excess of the prices that would have been sustained in a competitive market. As a result, Staff recommended an alternative to the gas proxy methodology adopted by the Commission in the July 25 Order. Namely, Staff recommended the use of producing-area prices plus transportation costs as a proxy for gas prices in computing the MMCP.

March 26 Order

In the March 26 Order, the Commission began by summarily adopting a number of the Presiding Judge's proposed findings. March 26 Order at ¶ 5. Addressing "Phase I Issues," the Commission first concluded that incremental, rather than average, heat rates should be used in calculating the MMCP, as they represent "the best means of replicating a competitive market." *Id*. at ¶ 13. The Commission also adopted the Presiding Judge's finding that only those units with a bid in the BEEP stack for an interval are eligible to set the MMCP during that interval. *Id*. at ¶ 21. Next, the

Commission generally affirmed the Presiding Judge's findings as to the types of energy eligible to set the MMCP, *id*. at ¶¶ 27, 32, 37, 41, 44, including the Presiding Judge's finding that AEPCO's units had provided sufficient heat rate data in order to allow their units to establish the MMCP. *Id*. at ¶ 52. However, addressing the mislogging issue, the Commission noted that its review of the record, as well as the additional evidence submitted in the "100-day discovery" proceeding,[3] indicated that an internal ISO audit has "already identified OOS units that may be eligible to set the BEEP Stack price under CAISO Operating Procedure M-403." *Id*. at ¶ 28. In light of this evidence, the Commission ordered the ISO to "determine whether mislogged OOS transactions were non-congestion transactions eligible to set the MCP," and also ordered the ISO to reflect these corrections in the final rerun "for purposes of both MCP and MMCP calculations." *Id*.

Addressing the proper gas price indices for the calculation of the MMCP, the Commission agreed with Staff's recommendation to modify the gas proxy formula "to use producing area-prices plus a tariff rate transportation allowance (including a fuel compression charge allowance) instead of California spot gas prices." *Id*. at ¶59. The Commission also stated that generators would be permitted to recover an additional fuel cost allowance in order to address comments that generators usually paid the California spot gas index price, but that this fuel allowance would not be incorporated into the MMCP. In order to verify that generators paid spot gas prices, the Commission required that generators base their additional fuel cost allowance on their actual daily costs of gas incurred to make spot power sales to the ISO and PX markets. *Id*. at ¶ 61.

[3] Docket Nos. EL00-95-069 and EL00-98-058, *et al*.

With respect to Phase II Issues, the Commission adopted most of the Presiding Judge's findings of fact. Specifically, on the issue of interest calculations, the Commission adopted the Presiding Judge's finding that "interest on both refunds and unpaid balances will be calculated in the manner required by the Commission's July 25 Order, i.e., calculated under Section 35.19a of the Commission's regulations." *Id*. at ¶ 140. The Commission also rejected proposals to use actual interest already applied as a result of Tariff provisions, reaffirming that the interest rate that would apply is the one set forth in 18 C.F.R. § 35.19a.

II. SPECIFICATION OF ERRORS AND REQUESTS FOR CLARIFICATION

The ISO respectfully submits that the March 26 Order erred in the following respects:

- Requiring the ISO to determine whether mislogged OOS transactions were non-congestion transactions eligible to set the historical Refund Period MCP (and the MMCP) pursuant to ISO Operating Procedure M-403. March 26 Order at ¶ 28.
- Finding that the heat rate data submitted by AEPCO were sufficient to allow its units to be eligible to set the MMCP. *Id*. at ¶ 52.
- Allowing generators a fuel cost allowance offset to refunds. *Id*. at ¶¶ 61-62.
- Allowing all generators a fuel cost allowance offset to refunds, instead of just those who can show they bought gas for spot electricity sales at prices based on the spot gas indexes previously used in computing the MMCPs. *Id*.

- Assuming that generators used spot gas purchases and their shortest-term contract gas purchases for spot electricity sales. *Id*.

Additionally, the ISO respectfully requests that the Commission clarify the following with respect to the March 26 Order:

- That the ISO's proposed methodology for calculating interest on refunds and unpaid balances, as set forth in Section E below, is consistent with the Commission's March 26 Order, as well as other Commission orders in this proceeding addressing the calculation of interest.

The ISO believes that this pleading is also the appropriate venue to make the Commission aware of several issues with respect to the settlements and billing rerun process that the ISO will perform in this proceeding, as well as the ISO's proposed schedule for completing this process. The ISO does so in Part III.A., below.

Finally, the ISO wishes to reiterate its position that there are inherent flaws in the refund methodology as adopted by the Commission in the July 25 Order, and modified in the December 19 and May 15 Orders. Specifically, the ISO continues to object to the following aspects of the Commission's previous orders:

- The exclusion from refund liability of spot purchases made by CDWR.
- The exclusion from refund liability of transactions made pursuant to the DOE Orders.
- The failure of the refund methodology to account for actual congestion that took place in real time.
- The adoption of a methodology for calculation of refunds that rewards generators for economic and physical withholding.

- The adoption of an unduly elevated and unsupported amount for non-fuel O&M costs.
- The adoption of an unduly generous bench-mark for reserve capacity Ancillary Services.
- The adoption of a 10% credit adder for certain purchases.
- The conclusion that the ISO and suppliers agreed to terms and rates for sales made pursuant to section 202(c) of the Federal Power Act during the period December 14, 2000, through February 7, 2001.

III. ARGUMENT

A. The ISO Must Perform a Preparatory Rerun and Adjustments Prior To Beginning The Settlement Rerun to Determine Refund Obligations.

In the March 26 Order, the Commission stated that it would "defer the settlements and billing process calculations until after the Commission makes a final decision on the matters in this proceeding." March 26 Order at ¶ 155. The ISO supports the Commission's deferral because of the extensive "Preparatory Production Database Rerun" that must be completed before the actual Refund Rerun. The main purpose of the Preparatory Rerun is to compile an accurate and up-to-date pre-mitigation baseline database to which the Commission-mandated mitigated price will be applied in order to calculate the final amount of refunds owed. There are two issues relating to this process that the ISO wishes to bring to the Commission's attention.

First, after analyzing what steps would be necessary to create an accurate pre-mitigation database, the ISO has determined that it must perform a number of additional adjustments to the baseline data and reruns of the production database *prior* to

beginning the Refund Rerun. Some of the issues that will be addressed in this process include cases of mis-reported meter data that can now be corrected, the resolution of various Good Faith Negotiations that can affect the volumes of various transactions subject to mitigation, and correction of the settlement of energy exchange transactions with other control areas that can have a significant impact in terms of volumes shifting between one time period and another. Furthermore, ISO staff in the settlements and billing department believes that adjustments should be made relating to several issues involving PX transactions that span trade dates prior to the Refund Period (April 1998 to October 1, 2000). Because the PX, which represented a significant portion of the ISO's market before 2001, is in bankruptcy and may wind up its affairs prior the conclusion of the Refund Proceeding, the ISO believes the market would benefit from having all open PX issues resolved, to the extent possible, at the time of the rerun for the Refund Proceeding. In total, this Preparatory Rerun process will address 18-20 issues, either through manual adjustments to transactions for periods prior to the rerun, or by inclusion in the Preparatory Rerun for transactions during the Refund Period.

The ISO has proposed to begin the Preparatory Rerun and adjustments on May 5, 2003, and estimates that it will take approximately 12 weeks to complete the process. This May 5 start date is conditioned on Commission direction with respect to the wall-off proposal filed in Amendment No. 51 (discussed below). Therefore, the ISO may have to delay the start of the Preparatory Rerun. At the end of this process, the ISO will allow Market Participants to raise disputes with respect to these calculations consistent with the provisions of the ISO Tariff. The ISO expects to be ready to commence the Commission-mandated Refund Rerun of its settlements system beginning 14-16 weeks

following initiation of the Preparatory Rerun. A more complete timeline, which accounts for all of the key steps relating to the refund process, is set forth in Section F below. As discussed in additional detail below, this estimate would likely need to be modified upward if the Commission does not grant the ISO's request for rehearing regarding the mislogging issue, or the ISO's request for clarification with respect to certain aspects of the interest calculation issue, each of which is discussed below. As is also explained below, if the Commission declines to grant the relief requested by the ISO with respect to the mislogging and interest issues, the entire Refund Rerun process itself could take significantly longer to complete.

Second, because of the complexity involved in performing the Preparatory Rerun and the Refund Rerun, the ISO has sought Commission approval to modify its Tariff to allow the entire "rerun process" (*i.e.,* the Preparatory Rerun as well as the Refund Rerun) to be invoiced separately ("walled off") from the standard, ongoing, ISO market invoicing process.[4] Settlement information relating to the reruns will continue to be presented to Market Participants through their normal daily settlement statements. Adjustments made as a result of the reruns will be identified by a distinct adjustment code and a unique reference ID identifying the type of adjustment (*i.e.,* a reversal of production data or new adjustments based on the updated rerun data). However, all of the invoicing of obligations resulting from the rerun process will be done separately from the standard ISO invoicing process. As is explained in greater detail in the ISO's request for Tariff amendment,[5] this wall-off process will benefit the market by avoiding

[4] This proposal was approved by the ISO Board on March 27, 2003, and the ISO filed the proposal on April 15, 2003, with the Commission as Amendment No. 51 to the ISO Tariff.

[5] See footnote 4, *supra*.

the problems and unnecessary complexities that would result from attempting to collect rerun-related charges on current-month invoices. For example, certain Scheduling Coordinator ("SC") debtors associated with recalculated charges are no longer active in the ISO markets, and the application of those recalculated charges to current invoices could expose new market entrants to charges for activities that occurred prior to their involvement in the ISO markets.

B. The Commission Should Revise, or at a Minimum Clarify, Several Aspects of the March 26th Order With Respect to the Issue of Mislogging

As set forth in the record compiled in the proceedings before Judge Birchman, the ISO, during an internal audit titled "Project X," determined that there were a number of instances during the Refund Period in which dispatches were logged as Out-of-Market ("OOM") and suppliers were paid the ex-post price for these transactions even though they had a bid in the BEEP stack. Transactions that met these criteria were labeled "GG Exceptions." As the ISO noted in the proceeding before Judge Birchman, Initial Brief of the California Independent System Operator Corporation as to Issues Two and Three, Docket Nos. EL00-95-045, et al. (Oct. 4, 2002) at 13-17 ("ISO Phase II I.B."), and in Reply Comments to the Commission, Reply Comments of the California Independent System Operator Corporation on Proposed Findings on California Refund Liability, Docket Nos. EL00-95-045, et al. (Feb. 3, 2003) at 52-53 ("ISO Reply Comments"), these transactions *may*, at least in some instances, have been more appropriately logged as Out-of-Sequence ("OOS") transactions, in which case the suppliers should have been paid according to the bid submitted into the BEEP stack.

After the set of GG Exceptions had been compiled, rather than attempt to determine which of the transactions were in fact OOS transactions, which would have required a pain-staking analysis of the relative timing of the suppliers' bids and the ISO's dispatches,[6] the ISO *assumed* they were all OOS transactions and made adjustments through its settlements system to pay the suppliers the difference between the full amount of their bid (under the soft cap regime then in place) and the ex-post price for that interval (which is the amount that participating generators receive when called Out-of-Market by the ISO). *See* Exh. ISO-37 at 34:20-35:8. However, the Project X audit was never intended to determine which of these "mislogged" transactions might have been eligible to set the BEEP clearing price (or, obviously, the MMCP). *E.g.,* Tr. at 3382:15-3383:16. The Presiding Judge recognized this in his proposed findings. Proposed Findings of Fact at ¶¶ 455-56.

In the March 26 Order, the Commission found, based on its review of the record in this proceeding, as well as additional evidence submitted in the "100-day discovery" proceeding (EL00-95-069, et al.), that this ISO internal audit "has already identified OOS units that may be eligible to set the BEEP Stack price under CAISO Operating Procedure M-403." March 26 Order at ¶ 28. The Commission directed the ISO to "determine whether mislogged OOS transactions were non-congestion transactions eligible to set the MCP," and stated that the "ISO's final rerun should reflect such corrections, for purposes of both MCP and MMCP calculations." *Id*.

[6] As explained in further detail below, it is possible that certain transactions that met the GG Exception criteria were actually OOM transactions because the generator at issue was dispatched Out-of-Market by the ISO for an extended period of time, and then subsequently submitted a bid into the BEEP stack for the period during which it was subject to the original OOM call.

For the reasons discussed below, the ISO requests that the Commission grant rehearing and rescind its direction to the ISO. If the Commission declines to do so, the ISO requests Commission clarification as to how the ISO should proceed in attempting to identify transactions that were eligible to set the historical MCP. As will be clear from the discussion below, there will be a significant amount of work involved in attempting to identify those transactions, and that work must be done before the historical MCPs can be reset in the Preparatory Rerun that was described in Part A. This means that any mislogging analysis must be completed *before* the ISO begins that Preparatory Rerun.

1. The ISO must first determine the universe of mislogged OOS transactions before it can assess which of these transactions were dispatched for system reliability reasons, and are therefore eligible to set the BEEP price

If the ISO is to implement the Commission's directive regarding mislogging, the first necessary step is to determine the universe of mislogged OOS transactions. In the March 26 Order, the Commission stated that the ISO, through its internal Project X audit, "has already identified OOS units that may be eligible to set the BEEP Stack price under CAISO Operating Procedure M-403." March 26 Order at ¶ 28. The ISO seeks clarification at the outset that the Commission did not mean that *all* of the transactions that were identified in Project X as GG Exceptions should be automatically treated as "mislogged OOS units" that are potentially eligible to set the historical MCP and MMCP. However, if the Commission did intend this result, then the ISO would respectfully request that the Commission reconsider that aspect of its decision.

As noted above, the Project X audit compiled the list of GG Exceptions based solely on whether there existed a valid bid in the BEEP stack for the interval in which a particular unit was dispatched and the transaction had been logged as OOM, but did not attempt to determine which of the GG transactions were mistakenly logged as OOM and should have been logged as OOS. Therefore, the fact that a transaction met the GG Exception criteria does not, in and of itself, mean that the transaction should have been logged as OOS. This conclusion was echoed by the Presiding Judge in his Proposed Findings, in which he stated "I agree with the ISO and find that, without more, one cannot determine that an OOM transaction should have been logged as an OOS transaction based simply on the price of the transaction reflected in data files." Proposed Findings at ¶ 461. In order to implement the Commission's decision, it will now be necessary for the ISO to analyze the GG Exception transactions to determine which of those OOM transactions should have been logged originally as OOS transactions.

In testimony and briefs, the ISO articulated two reasons why it would be erroneous to conclude, without additional analysis, that all of the transactions in the GG category should have been logged as OOS transactions. First, even in cases where there existed both an OOM call and a valid bid in the BEEP stack for the same unit, mislogging would only have occurred if the Scheduling Coordinator for the unit had submitted the bid *prior* to the OOM dispatch instruction by the ISO. Exh. ISO-37 at 34:20-35:1; ISO Phase II I.B. at 13-15. As the ISO's witness Mr. Gerber explained, there were some instances in which the ISO dispatched a unit as OOM for multiple hours, and the Scheduling Coordinator for that unit subsequently submitted bids for

some or all of those hours. In those circumstances, characterizing the ISO's dispatches as OOM was appropriate. Exh. ISO-37 at 35:1-8; ISO Phase II I.B. at 13; ISO Reply Comments at 52. Moreover, there were instances during the Refund Period in which the ISO entered into an agreement with an in-Control Area supplier to provide the ISO with OOM energy over a multi-day period (*i.e.,* an OOM transaction that was not the result of the ISO exercising its Tariff dispatch authority). In some of those cases, the supplier may have bid additional energy from the same unit into the BEEP stack during the same hours covered by the agreement. Again, in this situation, the designation of the first portion of that delivery (*i.e*., the portion covered by the agreement) as OOM would not constitute mislogging, although it would satisfy the GG Exception criteria. *See* Exh. CAL-53 at 17:13-19; ISO Phase II I.B. at 15-17; ISO Reply Comments at 52.

Therefore, in the event that the Commission continues to require the ISO to recalculate historical MCPs and the MMCPs to reflect potential "mislogging," the ISO requests that the Commission clarify that: (1) transactions that meet the GG Exception criteria are not, by definition, OOS transactions, and (2) additional analysis would be required by the ISO in order to determine which of those transactions should be treated as OOS (and further examined for eligibility to set the MCP and MMCP), and which were properly logged as OOM, under the scenarios described above. If the Commission's intent in its March 26 Order was to conclude that *all* GG exceptions are to be treated as OOS transactions, the ISO asks that the Commission reconsider that conclusion for the reasons stated above.

An analysis of which GG exceptions in fact should have been logged as OOS transactions will involve scrutinizing thousands of transactions, and therefore, will

require a significant devotion of resources on the part of the ISO and will also require the ISO to devote more time to the Preparatory Rerun process described above. Specifically, the ISO estimates that this analysis would require four full-time employees with the necessary system knowledge and experience working 40 hours a week over the course of six weeks. This, in turn, would add the same estimated six weeks to the ISO's overall refund schedule.

2. The ISO believes there exists no reliable method to determine, in every case, whether "mislogged" transactions are eligible to set the historical MCP; therefore, the Commission should reconsider its direction to the ISO to identify transactions eligible to set the historical MCP and units eligible to set the MMCP; if it does not do so, the Commission should clarify that the ISO should follow the steps available to it to try to make the determination, but if the ISO cannot with assurance determine that a transaction should have been eligible to set the MCP, it should not change the MCP or the MMCP.

Starting either from the universe of approximately 12,000 GG Exceptions identified in Project X, or from the smaller universe of actual OOS transactions culled from those GG Exceptions, there are two sources of information the ISO could use to attempt to identify which of those transactions were for "general system reliability" purposes, and therefore eligible to set the BEEP price under Operating Procedure M-403. First, in the ISO's OSMOSIS database, which contains records of OOM and OOS transactions, there are both "Reason" and "INSTR_TYPE" fields associated with each transaction. Under the Reason field, dispatches are indicated as having been for one of three reasons: "system," "intra-zonal," or "inter-zonal." Likewise, the INSTR_TYPE field also contains a code indicating the purpose of each dispatch. The specific INSTR_TYPE codes, in turn, belong to one of three broader categories: "energy," "local

reliability," or "other." Exh. GEN-60. At first glance, it would appear that the mislogged transactions could be sorted using these codes, with all of the transactions labeled with the Reason code "system" and an INSTR_TYPE belonging to the "energy" category counted as having been eligible to set the MCP.

Unfortunately, these two operator-entered fields in OSMOSIS are *not* a reliable indicator of the actual reason that a particular OOS dispatch was made by the ISO. As noted throughout this proceeding, the Project X audit concluded that inconsistent operator logging was a significant recurring problem for the ISO during the entire period reviewed. Exh. GEN-30 at 1. As further evidence of the recurring problem, the PricewaterhouseCoopers 2001 Operational Audit of the ISO found that operator logging of OOS transactions was not done in accordance with the ISO's governing operating procedures.[7] As noted in that audit, OOS transactions for reasons other than local congestion (*i.e.* system reliability) should not have even been logged in the OSMOSIS database in the first place, but instead should have been entered and processed exclusively through the BEEP software. Attachment A at 26. Moreover, the audit specifically found that OOS dispatches were being incorrectly logged in OSMOSIS for system conditions instead of intra-zonal congestion. *Id*. at 31, 40. That these codes are unreliable is not surprising, given that ISO operators were often under enormous pressure during the Refund Period to arrange sufficient energy to reliably operate the ISO Grid, and focused their efforts on this activity rather than ensuring that OOM and OOS transactions were properly logged. For these reasons, the ISO strongly urges that

[7] The relevant portion of this audit is included with this pleading as Attachment A. The ISO requests that the Commission take official notice of this audit, which is publicly available on the ISO's website, as it sheds additional light on the problems of operator logging during the Refund Period. Moreover, this document was not created by the ISO, but was prepared by an independent third party.

the eligibility of mislogged transactions to set the historical MCP and MMCP not be based solely on entries in the OSMOSIS fields.

Another data source that contains information with respect to the reason for OOS dispatches is the ISO's Scheduling and Logging Database (known as "SLIC"). SLIC contains narrative log entries describing operator events during each day, including information relating to many, but not all, OOM and OOS dispatches. The ISO could review the records in SLIC that relate to all transactions for which a code representing system reliability needs was entered in either the Reason field or the INSTR_TYPE field in the OSMOSIS database. As an initial matter, such a review would require a manual inspection of thousands of records, which would entail a significant burden for the ISO and a delay in completing the Preparatory Rerun process. The ISO estimates that this analysis would require four full-time employees with the necessary system knowledge and experience working 40 hours a week over the course of four weeks. This, in turn, would add the same estimated four weeks to the ISO's overall refund schedule.

In addition to the delay involved, there are shortcomings associated with using the SLIC logs, as well. First, SLIC records may not even exist for some of the mislogged transactions. In fact, one of the specific logging problems that Project X investigated was the absence of SLIC records for some transactions. Exh. GEN-31 at 2. And, even where SLIC records do exist, in some instances those records will not contain sufficient information to allow a determination to be made as to the reason for the dispatch. *See* Attachment C at 31 (noting that "Intra-Zonal Congestion is not always specifically stated in the SLIC log entry for OOS dispatches").

There exits no other data, beyond the SLIC logs and OSMOSIS codes, that the ISO can use to determine whether mislogged transactions were entered into for system or local reliability reasons. It would be impossible to re-create the system conditions that existed at the time that each mislogged transaction was dispatched, in order to determine the reason for those dispatches. Therefore, if the Commission desires that the ISO determine which transactions were for system reliability, despite the delay that will be involved, the ISO respectfully seeks clarification that the Commission intends the ISO to follow the two-step process set forth above – identify dispatches for which the OSMOSIS codes in the Reason or INSTR_TYPE fields indicate that they may have been performed for system needs, and review the SLIC logs with respect to those dispatches. The ISO seeks further clarification that if the ISO cannot make a clear determination from the SLIC log that a transaction was for system reliability, the ISO should not consider the dispatch eligible to set the historical MCP, nor the unit eligible to set the MMCP.[8]

However, given the delay involved in pursuing the process the Commission has ordered, and the uncertainty of the resolutions that would result, the ISO respectfully requests that the Commission reconsider its decision to require the ISO to recalculate historical MCPs and MMCPs to account for mislogging of OOS transactions during the Refund Period. The Commission has already found that prices paid during the Refund Period were unjust and unreasonably *high*. It would be most consistent with the

[8] Requiring the resetting of prices using unreliable data would be inconsistent with the Commission's reluctance to reset prices retroactively except under certain narrow circumstances *See, e.g.*, *New York Indep. Sys. Operator, Inc.*, 91 FERC ¶ 61,218 at 61,804 (2000). If one cannot be certain that a transaction should have been eligible to set the MCP, considerations of market certainty mentioned by the Commission in that case, and others, should prevail.

underlying purpose of this proceeding – to *reduce* unjust and unreasonable prices -- as well as principles of equity, for the Commission to leave in place the currently existing MCPs. To do otherwise would attempt to correct a perceived injustice resulting from the potential impact of OOS mislogging on the MCP and MMCP, but possibly create an injustice in the other direction through the use of unreliable data.[9]

Leaving the historical MCPs in place and not trying to add OOS units called for system reliability to those eligible to set the MMCP would also be consistent with the Presiding Judge's finding that, after a full proceeding pursuant to the Commission's May 15 Order addressing potential mislogging, no party had been able to make a showing that correcting for mislogging would have any effect on the MCP. The Presiding Judge had the benefit of observing the witnesses and reviewing all of the evidence relevant to this issue. He concluded that no party had shown that whatever mislogging occurred resulted in the historical MCPs being incorrect. He did so with knowledge, based on the ISO's testimony and briefing, of the kind of undertaking by the ISO that would be required to determine *whether* any such mislogging in fact had affected the MCP. Exh. ISO-37 at 35:21-36:6; ISO Phase II I.B. at 17-18. The ISO respectfully requests that the Commission reconsider its decision that, despite the Presiding Judge's findings, the ISO should be required to perform this task.

[9] If the Commission concludes that it still wishes the ISO to attempt to identify OOS transactions eligible to set the MCP, the ISO will do so and compare the bids associated with the eligible OOS transactions to the current historical MCP. Where the highest bid associated with an eligible transaction exceeds the current historical market clearing price for an interval, but is still below the applicable price cap, the historical market-clearing price, and resulting payments to suppliers, for those intervals will be adjusted accordingly in the Preparatory Rerun. Finally, the units involved in eligible OOS transactions will be included in the units eligible to establish the MMCP when the ISO recalculates those MMCPs pursuant to the Commission's March 26 Order.

C. The Commission Erred in Concluding that AEPCO's Heat Rate Data Was Sufficient to Allow its Units to Set the MMCP.

In his Proposed Findings of Fact, the Presiding Judge found that AEPCO's units that provided imbalance energy to the ISO during the Refund Period are eligible to set the MMCP during the Refund Period. Proposed Findings of Fact at ¶ 211. Specifically, Judge Birchman concluded that AEPCO had provided sufficient heat rate data such that the ISO could include AEPCO's units in the ISO's calculations of MMCPs during the Refund Period. *Id*. The Presiding Judge based these findings on his conclusion that AEPCO had satisfied several underlying criteria: (1) AEPCO's hourly bids adhere to ISO Operating Procedure M-403, which allows such bids to set the Hourly and Interval Ex Post Prices; (2) As required by the May 15 Order, AEPCO provided heat rate information to the ISO for the unit used to supply power to the ISO; (3) AEPCO submitted the requisite heat rate information to the ISO and (4) AEPCO's use of average heat rates for its GT units was appropriate because these units operated at only one point other than zero output. *Id*. at ¶ 217. In the March 26 Order, the Commission adopted the Presiding Judge's proposed findings on this issue without explanation. However, because the Presiding Judge's finding is unsupported by the record in this proceeding, the Commission should revise its decision and find that the information submitted by AEPCO's was not sufficient to allow its units to be considered in setting the MMCP.

As explained in the ISO's Comments on the Proposed Findings, the Presiding Judge was incorrect in concluding that AEPCO had provided "the requisite heat rate information to the ISO." Proposed Findings of Fact at ¶ 217. First, AEPCO never

identified the units from which it made specific sales to the ISO during the Refund Period. Without data showing which unit supplied what power, it is impossible to implement the July 25 Order's requirement that the marginal unit be selected from "the *actual units* dispatched in real time . . . in the real-time imbalance market." July 25 Order at 61,517. This is the case because the ISO does not have the necessary information to trace imports to specific generating resources. Exh. ISO-37 at 58:15-17.

Instead of providing meter data to demonstrate which units made specific sales to the ISO during the Refund Period, AEPCO simply assigned the unit with the highest heat rate or highest cost that was operating at the time to the California sale. Exh. AEP-12 (Bray) at 8:7-9. However, this method of unit attribution is insufficient for purposes of including AEPCO's units in the calculation of MMCPs. The fact that no party, other than AEPCO, addressed through testimony or cross-examination the specific issue of the attribution of AEPCO's units to California sales does not relieve AEPCO of the burden of presenting sufficient data to meet the Commission's requirement that any units included in the calculation of MMCPs be the "actual units dispatched in real time." July 25 Order at 61,517. That this burden rests squarely on AEPCO is clear from the May 15 Order, in which the Commission stated that out-of-state sellers would be eligible to set the mitigated price only if "*they* can provide the heat rate information to the ISO for the unit used to supply the power." May 15 Order at 61,654 (emphasis added). AEPCO has not provided this information, and its post-hoc mechanism of assigning the highest cost unit operating at the time to all California sales is inadequate. As the ISO pointed out in its Brief as to the Eligibility of Units Operated by AEPCO to Set the Mitigated Market Clearing Price During the Refund Period ("ISO AEPCO Brief"),

AEPCO's proposal is particularly dubious given the fact that AEPCO sold power to the ISO in one-hour blocks and agreed to accept the ex-post price for that hour. ISO AEPCO Brief at 5; *see also* Exh. S-26R at 55:6-8. Also, it is possible that AEPCO sought ways to meet its commitments to the ISO by substituting purchased power or some other resource for the highest-price unit that it alleges is associated with the bid. ISO AEPCO Brief at 6. This highlights AEPCO's failure to provide any meaningful information as to which units actually ran for purposes of sales made to California.

Moreover, allowing AEPCO's units to set the MMCP, absent data sufficient to establish that those particular units were actually providing energy to the ISO, is inconsistent with the Proposed Findings of Fact with respect to the eligibility of units inside the ISO system to establish the MMCP. Specifically, the Presiding Judge concluded that the ISO should exclude units from eligibility to set the mitigated price if meter data does not demonstrate that those units actually responded to the ISO's dispatch instructions. Proposed Findings of Fact at ¶¶ 203-210. As discussed above, AEPCO has provided no data to establish that any specific units actually provided energy to the ISO, and thus, AEPCO's units would fail this eligibility test. AEPCO should not be granted the unique privilege of eligibility without providing the necessary data simply because of its status as an out-of-state supplier.

AEPCO also failed to provide the ISO with sufficient information on the heat rates of its units to enable the ISO to construct incremental heat rate curves for those units. Instead, AEPCO submitted into the record only single point heat rates for all of its units that it alleges made sales to the ISO during the Refund Period. *See* Exh. AEP-13. AEPCO explained that it submitted incremental heat rates for its combined cycle units

that were "generally already in use" before AEPCO made a sale to California, and average heat rates for its simple cycle combustion turbines, which AEPCO asserts would not have been dispatched absent the sales it made into California. Exh. AEP-12 at 10:8-21. As the ISO pointed out in its Initial Comments on the Proposed Findings, the Presiding Judge's adoption of AEPCO's proffered incremental heat rates for its combined cycle units is based on speculation; there is no operational data in the record to support a conclusion that AEPCO properly calculated incremental heat rates for its combined cycle units. The Commission's refund methodology required the use of heat rates *calculated by the ISO* for each unit based on data provided to the ISO by suppliers in the format requested by the ISO (and approved by the Commission in the June 19 Order). *See* July 25 Order at 61,516-17; June 19 Order at 62,563. The Commission made no exception to this requirement for out-of-state sellers.

The Proposed Findings of Fact's conclusion regarding AEPCO's average heat rates is also unsupported by the record. Even assuming, *arguendo*, that AEPCO's combustion turbines were only used for sales to the ISO, it is not at all clear from AEPCO's testimony and exhibits that those GTs always went from startup (i.e., zero output) to "whatever operating point they obtained during the interval they operated." Proposed Findings of Fact at ¶ 234. A review of Exhibit AEP-13, in fact, suggests otherwise. For instance, on November 9, 2000, Exhibit AEP-13 shows that unit GT#3 operated for four consecutive hours (hours 19-22), presumably in order to make sales to the ISO. Exh. AEP-13 at 1. During those four hours, the heat rate of that unit fluctuated several times, suggesting that it was *not* operating at the same level of output during that four-hour period. Consequently, it would be inappropriate to use average heat

rates to calculate the cost of AEPCO's GT units, as using these heat rates would permit AEPCO to recover minimum load costs associated with these units, in violation of the Commission's methodology, first described in its April 26 Order. April 26 Order at 61,359; reaffirmed in the March 26 Order at ¶ 14.

For these reasons, the Commission should reconsider its finding that AEPCO's heat rate data was sufficient to allow its units to set the MMCP.

D. The Commission Should Decline to Permit Generators an Additional Fuel Cost Allowance Based on the Actual Daily Cost of Gas

As noted above, although the Commission agreed with Staff's recommendation to use producing area-prices plus a tariff rate transportation allowance instead of California spot gas prices in calculating the MMCP, the Commission also stated that generators would be permitted to recover an additional fuel cost allowance as an offset to their refund liability. The Commission specified that this allowance would be based on the actual daily costs of gas incurred by generators to make spot market sales to the ISO and PX. The Commission reasoned that this fuel cost allowance was necessary in order to "address comments stating that in most cases generators paid the California spot gas index price." March 26 Order at ¶ 61. The ISO respectfully requests that the Commission reconsider its decision on this issue, and decline to allow Generators this unnecessary additional mechanism. This result is merited for several reasons.

First, there is no logic in allowing those generators that did not actually purchase their spot gas needs at the inflated California spot index prices to recover a fuel cost

allowance, as the March 26 Order does.[10] In such cases, there is no reason to believe that generators will be unfairly harmed by now using the new gas proxy price in calculating the MMCP, without a fuel cost allowance; the old gas proxy price, based on the spot indexes, was also different form what those generators actually paid, but the Commission did not consider it necessary to include a fuel cost allowance. The purpose of both gas proxies was to "provide prices that emulate closely those that would result in a competitive market and that provide generators with a reasonable opportunity to cover their costs." March 26 Order at ¶ 56. However, if a generator cannot show that it actually purchased its spot gas needs at the California spot index prices, there is no reason to conclude that the new proxy would fail to provide that generator a "reasonable opportunity to recover [its] costs." Therefore, at a minimum, the Commission should limit eligibility for the additional fuel cost allowance to those generators that can make an affirmative showing that they actually purchased their gas used for spot energy sales to the ISO and PX at prices based on the inflated California spot indexes.

In any event, the additional fuel cost allowance is unnecessary to protect sellers and inequitable to buyers. The Commission has already provided generators the option to seek cost-based rates for all of their sales during the Refund Period if the MMCP methodology does not fully compensate them for their costs, including gas costs. The fuel cost allowance will simply act to further reduce the amount of total refunds and visit

[10] The March 26 Order states that "in order to verify that generators paid spot gas prices, we will require each generator to base its additional fuel cost allowance on its actual daily cost of gas incurred to make spot power sales in the PX and CAISO markets." This statement is, with all due respect, a non sequitur. Even if generators base their allowance on the actual costs of the gas they used to generate spot power for the PX and ISO, it does not follow that those generators necessarily paid California spot prices for that gas.

the consequences of the flawed original gas proxy methodology on buyers, who were certainly the most innocent parties in the circumstances that led to the dysfunction of the California spot gas market indices during the Refund Period. There is no justification for this result.

Finally, the Commission's assumption that generators' short-term gas purchases were necessarily used for their spot market sales into the ISO and PX markets is flawed. In that regard, the Commission assigned the shortest term gas to spot power sales by requiring each generator to rank its gas supplies by term and allocate its gas supply to its spot power fuel requirement starting with the shortest term gas supply, and proceeding sequentially to the next shortest gas supply until a generator's spot power demand for gas is met. March 26 Order at ¶ 61. The Commission cannot assume in a factual vacuum that short-term gas contracts are used solely for spot market sales. Similarly, the Commission cannot assume that long-term gas contracts only support long-term bilateral power sales. Rather, if the Commission implements this fuel cost allowance, it must examine each generator's portfolio on a case-by-case basis to determine which gas purchases actually supported spot power sales. As the ISO pointed out in its comments on the initial Staff report recommending the use of an alternate gas proxy methodology,[11] because gas supplies are typically purchased on a portfolio basis (*i.e.*, for multiple units) and include a mix of long-term and short-term contracts, there may often not be a direct temporal link between specific gas purchases within a generator's portfolio and the fuel burned by a generating unit on any specific

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[11] Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices, Initial Report on Company-Specific Separate Proceedings and Generic Reevaluations; Published Natural Gas Price Data;

day. *Comments of the California Independent System Operator Corporation Concerning the Method for Determining Natural Gas Prices*, Docket Nos. EL00-95-045, et al. (October 15, 2002) at 17-18. Generators' diverse mixture of long- and short-term gas contracts is a hedging strategy not an assignment of particular gas contracts to particular power sales. However, the Commission arbitrarily and artificially assigns long term gas contracts to long-term power sales and short-term gas contracts to spot power sales. The Commission must consider the timing of any long-term gas purchase agreements and power sales agreements. For example, it would be inappropriate for the Commission to jump to the conclusion that a long-term gas contract executed five years after a generator executed a long-term power sales agreement supports such power sales agreement. Yet that is exactly the conclusion the Commission would reach based on the methodology it adopted in its order. Under these circumstances, the proposed fuel cost allowance invites a host of gaming opportunities related to how gas procurement costs are allocated to the output of specific plants during specific hours.

E. The Commission Should Clarify that the Following Methodology for Calculating Interest is Consistent with the Commission's March 26 Order

In the March 26 Order, the Commission stated that it would "adopt the Presiding Judge's proposed finding that interest on both refunds and unpaid balances will be calculated in the manner required by the Commission's July 25 Order, *i.e*., calculated under Section 35.19a of the Commission's regulations" (the "FERC rate").[12] The

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and Enron Trading Strategies, Docket No. PA02-2-000, August 2002. The ISO hereby incorporates its Comments by reference.

[12] Section 35.19 provides that the rate of interest shall be at an average prime rate for each calendar quarter, and that this rate will be compounded quarterly. 18 C.F.R. § 35.19 (2002).

Commission also stated that interest was to be calculated separately for the ISO and PX markets. Beyond these requirements, however, the Commission did not opine on or endorse a particular methodology for calculating interest. Therefore, the ISO requests clarification that the following methodology is appropriate for calculating interest on unpaid balances and refunds pursuant to the Commission's March 26 Order for transactions in the ISO markets entered into during the Refund Period. The ISO believes this methodology complies with the Commission's holdings on interest. It is also, to the extent possible given the Commission's orders, consistent with the ISO's standard settlement and invoicing procedures as set forth in the ISO Tariff, as well as the principles underlying those procedures. Finally, the ISO believes that this methodology can be reasonably implemented, consistent with the Commission's overall approach to determining its refund methodology. December 19 Order at 62,202.

1. Calculation of Interest With Respect to Unpaid Balances

In applying interest to unpaid balances, the first step, logically, is to determine all "unpaid balances" relating to transactions entered into during the Refund Period. In order to do so, it is necessary to have the following information as to each Refund Period obligation: (1) the amount of the obligation (in dollars), (2) the date on which it became an obligation (*i.e.,* was due to be paid), and (3) the date on which it was satisfied (if ever). For obligations that have not been satisfied, interest will be applied up until the Payment Date for the final refund invoices.

The ISO proposes to determine the amount of Refund Period obligations by using the original ISO monthly invoices that were issued to Market Participants during

the Refund Period (October 2000 through June 2001). These invoices reflect all of the charges and credits accrued by a Scheduling Coordinator ("SC") with respect to the ISO's markets during each month of the Refund Period. If the net of all charges and credits on a particular invoice results in an SC being owed money by the ISO markets, then that SC is considered an ISO Creditor for that month. On the other hand, if the net of all charges and credits results in an SC owing money to the ISO markets, then that SC is considered an ISO Debtor for that month. Adjustments will be made to the original amounts invoiced, however, in order to exclude charges and credits traceable to transactions on trade dates outside the Refund Period and to remove interest already assessed pursuant to the ISO Tariff. Each of these adjusted monthly invoiced amounts will represent an "obligation" for purposes of calculating interest. Thus, each Market Participant, for each month in which it engaged in activity in the ISO markets and was invoiced for that activity, will have an obligation that is potentially subject to interest.

Moreover, each monthly invoice has an associated Payment Date, which, under the ISO Tariff, is the date on which invoiced amounts are due to be paid by Market Participants. For purposes of calculating interest, the ISO will use the Payment Dates associated with the original invoices as the date on which the obligations reflected in these invoices were due. Thus, if a Market Participant did not satisfy an obligation, as indicated on an original Refund Period invoice (adjusted as noted above), by the Payment Date for that invoice, then the ISO will calculate and assess interest at the FERC rate starting on the Payment Date. Finally, the ISO keeps a record of all cash payments made by SCs, including the date of payment and the allocation of those

payments to outstanding monthly obligations.[13] These records constitute the necessary set of information as to when Refund Period obligations were satisfied, to the extent they have been satisfied.

A related issue is how to account for adjustments to Refund Period transactions that were made and invoiced *outside* of the Refund Period. As noted in the record, the ISO often makes adjustments to transactions outside of the month in which they are originally invoiced. *See, e.g.*, Exh. GEN-36 at 33:15-19. The financial impacts of such an adjustment is reflected on the next monthly invoice after the adjustment is made. For purposes of calculating interest for this proceeding, it is necessary to decide when those adjustments become "obligations" – at the time that the original transaction became an obligation (*i.e.,* the Payment Date for the invoice on which the original transaction appeared) or at the time that any financial obligation relating to the adjustment was due (*i.e.,* the Payment Date for the invoice on which the adjustment appeared). For several reasons, the ISO proposes to adopt the latter approach.[14] First and foremost, establishing the obligation date for adjustments as the date when those adjustments were invoiced is most consistent with the financial provisions of the ISO Tariff, pursuant to which Market Participants are liable for obligations at the time at which they are informed of those obligations, and not before. *See* ISO Tariff, Section 11.9. This approach is also consistent with the principle of fair notice. Moreover, in order to have interest on adjustments run from the time the original transaction become an obligation would require that the ISO engage in the extremely onerous process of

[13] Pursuant to the ISO Tariff, SABP 6.10.2, payments are allocated on a "first in first out basis," meaning that a payments is first applied to an SC's oldest outstanding liability.

matching each adjustment to its original transaction. If the Commission rejects the ISO's proposal on this issue and requires the ISO to engage in this matching process, it would also require a significant amount of time for the ISO to implement, as well as for Market Participants to decipher and understand. The ISO estimates that this would require three to six months of effort in order to re-invoice and re-settle all adjustments from October 2000 through January 2003 by original trade date, apportion the cash paid on each invoice between the current and previous charges, re-apply all cash paid and offsets for all periods, and, finally, to reverse and then recalculate the interest previously charged on the unpaid invoices for the post Refund Period.

Additionally, two adjustments must be made with respect to the original ISO invoices in order to accurately determine amounts unpaid by Market Participants for purposes of interest calculation using the FERC rate. First, the October 2000 and June 2001 invoices must be prorated by day in order to ensure that interest is not applied on amounts relating to transactions during those months but outside of the Refund Period (*i.e.,* transactions entered into on October 1, 2000, and from June 21 through June 30, 2001). In the course of normal operations, the ISO does not match cash received from and distributed to Market Participants to specific transactions, as an invoice is the net of all transactions for the billing period. Therefore, there is no inherently prescribed method for determining which amounts left unpaid should be earmarked to which transactions. In order to resolve this issue, the ISO believes that the fairest method is to distribute cash to transactions reflected on the October and June invoices on a "first-in first-out" ("FIFO") basis (which parallels the tariff application of funds to the oldest

[14] This means that the ISO would not assess interest at the FERC rate on those adjustments that were invoiced outside of the Refund Period because they did not become obligations during the Refund Period.

invoice first). This methodology is best explained by using of an example. Assume that a Market Participant owed the ISO markets a total of $3 million for the month of June 2001, and that after calculating the Participant's debits and credits for transactions entered into just for the period June 1 through June 20, 2001, the ISO determines that the Participant owed $2 million to the ISO markets for that period. Also assume that of the total $3 million owed for the month of June 2001, the Participant paid $1.5 million on the Payment Date. Under the FIFO rule, the entire $1.5 million would be subtracted from the $2 million owed to the ISO markets for the June 2001 Refund Period transactions, leaving an unpaid balance of $500,000 for the Participant's June 2001 Refund Period transactions. The ISO would then assess interest at the FERC rate based on this $500,000, up until the point at which the Market Participant satisfied that obligation. Likewise, if the Participant had paid $2 million of its June 2001 obligation on the Payment Date, under the FIFO rule, that Participant would be considered to have no unpaid balance relating to June 2001 Refund Period transactions, and as a result, no interest would be calculated for that month in this proceeding. The only interest would be the default interest provided for in the Tariff on the post June 20, 2001 balance.

The next step in determining interest on unpaid balances is to reverse the ISO's original interest calculations. Pursuant to Section 11.12 of the ISO Tariff, the ISO charges interest to debtors on unpaid amounts receivable at a rate of prime plus 2%, but does *not* pay interest on amounts payable. Interest charged in the current month is based on unpaid invoice receivable balances from all previous months. However, because the Commission has explicitly ordered that the interest at the FERC rate supersede original interest amounts charged on unpaid balances during the Refund

Period, the original interest charged on amounts receivable must be backed out during the calculation of Refund Period interest. The ISO proposes to accomplish this by crediting each Market Participant the amount of the original interest charged for the month in which it was invoiced, and netting that amount against any charges or obligations of the Market Participant in the Preparatory Rerun invoice.

The third step in this process is to apply the Commission mandated interest rate set forth in Section 35.19a to the unpaid balances – both amounts receivable and amounts payable – from the Refund Period. This is done by assessing interest at the FERC rate to each unpaid obligation (as reflected in the original Refund Period invoices, revised to remove original interest amounts and prorated as necessary), from the original Payment Date up until the time at which it was satisfied (if ever). For example, assume that a Market Participant owed $2 million for activities reflected in its February 2001 invoice, but remitted only $1 million to the ISO on the Payment Date of March 15, 2001, resulting in an unpaid balance of $1 million for that month. Then, on April 15, 2001, that Market Participant paid to the ISO the $1 million outstanding balance for the February 2001 invoice. After first backing out the interest already charged for those 30 days (March 15 through April 14) at the ISO rate, the ISO would calculate interest at the FERC rate on the $1 million by multiplying that $1 million by the interest rate specified in 18 C.F.R. § 35.19.

As noted above, for those unpaid obligations that are still outstanding, the ISO will calculate interest until the date on which Refund Rerun invoices are due from Market Participants. However, because the ISO will need to have completed its interest calculations prior to preparing the final Refund Rerun invoice, it may be necessary to

issue a supplemental invoice after the Refund Rerun invoice is issued. The trigger for a supplemental invoice would be the payment by Market Participants of any outstanding balances between the date on which the ISO begins its interest calculations and the date on which the Refund Rerun invoice is due. This is the case because, in that situation, interest should only be charged up until the date on which the Market Participant satisfied the outstanding obligation, rather than the due date for the Refund Rerun invoice. This supplemental invoice will serve to credit the difference back to Market Participants as necessary.

Another issue that needs to be resolved with respect to interest calculations on unpaid amounts is how to handle the allocation of interest for those months during the Refund Period in which there is a mismatch between accounts receivable and accounts payable (*i.e.,* amounts charged to ISO Debtors do not match amounts due to ISO Creditors). These mismatches are the result of several circumstances, including the manner in which CERS settlements were invoiced (due to CERS assuming the creditworthiness obligations of the Investor Owned Utilities), and the resettlement of Energy Exchange transactions. Because interest on unpaid balances, pursuant to the Commission's orders, must be reflected on both accounts receivable and accounts payable, differences in accounts receivable and accounts payable will result in different amounts of interest receivable and payable, which, in turn, will result in a net cash payment to or collection from SCs and thus violate the ISO's position as a cash neutral entity. In order to spread any imbalances fairly, the ISO proposes to implement the following mechanisms:

- If the total interest due from debtors for the Refund Period exceeds the interest payable to creditors for the Refund Period, then the excess interest receivable will be prorated back to the debtors and serve to reduce the amount of interest owed in proportion to their respective shares of the total interest owed by all debtors. Thus, creditors will receive the full amount of interest at the FERC rate on amounts owed to them but will not receive "bonus" interest on the additional amounts reflected as owed by debtors.
- If the total interest payable to creditors for the Refund Period exceeds the interest receivable from debtors for the Refund Period then the excess interest payable (*i.e.*, the shortfall in available cash) will be prorated back to creditors in proportion to the total interest calculated as owing to them. Again, this mechanism is necessitated by the fact that the ISO, as a cash-neutral entity, cannot pay out amounts to creditors greater than the amounts that it collects from debtors. If the Commission is not persuaded to adopt a pro rata reduction in interest payments to ISO Creditors under these circumstances, then the ISO will be required to charge debtors excess interest for the additional amount needed to make up for this shortfall.

Finally, there is the issue of assessing interest to bankrupt entities with transactions in the ISO markets during the Refund Period. The Commission made no exception for bankrupt entities nor provided any special rules for assessing interest on the obligations of such entities. Therefore, the ISO proposes to calculate interest on the unpaid balances for such entities in the same manner as all other Market Participants. Any uncollected amounts from bankrupt entities will be counted as a non-payment

(default) according to the provisions of the ISO Tariff and the cash shortfall will be spread pro rata to ISO creditors.

2. Calculation of Interest With Respect to Refunds

The ISO proposes that interest be calculated on refund adjustment obligations as follows. First, the total refund adjustment owed or owing to each Market Participant, determined through the ISO's settlement rerun, will be netted by month. For example, assume a Participant was, for one month during the Refund Period, owed $30 million by the ISO markets as a result of energy sales made into the ISO markets, but that that Participant also owed the ISO market $10 million as a result of purchases and other charges. Also assume, as a result of application of the MMCP, the $30 million owed by the ISO market to the Participant for its energy sales is reduced to $20 million, and that the $10 million owed by the Participant to the ISO markets for its purchases is reduced to $5 million. Therefore, for this Participant, there exist refund adjustments in the amount of $10 million in refunds that the Participant owes to the ISO market and $5 million in refunds that the Participant is owed by the ISO market. These amounts would be netted to end up with a $5 million refund adjustment owed by the Participant to the ISO market. It is this $ 5 million that will be assessed interest at the FERC rate, and the Participant would owe that interest to the ISO market. This netting process will also take into account any applicable offsets to refunds (e.g., emissions offsets). Total offsets will be allocated to each individual month on a pro rata basis, and then subtracted from each month's refund total. Using the previous example, if the same Participant had an emissions offset for the month in question in the amount of $ 1 million, then that

Participant would owe a net of $4 million in refund adjustments. The net amount of refund adjustments owed or owing for each month will then be assessed interest at the FERC rate (described above) from the date on which the original transaction was entered into until the date on which the ISO issues the Refund Rerun invoices.

3. Invoicing of Interest Obligations

As a result of the previous two steps, the ISO will have, by month, a complete set of interest calculations on both unpaid balances and refunds. These two interest amounts will be reflected on one final invoice for each Market Participant for the Refund Period, which will show all amounts owed and owing to the Market Participants as a result of the refund calculations and application of interest to both unpaid balances and refunds.

The ISO believes that the foregoing process will strike the best balance between accuracy, fairness to Market Participants, and feasibility of implementation under the time constraints imposed by the Commission for resolving this proceeding. Therefore, the ISO urges the Commission to clarify that the process described herein is consistent with its March 26 Order.

F. Timeline for Completion of Reruns, Interest Calculations, and Invoicing

The following are the various steps that the ISO will need to take in order to complete the refund process, as well as its current best estimate as to how long each of those steps will take.

- Preparatory rerun and production of associated settlement statements - 12 weeks.

- Period for Market Participants to raise any disputes associated with the preperatory rerun settlement statements, and ISO effort to implement any necessary corrections as a result of any such disputes - 2.5 to 3 weeks.
- Refund rerun and production of associated settlement statements - 12 weeks.
- Period for Market Participants to raise any disputes associated with the Refund Rerun settlement statements, and ISO effort to implement any necessary corrections as a result of any such disputes - 2.5 to 3 weeks.
- Calculation of interest - 2 weeks.
- Bulk load of data into production in order to produce invoices (the preparatory rerun invoice and Refund Rerun invoice will be issued on separate days, with all interest adjustments included on the rerun invoice) – 4 to 5 weeks.
- Cash clearing of both rerun invoices - 1 week.
- Issuance of supplemental invoice to account for changes to interest amounts due, as explained in Part E above - 3 weeks.

Again, to reiterate, this schedule is based on the Commission granting the ISO's request for rehearing with respect to the mislogging issue, and clarifying that the ISO's proposed methodology for calculating interest is appropriate. If the Commission does require the ISO to conduct an analysis with respect to mislogged OOS transactions, and/or reject's the ISO's methodology for calculating interest, then this entire process will take significantly longer to complete, as detailed above.

IV. CONCLUSION

Wherefore, for the reasons discussed above, the ISO respectfully requests that the Commission revise and/or clarify the March 26 Order as requested above.

Respectfully submitted,

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