

UNITED STATES OF AMERICA  
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;  
Nora Mead Brownell, Joseph T. Kelliher,  
and Suedeen G. Kelly.

California Independent System Operator Corporation      Docket No. ER04-835-000

ORDER ON TARIFF AMENDMENT NO. 60

(Issued July 8, 2004)

1. On May 11, 2004, the California Independent System Operator Corporation (CAISO) filed Amendment No. 60 to its open access transmission tariff (tariff) to modify the tariff provisions related to implementation of the temporary must-offer obligation. The Commission accepts, subject to modification, Amendment No. 60. The order also establishes hearing procedures regarding the allocation of must-offer costs. This order benefits customers because it allows the CAISO to operate its system with reliability while also effectively managing costs.

**Background**

2. Through a series of orders issued since April 2001 as detailed below, the Commission has addressed the must-offer obligation, including application and compensation issues. The must-offer obligation was imposed as an element of the mitigation and monitoring plan in response to the California energy crisis. Since its adoption, the must-offer obligation provisions have gone through as many as six revisions yet there remains controversy over aspects of the must-offer obligation. Among these is a relatively recent issue that arose last August in which the CAISO and the owner of a Condition 2 RMR Unit contacted the Commission's Enforcement Staff. The controversy surrounded the ability of the CAISO to extend the must-offer obligation to units under RMR contracts and thus use such units for system as opposed to local reliability needs. While Commission staff, the CAISO, and market participants held several conference calls and one technical conference, there was no resolution of the issue. The instant filing addresses this issue in addition to several other outstanding issues.

### **The Must-Offer Obligation**

3. In an April 26, 2001 Order, the Commission established a prospective mitigation and monitoring plan for the California wholesale electric markets.<sup>1</sup> One of the fundamental elements of the plan was the implementation of a must-offer obligation, pursuant to which most generators serving California markets are required to offer all of their capacity in real time during all hours if it is available and not already scheduled to run through bilateral agreements. The Commission explained that:

this must-offer obligation is designed to ensure that the ISO will be able to call upon available resources in the real-time market to the extent that energy is needed. The basis for the requirement is that, under competitive conditions, a generator that has available energy in real time should be willing to sell energy at a price that covers its marginal costs, since it has no alternative purchaser at that time.<sup>2</sup>

4. In the June 2001 Order on rehearing, the Commission explained that the must-offer obligation is “designed to prevent withholding and thereby to ensure that the ISO will be able to call upon available resources in the real-time market to the extent that energy is needed.”<sup>3</sup> This order clarified that (1) the must-offer obligation applies to qualifying facilities and (2) generators should not be exempt from the must-offer obligation absent a showing that running a unit would violate a certificate, result in criminal violations or penalties, or result in a qualifying facility (QF) unit violating its contract or losing its QF status.

5. The CAISO implemented the must-offer requirement beginning July 20, 2001.

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<sup>1</sup> San Diego Gas & Electric Co., *et al.*, 95 FERC ¶ 61,115 at 61,355-57 (2001) (April 2001 Order), *order on reh’g*, San Diego Gas & Electric Co., *et al.*, 95 FERC ¶ 61,418 (2001) (June 2001 Order), *order on reh’g*, San Diego Gas & Electric Co., *et al.*, 97 FERC ¶ 61,275 (2001), *order on reh’g*, San Diego Gas & Electric Co., *et al.*, 99 FERC ¶ 61,160 (2002), *petition pending sub nom.* Public Utilities Commission of the State of California, *et al. v. FERC*, 9<sup>th</sup> Cir. Nos. 01-71051, *et al.* (placed in abeyance Aug. 21, 2002).

<sup>2</sup> April 2001 Order at 61,356.

<sup>3</sup> June 2001 Order, 95 FERC ¶ 61,418 at 62,551.

6. In the December 2001 Order on rehearing, the Commission denied a request to limit the must-offer obligation to emergency conditions or peak months. The Commission explained that it will apply the obligation in all hours to ensure that all available energy is in the market and prevent withholding.<sup>4</sup>

7. In a separate order issued the same day, addressing a CAISO compliance filing, the Commission clarified that generators subject to the must-offer obligation should have the ability to recover their costs for complying with the CAISO's instruction to keep their units on-line at minimum load status.<sup>5</sup> The Commission directed the CAISO to compensate a generator for its actual costs "during each hour when that generator is: (1) not scheduled to run under a bilateral agreement; (2) not on a planned or forced outage; and (3) running in compliance with the must-offer obligation but not dispatched by the ISO."<sup>6</sup> The Commission further found reasonable the CAISO's proposal to grant exemption of the must-offer obligation under certain circumstance, and directed the CAISO to make a compliance filing providing sufficient specificity to ensure that the CAISO's procedures to exempt generators are non-discriminatory and transparent to market participants and the Commission.

8. Subsequent to the December 2001 Orders, the CAISO submitted a series of compliance filings, and the Commission issued a series of orders, addressing the tariff revisions proposed by the CAISO to implement the must-offer obligation, compensation for generators operating subject to the obligation, and procedures for generators to request, and the CAISO to grant, exemptions to the must-offer obligation.<sup>7</sup>

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<sup>4</sup> December 2001 Order, 97 FERC ¶ 61,275 at 62,243.

<sup>5</sup> San Diego Gas & Electric Co., *et al.*, 97 FERC ¶ 61,293 at 62,363 (2001) (December 2001 Compliance Order), *order on reh'g*, 99 FERC ¶ 61,159 (2002).

<sup>6</sup> *Id.*, 97 FERC ¶ 61,293 at 62,363.

<sup>7</sup> San Diego Gas & Electric Co., *et al.*, 99 FERC ¶ 61,158 (2002) (addressing the CAISO's January 25, 2002 compliance filing); San Diego Gas & Electric Co., *et al.*, 101 FERC ¶ 61,112 (2002) (addressing the CAISO's June 24, 2002 compliance filing); San Diego Gas & Electric Co., *et al.*, 102 FERC ¶ 61,285 (2003) (addressing December 2, 2002 compliance filing); San Diego Gas & Electric Co., *et al.*, 105 FERC ¶ 61,196 (2003) (addressing April 14, 2003 compliance filing), *reh'g pending*. On December 15, 2003, the CAISO submitted a compliance filing in response to the most recent order, which is pending before the Commission.

### **Reliability Must-Run Units**

9. In a March 31, 1997 tariff filing, the trustee for the CAISO<sup>8</sup> proposed a master *pro forma* must-run agreement with three subsidiary *pro forma* agreements for compensating must-run generating units that are needed for purposes of local reliability. One of these subsidiary *pro forma* agreements - referred to as "Condition C" - was intended to provide for specialized treatment of units that are not expected to operate profitably in the market. The investor-owned utilities (IOUs) proposed that these units be paid an availability payment consisting of their fixed costs, including annual recovery of initial capital investment as well as an additional payment for running costs when the CAISO calls on the unit to run.<sup>9</sup> The owner of a Condition C unit was not allowed to bid into the ISO/PX markets or sell under bilateral contracts.

10. In an order issued October 30, 1997, the Commission approved the CAISO's proposed *pro forma* contract, but directed the CAISO to address a number of issues in a subsequent compliance filing.<sup>10</sup> With regard to the specialized treatment for Condition C units, the Commission specifically noted a concern that the restriction on market participation "may unnecessarily deny the market access to potentially desirable sources of power."<sup>11</sup> The Commission nonetheless accepted the IOUs' proposal because "it is unlikely that units with low enough costs to be dispatched in the PX would opt for [Condition 2 treatment]" and directed the ISO to justify or eliminate the bidding restriction in its compliance filing.

11. On October 31, 1997, the CAISO filed proposed amendments to the *pro forma* must-run agreements originally filed on March 31, 1997. In addition, each of the IOUs (Southern California Edison Company, Pacific Gas and Electric Company and San Diego Gas and Electric Company) subsequently filed proposed facility-specific must-run agreements.

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<sup>8</sup> The CAISO had not yet been formed, and the Trustee acted on behalf of the CAISO until the CAISO was formed.

<sup>9</sup> Pacific Gas & Electric Company, 81 FERC ¶ 61,122 (1997).

<sup>10</sup> *Id.* at 61,555.

<sup>11</sup> *Id.* at 61,558.

12. On December 17, 1997, the Commission issued an order accepting the IOUs' proposed must-run agreements for filing, suspended them, and set them for hearing before an administrative law judge.<sup>12</sup> The Commission did not accept the CAISO's proposed modifications to its *pro forma* must-run agreements for filing; rather the CAISO's submittal was treated as a counterproposal to the IOU's proposed must-run agreements in the hearings which were established.

13. More than two years of negotiations among the IOUs and the CAISO lead to a comprehensive settlement regarding RMR issues and a restatement of the Must-Run Agreement in the form of the current RMR contracts. Condition C under the Must-Run Agreement was replaced with Condition 2 under the RMR contract, and the underlying restriction on participation in other market transactions remained unchanged.<sup>13</sup>

14. A number of parties, including FERC Staff and the IOUs, filed comments in support of the RMR contract settlement. These parties supported the settlement even though the RMR contracts continued to contain the restriction originally questioned by the Commission. The Commission thereafter accepted the settlement and the restriction on Condition 2 Units' market participation became effective along with the other terms and conditions of the RMR contract.<sup>14</sup>

#### **Summary of Amendment No. 60**

15. The CAISO proposes to modify the tariff provisions that implement the must-offer obligation. According to the CAISO, these modifications were developed primarily through an extensive stakeholder process. According to the CAISO, the purpose of the proposal is threefold: (1) to provide for a more rational and efficient process for granting or denying waivers of the must-offer obligation; (2) modify certain payment terms and the allocation of must-offer costs in a manner more consistent with cost causation principles; and (3) set forth clear conditions in which Condition 2 Units are committed outside of the RMR contract to meet system reliability requirements.

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<sup>12</sup> Pacific Gas & Electric Company, 81 FERC ¶ 61,322 (1997).

<sup>13</sup> See Initial Comments of the California ISO in Support of Offer of Settlement at 5-7, Docket Nos. ER98-495-000, *et al.* (Apr. 19, 1999).

<sup>14</sup> California Independent System Operator Corporation, 87 FERC ¶ 61,250 (1999).

16. The proposed revisions to the must-offer provisions of the CAISO tariff include: developing and making publicly available an operating procedure for committing generating units; posting information on must-offer procurement and costs; using a Security-Constrained Unit Commitment (SCUC) application to minimize must-offer commitment costs; revising the gas cost proxy used in the Minimum Load Cost Compensation (MLCC) payment and start-up payments; including auxiliary power as a recoverable start-up cost; eliminating the current practice of rescinding MLCC payments when a unit provides ancillary services; revising the timing of the must-offer waiver denial process to facilitate bidding in the day-ahead ancillary services markets; and clarifying self-commitment and its implications on MLCC payment.

17. The CAISO also proposes to revise the methodology pursuant to which minimum load costs are allocated. In the stakeholder process leading up to the Amendment 60 filing, the CAISO informed market participants the significant extent to which it has been revoking must-offer unit waivers for local, not system, reliability needs. Currently, the must-offer obligation costs are socialized, which is consistent with the stated purpose of preventing withholding to ensure that the CAISO will be able to call upon available resources in the real-time market. Now that it is clear that the CAISO regularly relies on revocation of must-offer waivers to meet local and zonal reliability needs as well as system needs (see the graphs at page 32 of the Amendment 60 transmittal letter), it has proposed a new cost allocation methodology that would allocate costs differently dependent on whether a must-offer waiver is revoked for system, zonal or local needs.

18. As already mentioned above, the CAISO has, on occasion, attempted to dispatch Condition 2 Units, which are designated to address local reliability problems, to meet system reliability needs, namely control area supply shortfalls. According to the CAISO, generator owners have resisted operating Condition 2 Units except as provided under the terms of the RMR contract. Informal attempts to resolve this matter have not been successful. Thus, the CAISO proposes a framework for dispatching Condition 2 RMR Units outside of the RMR contract to meet system reliability requirements. The CAISO proposes that, when needed for system (as opposed to local) reliability, Condition 2 RMR Units may be called out-of-market pursuant to the terms and conditions of the CAISO tariff. According to the CAISO, RMR owners would receive the same compensation to which they would be entitled under the RMR contract.

19. The CAISO requests a July 11, 2004 effective date for all but two of these proposed tariff changes. Specifically, it requests the provisions relating to the allocation of minimum load costs to be effective ten days after notice to the market and the Commission that Phase 1B of the CAISO's 2002 market redesign proposal (MD02) software is ready to be deployed. Also, the use of SCUC is proposed to be effective ten days after notice by the CAISO.

**Notice of Filings, Interventions and Protests**

20. Notice of the CAISO's filing was published in the *Federal Register*, 69 Fed. Reg. 29,292, with motions to intervene and protests due on or before June 1, 2004.

21. A timely, unopposed motion to intervene was filed by Northern California Power Agency. Timely, unopposed motions to intervene with comments and/or protests were filed by Cities of Anaheim, Azusa, Banning, Colton, and Riverside, California (Southern Cities); California Municipal Utilities Association (CMUA); California Department of Water Resources State Water Project (SWP); Modesto Irrigation District (MID); Transmission Agency of Northern California (TANC); Duke Energy North America LLC and Duke Energy Trading & Marketing L.L.C. (Duke Energy); Independent Energy Producers Association (IEP); Powerex Corp. (Powerex); City of Redding California, City of Santa Clara California, and M-S-R Public Power Agency (Cities/M-S-R); Sacramento Municipal Utility District (SMUD); Calpine Corp. (Calpine); Mirant Americas Energy Marketing, LP, Mirant California, LLC, Mirant Delta, LLC, and Mirant Potrero, LLC (Mirant); Metropolitan Water District of Southern California (MWD); West Coast Power LLC, El Segundo Power, LLC, Long Beach Generation LLC and Cabrillo Power II LLC (collectively "West Coast Power") and Williams Power Company, Inc. (Williams) (and collectively with WCP, "WCP/Williams"); the California Electricity Oversight Board (California EOB); and the Northern California Power Agency and its members (NCPA).

22. A timely notice of intervention and protest was filed by the California Public Utilities Commission of the State of California (California PUC).

23. Turlock Irrigation District (Turlock) and City of Vernon, California (Vernon) filed motions to intervene one day out-of-time. On June 2, 2004, Southern California Edison Company (SoCal Edison) and Pacific Gas and Electric Company (PG&E) filed motions to intervene one day out-of-time and comments. San Diego Gas & Electric Company (SDG&E) and Los Angeles Department of Water and Power (LADWP) also filed motions to intervene out-of-time and comments.

24. On June 16, 2004, the CAISO and SoCal Edison filed separate motions for leave to answer and answers to the comments and protests. On June 28, 2004, SWP filed an answer to the CAISO's answer.

**Discussion****A. Procedural Matters**

25. Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.214 (2003), the timely, unopposed motions to intervene serve to make the entities that filed them parties to the proceeding.

26. Turlock, Vernon, SoCal Edison and PG&E filed motions to intervene one day late. SDG&E and LADWP also filed motions to intervene out-of-time. These parties have demonstrated an interest in this proceeding which cannot be adequately represented by any other party. The Commission finds that granting their late-filed motions to intervene will not delay, disrupt, or otherwise prejudice this proceeding, or place an additional burden on existing parties. Therefore, for good cause shown, we will grant the late filed motions to intervene.<sup>15</sup>

27. Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(2) (2003), prohibits an answer to a protest or answer unless otherwise ordered by the decisional authority. We will accept the CAISO's, SoCal Edison's and SWP's answers because they have provided information that assisted us in our decision-making process.

## **B. Dispatch of Condition 2 Units for System Reliability**

### **ISO Proposal**

28. As explained above, pursuant to the *pro forma* RMR contract, Condition 2 RMR Units are paid their full annual fixed and variable costs<sup>16</sup> and may not participate voluntarily in market transactions.<sup>17</sup> According to the *pro forma* RMR contract, the CAISO may only call on Condition 2 Units to address local reliability problems, manage intra-zonal congestion or provide ancillary services. The CAISO explains that, at times, it has experienced control-area supply shortfalls that Condition 2 Units could relieve. However, because such shortfalls are not local reliability problems, the CAISO cannot call Condition 2 Units under the terms of the *pro forma* RMR contract to relieve such shortfalls.

29. The CAISO explains that, when called on in the past for system reliability purposes, owners of Condition 2 Units have argued that, because of the limitation on operation set forth in the *pro forma* RMR contract, such units are not subject to the must-offer obligation or to the terms and conditions of the CAISO tariff that conflict with the

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<sup>15</sup> See 18 C.F.R. § 385.214(d) (2003).

<sup>16</sup>The variable cost payment is determined in Schedule C of the RMR Contract.

<sup>17</sup> The RMR contract defines "market transaction" as "a delivery of Energy or provisions of Ancillary Services from a Unit pursuant to a Direct Contract or bids into markets run by the PX, ISO or any similar entity."

RMR contract. The CAISO contends that it has the authority to call on Condition 2 Units pursuant to section 5.6.1 of the tariff, which authorizes the CAISO to call on any unit owned or controlled by a Participating Generator in circumstances in which the CAISO considers that a system emergency is actual, imminent or threatened. According to the CAISO, the RMR contract holders have also entered into Participating Generator Agreements. Thus, while the *pro forma* RMR contract limits the kind of service the CAISO can take under the contract, the *pro forma* RMR contract does not preclude the CAISO from dispatching Condition 2 Units outside of the *pro forma* RMR contract under the terms of the tariff. Further, the CAISO argues that, since a participating transmission operator has agreed to pay for the fixed costs akin to a full cost of service contract, it is reasonable to require that the unit be operated for any purpose, and not limited to local reliability.

30. The CAISO proposes to modify tariff section 5.6.1 to authorize the CAISO to commit Condition 2 Units “if the ISO has reasonably used all other available and effective resources to prevent a threatened System Emergency without declaring that a System Emergency exists.” In other words, the CAISO will not have to declare a System Emergency before committing Condition 2 Units for non-RMR service. The CAISO explains that, because Condition 2 Units cannot voluntarily participate in market transactions, it proposes to request service from such units outside of the *pro forma* RMR contract through an out-of-market call. It also proposes tracking combined RMR and non-RMR service for Condition 2 Units and counting non-RMR service towards the determination of these units’ subsequent years’ service limits.

31. The CAISO also proposes to compensate Condition 2 Units by paying the Unit’s variable cost for non-RMR energy produced by the RMR unit in response to CAISO dispatch instruction.<sup>18</sup> The CAISO also proposes to compensate Condition 2 Units for non-RMR start-up costs. It states that these rates are consistent with those that the CAISO would normally pay for RMR contract service. The CAISO further proposes to allocate the start-up costs associated with dispatching a Condition 2 RMR Unit for non-RMR use to metered demand and export. The CAISO states that this is consistent with the current method for allocating start-up costs. The CAISO also proposes to allocate the related energy costs for calling on non-RMR service from a Condition 2 RMR unit to the market, as the CAISO currently does for any out-of-market dispatch.

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<sup>18</sup> The RMR contract stipulates that Condition 2 Units will not retain revenues from participation in market transactions dues to a CAISO dispatch notice.

### **Comments and Protests**

32. The California EOB and PG&E support the use of Condition 2 RMR units for system-wide reliability needs, when necessary and with clear conditions on use. The California EOB states that there should be a clear rule to prevent CAISO overuse of Condition 2 units for system-need. It believes that the CAISO should also establish a hierarchy of resources to be called on prior to the Condition 2 units. It argues that non-RMR service should not count towards determination of future annual service limits to discourage the CAISO from over-committing the Condition 2 units on an annual basis. PG&E believes that Condition 2 units should not have a blanket exemption from the must-offer obligation because it creates an additional, undesirable incentive to move RMR units to Condition 2 and increases the cost of reliability services to end-use customers. Further, to continue to allow Condition 2 units to be exempt from the must-offer process turns what was intended to be a market power mitigation device into a tool that creates market power situations, because Condition 2 reduces the amount of generation available to the market.

33. SoCal Edison contends that the CAISO has proposed a complicated scheme for the use of Condition 2 RMR Units under the must-offer requirement. It notes that the CAISO's filing does not include any requirements that the CAISO apprise interested parties on the CAISO's efforts to avoid using Condition 2 Units for non-local reliability needs so that affected parties can assess the reasonableness of the CAISO's efforts. It believes that the CAISO should be required to make a compliance filing describing how it will provide the information on its use of Condition 2 Units. Duke Energy also seeks clarification from the CAISO as to what constitutes reasonable efforts to use all available and effective non-Condition 2 RMR units before using Condition 2 RMR Units.

34. IEP, WCP and Mirant believe that the CAISO's proposal should be rejected because Condition 2 Units exist specifically to address local reliability needs. Further, the parties state that the negotiated RMR contracts governing the use of these units do not anticipate their use to address system-wide needs. IEP contends that the CAISO proposal reflects an "end run" on the existing tariff provisions "that specifically allow CAISO to direct unit operations in the case of a system emergency, which would necessarily include the capacity found in Condition 2 units."<sup>19</sup>

35. Mirant and WCP believe that, if the Commission allows these units to operate outside of the terms of the RMR contract, the RMR unit owners must be compensated accordingly and the costs of dispatch be allocated appropriately. Mirant and WCP argue

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<sup>19</sup> IEP at 24.

that payment at the rates set forth in Schedule G to the RMR contract would adequately compensate the owners of Condition 2 Units for wear and tear caused by dispatches that were not contemplated when the RMR contracts were negotiated. WCP contends that the CAISO's pricing proposal is complicated and destroys the price signal that should be maintained if Condition 2 Units are permitted. It suggests that, if the CAISO's proposal is adopted, market prices should reflect scarcity and opportunity costs. WCP thus proposes that, as a condition of implementing Condition 2 dispatches, the real-time clearing price be set at \$250/MWh for all intervals in which the Condition 2 Unit is called upon.

36. The CPUC opposes the proposal to supplement the payments that Condition 2 Units will receive to compensate them for variable costs when the CAISO seeks to dispatch these units in order to address system-wide, rather than strictly local, reliability problems. The CPUC contends that Condition 2 Units are paid their full annual fixed costs and, in exchange, may not participate voluntarily in any market. They are also fully compensated for the variable costs of operating the plant when dispatched. Although the CPUC states that it understands the reasons why the CAISO believes that it needs to provide this extra compensation to Condition 2 Units when they are dispatched outside the RMR Contract, the CPUC considers that it is inherently unjust and unreasonable to pay Condition 2 Units more than their actual fixed and variable costs.

### **CAISO and SoCal Edison Answers**

37. In its answer, the CAISO states that it has existing authority under section 5.6.1 of the tariff to issue an out-of-market (OOM) dispatch to "all Generating Units... that are owned or controlled by a Participating Generator...during a System Emergency and in circumstances in which the ISO considers that a System Emergency is imminent or threatened."<sup>20</sup> It reiterates that there is no specified exemption for RMR Condition 2 Units nor should there be. Condition 2 Units are Generating Units owned/controlled by a Participating Generator and are subject to Participating Generator Agreements (PGAs). The CAISO further contends that, because section 5.6.1 applies to all PGA units, Condition 2 Units necessarily must be subject to the provisions of section 5.6.1. The CAISO further states that "it is an absurd proposition, that in cases of System Emergency, the ISO would not be able to call on all units subject to PGAs to resolve the emergency."<sup>21</sup>

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<sup>20</sup> CAISO Answer at 50.

<sup>21</sup> *Id.* at 51.

38. The CAISO explains that, in general, “reasonable efforts” to use all available and effective non-Condition 2 Units would require the CAISO to revoke the waiver of an effective non-Condition 2 Unit. It notes that the general rule may not apply where, for example, revoking the waiver of a non-Condition 2 Unit would be effective in resolving one reliability problem but have a detrimental effect on a different reliability problem.

39. The CAISO also answers that its proposal provides adequate compensation and that Condition 2 Units should not influence prices in the ISO’s markets. It contends that compensation based on Schedule G would represent a windfall and discourage units from transferring to Condition 1. SoCal Edison claims that the CAISO’s compensation proposal is equitable because the fixed costs of Condition 2 Units are recovered through the RMR contract.

### **Commission Determination**

40. The CAISO proposal to dispatch Condition 2 RMR Units consists of 11 separate elements. The Commission finds certain elements of this proposal acceptable and modifies others. Our modifications to the CAISO’s proposal are discussed in detail below. The elements not specifically discussed have been determined to be just and reasonable.

41. As a general matter, we believe it is preferable that market participants rely on market mechanisms such as bilateral forward contracts for the provision of service. We view non-market mechanisms such as the Condition 2 RMR contracts to be stop gap measures to be in place until structural and/or market reforms are in place. We are encouraged by the CPUC’s procurement proceeding and the potential there for a properly structured locational resource requirement, which should help reduce the need for CAISO to enter into RMR agreements. In the longer term and with implementation of the revised market design, market participants will have timely access to additional information that will help them make informed investment decisions further mitigating the need for the CAISO to enter into RMR agreements.

### **Condition 2 System-Wide Usage**

42. It is evident that the *pro forma* RMR contract limits the dispatch of Condition 2 Units to resolve local reliability problems or to relieve intra-zonal congestion but, in addition, the RMR contract allows the CAISO to issue an RMR dispatch notice as a result

of a “system emergency.”<sup>22</sup> Specifically, the definition of “Dispatch Notice” set forth in the *pro forma* RMR contract includes “a notice deemed to have been given by ISO for the Energy actually Delivered by a Unit that starts or increases Energy output as a result of a “system emergency” as defined in the ISO tariff . . . .”<sup>23</sup> Therefore, it is apparent that, in order for the CAISO to dispatch Condition 2 Units for system reliability, the CAISO must issue a System Alert and/or Warning.<sup>24</sup> By issuing a System Warning the CAISO will be notifying market participants that a “System Emergency is imminent or threatened,” which may ultimately necessitate the dispatch of a Condition 2 Unit for purposes other than local reliability. By notifying market participants of a potential System Emergency the CAISO will be advising all available generating units that additional steps must be taken to ensure system reliability. This notice will allow any and all capable generating units the opportunity to address the situation and potentially stem the need for the CAISO to dispatch Condition 2 Units.

43. We note that this measure is already contained in the CAISO tariff and urge the CAISO to avail itself of this effective provision to maintain the reliability of the grid. We disagree with the CAISO that it should be able to dispatch Condition 2 Units outside the terms of the *pro forma* RMR contract without first notifying market participants of the possibility that grid reliability may be compromised. Therefore, we direct the CAISO to modify its proposal to reflect that Condition 2 Units may only be dispatched when a System Emergency is imminent or threatened and the CAISO has issued the appropriate notice to market participants.

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<sup>22</sup> The CAISO defines a System Emergency as conditions beyond the normal control of the CAISO that affect the ability of the CAISO Control Area to function normally including any abnormal system condition which requires immediate manual or automatic action to prevent loss of Load, equipment damage, or tripping of system elements which might result in cascading outages or to restore system operation to meet the minimum operating reliability criteria.

<sup>23</sup> CAISO *pro forma* RMR Contract at 5.

<sup>24</sup> The CAISO Dispatch Protocol states that the CAISO will provide notifications to Market Participants to communicate unusual system conditions or emergencies. The CAISO uses Alerts, Warnings, and Emergencies to communicate a loss of resources and/or a forecast or existing deficiency in Operating Reserve.

**“Reasonable Efforts” to use “All Available Effective Non-Condition 2 Units”**

44. Intervenors assert that the CAISO’s statement that it will use “reasonable efforts to use all available and effective non-Condition 2 Units before using Condition 2 RMR units” to address system reliability concerns is too vague and gives little assurance that the CAISO will indeed dispatch Condition 2 Units as a last resort. The CAISO states in response that it will limit use of Condition 2 Units until after it has reasonably exhausted all other viable and effective options. Intervenors also request that the CAISO expressly define what “effective” means in terms of a unit’s effectiveness in relieving a constraint. WCP/Williams suggest that a unit is effective when it has a ten percent effectiveness factor, i.e., a 0.1 MW effect on the constraint for every MW dispatched from the unit. The CAISO responds that this condition should be rejected without discussing its merits. Further, the California EOB suggests that the CAISO should establish a hierarchy of resources to be called on prior to the Condition 2 Units.

45. We acknowledge that the CAISO proposes to revoke the waivers of all effective must-offer units before dispatching Condition 2 Units. We agree with the CAISO that this is an appropriate measure; however, if the CAISO fails to revoke any such waiver, the burden is on the CAISO to demonstrate why such a waiver would be inappropriate to assist in alleviating the System Emergency. Further, while we recognize the CAISO’s proposal to utilize evaluative methods in determining effective units for system reliability has merits we find that the language of the CAISO’s proposal that it will use “reasonable efforts to use all available and effective non-Condition 2 Units” is vague and must be further defined. The clarification offered by the CAISO does little to ease the concerns of intervenors as well as this Commission. We find it appropriate that those parties affected by the CAISO’s proposal know the full extent of the CAISO’s efforts in attempting to avoid dispatching Condition 2 units. Therefore, we direct the CAISO, in a compliance filing, to stipulate what constitutes “reasonable efforts to use all available and effective non-Condition 2 RMR units before using Condition 2 Units.” In addition, we will require the CAISO to incorporate into its tariff an explicit procedure for the dispatch of Condition 2 RMR Units for system reliability.

46. We also direct the CAISO’s Department of Market Analysis (DMA) to monitor the dispatch of Condition 2 RMR units for system reliability. This information is to be reported to the Commission on a quarterly basis.

**Service Limits**

47. The terms of the *pro forma* RMR contract determine service limits set by a rolling five-year average. The CAISO’s proposal states that non-RMR service shall count against these units’ service limits. The Commission believes it to be inappropriate for the CAISO to count dispatch of a Condition 2 Unit for system reliability in determining

service limits of these units. By dispatching a Condition 2 Unit for system reliability the CAISO will effectively be utilizing a contracted unit for a purpose outside of the negotiated terms of the contract. The service limits in that contract, however, should logically be tied solely to the service actually provided for by the contract. Dispatches for system reliability were not contemplated during the original negotiations and therefore, should not be counted in determining allowable service limits of these units. Therefore, we do not believe that dispatch of a Condition 2 Unit for system reliability should impact the service limits, as defined in section 4.11 of the *pro forma* RMR contract, and we direct the CAISO to modify its proposal accordingly.

### **RMR Compensation**

48. The CAISO proposes to compensate Condition 2 RMR units for system reliability service in the same manner it would if dispatched for local reliability. The Commission believes it is important that market prices accurately reflect market conditions. The CAISO's proposed compensation for the out-of-market dispatch of Condition 2 Units for system-wide reliability does not achieve this result. By relying on Condition 2 Units for system reliability, the CAISO will depress the real-time market clearing price and thus, not reflect actual scarcity and operating reserve deficiencies that necessitated such dispatch.

49. Further, we believe that RMR owners should be compensated for the increase in costs that will result from being subject to system-wide Condition 2 dispatches. Dispatches for system reliability will cause Condition 2 Units to incur additional operation and maintenance costs and these units should be allowed recovery of these additional costs. Schedule G to the RMR contract was included to ensure RMR owners a reasonable opportunity to recover such additional costs.<sup>25</sup> We believe that, by compensating all system-wide reliability dispatches of Condition 2 RMR Units at the rates set forth in Schedule G to the RMR contract, such units will be compensated for the additional costs incurred by dispatches that were not contemplated during negotiation of

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<sup>25</sup> The Schedule G rate applies when the CAISO dispatches a Condition 2 Unit for local reliability needs and the contract service limits have been exceeded. Under Schedule G, a generator can choose between two compensation options. Option A compensates a unit for 150 percent of its variable cost as computed under Schedule C (*i.e.*, 100 percent as calculated under Schedule C and a 50 percent adder), a fixed cost payment, and start-up costs. Option B compensates a unit for 100 percent of its variable cost as computed under Schedule C, a fixed cost payment and three times the unit's start-up costs.

the *pro forma* RMR contract. Further, it is our belief that such a rate will provide a disincentive to the CAISO to rely excessively upon Condition 2 Units for system reliability while compensating unit owners for usage outside the terms of negotiated RMR contracts. Therefore, we direct the CAISO to modify its proposal to allow for Schedule G compensation for all Condition 2 units dispatched for system reliability.

### **Cost Allocation**

50. The CAISO proposes to allocate start-up costs associated with Condition 2 system reliability dispatch to metered load and exports. It also proposes to allocate the cost for energy associated with system reliability dispatch to the market, as the CAISO currently does for any out-of-market dispatch. The Commission believes that if a System Emergency facilitates the need for the CAISO to dispatch a Condition 2 RMR Unit, both the energy and start-up costs associated with that dispatch should be allocated to all beneficiaries. By doing so, those benefiting from the dispatch of the Condition 2 Unit will be paying for the services provided by that unit. We believe that the CAISO has developed a methodology that properly allocates the costs associated with non-RMR use of a Condition 2 RMR Unit on a system-wide basis.

### **Further Study by DMA**

51. We have concerns regarding the market prices that result from out-of-market dispatch of Condition 2 Units, especially during system emergencies. Out-of-market purchases may artificially dampen the appropriate real-time clearing price. It is possible that the incremental cost of dispatching of Condition 2 Units may be higher than any accepted market bid in the BEEP stack. In this case, the real-time price will not reflect the actual incremental cost of serving CAISO load. It is appropriate that the price reflect the cost of the least efficient unit dispatched to serve load. The use of out-of-market purchases can also create a potential opportunity for monopsony abuse. Accordingly, we direct the DMA to evaluate the merits of setting the real-time market clearing price, during system emergencies, at the higher of (1) the incremental costs of the Condition 2 Unit used to serve system load and (2) the highest accepted market bid. We also direct the DMA to evaluate options for setting the market clearing price at times in which insufficient resources are available to the CAISO to fully meet load and operating reserve requirements.

52. We note that Condition 2 Units are prohibited from participating in the market, and may provide energy or ancillary services only when directed to do so by the CAISO. Lower-cost units may elect the Condition 2 contract, especially when the full cost-of-service revenues guaranteed by the Condition 2 contract are likely to exceed market revenues. At times, Condition 2 units might have lower costs than other generators that are dispatched, and thus, the Condition 2 restrictions may prevent lower-cost Condition 2

Units from displacing higher-cost energy. The result would be higher costs to serve California loads. We direct the DMA, in a report to the Commission, to evaluate the magnitude of these higher costs, to identify the benefits for the production restrictions, and to evaluate whether the magnitude of the benefits of the production restrictions outweigh the resulting higher energy costs. Further the report should evaluate the impact of the CPUC resource adequacy requirements on the need for RMR units as part of the CAISO market. We direct the DMA to file the report with the Commission by December 31, 2004.

**C. Allocation of Must-Offer Obligation Costs**

**1. Allocation Methodology Based on System, Zonal and Local Reliability Needs**

**CAISO Proposal**

53. Currently, the CAISO allocates start-up fuel costs and minimum load costs to metered demand within the CAISO Control Area, plus exports to other control areas within California.<sup>26</sup> The CAISO characterizes this methodology as providing “a measure of rough justice,” as all Scheduling Coordinators are presumed to have contributed to the need in proportion to the demand they place on resources supplying the CAISO control area system. It explains that certain Scheduling Coordinators that claim to have sufficient resources to serve their own load and exports have complained to the CAISO that they are improperly allocated minimum load costs when a unit is operated to address a problem that they have not created. Further, the CAISO indicates that it regularly commits units to operate at minimum load under the must-offer obligation for local reliability reasons. Currently, in such circumstances, the cost of the must-offer unit is allocated to all Scheduling Coordinators, regardless of their location in relation to the local reliability problem for which the unit was operated.

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<sup>26</sup> CAISO Transmittal letter at 31. *Citing* June 2001 Order, 95 FERC ¶ 61,418 at 62,563; San Diego Gas & Electric Co., *et al.*, 97 FERC ¶ 61,293 at 62,363.

54. The CAISO states that it is proposing to modify its methodology for allocating minimum load costs in those situations when the must-offer unit is operated at minimum load to better reflect cost-causation principles. Specifically, it proposes that: (1) when a must-offer unit is operated for local reliability needs the incremental location cost<sup>27</sup> would be allocated to the Participating TOs in whose service area the unit is located;<sup>28</sup> (2) when a unit operates to provide zone-wide benefits or to manage inter-zonal congestion, costs would be allocated to the affected or congested zone; and (3) when a unit operates because of a control area-wide requirement, costs would be allocated in two tiers, first, to net negative uninstructed deviation (NNUD) with a per-MWh “cap” on the rate and, second, any remaining costs would be allocated using the current methodology to metered demand and exports. Further, when a unit committed for local reliability also provides system benefits, the CAISO would allocate to the Participating TOs only the incremental cost of committing that particular unit over the cost of committing a cheaper available unit that would have been committed to meet system needs absent the local requirement.

55. The CAISO requests that the proposed tariff modifications needed to implement the revised cost allocation methodology be made effective ten days after notice to the market and the Commission that Phase 1B MD02 software is ready to be deployed.

### **Comments and Protests**

56. SWP states that, while Amendment 60 is a “step in the right direction” with regard to the CAISO’s attempt to allocate must-offer costs based on cost causation, it does not go far enough. SWP and MWD suggest that because the CAISO has indicated that must-offer needs are determined based on forecast peak demand, it should allocate minimum load costs to those customers using the grid during peak hours. SWP further argues that the CAISO’s proposal to allocate localized reliability costs on a Participating TO service area basis does not comport with the Commission’s recent statement that reliability costs incurred by an ISO/RTO for a localized subset of load should be borne by the local area

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<sup>27</sup> Incremental locational cost is defined as the additional costs associated with committing and operating a particular unit to meet a local reliability requirement over the costs of a less expensive unit that would have been committed and operated absent the local reliability requirement.

<sup>28</sup> A local reliability requirement would be defined as a requirement arising due to a constraint on a transmission component that is not part of a defined active inter-zonal interface. The CAISO’s Attachment E is a “White Paper” that describes in detail how it intends to distinguish between local, zonal and system requirements.

benefiting from the reliability improvement.<sup>29</sup> It contends that, to comport with the Commission's policy, must-offer costs should be allocated to the localized subset of load for which they are incurred. It also asks the CAISO to provide additional explanation of the proposal for allocating must-offer costs incurred to meet zonal or grid-wide needs. Finally, SWP asks that the Commission act on Amendment 60 consistent with its policy stated in PJM, and requests that the matter be set for hearing to assure that principles of cost causation are applied based on substantial evidence.

57. TANC, MWD and Southern Cities contend that the criteria the CAISO proposes for determining whether minimum load costs are local, zonal or control area-wide are vague and subject to CAISO discretion, and ask that these categories be more clearly defined. TANC requests an examination of the CAISO proposal to establish criteria to allocate MLC to all loads within the affected or congested zone, claiming that (1) existing congestion management procedures address these circumstances and (2) costs should be allocated to CAISO load served by the new firm use on these interfaces, not all load within the zone. MWD questions the CAISO's proposed methodology for determining the incremental cost of local reliability when a unit is run for local reliability problems and at the same time meets system needs.

58. TANC argues that the CAISO failed to justify the proposed "cap" rate on system-wide costs allocated to NNUD. Powerex contends that minimum load costs should not be allocated to NNUD when the uninstructed deviation is beyond the control of the scheduling coordinator.

59. Mirant argues that exports from the CAISO to in-state control areas should not be charged for must-offer capacity since the purpose of the must-offer obligation is to meet load in the CAISO control area. Similarly, SMUD and LADWP contend that Wheel-Through transactions, in which neither load nor generating services are within the CAISO control area, do not place demand on energy sources supplying the CAISO control area and, therefore, should not be allocated minimum load costs. LADWP also argues that allocation of must-offer costs to existing transmission contracts (ETCs) would result in double cost recovery.

60. The California EOB supports the allocation proposal. IEP asks the Commission to direct the CAISO to explain why it is seeking to delay implementation of the proposal to correct the allocation mechanism until deployment of Phase 1B modifications. Like SWP, IEP asks that the Commission analyze the CAISO's cost allocation proposal in light of the recent PJM ruling. SDG&E also supports the proposal but is generally

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<sup>29</sup> PJM Interconnection, L.L.C., 107 FERC ¶ 61,112 at P 19-22 (2004) (*PJM*).

concerned about the criteria the CAISO intends to use for such allocation (local, zonal, etc.). PG&E supports the allocation proposal, including the proposal to allocate certain costs to Participating TOs, provided that the allocation be made effective concurrent with Commission approval of Participating TO tariff revisions to allow them to recover these costs not previously incurred.

### **CAISO Answer**

61. The CAISO claims that its proposal to allocate minimum load costs follows cost-causation principles. It contends that allocation of a portion of costs to exports is reasonable because Wheel-Through schedules contribute to congestion. It also notes that the CAISO's allocation proposal will greatly reduce the volume of must-offer costs allocated to in-state exports. In response to protests asserting that the CAISO has not justified the cap on allocating minimum load costs to NNUD, it states that the cap is appropriate to prevent a limited group of participants from bearing unreasonable costs. It contends that Attachment E provides sufficient detail to distinguish between local, zonal and system requirements. It also states that, after further consideration, it agrees with certain intervenors who advocate the allocation of minimum load costs on a daily, instead of monthly, basis. However, it would allocate costs based on totals for all hours of the day, and not just peak hours. The CAISO contends that the implementation of compensation measures adopted by the Commission in PJM go beyond the scope of the Amendment 60 filing and should not be considered by the Commission. It also points out that (1) the PJM order recognizes that there is no standard regulatory response to compensation issues and (2) the CAISO's proposed tariff changes culminated from a nine-month stakeholder process that took place prior to issuance of the PJM order.

### **Commission Determination**

62. The must-offer obligation was introduced as a temporary measure to prevent withholding in the midst of the California energy crises.<sup>30</sup> It is clear from the CAISO's filing that its use of must-offer units has shifted, and is now used as a tool to address not only system-wide, but also zonal and local, reliability needs. The CAISO's proposed cost allocation methodology attempts to reconcile this shift in usage and corresponding shifts in costs causation. As a general matter, the Commission believes that the entities that cause costs should pay for such costs.<sup>31</sup>

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<sup>30</sup> See, e.g., April 2001 Order at 61,356.

<sup>31</sup> PJM, 107 FERC ¶ 61,112 at 22.

63. The CAISO's proposal on the allocation of costs related to the units operating pursuant to the must-offer obligation raises issues of material fact that cannot be resolved based on the record before us, and are more appropriately addressed in the hearing ordered below.<sup>32</sup> Our preliminary analysis indicates that the CAISO's costs allocation proposal has not been shown to be just and reasonable, and may be unjust, unreasonable, unduly discriminatory or preferential or otherwise unlawful. Therefore, we will accept for filing the proposed modification to the CAISO tariff related to cost allocation, suspend it for a nominal period, and make it effective ten days after CAISO notice to the market and the Commission that Phase 1B MD02 software is ready to be deployed,<sup>33</sup> as requested, and subject to refund. We will waive the 120-day notice requirement in 18 C.F.R. § 35.3(a) (2003) to permit the proposed change to become effective ten days after CAISO notice to the market and the Commission that Phase 1B software is ready to be deployed, as requested.

64. Although we do not have the benefit of a presiding judge's report, based on a review of the record, we expect that, assuming the proceeding does not settle, the presiding judge should be able to issue an initial decision within approximately ten months from the date of this order. If the presiding judge is able to render a decision within that time, we estimate that we will be able to issue our decision within approximately five months of the filing of briefs on and opposing exceptions.

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<sup>32</sup> In *Pacific Gas & Electric Co., et al.*, 108 FERC ¶ 61,017 (2004), issued concurrently with this order, the Commission sets for hearing and consolidates with the proceeding in this docket PG&E's complaint against the CAISO relating to the current allocation of must-offer obligation costs.

<sup>33</sup> See *Central Hudson Gas & Electric Corp., et al.*, 60 FERC ¶ 61,106 at 61,338, *reh'g denied*, 61 FERC ¶ 61,089 (1992).

## 2. Reliability Service Costs

### CAISO Proposal

65. The CAISO proposes that must-offer costs related to local reliability be labeled as “Reliability Service Costs.” It believes that Minimum Load Costs for units committed to meet local reliability requirements are “Reliability Service Costs” and proposes to define such costs in its tariff.<sup>34</sup>

### Comments and Protests

66. TANC, Modesto, and Cities/M-S-R argue that the CAISO’s proposed definition of Reliability Service Costs does not have a functional purpose or application to the CAISO Tariff. They assert that the only foreseeable application of this newly defined term is to effect the pass through of these costs by Participating TOs. SMUD believes that the definition for Reliability Service Costs should be struck because it is overly broad and does not properly represent the principle of cost causation. SWP argues that the definition should be rejected because it conflicts with the Commission’s ruling that the CAISO can incur such costs only for facilities under CAISO control, as opposed to all facilities within the CAISO control area<sup>35</sup> and because it conflicts with the policy set forth in PJM.

### CAISO and SoCal Edison Answers

67. The CAISO states that it included the proposed Reliability Service Costs definition because it accurately reflects that when a unit is committed for local reliability reasons, those costs are legitimate Reliability Service Costs, just as RMR costs are legitimate. The CAISO notes that it proposes to allocate such costs to the Participating

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<sup>34</sup> The CAISO defines Reliability Service Costs as the costs associated with services provided by the ISO: 1) that are deemed by the ISO as necessary to maintain reliable electric service in the ISO Control Area; and 2) whose costs are billed by the ISO to the Participating TO pursuant to the ISO Tariff. Reliability Service Costs include costs charged by the ISO to a Participating TO associated with the service provided under an RMR Contract (section 5.2.8), local out-of-market dispatch calls (section 11.2.4.2.1) and Minimum Load Costs associated with units committed under the must-offer obligation for local reliability requirements (section 5.11.6.1.4).

<sup>35</sup> *Citing California Independent System Operator Corp.*, 107 FERC ¶ 61,152 (2004).

TOs just as RMR costs are allocated. The CAISO also notes that while it believes Participating TOs should be able to recover these costs in rates, Amendment No. 60 takes no position with respect to how these costs should be allocated among the Participating TO's customers.

68. SoCal Edison states that Reliability Service Costs must be clearly defined in the CAISO Tariff not only to enable the CAISO to appropriately allocate costs to Participating TOs, but also to avoid the grossly repetitive litigation over the ability of the Participating TOs, who pay these costs in the first instance, to recover such costs from their customers. It also argues that, contrary to LADWP's position, a Participating TO's ETC customers may be assessed Reliability Service Costs if the Participating TO has demonstrated that its costs were unbundled and no double recovery occurs.

### **Commission Determination**

69. The CAISO proposes to define the costs associated with maintaining reliable electric service within the CAISO Control Area as Reliability Service Costs. Generally, we find it reasonable for the CAISO to define costs incurred in order to maintain the reliability of the grid as reliability costs. However, because we have set for hearing the reasonableness of the CAISO's proposed cost allocation methodology, this definition will be subject to the outcome of that hearing.

70. We disagree with intervenors' protests that the inclusion of a definition of Reliability Service Costs is simply a means to facilitate the pass through of these costs by PTOs. We note that the CAISO explicitly declined a stakeholder request to indicate in its tariff that such costs are recoverable in another entity's tariff.<sup>36</sup> We further note that nowhere in the CAISO's application does it indicate that the classification of costs as Reliability Service Costs will lead to additional costs being collected by any particular entity. We believe that the appropriate method for a Participating TO to pass through reliability related costs should be decided in a separate application.

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<sup>36</sup> CAISO Transmittal letter at 35.

**D. The Must-Offer Obligation****1. Use of a SCUC Computer Application to Determine Waivers of the Must-Offer Obligation****CAISO Proposal**

71. The CAISO notes that, while the Commission rejected a proposal to grant waivers of the must-offer obligation in such a way as to minimize cost,<sup>37</sup> the Commission subsequently indicated that it did not intend to completely exclude economic considerations from the waiver process and invited a filing under FPA section 205.<sup>38</sup> The CAISO proposes to incorporate the use of a security-constrained unit commitment (SCUC) computer application to grant, revoke or deny waivers to minimize start-up and minimum load costs once reliability needs have been met. It contends that the use of SCUC will provide transparency and efficiency compared to the first-come, first-served approach currently in use. According to the CAISO, it must integrate SCUC with existing applications prior to implementation and, therefore, requests an effective date 10 days after notice by the CAISO.

72. The CAISO states that, after integration of the SCUC application and until the “Full Network Model” is implemented as part of the MD02 modifications, units needed for local reliability requirements will be committed manually outside the SCUC process. In other words, SCUC will commit units only for CAISO control area-wide requirements to meet demand and to ensure that there is sufficient transfer capability to deliver energy from one zone to another.

**Comments and Protests**

73. SMUD and PG&E support the use of SCUC as a mechanism for injecting an economic optimization element to the must-offer obligation process. PG&E also states that the use of the SCUC application is consistent with industry best practices as it is currently used by other ISOs to dispatch and ensure that reliability needs are met.

74. WCP/Williams believe that the SCUC application is not practical or justified since it will not apply a Full Network Model. Calpine is concerned that the adoption of

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<sup>37</sup> San Diego Gas & Electric Co., *et al.*, 99 FERC ¶ 61,158 at 61,630.

<sup>38</sup> California Independent System Operator Corp., 101 FERC ¶ 61,061 at P 72 (2002).

the SCUC could lead to unintended consequences and market distortions. It argues that newer and more cost efficient units may bear disproportionate financial and operational consequences of the must-offer obligation due to the inclusion of economic considerations in the waiver denial process. This could lead to the penalization of newer units through the repeated denial of waivers. Calpine urges the Commission to deny the use of the SCUC application as it is unjustifiably discriminatory against newer, more efficient generation and may result in the deterrence of new critically necessary capacity in California.

### **CAISO Answer**

75. The CAISO acknowledges that many must-offer units are committed for local reliability purposes, and that the initial implementation of SCUC would not affect such units. However, it contends that, SCUC would not lower overall costs when units are committed for local reliability problems because there is no choice among units to commit at the local level. It also notes the need for SCUC to support the three-part cost allocation proposal. While the CAISO agrees with Calpine that SCUC would tend to commit new, efficient units, it claims that such units are more likely to be selling power in the market and not requesting a waiver of the must-offer obligation. It notes that the Commission has approved the use of least-cost SCUC for other independent system operators<sup>39</sup> and contends that the CAISO should similarly be permitted to optimally commit the lowest cost units available.

### **Commission Determination**

76. We accept as just and reasonable the CAISO's proposal to use the SCUC application when determining must-offer waivers to minimize start-up and minimum load costs once reliability needs have been met. Therefore, the tariff provision in section 6.11.6.2 is accepted effective ten days after notice by the CAISO. Although the CAISO would use SCUC for system-wide and zonal, not local, needs prior to the implementation of the Full Network Model as part of MD02, there are efficiency and cost minimization benefits to be gained from the CAISO's proposal. As the CAISO notes, it is likely that SCUC will not have a significant impact when determining waivers to address local reliability needs due to the limited number of units available in a locality to meet such needs. It does not appear that newer units would be "punished" by the application of SCUC. Such units are not subject to the must-offer obligation when self-committed. If they are not self-committed and are denied a waiver, this determination is made on the

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<sup>39</sup> *E.g.*, Midwest Independent Transmission System Operator, Inc., 102 FERC ¶ 61,196 (2003).

basis of first, reliability needs, and second, economic cost minimization as determined by the SCUC application. Thus, this process, as explained by the CAISO, does not raise concerns of undue discrimination.

## 2. Calculating Start-Up and Minimum Load Cost Compensation Payment

### CAISO Proposal

77. The CAISO explains that, while the Commission has directed generators operating pursuant to the must-offer obligation to invoice the CAISO for start-up fuel costs, the cost of auxiliary power needed to run equipment until the generator has been synchronized and can furnish power on its own is not included in the start-up cost. The CAISO currently allows RMR owners to recover auxiliary power costs in start-up charges, and it proposes a tariff modification to allow similar treatment for must-offer resources. The CAISO also proposes to include intrastate gas transportation and municipal use fees in minimum load costs. It notes that the Commission previously rejected a similar request made by Dynegy,<sup>40</sup> but urges the Commission to reconsider and allow the recovery of such charges to the extent that they are volumetric as-incurred charges.

78. Currently, to determine gas inputs for minimum load cost and start-up fuel cost compensation, the CAISO calculates the average of the monthly bid-week indices for three delivery points: Malin, PG&E Citygate and SoCal Gas (large packages).<sup>41</sup> The CAISO proposes to change this formula and, instead, use the same daily gas price index currently used to set the price for RMR Units.<sup>42</sup> The CAISO states that it performed a

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<sup>40</sup> San Diego Gas & Electric Co., *et al.*, 99 FERC ¶ 61,159 at 61,642.

<sup>41</sup> San Diego Gas & Electric Co., *et al.*, 95 FERC ¶ 61,418 at 62,561.

<sup>42</sup> To determine commodity prices for RMR Units, Schedule C (Variable Cost Payment) of the RMR contract specifies two-day location-specific averages of the following indices: an average of the midpoint of the Gas Daily index for SoCal Gas, Large Packages; the BTU Daily Gas Wire index for the SoCal Border (Topock); and midpoint of the NGI Daily Gas Price index for the Southern Border for units in SP-15. For facilities within the service territory of PG&E, the commodity price is based on an average of the midpoint of the Gas Daily index for PG&E Citygate and the NGI Daily Gas Price index for PG&E Citygate.

study which shows that a change in calculation would not have had an appreciable effect on recent MLCC costs. It states that the use of one index for both must-offer and RMR Units will promote consistency and reduce potential errors and disputes.

### **Comments and Protests**

79. Duke Energy, WCP/Williams and IEP support the CAISO's proposals to accept auxiliary power costs, intrastate transportation costs and municipal use fees as legitimate start-up and minimum load (SU/ML) cost recovery components of must-offer generating units. In addition, these parties support the CAISO's proposal to use the two-day average gas price specified in Equation C1-8 in Schedule C to the RMR contract for calculation of SU/ML costs. Notwithstanding, WCP/Williams states that the approval of these changes to the minimum load costs compensation payment calculations must be conditioned on the CAISO filing all of the requisite tariff language, which has apparently been omitted in Amendment No. 60.

### **CAISO Answer**

80. In its answer, the CAISO acknowledges that it filed appropriate changes to the start-up fuel costs and minimum load costs<sup>43</sup> provisions of the ISO Tariff but mistakenly indicated the CAISO was making changes to the calculation of the proxy price.<sup>44</sup> The CAISO states that the proposed changes to the gas cost used for the proxy bids was not a part of the stakeholder meetings.

### **Commission Determination**

81. We note that the CAISO made a similar request to include auxiliary power, intrastate transportation costs and municipal use fees as legitimate cost recovery components under its May 11, 2004 revised market design proposal.<sup>45</sup> The Commission accepted the CAISO's proposal to include these costs because the inclusion of these costs will allow suppliers to recover their actual costs to start-up and run at minimum load in

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<sup>43</sup> See Sections 2.5.23.3.7.6 and 5.11.6.1.2 of the ISO Tariff, respectively.

<sup>44</sup> See the CAISO's Application at p. 43.

<sup>45</sup> The CAISO modified its Residual Unit Commitment (RUC) process to respond to market participants' feedback to include the aforementioned costs components as legitimate costs under RUC. In addition, the CAISO in response to market participants' feedback proposed to use RMR contract gas costs for RUC.

order to respond to a residual unit commitment dispatch by the CAISO.<sup>46</sup> Since the must-offer obligation and residual unit commitment process are both reliability tools for the CAISO to call upon a particular unit to meet local and system-wide reliability, and these are actual costs incurred by generators in order to comply with the must-offer obligation, the Commission finds it appropriate to also allow suppliers to recover these costs under the must-offer obligation requirement. Accordingly, we will accept the CAISO proposal to include these costs as a component of start-up and minimum load costs to be recovered prospectively and also under its revised market design proposal.

82. With respect to the CAISO proposal to use the same daily gas price index as the RMR units to calculate start-up and minimum costs, we find the proposal is reasonable because it meets the standards put forth in the Commission's Policy Statement on Natural Gas and Electric Markets.<sup>47</sup> On May 5, 2004, the Commission issued a "Report on Natural Gas and Electricity Price"<sup>48</sup> in which the Commission found certain indices to be in substantial compliance with the standards of the Policy Statement<sup>49</sup> or compliance subject to conditions.<sup>50</sup> We note that the three indices that the CAISO currently uses for RMR units (Platts Gas Daily, NGI and BTU) comply with the standards of the Policy

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<sup>46</sup> See California Independent System Operator Corp., 107 FERC ¶ 61,274 (2004).

<sup>47</sup> Price Discovery in Natural Gas and Electric Markets, 104 FERC ¶ 61,121 (Policy Statement) (2003). The Commission required that any prospective use of an index in a jurisdictional entity's tariffs meet the criteria set forth for price index developers and reflect adequate liquidity at the referenced location to be reliable.

<sup>48</sup> See PL03-3-004 and No. AD03-7-004.

<sup>49</sup> We note that Argus, Energy Intelligence, ICE, Io, NGI, and Platts were deemed to be in substantial compliance with the standards of the Policy Statement (a) on condition that they publish direct volume and transaction number data on which index prices are calculated (or indicate when no such data is available) and (b) on condition that they affirm the Commission will, upon an appropriate request, have access to relevant data in the event of an investigation of possible false price reporting or manipulation of prices.

<sup>50</sup> Bloomberg, Btu/DTN, and Dow Jones were be deemed conditionally to be in substantial compliance subject to the conditions noted above, and also pending a further showing by each of them on progress in (1) making their methodologies public; (2) instituting measures to provide more complete transaction information; and (3) implementing audit procedures.

Statement. In addition, we agree with the CAISO that a daily gas price index is more in line with the unit commitment process under the must-offer requirement because gas for these units is typically purchased in the spot market. Thus, we will accept the proposed use of a daily gas index to calculate the start-up and minimum load costs.

**3. Non-Rescindable Minimum Load Cost Compensation for Units Providing Ancillary Services**

**CAISO Proposal**

83. The CAISO tariff currently provides that, when a must-offer generator that has been denied a waiver and, thus, is being paid minimum load costs is awarded ancillary services in the hour-ahead market or has a final hour-ahead schedule, the generator is not eligible to recover minimum load costs for such hours. The CAISO states that, to help overcome chronic shortages on ancillary services bids, it proposes to make must-offer generators eligible to recover minimum load costs when they provide ancillary services or provide imbalance energy as directed by the CAISO.

**Comments and Protests**

84. Duke Energy and WCP/Williams support the CAISO's proposal not to rescind start-up and minimum load cost payments in hours where a must-offer generating unit is only providing Ancillary Services or dispatched by the CAISO to provide imbalance energy. The CPUC is opposed to the minimum load costs payment. The CPUC argues that the CAISO's proposal could result in the overpayment of minimum load costs in order to resolve insufficient bidding problems in the ancillary services market. The CPUC claims that the overpayment may stem from the fundamental problem that some entities (the must-offer waiver denied units) in the ancillary services market will receive an administrative minimum load costs payment while the rest of the ancillary service market participants will have to recover start-up and minimum load costs payments in their ancillary services bids. In the event that the non-must-offer entity's bid clears the market, the must-offer waiver denied entity will receive both the administrative minimum load costs payment as well as the market clearing price, which includes the recovery of a minimum load costs payment.

85. PG&E contends that the CAISO's proposal will increase ancillary services costs. In addition, PG&E argues that allowance of a non-rescindable minimum load costs payment will cause many units to shut down to receive both payments and may have adverse impacts upon the apparent availability of generation. As a result, PG&E

recommends that the Commission not approve the payment of ancillary services to units also receiving minimum load costs compensation, or at least not add this element until the countervailing reduction in uninstructed energy payment for MD02 Phase 1B is implemented at the same time.

86. Powerex is also opposed to the CAISO's proposal. It claims that the CAISO informed market participants that zonal procurement of ancillary services is needed to address the discrepancy between the demand and supply in SP15 and NP15.<sup>51</sup> It further claims that the CAISO also has indicated that it was uncertain whether or not rescinding the minimum load costs payment would be the answer to the bid insufficiency problem in SP15. According to Powerex, an alternative proposal has been presented in which the CAISO would proceed with zonal procurement without making the modification that would rescind the minimum load costs payment relying on the ancillary services market to balance supply and demand, i.e., ancillary services prices in SP15 will increase with zonal demand to provide the price incentive for must-offer units to participate in the ancillary services market. Powerex contends that the alternative proposal is a workable option that should be implemented before adopting the CAISO's proposal.

#### **CAISO Answer**

87. In its answer, the CAISO contends that eliminating the rescission of commitment payments when waiver-denial units sell ancillary services to the CAISO will not increase outlays for these payments since the CAISO will commit the same amount of capacity with or without rescission. Furthermore, since units have historically chosen commitment payments over capacity payments, there are no true savings in rescinded commitment payments that will be lost with non-rescission. The CAISO states that the only anticipated change will be the increased capacity offered in the day-ahead ancillary service markets.

88. Because the ancillary service markets operate as a single-price auction, the CAISO states that all lower-priced bids will receive a premium over their bid price when the market-clearing price is set by a higher-priced bid. The CAISO states that, as a result, waiver-denial units may receive a premium over their bid price, or be "double-paid" as the CPUC suggests. However, the CAISO contends that this is immaterial since the CAISO's ancillary service markets operate as a single price auction in which all selected bids priced below the market-clearing price will receive a premium over their bid price.

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<sup>51</sup> *E.g.*, Powerex states that ancillary services procurement has been predominantly from resources in NP15, to the point where only 15 percent of ancillary services were purchased from SP15 resources in the first quarter of 2004.

In this context, rescission of the unit commitment compensation when a waiver-denial unit sells ancillary services to the CAISO will subject this unit to start-up and minimum load costs that were capitalized into the capacity bid from the non-waiver denial unit. The CAISO asserts that this approach will not guarantee that the unit is made whole for being committed by the CAISO.

### **Commission Determination**

89. We find the CAISO's proposal to no longer rescind the minimum load costs payment to must offer generating units awarded ancillary services is reasonable. We understand one of the reasons for the current shortage of ancillary service bids is related to a possible flaw in the market. Specifically, the current hour-by-hour design of the ancillary services markets and the lack of a separate start-up and minimum load cost bid and payment means suppliers may not be awarded enough hours in the ancillary services markets to recover those costs. As a result, we find that the benefits of implementing a non-rescindable minimum load cost payment will provide generators a greater incentive to bid into the ancillary services market because a comparable payment removes the risk and uncertainty of whether to participate in the market.

## **4. Self-Committed Units and SU/ML Costs Compensation**

### **CAISO Proposal**

90. Under the current tariff provisions, the scheduling coordinator submits schedules for energy in the day-ahead market. The CAISO considers units with day-ahead schedules as "self-committed" for those hours in the next day, and this unit is not eligible to recover minimum load costs during such self-commitment periods. The CAISO tariff also permits the CAISO to extend the self-commitment period as necessary to accommodate generating unit minimum up and down times. The CAISO states that scheduling coordinators can withdraw the unit between the day ahead and real-time markets. It believes that under the current tariff, the self committed day-ahead schedule is binding, even if the scheduling coordinator withdraws its day-ahead schedule for the self commitment period. The CAISO states that this binding commitment could require units scheduled in the day-ahead market to remain in operation in real-time even if the CAISO does not require the unit to operate. The CAISO states that this process creates an inefficient outcome.

91. Therefore, the CAISO proposes to allow scheduling coordinators to request waiver for continued operations during self commitment periods. Thus, the scheduling coordinator will request waiver of continued operations and, if the unit is not required to operate in real-time, the CAISO will grant waiver to shut down. However, if the unit is needed in real-time, the CAISO will deny waiver and the unit will not be eligible to

recover minimum load costs. In support of this non-recovery of minimum load costs, the CAISO essentially argues that a generator could game the process to ensure a minimum load costs payment because the odds are high that the CAISO will have to deny waiver based on the fact that the CAISO already assumed for operational purposes that the unit was operating.

### **Comments and Protests**

92. Duke Energy and Mirant request that the Commission reject the CAISO's proposal not to pay SU/ML costs to a generating unit that withdraws or nullifies its day-ahead schedule in the hour-ahead timeframe, but is denied waiver of the must-offer obligation. They argue that a generating unit that withdraws its day-ahead schedule in the hour-ahead timeframe is no longer "self-committed" for purposes of the must-offer obligation because the change in schedule occurs before the actual real-time market. They state that if the owner of a unit wants to shut down and the CAISO wants to keep the unit running at minimum load, the CAISO should be required to pay the costs to compensate a generator for keeping the unit running at minimum load.

93. Duke Energy and Mirant dismiss as speculative the CAISO's concern that generators will "submit meaningless day-ahead energy schedules to maximize the likelihood that a unit's waiver will be denied." Duke Energy notes that generators proven to have engaged in such market behavior would appear to be subject to penalties under the recently accepted CAISO Tariff Amendment No. 55.

### **CAISO Answer**

94. The CAISO contends that it clarified at length the CAISO's interpretation of tariff section 5.11.6 regarding self-committed units. The CAISO states that its proposal benefits suppliers by allowing the CAISO to grant a waiver for a unit self-committed in the day-ahead timeframe, where before the unit owner could neither request nor the CAISO grant such a waiver.

### **Commission Determination**

95. We find that the CAISO's proposal to allow scheduling coordinators to request waiver for continued operations during self-commitment periods, and allow the CAISO to grant a waiver if the unit is not required to operate in real-time, to be just and reasonable. However, our review of the proposal indicates that if a waiver is denied by the CAISO, it should be required to compensate a generator for the minimum load costs associated with being available to meet local or system-wide reliability. We also agree with Duke Energy and Mirant that the CAISO's concern that generators will "submit meaningless Day-Ahead Energy Schedules to maximize the likelihood that the unit's

waiver will be denied”<sup>52</sup> is speculative and such behaviors may be subject to penalties under the recently accepted ISO Tariff Amendment No. 55. Accordingly, we direct the CAISO to submit a compliance filing that would reflect the generator’s right to compensation for minimum load costs when a request for waiver is denied by the CAISO.

## **5. Moving a Unit to Dispatchable Minimum Load**

### **CAISO Proposal**

96. The CAISO states that when a unit provides ancillary services, it must operate at a level such that it can immediately respond to real-time dispatch instructions for increased output. According to the CAISO, a steam turbine generating unit typically has an operating level at which the unit can operate stably but cannot immediately respond to real-time dispatch instructions. In certain instances, the CAISO may need a unit operating at the higher responsive level, while at other times it may only need the unit operating at the lower unresponsive minimum level. Currently, if the CAISO requires a unit to be operating at the higher level, it instructs the unit to that level according to its bid and pays it according to that bid, even if the bid must be taken out-of-sequence.

97. The CAISO proposes that, when it requires a unit to be operating at the higher responsive level, the CAISO move the unit to that level and pay it the greater of its costs or the market clearing price for the range between its lowest stable minimum load and the higher operating point. The CAISO’s proposal to pay MLCC up to Pmin (low or manual minimum load) and then to pay the greater of cost or the market clearing price up to the higher (dispatchable) minimum load, would be in effect until the Phase 1B modifications take effect.

### **Comments and Protests**

98. IEP states that it does not oppose the CAISO’s use of alternative minimum load points to enhance the reliability the capacity can provide, provided these points are pre-defined, and payments are fully compensatory. However, IEP contends that the proposed language is not sufficiently clear, and asks that the CAISO modify its proposal to provide further clarity in order to avoid future disputes and assure that units’ costs are fully recovered.

99. Duke argues that the Commission should reject the CAISO’s proposal to pay the greater of a must-offer generating unit’s cost or the market clearing price when it

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<sup>52</sup> CAISO Transmittal Letter at 20.

dispatches the unit from its minimum load point to a higher responsive level out-of-sequence. Duke believes that the CAISO's proposal would allow it to dispatch substantial quantities of energy from must-offer generating units, out-of-sequence, with no recovery of fixed costs. Duke asserts that if the unit is dispatched, out-of-sequence for local reliability, the unit should be paid its bid, subject to Automatic Price Mitigation.

### **CAISO Answer**

100. In response to Duke, the CAISO states that until Phase 1B is put into effect, a unit will already be receiving a substantial payment towards its fixed costs through the Uninstructed Imbalance Energy payment, which is paid in addition to minimum load Costs. The CAISO believes that its proposal to pay the greater of the market clearing price or cost when dispatching a unit to its dispatchable minimum load may also provide some fixed cost recovery. The CAISO asserts that there is no reason why fixed cost recovery should be paid both through the Uninstructed Imbalance Energy payment for the minimum load amount and through an as-bid payment for the amount between manual minimum load and dispatchable minimum load.

### **Commission Determination**

101. We find the CAISO's proposal to pay the greater of the market clearing price or a unit's cost when dispatching a unit to its dispatchable minimum load appropriate. The CAISO's proposal gives a generator that has been dispatched to a higher response level greater assurance of cost recovery. Therefore, generators are more apt to respond to the CAISO instructions when needed.

## **6. Transparency Issues**

### **CAISO Proposal**

102. The CAISO states that, during the stakeholder process, many participants raised concerns about the lack of transparency regarding must-offer related processes. The CAISO states that it agreed to post an operating procedure explaining the process pursuant to which the CAISO determines its capacity procurement target. Likewise, the CAISO has agreed to publish on its OASIS website, beginning in early July 2004, for each hour, the total number of units, total MW of minimum load, total MW capacity, and total minimum load costs for units whose waivers were revoked or denied, categorized by zone and by the reason the unit's waiver was revoked or denied. It will also publish total monthly start-up costs categorized by zone and the reason the unit's waiver was revoked or denied. The CAISO does not propose any tariff revisions to implement these changes.

### **Comments and Protests**

103. CMUA, IEP, SoCal Edison and PG&E all comment that greater transparency is needed. SoCal Edison asks the Commission to direct the CAISO to make a compliance filing on the issue of how the CAISO will provide to market participants information on its criteria for the use of Condition 2 Units for non-local reliability needs. SoCal Edison also asks the CAISO to provide information sufficient for market participants to understand the operating criteria or reliability need used by the CAISO to determine whether to deny a must-offer waiver. IEP supports the CAISO's publication regarding the size and location of resources denied a must-offer waiver, but protests that the lag time is too long and unjustified. It also suggests that, where unit-specific data is considered sensitive, the CAISO should publish aggregate zonal data. It also contends that the CAISO's proposal to undertake settlement of must-offer costs on a monthly basis rather than an hourly basis undermines transparency.

104. PG&E and WCP/Williams ask that the CAISO provide further information on how it determines its capacity procurement target, and particularly focus on the need for and how it determines the additional "margin" in its procurement formula. WCP/Williams ask that the Commission direct the CAISO to finalize its draft operating procedures related to its procurement formula (Operating Procedure M-432) and to include it in a compliance filing in this docket.

105. CMUA contends that the CAISO has not included protocols that are necessary to ensure transparency of grid operations and must-offer waiver determinations. As examples of topics in the Amendment 60 filing requiring greater transparency, it points to (1) "off-line" power flow analysis used by the CAISO to determine which units to commit for local reliability, and (2) the CAISO's method for determining the amount of capacity needed to cover demand forecast error and forced outages in its capacity procurement target. It asks that the Commission direct the CAISO to file specific operating protocols for stakeholder consideration and as part of a compliance filing.

### **CAISO Answer**

106. The CAISO states that it is committed to making information available that would assist load-serving entities (LSEs) in procuring capacity that would also meet local area reliability needs, and that such information can be used to understand the reliability needs driving the must-offer waiver denial. The CAISO states that it will finalize and re-post on its website by July 12, 2004 Operating Procedure M-432 relating to capacity procurement. In response to IEP, the CAISO states that the 30-day lag time is necessary

because a shorter posting time may encourage market participants that could exercise market power based on their location relative to a particular constraint. Further, in response to PG&E, the CAISO states that the “margin” described in the Amendment 60 filing is based on operating experience and current conditions, not a formula.

### **Commission Determination**

107. We are satisfied with the CAISO’s explanation of its efforts to provide additional information to market participants related to the must-offer obligation, the use of Condition 2 Units, and the CAISO procurement target. However, we will require that the CAISO submit in a compliance filing its Operating Procedure M-432 related to the CAISO’s capacity procurement target.

## **7. Capacity Payment**

### **CAISO Proposal**

108. In its proposal, the CAISO acknowledges that capacity committed under the must-offer obligation has value. It further acknowledges that although capacity compensation was discussed at each must-offer stakeholder meeting, stakeholders could not reach consensus on this issue. The CAISO states that suppliers adamantly supported some form of capacity payment while LSEs adamantly opposed a capacity payment. Consequently, the CAISO states that the proposed modifications to the must-offer requirement do not allow for a capacity payment. Moreover, the CAISO indicates that it has concerns about implementing a capacity payment at this time. Specifically, the CAISO states among other things that: (1) there is a potential for unintended consequences that could result from the hasty creation and implementation of a capacity market or a new capacity payment. The CAISO contends that this type of market, if developed prior to the implementation of the MD02 redesign, would be built and operated on systems that will be scrapped when the MD02 redesigns are implemented; (2) there are some fixed cost recovery sources available for units providing capacity under the must-offer obligation;<sup>53</sup> (3) creating a capacity payment for capacity committed

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<sup>53</sup> For instance, the CAISO states that a generating unit committed under the must-offer obligation can still earn some fixed cost recovery through its energy bid if it is not the marginal supplier of energy. In addition, the CAISO states that when it commits a unit for local reliability requirements, the CAISO pays for any Energy dispatched from that unit at that unit’s bid price, dispatching that unit out-of- sequence as necessary. The CAISO also states that its proposal to eliminate rescinding minimum load cost compensation when a unit provides ancillary services and pay the greater of market clearing price or the units cost if the CAISO must instruct a unit to operate above its

(continued)

due to the must-offer waiver denials would have collateral effects on the current markets; and (4) no specific capacity is being reserved under the must-offer obligation, and the CAISO has no right to a specific amount of capacity under the must-offer obligation.

### **Comments and Protests**

109. Several Intervenors argue that it is inappropriate for the CAISO not to pay a capacity payment for the capacity committed under the must-offer obligation. Duke Energy states that the CAISO presents no compelling argument as to why must-offer generators should not continue to receive contributions to fixed costs through payments for uninstructed energy that the CAISO proposes to eliminate after the implementation of Phase 1B. Accordingly, Duke Energy argues that the Commission should grant pending rehearing request of its Order on Proposed Tariff Amendment No. 54, and direct the CAISO to modify its tariff to permit must offer generating units to continue to receive two payments for their minimum load energy: (1) start-up and minimum load costs; and (2) the uninstructed imbalance energy price, until implementation of the CAISO's residual unit commitment proposal.

110. WCP/Williams contend that the CAISO's refusal to provide capacity payments to units that are operating under the must-offer obligation is unjust and unreasonable. WCP/Williams states that the CAISO's position on this issue will perpetuate existing market distortions and is patently biased against must-offer generators. WCP/Williams state that there are a number of approaches that the CAISO could take to provide a capacity payment to generators. First, WCP/Williams state that one possible interim solution to the capacity payment issue is to accelerate the implementation of RUC. Second, they state that, at a minimum, the Commission should uphold its prior orders and require the CAISO to continue to pay the uninstructed imbalance energy price as a contribution toward fixed costs in addition to minimum load costs compensation.<sup>54</sup> Finally, WCP/Williams suggest that the CAISO rely on the ancillary services markets for procurement of capacity that is not being procured through the must-offer obligation.

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Minimum Load operating level as other ways to recover fixed costs.

<sup>54</sup> WCP/Williams contend that the CAISO surreptitiously sought to remove a must-offer generators contribution to fixed costs in Amendment 54, erroneously believing that such a payment constitutes a "double payment." They argue that the Commission did not precisely address this issue. They contend that, through the Commission's silence on this issue, the CAISO believes the Commission approved its netting proposal.

111. IEP asserts that there should be a backstop capacity payment mechanism for the capacity from the unit's minimum load level to the unit's maximum load level "reserved" by the CAISO through the must-offer waiver process, and suggests the capacity payment could be determined by a "reference" proxy determined by an independent entity. IEP contends that the proxy value must be fully compensatory and include elements such as the scarcity value of such capacity, fixed costs contribution, and risk-associated costs. Moreover, to provide incentives to LSEs to acquire resources bilaterally that will provide for reliability needs, IEP states that the CAISO should collect an administrative fee from resource-insufficient LSEs that would be allocated to the capacity that must be acquired by CAISO.

### **Commission Determination**

112. The CAISO did not file in the instant proceeding tariff sheets to incorporate a capacity payment under its tariff. Accordingly, we find the issue of whether it is reasonable to include a capacity payment and the various alternatives the CAISO may use to implement this capacity payment is not before the Commission in this proceeding. Nor have intervenors convinced us of the need to institute a section 206 investigation on this matter.

113. With respect to Duke Energy's and WCP/Williams' assertion that the CAISO should be required to continue to pay the uninstructed imbalance energy price as a contribution to fixed costs, again, we find that this is not the appropriate proceeding to address this issue. WCP/Williams currently has pending a Motion for Clarification, or, in the Alternative, Request for Rehearing on this issue in the Amendment No. 54 proceeding.<sup>55</sup> The Commission will address this issue in a subsequent order on rehearing.

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<sup>55</sup> See "Joint Motion for Clarification, or, in the Alternative, Request for Rehearing," submitted on November 21, 2003 under Docket No. ER03-1046-000. See also "Joint Protest to California Independent System Operator Corporation's Compliance Filing," submitted on December 12, 2003 under Docket No. ER03-1046-002; "Joint Comments to California Independent System Operator Corporation's Compliance Filing and Motion For Leave To File Supplemental Comments," submitted on January 6, 2004 under Docket No. EL00-95-091, *et al.*

## 8. Termination of the Must-Offer Obligation

### CAISO Proposal

114. Powerex states that the Commission should make clear that the must-offer requirement is merely a temporary process that must be eliminated as part of the CAISO's comprehensive market design. IEP urges the Commission to terminate the current must-offer obligation and direct the CAISO to enter into Short-Term Reliability Contracts to secure the capacity it requires for reliability purposes until such time as there is full implementation of MD02 and a resources adequacy requirement is in place.<sup>56</sup>

### Commission Determination

115. The Commission agrees with Powerex that the must-offer requirement should be temporary. In a June 17, 2004 Order addressing CAISO market design issues, the Commission recognized the CPUC's plan to phase in resource adequacy requirements beginning in 2005 and plans for full implementation of the resource adequacy requirement beginning on June 1, 2006 or January 1, 2008.<sup>57</sup> The Commission suggested that if the CAISO determines that the resource adequacy requirements that exist at the time its proposal goes into effect are sufficient to meet its operational needs, the resource adequacy requirements and obligations will serve to replace the existing Commission must-offer obligation.

116. With respect to IEP's proposal to terminate and replace the current must offer requirement with Short-Term Reliability Contracts, we will deny the proposal as outside the scope of this proceeding. We note that if IEP believes the current must offer obligation is unjust and unreasonable, it may initiate a section 206 proceeding under the Federal Power Act to challenge the justness and reasonableness of the current method and seek an alternative proposal.

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<sup>56</sup> We also note that Calpine supports IEP's alternative proposal.

<sup>57</sup> California Independent System Operator Corp., 107 FERC ¶ 61,274 at P 26-28.

## **9. Metered Sub-system Operators**

### **CAISO Proposal**

117. The CAISO states that the changes proposed in the Amendment No. 60 filing should not conflict with the principles of the MSS Agreement (MSSA). In its application, the CAISO offers that if MSS Operators believe that the provisions of the instant filing conflict with the MSSA, the CAISO is willing to work with those entities to address any concerns.

### **Comments and Protests**

118. NCPA reiterates its view that the CAISO proposal to exempt MSS and MSSA entities from the must-offer obligation is justified by the duties and responsibilities undertaken by MSS and MSSA Entities when they enter such agreements.

119. Silicon Valley Power (SVP) requests that the Commission direct the CAISO to clarify that either (1) MSS Operators such as SVP are exempt from the must-offer obligation or (2) certain must offer provisions proposed in the Amendment 60 filing are not appropriate in the context of MSS Operators and therefore are not applicable to MSS Operators.

120. The CAISO, in its answer, states that the MSS operators are exempt from the must-offer obligation.

### **Commission Determination**

121. MSS Operators have always been exempt from the must-offer obligation throughout the history of the must-offer obligation. The Commission believes that the CAISO's answer has alleviated the intervenors' concerns. We note, however, in conditionally accepting the provisions contained in Amendment No. 60, we do not intend to allow the CAISO to violate any provision contained in the MSS Agreement.

### **E. Effective Date**

122. The CAISO requests a July 11, 2004 effective date for all but two of the proposed tariff changes. It requests that the provisions relating to the allocation of minimum load costs to be effective ten days after notice to the market and the Commission that Phase 1B MD02 software is ready to be deployed. It further requests that the tariff provisions relating to the use of SCUC be effective ten days after notice by the CAISO.

123. With two exceptions, the proposed tariff sheets are accepted for filing, subject to modification, to become effective on July 11, 2004. As discussed above, with regard to the tariff provisions relating to the allocation of minimum load costs, we will waive the 120-day notice requirement in 18 C.F.R. § 35.3(a) to permit the proposed change to become effective ten days after CAISO notice to the market and the Commission that Phase 1B MD02 software is ready to be deployed, as requested. Further, we will make the tariff provisions relating to the use of SCUC effective ten days after notice by the CAISO.

The Commission orders:

(A) With two exceptions, the CAISO's proposed tariff revisions are hereby accepted for filing, as modified, to become effective on July 11, 2004. The CAISO's proposed tariff revisions relating to the use of SCUC are hereby accepted for filing, to become effective ten days after notice by the CAISO to the market and the Commission, as discussed in the body of this order. The CAISO's proposed tariff revisions relating to cost allocation are hereby accepted for filing, suspended for a nominal period, to become effective ten days after CAISO notice to the market and the Commission that Phase 1B MD02 software is ready to be deployed, subject to refund, as discussed in the body of this order.

(B) The CAISO is hereby directed to submit a compliance filing within 30 days of the date of this order, as discussed in the body of this order.

(C) The CAISO's Department of Market Analysis is hereby directed to monitor the dispatch of Condition 2 RMR Units for system reliability and report this information to the Commission on a quarterly basis, as discussed in the body of this order.

(D) The CAISO's Department of Market Analysis is hereby directed to file a report with the Commission by December 31, 2004, as discussed in the body of this order.

(E) Pursuant to the authority contained in and subject to the jurisdiction conferred upon the Federal Energy Regulatory Commission by section 402(a) of the Department of Energy Organization Act and by the Federal Power Act, particularly sections 205 and 206 thereof, and pursuant to the Commission's Rules of Practice and Procedure and the regulations under the Federal Power Act (18 C.F.R. Chapter I), a public hearing shall be held concerning the justness and reasonableness of the CAISO's proposed tariff revisions relating to cost allocation.

(F) A Presiding Administrative Law Judge, to be designated by the Chief Administrative Law Judge for that purpose, pursuant to 18 C.F.R. § 375.304 (2003), must convene a prehearing conference in this proceeding to be held within approximately fifteen (15) days after issuance of this order, in a hearing or conference room of the Federal Energy Regulatory Commission, 888 First Street, N.E., Washington, D.C. 20426. The prehearing conference shall be held for the purpose of establishing a procedural schedule. The presiding judge is authorized to establish procedural dates and to rule on all motions (except motions to dismiss) as provided for in the Commission's Rules of Practice and Procedure.

By the Commission.

( S E A L )

Linda Mitry,  
Acting Secretary.