November 10, 1999

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

Re: California Independent System Operator Corporation,
Docket No. ER00-____-000
Amendments to the ISO Tariff

Dear Secretary Boergers:

Pursuant to Section 205 of the Federal Power Act ("FPA"), 16 U.S.C. § 824d, and Section 35.13 of the Commission's regulations, 18 C.F.R. § 35.13, the California Independent System Operator Corporation ("ISO")[1] respectfully submits for filing six copies of an amendment ("Amendment No. 23") to the ISO Tariff. Amendment No. 23 would modify the Tariff to provide an alternative payment option for ISO Dispatch orders. Resources would be given the choice to continue to receive the current pricing for ISO Dispatch orders (the "Hourly Ex Post Price") or a new payment option that includes, if applicable, a payment for market capacity, market Energy, and verifiable start-up fuel costs and gas imbalance charges. The alternative payment option (as well as the current pricing provisions) would apply to resources that have not bid into the relevant ISO markets and to resources required to satisfy a local need where there is a non-competitive supply of bids.

I. BACKGROUND

In normal circumstances, the ISO obtains the Energy it needs to balance Loads and resources in real time (i.e., Imbalance Energy) and for reliable operation of the ISO

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

Controlled Grid (e.g., to satisfy locational requirements) from Energy that resources[2] have bid into the ISO's Real Time Markets or from capacity that has been selected in the Ancillary Services Markets. Recourse to these markets, however, is not always feasible. Deficiencies of Imbalance Energy bids may arise from market anomalies, which can occur anytime, or from capacity shortages (such as have been experienced in California during periods of high Load in summer months and during natural gas curtailments in winter months). Even when bids are sufficient, as is likely in shoulder seasons or off-peak, they may not be an effective response to the ISO's needs because of transmission outages or other location-specific requirements. The ISO Tariff therefore permits the ISO in certain circumstances to issue Dispatch orders to Participating Generators and System Resources [3] that have not bid into the relevant ISO markets.[4] These circumstances include the following:

- a deficiency of Ancillary Service Energy bids and of Supplemental Energy bids in the Balancing Energy and Ex Post Pricing ("BEEP") stack;
- the absence of Adjustment Bids and Imbalance Energy bids in the BEEP stack that can be effective in resolving adverse system conditions (e.g., due to locational requirements); or
- a real time system problem or an imminent System Emergency.

All Energy Bids associated with Ancillary Service capacity awards and Supplemental Energy are placed in economic order in the Imbalance Energy or "BEEP" stack. When the ISO responds to real time requirements by dispatching a resource that has bid into the Supplemental Energy market or has been awarded capacity in the Ancillary Services Markets, the resource receives the BEEP Interval Ex Post Price. If the ISO, in order to meet a particular need, selects a resource that has bid into the Imbalance Energy market out of sequence, the resource is paid (or charged, in the case of decremental dispatch) its bid price (unless it is capable of exercising locational market power, in which case its out-of-sequence bid may be subject to scrutiny, and disqualified).[5] If, however, for the reasons discussed above, the ISO issues a Dispatch order to a resource that has not submitted a market bid, the dispatched resource receives (or pays in the case of decremental Dispatch) the Hourly Ex Post Price.[6] The Hourly Ex Post Price is the weighted average of BEEP Interval Ex Post Prices during each hour.

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[2] Resources include Generating Units, imports, and Participating Loads.

[3] System Resources are a group of resources located outside the ISO Control Area capable of providing Energy and/or Ancillary Services to the ISO Controlled Grid.

[4] *See, e.g.,* Sections 5.1.3, 5.6.1, and 7.2.6.2 of the ISO Tariff.

[5] *See* Section 7.3.2 of the ISO Tariff.

[6] *See* Sections 11.2.4.1 and 11.2.4.2 of the ISO Tariff. The currently effective version of Section 11.2.4.1 is found in the temporary provisions in Section 23 of the ISO Tariff.

Ever since the ISO Operations Date, Generating Unit owners have informed the ISO through stakeholder meetings and individual correspondence that payment for these Dispatch orders at the Hourly Ex Post Price does not always provide adequate compensation for out-of-pocket costs. A Generator may be off-line when it receives a Dispatch order, and an owner can be at risk of operating without sufficient compensation for start-up fuel costs and variable costs and any potential gas imbalance charges. As a result of these concerns, the ISO has explored cost-based alternative payment options for resources to which the ISO has issued such Dispatch orders.

A new payment option is also necessary to assist the ISO in managing transmission outage contingencies and locational market power problems where Reliability Must-Run ("RMR") Generation is not available. The ISO has encountered situations where the forced or scheduled maintenance of a transmission facility required local generation to be on-line and provides an opportunity for exercise of locational market power due to a lack of adequate competition to resolve the attendant Intra-Zonal Congestion. In these situations, as soon as the condition is known, sudden changes in bid prices invariably occur. In addition, the ISO has observed what appears to be intentional capacity withholding or intentional overscheduling along with a sudden change in the bid prices for the resources needed to resolve Intra-Zonal Congestion where no competitive market exists. To date, the ISO has managed these outages and locational market power problems using RMR Generation where available. Because of the locational requirements, and concomitant local market power concerns, the ability to use a market-based option to resolve Intra-Zonal Congestion is limited at this time.

II. THE AMENDMENT

In Amendment No. 23, the ISO proposes Tariff revisions that would permit resources that have not bid into the relevant markets to elect, on an annual basis, to receive either the Hourly Ex Post Price for ISO Dispatch orders or a new, alternative payment option. Discussions of these issues with stakeholders led to the approval by the ISO Governing Board, at its August 1999 meeting, of a proposal to provide an alternative pricing option for resources that have not bid into the markets but are called upon by the ISO. The ISO circulated draft tariff language to Market Participants in early October and, after considering the comments that were received, the ISO Governing Board confirmed its approval of the proposal at its October 28, 1999, meeting. In addition, the Governing Board directed Management to convene a stakeholder meeting to discuss the implementation details of the proposal. On November 3, 1999, the ISO Management discussed with stakeholders the circumstances in which it requires Energy from resources that have not bid into the markets or are dispatched to satisfy a locational requirement that cannot be meaningfully met through the market, and in which the proposed payment alternative would apply, at its monthly Market Issues Forum ("MIF") meeting. At the MIF meeting, Management provided the details regarding the criteria and circumstances under which the ISO will call upon resources through Dispatch orders. Management also made a commitment to work with stakeholders to develop operating procedures that would reflect such details.[7]

Under Amendment No. 23, the payment to be made under the alternative option for incremental Dispatch orders would include a capacity component tied to market indicators, an Energy component tied to market indicators, a component that permits the recovery of fuel-related start-up costs, and a component that would permit recovery of verifiable daily gas imbalance charges incurred solely as a result of the ISO's Dispatch order. The capacity payment component is tied to the average Day-Ahead price for Spinning and Non-Spinning Reserves for the preceding three similar days (e.g., Business Days when the Dispatch order occurs on a Business Day) for the same Settlement Period, and the Energy payment component is tied to an average calculated using the PX Day-Ahead, PX Hour-Ahead and ISO Real Time Energy prices for the preceding three similar days for the same Settlement Period. For decremental Dispatch orders, there would be an Energy payment to the ISO equal to the Market Clearing Price for the relevant Settlement Period for the applicable Energy market less any verifiable daily gas imbalance charges. The ISO's proposal requires all resources subject to an ISO Dispatch order to use "best efforts" to mitigate or eliminate gas imbalance charges.

Amendment No. 23 also includes proposed revisions that clarify the circumstances in which the ISO will use Dispatch orders to address locational problems, confirming that the ISO will use that authority both when effective economic redispatch bids are unavailable and when a competitive market for such bids is not present.

Finally, Amendment No. 23 modifies provisions that govern the allocation of costs for all ISO Dispatch orders. As modified, the cost responsibility for these payments will be allocated according to the reason for the Dispatch order. If a resource is Dispatched to address transmission outages or the ISO's locational reliability needs, the costs of such calls will be allocated to the Participating Transmission Owner ("PTO") in whose Service Area the transmission facility is located or the location-specific requirement arises. If the Dispatch order is the result of market shortages or any other system-wide requirement, the costs will be allocated to Load. If the ISO needs to procure such services Zonally, the ISO will allocate the costs related to such Dispatch orders to Load within the Zone. As is done today, when the ISO issues any such Dispatch order, the ISO will record the reason.

III. STAKEHOLDER COMMENTS

As noted above, the ISO circulated draft tariff language and received stakeholder comments prior to the October meeting of the ISO Governing Board. The October Board

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[7] There is an existing Operating Procedure that addresses Out of Market and Non-Scheduling Coordinator purchases. *See* ISO Operating Procedure S-318, which is posted on the ISO Home Page at www.caiso.com/thegrid/operations/opsdoc/sched/. The vehicle for addressing the concerns of stakeholders may be a revision to this existing procedure.

materials are attached as **Attachment 3** to this pleading and contain a summary of the comments received by the ISO. After consideration of all comments, ISO Management continued to recommend the proposal and it subsequently was approved by the ISO Governing Board at the October meeting. The issues raised by the comments fall into a number of general categories. As explained further below, the comments either have been addressed by the ISO in developing the filing or do not provide a basis for rejecting the proposal.

A. Criteria and Implementation Details.

Some commenters asked for details about the criteria the ISO will use to determine why an out-of-market call was made. While the ISO believes its proposal is sufficiently detailed in this regard, as stated earlier, the ISO has made a commitment to work with stakeholders to develop an operating procedure that would provide the requested details.

B. Use of the Alternative Payment Option to Manage Intra-Zonal Congestion.

Certain commenters oppose the use of the alternative payment for out-of-market calls when managing Intra-Zonal Congestion, claiming that the ISO should instead rely exclusively on market principles or designate RMR Units.

The ISO does rely on market principles to resolve Intra-Zonal Congestion when there is a competitive supply of Adjustment Bids or Imbalance Energy Bids.[8] Requiring the ISO to rely on such bids when the supply is not competitive, however, would artificially inflate the cost of relieving Intra-Zonal Congestion. The proposed alternative payment option for resources that respond to ISO Dispatch orders would only be used to resolve Intra-Zonal Congestion when: (1) there is not a competitive supply of Adjustment Bids or Imbalance Energy bids, *and* (2) no RMR Unit is available that can relieve the Congestion.

The ISO does not agree that it should be required to enter into RMR Contracts with any resource that may be called upon to mitigate Intra-Zonal Congestion. Intra-Zonal Congestion is expected to be infrequent and small in magnitude. To address such situations, it makes more sense to develop a payment option that protects Generators against adverse financial consequences when they respond to ISO Dispatch orders than to enter into additional RMR Contracts, which obligate the ISO and California consumers to support the fixed costs of a Generating Unit. In response to concerns that out-of-market

[8] As provided for in Section 7.2.6.2 of the ISO Tariff, if there are no available Adjustment Bids or Imbalance Energy bids, the ISO can use its authority to redispatch resources. Section 7.2.6.2 currently provides, "Except as provided for in Section 5.2, during the initial period of operation, the ISO will perform Intra-Zonal Congestion Management in real time using available Adjustment Bids and Imbalance Energy bids, based on their effectiveness and in merit order, to minimize the cost of alleviating Congestion. In the event, no Adjustment Bids or Imbalance Energy Bids are available, the ISO will use its authority to direct the redispatch or resources."

calls frequently will be used to manage Intra-Zonal Congestion, the ISO's Department of Market Analysis ("DMA") has noted that the ISO's proposal will reduce the incentive to create Intra-Zonal Congestion when there is not a competitive supply of Adjustment Bids and Imbalance Energy Bids. As a result, Intra-Zonal Congestion should diminish as compared to the current situation.

In addition, exclusive use of RMR for Intra-Zonal Congestion Management when the supply of bids is not competitive would mean effectively that RMR is the only tool for mitigating market power. The result of such a policy would require the ISO to sign contracts which pay fixed costs for every conceivable circumstance and transmission configuration where market power could occur and could easily lead to a RMR Contract for every Generator. Such an outcome is counter to the market principles on which the ISO is based.

C. Cost Allocation Issues.

Some comments questioned the proposal's allocation of costs paid to resources that respond to Dispatch orders. If a resource is dispatched to address a transmission outage or a locational reliability need, the proposal allocates the costs to the local Participating TO; otherwise, costs are allocated to Load.

This approach to cost allocation is reasonable and appropriate. When Dispatch orders are issued in order to address a problem on a Participating TO's transmission facilities that cannot be remedied through competitive redispatch bids, allocating the costs to that Participating TO provides it with an incentive to take measures to address the problem, if the costs of doing so are less than the costs the ISO incurs to make payments to resources that respond to the Dispatch orders.

When the Dispatch orders are issued due to market shortages or other system-wide conditions, the resulting costs should be borne by all Loads. This does not represent a change from the manner in which such costs are currently allocated.

D. Alternative Payment Option.

Some comments viewed the payment alternative as too lucrative, inasmuch as it goes beyond recovery of start-up costs; others argued that the alternative option was insufficient to protect Generators' financial interests. Neither view is correct.

The comments that urged lower payments ignore some of the situations in which Generators might be called upon to respond to a Dispatch order. For example, there may be circumstances where the ISO needs a particular resource in a particular location even though that resource may not be running. In these situations, the proposed amendment would ensure the Generator would recover its start-up costs. These comments also fail to appreciate that the alternative payment option may be *less than* the Hourly Ex Post

Price in certain hours and that the election a Generator must make is an annual election. A Generator may not switch back and forth between the Hourly Ex Post Price and the alternative payment option as it pleases; it must choose one or the other on an annual basis.

Contrary to the position of those who advocate compensation for additional costs, such as variable operating and maintenance costs and lost market opportunity costs, the ISO believes the its alternative payment option, with its various components, adequately responds to the concerns about a generator recovering its costs for an out-of-market call. In addition, if the Generator has bid into the market and the market opportunity costs are sufficiently high, the Generator should be dispatched through the market which would alleviate the need for the out-of-market Dispatch call.

E. <u>Withholding Concerns.</u>

Some comments expressed concern that the alternative payment option will encourage withholding because the calculated price is substantially greater that the variable cost of the unit. The ISO, however, has designed the proposal to minimize the risk of strategic withholding. The use of a rolling average (i.e., the last three similar days) for the capacity and Energy payments reduces the likelihood of withholding. Under the terms of the proposal, the three most recent similar days are used to calculate the capacity and Energy payments. Thus a Generator could, after seeing three similar settlement periods with high prices, withhold on the fourth day in the same settlement period to receive the alternative payment option. However, the Generator would have no assurance that the market clearing price in that settlement period would result in less revenues than the revenues under the alternative payment option. The ISO also intends to have its DMA closely monitor the frequency of Dispatch orders and any changes in bidding strategy attributable to the new payment option. If it uncovers evidence of strategic withholding by a Market Participant, the ISO can take appropriate action.

IV. EFFECTIVE DATE

The ISO requests a waiver of the 60-day filing requirement of 18 C.F.R. § 35.3 and an effective date of January 1, 2000. The new payment option will assist the management of transmission outage contingencies and locational market power problems where RMR Generation is not available. As described above, the ISO has observed what appears to be intentional capacity withholding or intentional overscheduling along with sudden changes in the bid prices for resources needed to resolve Intra-Zonal Congestion in circumstances such as these where no competitive market exists. The proposed revisions are necessary to provide fair compensation to resources Dispatched by the ISO to address these contingencies. The proposed revisions will also clarify the ISO's authority to use Dispatch orders in such circumstances. The extensive stakeholder review of these revisions has delayed the filing beyond the date necessary to meet the 60-day notice requirement and still fulfill this need. The ISO's proposal should be permitted to go into effect no later than the start of next year so that it will be able to effectively manage Intra-Zonal Congestion when there are insufficient bids or no competitive market exists, while ensuring that resources receive fair compensation for ISO Dispatch Orders.

V. NOTICE AND SERVICE OF DOCUMENTS

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

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The ISO has served copies of this letter, and all attachments, on the Public Utilities Commission of the State of California, the California Energy Commission, the California Electricity Oversight Board, and on all parties with effective Scheduling Coordinator Service Agreements under the ISO Tariff. In addition, the ISO is posting this transmittal letter and all attachments on the ISO's Home Page.

VI. SUPPORTING DOCUMENTS

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

Attachment 1	Revised Tariff Sheets.
Attachment 2	"Black-lined" Tariff provisions showing additions to and deletions from existing Tariff provisions.
Attachment 3	The October 20, 1999 memorandum for the ISO Governing Board describing the need for and basis of the proposed alternative pricing option for resources that respond to ISO Dispatch orders, with attachments.
Attachment 4	A form of Notice suitable for publication in the Federal Register.

An additional copy of this filing is enclosed to be date-stamped and returned to our messenger. If there are any questions concerning this filing, please contact the undersigned.

Respectfully submitted,

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