

September 14, 2000

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-\_\_\_\_ - \_\_\_\_  
Amendment No. 31 to the ISO Tariff**

Dear Secretary Boergers:

Pursuant to Section 205 of the Federal Power Act,<sup>1</sup> and Section 35.13 of the Commission's regulations,<sup>2</sup> the California Independent System Operator Corporation ("ISO")<sup>3</sup> respectfully submits for filing an original and six copies of an amendment to the ISO Tariff ("Amendment No. 31"). As explained below, the proposed amendment would remove the existing termination date of the ISO's authority to disqualify Imbalance Energy and Ancillary Service bids that exceed levels specified by the ISO, and would confirm the ISO's authority to establish price caps for all of its markets.

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<sup>1</sup> 16 U.S.C. § 824d.

<sup>2</sup> 18 C.F.R. § 35.13.

<sup>3</sup> Capitalized terms not otherwise defined herein are defined in the Master Definitions Supplement, Appendix A to the ISO Tariff.

## I. BACKGROUND AND REASONS FOR FILING

### A. The ISO's Authority to Cap Prices In Its Markets

Over the past several years, the Commission has on several occasions confirmed the ISO's authority to reject bids in its real-time Imbalance Energy and Ancillary Service markets that exceed ceiling price levels established by the ISO.<sup>4</sup> In Amendment No. 21 to the ISO Tariff, the ISO proposed to extend until November 15, 2000 its authority to disqualify bids submitted in each of its markets that exceed levels specified in advance by the ISO in accordance with criteria adopted by its Governing Board. The Commission accepted the ISO's proposal.<sup>5</sup>

In the Amendment No. 21 Order, and more recently in the July 28, 2000 order in Docket No. EL00-91-000,<sup>6</sup> the Commission recognized that the ISO's authority to establish ceiling prices for its markets stems from the fact that it is functioning as a buyer in those markets (on behalf of Market Participants that are meeting their needs for Energy and Ancillary Services in them):

The proposed cap is not a cap on what a *seller* of Ancillary Services may charge to the ISO but rather is a cap on what the ISO as *purchaser* is willing to pay. The ISO has no more, or less, discretion than any other buyer of services.<sup>7</sup>

The Commission noted that sellers are not required to bid into the ISO's markets, so that the ISO's ceiling on the prices it is willing to pay does not function as a cap on the prices that the sellers can charge.<sup>8</sup>

In the July 28 Order, the Commission explained the basis of its ruling in the Amendment No. 21 Order, stating:

[W]e did not allow the ISO to establish the prices that sellers may charge, only the price that the ISO is willing to pay. Because sellers are not required to sell to the ISO, the ISO cannot dictate their price.<sup>9</sup>

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<sup>4</sup> See *Request to Extend Price Caps* (report of the California ISO Department of Market Analysis) (Aug. 10, 2000), at 2-3 ("DMA Report"). The DMA Report is included in the present filing as Attachment C.

<sup>5</sup> *California Independent System Operator Corporation*, 89 FERC ¶ 61,169, at 61,511 (1999) ("Amendment No. 21 Order").

<sup>6</sup> *Morgan Stanley Capital Group Inc. v. California Independent System Operator Corporation*, 92 FERC ¶ 61,112 (2000) ("July 28 Order").

<sup>7</sup> Amendment No. 21 Order at 61,511 (emphasis in original).

<sup>8</sup> *Id.*

<sup>9</sup> July 28 Order at 61,431.

The Commission reaffirmed this ruling in the July 28 Order, denying a challenge to the ISO's exercise of its price cap authority because "notwithstanding the maximum purchase price at what the ISO as purchaser is willing to pay, the ISO has no more or less ability to procure capacity and energy than any other buyer of these services."<sup>10</sup>

Notwithstanding the Commission's recognition that the ISO's authority to establish ceiling prices in its markets derives from its status as a purchaser, that authority, as described in Section 28 of the ISO Tariff, is currently limited to the period extending through November 15, 2000. For the reasons described below, the ISO has determined that it would be inappropriate, given current market conditions, to allow that authority to lapse. The ISO is accordingly submitting this amendment to remove the termination date currently included in Section 28. The ISO Tariff would thus provide notice to all sellers participating in its markets that the ISO is not willing to purchase at prices exceeding the purchase price caps it establishes and publishes from time to time, in accordance with the criteria established by the ISO Governing Board.

#### **B. Consideration By the ISO Governing Board of the Continued Need For Price Caps**

At its meeting on September 6-7, 2000, the ISO Governing Board considered options for addressing the problems with the operation of the markets in California described in the DMA Report. In that report, the ISO's Department of Market Analysis concluded that the extension of price cap authority is necessary because of concerns that the California markets are not workably competitive during high-load periods, and that measures to mitigate the resultant

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<sup>10</sup> *Id.* See also *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and California Power Exchange*, 92 FERC ¶ 61,172, slip op. at 8 (2000) ("SDG&E Order") (stating that the ability of the ISO to set the level of its price caps is "in its discretion").

Additionally, in the SDG&E Order, the Commission concluded that the case record before it did not justify imposing immediate price caps, and instead instituted a hearing under section 206 of the Federal Power Act ("FPA") on the prices and the appropriate terms of tariffs and agreements concerning the California markets. *Id.* at 7-8. The ISO notes that the California Electricity Oversight Board ("EOB") recently filed a complaint in which the EOB acknowledged that its complaint reiterated issues that were placed before the Commission in the SDG&E Order, and requested, among other things, that the Commission impose maximum levels for price caps, and that the EOB's complaint be consolidated with the SDG&E Order's dockets. Complaint of the California Electricity Oversight Board, Docket No. EL00-104-000 (Aug. 29, 2000), at 2. The ISO plans to file an answer to the EOB's complaint by September 18, 2000, as permitted by the Commission in its August 29, 2000 notice of filing. The ISO will not oppose consolidation of the EOB's complaint with the dockets described above, so that the Commission can render a decision in a single proceeding that consists of the consolidated dockets, under section 206 of the FPA, and be able to consider, in that consolidated docket, the issue of whether to prescribe particular price cap levels or to leave flexibility so that the ISO may best respond to changing circumstances.

high prices of electricity are not yet adequately developed.<sup>11</sup> The Commission reached the same conclusion in its recent SDG&E Order, where it stated:

[N]umerous reports prepared by the independent monitoring bodies of the PX and ISO . . . indicate that, despite significant increases in demand, there has been no corresponding increase in the construction of new generation. Given the lack of any meaningful demand response, this means that virtually all bids must be accepted when these shortage conditions arise. In addition, these reports indicate that most of the load in California is being met through spot market wholesale purchases rather than longer-term power sale contracts and hedging arrangements that could provide price certainty and stability. As a result of all these factors, there are periods when all generation must be accepted, regardless of the bid price, and sellers may be in a position to act on this knowledge and raise bids above the level that would be expected solely as a result of scarcity.<sup>12</sup>

The DMA recommended that the ISO's price cap authority be extended until a comprehensive market reform proposal is implemented to address mitigation measures for global and locational market power.<sup>13</sup> The Board considered various options for responding to the DMA's concerns, including the following:

- permitting the ISO's price cap authority to expire;
- asserting continued price cap authority without an amendment to the ISO Tariff; and
- modifying the ISO Tariff to extend the ISO's price cap authority.

To aid in evaluating these options, the Board also had at hand a memorandum prepared for the Board's use by the Director of the DMA and the ISO's Senior Regulatory Counsel.<sup>14</sup> The Board weighed the strengths and weaknesses of each option, including those described in the Board Memorandum, and also considered the appropriateness of preserving the ISO's flexibility to place appropriate limits on the prices paid in its markets. The Board ultimately adopted a resolution that approved the following actions:

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<sup>11</sup> DMA Report, Attachment C, at 3.

<sup>12</sup> SDG&E Order, slip op. at 6-7.

<sup>13</sup> DMA Report, Attachment C, at 3, 10.

<sup>14</sup> See Memorandum Concerning Extension of Price Cap Authority and Levels of Price Caps After October 15, 2000 (Aug. 29, 2000), at 3-4 ("Board Memorandum"). This memorandum is included in the present filing as Attachment D.

- the filing of an amendment to the ISO Tariff to remove the November 15, 2000 date for the termination of the ISO's authority to establish price caps in the ISO's markets;
- the continuation of the provision setting the price cap at \$250 and of the other provisions set forth in the Board's "Price Cap Resolution 8-1" of August 1, 2000 beyond October 15, 2000 until further directed by the Board in a further resolution;<sup>15</sup> and
- the provision of a report and analysis to the Board by no later than March 31, 2001 that includes an assessment of market competitiveness in Summer 2001, a timetable for the implementation of Congestion Management Reform and other Comprehensive Market Redesign components that could affect the need for price caps, and a recommendation regarding the need for and level of price caps for Summer 2001.<sup>16</sup>

These Board actions are intended to allow the ISO to provide relief from excessively high electricity prices until the ISO is able to mitigate market power through a longer-term approach that will be part of the ISO's Comprehensive Market Redesign proposal to be filed with the Commission in November 2000. Significantly, in the SDG&E Order the Commission noted that the ISO's continued ability to establish purchase price caps in its markets addressed concerns "that pricing volatility be mitigated," both in the ISO's markets and in other markets where sellers' bids are disciplined by the maximum prices established for the ISO's markets.<sup>17</sup>

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<sup>15</sup> A copy of the Board's "Price Cap Resolution 8-1" is included in the present filing as Attachment E. In the present filing, references to "the Board's resolution" are to the September 7 resolution, not the August 1 resolution.

<sup>16</sup> A copy of the Board's resolution is included in the present filing as Attachment F.

<sup>17</sup> SDG&E Order, slip op. at 8. In addition to the ISO materials described above, the Market Surveillance Committee of the ISO has released a report on the June 2000 price spikes in the California Energy and Ancillary Services markets – *An Analysis of the June 2000 Price Spikes In the California ISO's Energy and Ancillary Services Markets* (Sept. 6, 2000) ("MSC Report"), which is included in the present filing as Attachment G. Among other things, the MSC Report states that "price caps are of limited effectiveness in constraining market power during high demand periods." *Id.* at 2. The ISO does not believe that price caps provide the complete answer, or even the preferred answer, to the problem of market power. However, price caps "will serve to discipline prices in both the ISO and PX," SDG&E Order, slip op. at 8, in the interim until comprehensive market reform measures have been implemented to address the problem of market power.

### **C. Consideration of Increased Forward Energy Purchases by the ISO**

In the SDG&E Order, the Commission expressed concern about the volume of Energy the ISO has been procuring in real time due to underscheduling of loads. As a response to this problem, the Commission directed the ISO “to immediately institute a more forward approach to procuring the resources necessary to reliably operate the grid.” The Commission further directed the ISO “to factor these reforms into an analysis of the need for and level of purchase price caps and to include this analysis as support for any filing it makes to extend its purchase price cap authority.”<sup>18</sup>

In response to the Commission’s order, the ISO has initiated an effort to assess the desirability of meeting anticipated real-time demands through the procurement of Energy in forward markets.<sup>19</sup> The ISO agrees with the Commission that taking a more forward approach to procuring Energy to meet anticipated real-time needs should help to lower the overall cost of meeting these needs. Purchasing Energy on a more forward basis provides the purchasing entity with greater negotiating leverage as it is not in a “must buy” situation. Additionally, offering to sellers purchase contracts that involve blocks of power over multiple days should entice sellers to offer Energy at more competitive prices. The ISO therefore hopes that load-serving entities will be provided with the authority to forward contract to the extent consistent with a reasonable supply portfolio, and that they will utilize that authority. Absent a substantial commitment by demand to the forward markets, it is unlikely that those markets will produce the significant consumer benefits of which they are capable. Despite the possibility that greater portions of their loads soon will be placed in the forward markets by the load-serving entities, and that, if underscheduling continues, the ISO will procure a portion of its real-time Energy needs through forward contracts, the ISO does not believe that these changes affect the need for purchase price caps. As discussed in the attached DMA report, the fundamental factors necessitating the need for price caps are (1) tight supply conditions during peak load periods, (2) an underdeveloped hedging market, and (3) a lack of price-responsive demand.<sup>20</sup> The ISO certainly does not believe that its limited entry into the forward markets will have a significant impact on the development of a more active hedging market, particularly in the near term. Moreover, neither participation in the forward markets by the ISO nor by the load-serving entities will impact the other two factors necessitating the need for price caps (tight supply conditions and a lack of price-responsive demand).

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<sup>18</sup> *Id.* at 11.

<sup>19</sup> The ISO recently filed Amendment No. 30 to the ISO Tariff to confirm its authority to enter into such contracts and to allocate the resulting costs appropriately. See Transmittal Letter for Amendment No. 30 to the ISO Tariff, Docket No. ER00-3636-000 (Sept. 11, 2000).

<sup>20</sup> DMA Report, Attachment C, at 6, 10.

## II. DESCRIPTION OF FILING

In accordance with the Board's resolution, the ISO proposes to modify the ISO Tariff to eliminate the restriction contained therein that confers upon the ISO price cap authority only until November 15, 2000.<sup>21</sup> Additionally, the ISO proposes to modify the Tariff to confirm that bid caps may be established for all of the ISO's markets, as provided in the Board's resolution.

Consistent with the current ISO Tariff provision and prior Commission rulings,<sup>22</sup> the proposed amendment would not specify the particular level of the purchase price caps that the ISO will establish. Rather, it preserves the discretion of the ISO, in accordance with criteria adopted by the ISO Governing Board, to adjust price cap levels as appropriate to respond to changes in market conditions. In addition, as noted above, the ISO Governing Board has directed management to prepare an analysis after the upcoming winter assessing the continued need for purchase price caps and their appropriate levels.

## III. EFFECTIVE DATE

As noted above, the ISO's authority to cap bids in its markets will expire on November 15, 2000, absent further action by the Commission. The ISO accordingly proposes to make the modification to Section 28 of the ISO Tariff effective on November 15, 2000.

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<sup>21</sup> The inherent authority of the ISO to establish price caps, described *supra* in footnotes 4-10 and accompanying text, implies that this authority does not derive from an express provision of the ISO Tariff. Nevertheless, the ISO believes that its price cap authority should be detailed in a Tariff provision, for the following reason: The ISO establishes its contractual relationship to sellers in its markets through their execution of Scheduling Coordinator Agreements, which make the Scheduling Coordinators' participation in the ISO's markets subject to the terms of the ISO Tariff. It is important, therefore, that the Tariff leave no ambiguity as to the ISO's ability to establish price caps. See Board Memorandum, Attachment D, at 4.

<sup>22</sup> See Amendment No. 21 Order at 61,507 (citing *AES Redondo Beach, L.L.C., et al.*, 84 FERC ¶ 61,046 (1998)); *California Independent System Operator Corporation*, 86 FERC ¶ 61,059, at 61,202 & n.16 (1999).

#### **IV. 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 California Public Utilities Commission, 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 Home Page.

#### **V. SUPPORTING DOCUMENTS**

In addition to this transmittal letter, this filing is supported by the following documents:

- the revised Tariff sheet reflecting the proposed amendment (Attachment A);
- a black-lined version of Section 28 of the ISO Tariff, showing the changes proposed herein (Attachment B);
- the DMA report dated August 10, 2000 (Attachment C);
- the Board memorandum dated August 29, 2000 (Attachment D);
- the Board's "Price Cap Resolution 8-1" (Attachment E);
- the Board's price cap resolution dated September 7, 2000 (Attachment F);
- the MSC report dated September 6, 2000 (Attachment G); and

- notice of this filing, suitable for publication in the Federal Register (Attachment H), together with a diskette containing that notice in electronic form.

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

Respectfully submitted,

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