

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

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

California Independent System Operator Corporation	Docket Nos. ER04-835-001 ER04-835-002 ER04-835-003
---	--

ORDER ON REHEARING AND COMPLIANCE FILING

(Issued October 29, 2004)

1. On July 8, 2004, the Commission issued an order accepting, subject to modification, the California Independent System Operator Corporation's (CAISO's) Amendment No. 60 to its open access transmission tariff (tariff), which proposed modifications to the tariff provisions related to the implementation of the temporary must-offer obligation.¹ In addition, the July 8 Order established hearing procedures regarding the allocation of must-offer costs. On August 10, 2004, as supplemented on September 2, 2004, the CAISO submitted a compliance filing as directed by the July 8 Order. In this order, the Commission accepts the CAISO's compliance filing
2. Further, intervenors seek rehearing regarding the requirement that the CAISO notify market participants of a system emergency before dispatching "Condition 2" generating units to address system reliability; the appropriate compensation for Condition 2 Units dispatched for system reliability; recovery of minimum load costs by must-offer generators that provide ancillary services; and payment of the greater of the market clearing price or a unit's costs when dispatching a unit from its dispatchable minimum load point to a higher response level. In this order, we grant in part and deny in part requests for rehearing of the July 8 Order. This order benefits customers because it allows the CAISO to operate its system reliably while also effectively managing costs.

¹ *California Independent System Operator Corp.*, 108 FERC ¶ 61,022 (2004) (July 8 Order).

Background

3. Through a series of orders issued since April 2001, the Commission has addressed the CAISO's implementation of the temporary must-offer obligation, including application and compensation issues.² In Amendment No. 60, the CAISO proposed to modify the tariff provisions that implement the must-offer obligation. According to the CAISO, the purpose of the proposed modifications was threefold: (1) to provide for a more rational and efficient process for granting or denying waivers of the must-offer obligation; (2) to modify certain payment terms and the allocation of must-offer costs in a manner more consistent with cost causation principles; and (3) to set forth clear conditions in which Condition 2 Reliability Must-Run (RMR) Units are committed outside of the RMR contract to meet system reliability requirements.

4. The July 8 Order accepted, subject to modification, the CAISO's proposed tariff revisions, and also established hearing procedures regarding the allocation of must-offer costs.

Procedural Matters

5. Timely requests for rehearing were filed in Docket ER04-835-001 by Powerex Corp. (Powerex); the California Electricity Oversight Board (CEOB); and Duke Energy North America, LLC and Duke Energy Trading and Marketing, LLC (collectively, Duke). The Sacramento Municipal Utility District (SMUD) filed a "statement in the affirmative and, in the alternative, motion for clarification."

6. Notice of the CAISO's compliance filing, Docket No. ER04-835-002, was published in the *Federal Register*, 69 Fed. Reg. 52,006, with motions to intervene and protests due before August 31, 2004. Duke filed a timely protest. On September 15, 2004, the CAISO filed an answer to Duke's protest.

7. Notice of the CAISO's supplement to its compliance filing, Docket No. ER04-835-003, was published in the *Federal Register*, 69 Fed. Reg. 56,211, with motions to intervene and protests due before September 23, 2004. Powerex filed a timely protest and the California Department of Water Resources State Water Project (SWP) filed a protest one day late.

² See July 8 Order, 108 FERC ¶ 61,022 at P 3-8 for a detailed description of the evolution of the must-offer obligation.

Discussion

I. Requests for Rehearing

A. Procedural Issues

8. SMUD filed what it characterizes as a “statement in the affirmative,” setting forth its understanding of a statement in the July 8 Order, and asking the Commission to affirm its understanding. It then states that, “in the absence of a response in the alternative by the Commission or the CAISO, SMUD will consider such silence as an affirmation of SMUD’s understanding . . .”³ SMUD further states that, if the CAISO files an opposition to the statement in the affirmative, SMUD requests that the Commission grant clarification.

9. SMUD is mistaken in its belief that, in the absence of a Commission response, it may assume that such silence as an affirmation of SMUD’s position. The Commission will not tolerate such attempts at “self-help.” Further, since the CAISO has not responded to SMUD’s pleading, its request for clarification is moot. Accordingly, having neither a request for rehearing nor clarification properly before us, we reject SMUD’s pleading.

B. Dispatch of Condition 2 Units for System Reliability

1. Notification of System Emergency

10. 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. In its Amendment No. 60 filing, the CAISO proposed to modify tariff section 5.6.1, relating to system emergencies, 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.” The July 8 Order accepted the CAISO’s proposal to dispatch Condition 2 Units for system emergencies, with the further modification that the CAISO first notify market participants that a system emergency is imminent or threatened, pursuant to the existing terms of tariff section 5.6.1.⁴

11. The CEOB seeks rehearing of the provision of the July 8 Order that grants the CAISO authority to dispatch Condition 2 Units for imminent or threatened system emergencies. The CEOB claims that there may be system reliability issues that do not

³ SMUD motion at 1.

⁴ July 8 Order, 108 FERC ¶ 61,022 at P 42-43.

rise to the level of a system emergency but still warrant the dispatch of Condition 2 Units. It contends that, in order to have the necessary flexibility, the CAISO should have the authority to dispatch Condition 2 Units prior to the declaration of a system emergency. Further, the CEOB contends that notification to market participants is not warranted. The CEOB argues that, by requiring the CAISO to notify market participants of imminent system emergencies, market participants will be given the opportunity to exercise market power at a time when the grid is most vulnerable.

Commission Determination

12. The CAISO proposed to modify section 5.6.1, which explicitly relates to system emergencies, to provide authority for the CAISO to dispatch Condition 2 Units for system-wide reliability needs. This is appropriate because the CAISO's authority to dispatch RMR units is limited by the RMR contracts. Moreover, the CAISO itself proposed that it have the ability to call on Condition 2 Units only where there is a "threatened System Emergency."

13. Regarding, the CEOB claims that the notice requirement could result in the exercise of market power, the Commission considers claims regarding the possible exercise of market power very seriously. However, in this case, the July 8 Order merely directed the CAISO to comply with the pre-existing notification requirement of its tariff. Further, the ability for withholding in times of emergency is minimized since the CAISO has the ability to call on available resources through the must-offer obligation, and on Condition 2 Units as well, when needed to meet load. Because the CEOB has proffered no arguments that convince us we have erred, we will deny the CEOB's request for rehearing on this point.

2. Compensation of Condition 2 Units

14. The July 8 Order rejected the CAISO's proposal to compensate Condition 2 Unit owners for system reliability service in the same manner it would if dispatched for local reliability.⁵ It explained that, by relying on Condition 2 Units for system-wide reliability, the CAISO will depress the real-time market clearing price and, thus not reflect actual scarcity. Rather, the July 8 Order directed the CAISO to compensate Condition 2 Units that are dispatched for system reliability at the rate set forth in Schedule G of the RMR

⁵ *Id.* at P 48.

Contract.⁶ It explained that payment based on the Schedule G rate will enable RMR owners to be compensated for the additional costs that will result from being subject to system-wide Condition 2 dispatches. Further, compensation based on the Schedule G rate will provide a disincentive to the CAISO to rely excessively upon Condition 2 Units for system-wide dispatches.

15. The CEOB argues that it is inappropriate to apply the Schedule G rate to compensate Condition 2 Units dispatched for system reliability. It contends that the Schedule G rate acts as a penalty for the CAISO's underestimation of the scheduled need for Condition 2 Units. However, CEOB state that since the issue here is the compensation of Condition 2 Units for dispatches outside of the RMR contract, there is no issue of underestimation of service and, hence, the penalty rate should not apply. As an alternative, it proposes to compensate Condition 2 Units based on Schedule F of the RMR contract with either a 10 percent or 20 percent adder (*e.g.*, the Schedule F rate multiplied by 1.1 or 1.2).

Commission Determination.

16. The terms of the *pro forma* RMR contract were developed through a prolonged and, by all accounts, difficult negotiation process. Service limits for the dispatch of each RMR Condition 2 Unit for local reliability needs under the terms of the *pro forma* contract were determined with the understanding that any dispatch outside these negotiated service limits would be compensated at a certain rate, specified in Schedule G. Accordingly, the Commission believes that it is appropriate that a Unit dispatched for system reliability should be paid at the same rate as that used for other dispatches outside the service limits. The CEOB's request for rehearing of this issue is therefore denied.

⁶ *Id.* at P 49. 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.

C. The Must-Offer Obligation

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

17. The July 8 Order explained that, under the existing CAISO tariff, 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 for minimum load cost compensation (MLCC) for such hours.⁷ To help overcome chronic shortages on ancillary services bids, the CAISO proposed 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. The Commission accepted the CAISO's proposal and found that a non-rescindable minimum load cost payment would "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."⁸

18. Powerex claims that that the Commission's acceptance of the CAISO's proposal is short-sighted. According to Powerex, although the CAISO's proposal provides an incentive for must-offer generators who are receiving MLCC to offer into the ancillary services market, generators not receiving MLCC will no longer find it profitable to sell into an ancillary services market that is depressed by uneconomic units that are being subsidized to run for reliability purposes.⁹ Powerex contends that the more capacity that is committed through MLCC, the more distorted the price signal becomes. Therefore, it argues, the Commission should not have accepted CAISO's proposal.

19. Powerex also claims that the price-depressing effects of the CAISO's proposal are exacerbated by the fact that system resources imports are not provided the opportunity to compete to provide imbalance energy similar to that provided by must-offer units. It advocates the implementation of an interim mechanism to allow system resources to compete to provide capacity and energy that must-offer units currently provide to meet the CAISO control-area wide needs.¹⁰ Powerex contends that an effective market alternative will lead to efficient market outcomes and behaviors.

⁷ *Id.* at P 82.

⁸ *Id.* at P 88.

⁹ *See* Powerex at 3-4.

¹⁰ Powerex states that, while it raised this issue in its protest of the CAISO's May 11, 2004 Amendment No. 60 filing, the Commission did not address it in the July 8 Order.

Commission Determination

20. We will deny Powerex's rehearing request to rescind the minimum load cost payment when a unit provides ancillary services. The Commission continues to believe that the CAISO's proposed non-rescindable minimum load costs payment is reasonable because it: (1) addresses the chronic shortage of bids in the ancillary services market; (2) provides must-offer generators an incentive to bid into ancillary services market; and (3) provides must-offer generators a greater assurance to recover start-up and minimum load costs. We also note that Powerex provides no evidence that the ancillary services market will not benefit from this proposal. Rather, Powerex speculates that the proposed compensation to must-offer units will depress ancillary services prices to the point where generators that were previously transacting in the day ahead ancillary services market will find it no longer profitable to sell into this market but, instead, will seek must-offer waiver denial and minimum load costs. We acknowledge the fact that it is possible ancillary services prices may decrease due in part to more competition. However, we believe the proposal will continue to provide adequate incentives to market participants that previous transacted in the day ahead ancillary services market.

21. With regard to Powerex's suggestion that the Commission direct the CAISO to allow system resources to provide the capacity and energy that must offer generators currently provide to meet CAISO control area wide needs, we find that Powerex's alternative proposal is outside the scope of this proceeding because the proposal does not respond to the specific modifications submitted by the CAISO in its May 11 filing. Therefore, we deny its proposal on rehearing.

2. Moving a Unit to Dispatchable Minimum Load

22. The July 8 Order accepted the CAISO's proposal to pay the greater of the market clearing price or a unit's incremental costs when dispatching a unit from its dispatchable minimum load point to a higher response level so that it can respond to real-time dispatch instructions to provide ancillary services.¹¹ The order explained that the CAISO's proposal gives generators that have been dispatched to a higher response level a greater assurance of cost recovery and, thus, generators will be more apt to respond to the CAISO's instructions when needed.

23. On rehearing, Duke argues that the Commission erred because the CAISO's proposal does not give generators greater assurance of cost recovery. Duke contends that a must-offer generator that is paid only the incremental cost of generating the additional energy between minimum load and the higher response level will not recover its fixed

¹¹ July 8 Order, 108 FERC ¶ 61,022 at P 100.

costs. Nor, according to Duke, can a generator that is dispatched out-of-sequence recover any fixed costs through infra-marginal revenues. Thus, it argues that the CAISO's proposal compels generators to provide a local reliability service at cost, in conflict with Commission precedent¹² and discriminate against must-offer generators that do not have an RMR contract that provides a return on fixed costs.

24. Duke also claims that the CAISO's proposal does not provide assurance that the CAISO will move must-offer generators to higher operating points only when needed to respond to subsequent dispatch instructions. It is concerned that the proposal could provide the CAISO with an incentive to move units to higher operating points to avoid dispatching additional bids and, in the process, lower the market clearing price. Duke urges the Commission to reinstate the existing tariff provision, which pays a generator instructed to operate at a higher response point according to its bid and subject to Automatic Price Mitigation. According to Duke, the existing provision more fairly compensates must-offer generators and ensures that the CAISO does not misuse out-of-sequence dispatches to influence market outcomes. Alternatively, it asks that the Commission require the CAISO to revise its formula for calculating the cost of incremental energy to include the price of gas and intrastate transportation costs pursuant to a schedule set forth in the RMR contract and municipal use fees.

Commission Determination

25. We continue to believe that the CAISO's proposal to pay must-offer generators the greater of the market clearing price or cost when dispatched to a higher response level is reasonable. It is our understanding that the physical characteristics of certain units will require them to run at a higher operating level to respond to real-time dispatchable instructions for ancillary services.¹³ The Commission does not consider this requirement to operate at a higher level to be a significant change in the status of the unit, but rather as the CAISO states, its a prerequisite to allow for possible availability of the unit for ancillary services in real-time.¹⁴ Contrary to Duke's argument, we find that the CAISO's proposal may provide generators with some contribution to fixed costs when required to

¹² *Citing PJM Interconnection, L.L.C.*, 107 FERC ¶ 61,112 at P 40 (2004) (must-run units need to be compensated at a level that adequately covers their fixed and variable costs).

¹³ For example, in Amendment No. 60 filing, the CAISO indicates that a steam turbine generating unit may have an operating level where the unit can operate stably but cannot immediately respond to real-time dispatch instructions to provide ancillary services.

¹⁴ See P. 29 of the CAISO's May 11, 2004, transmittal letter in Docket No. ER04-835-000.

ramp up to the higher response level. Particularly, if the market clearing price for imbalance energy is greater than the incremental costs of operating at the higher response level. We also note that if a unit is subsequently dispatched for ancillary services out of sequence, the unit will be eligible to recover its bid cost for ancillary service, which also should provide some contribution to fixed costs. As a result, we find that the CAISO's proposal is reasonable and, therefore, deny Duke's request for rehearing on this issue.

26. With respect to Duke's contention that the same formula for minimum load cost should be applied to units operating above minimum load, we will grant Duke's request for rehearing and require the CAISO to modify the ISO tariff section 5.11.6.1.2.1 (Operating Must-Offer Generating Units above Minimum Load) to reflect the same compensation level as section 5.11.6.1.2 (Minimum Load Cost). We note that whether a supplier is running at minimum load or a higher than minimum load level, the supplier will incur the same costs in order to respond to a must-offer dispatch by the CAISO. For instance, intrastate transportation costs and municipal use fees are legitimate cost recovery components that suppliers will incur at either operating level and therefore, should be allowed to recover such costs. As a result, we find it appropriate and consistent for the CAISO to modify its tariff to reflect the same cost compensation level as accepted in the July 8 Order.¹⁵

27. We find Duke's allegation that the CAISO may have the incentive to move units to higher operating points to avoid dispatching additional bids and, in the process, lower the market clearing price is purely speculative. We believe that the CAISO's commitment to publish must-offer related processes on its OASIS website¹⁶ will provide Duke and other market participant's greater transparency to understand the reason a unit's waiver was revoked, denied or dispatched to an operating level above minimum load. Therefore, we deny rehearing on this point.

II. Compliance Filing

A. Procedural Issues

28. Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(2) (2004), prohibits an answer to a protest or answer unless otherwise ordered by the decisional authority. We will accept the CAISO's answer to Duke's protest because it has provided information that assisted us in our decision-making process.

¹⁵ July 8 Order, 108 FERC ¶ 61,022 at P 80-81.

¹⁶ *Id.* at P 101.

29. SWP filed a motion to submit a protest one day late. SWP had previously filed a timely motion to intervene. Given the absence of undue delay or prejudice, we find good cause to accept SWP's late filing.

B. Netting of *Ex Post* Revenues Against Minimum Load Costs

30. Duke protests that the CAISO's proposed tariff sheets¹⁷ include language regarding the netting of *ex post* revenues against minimum load costs; which the Commission had explicitly rejected in an August 5, 2004 Order.¹⁸ Duke asks that the Commission reject the revised tariff sheets and direct the CAISO to delete the netting requirement as required by the earlier Commission order.

31. The CAISO responds that it made a separate filing to comply with the August 5 Order. However, the CAISO contends that separate proceedings require separate compliance filings and, therefore, it was not required to comply with a directive from the Amendment No. 54 docket in the Amendment No. 60 compliance proceeding.

Commission Determination

32. In its transmittal letter, the CAISO indicates that Attachments C and D to the ISO's compliance filing, which contain the tariff language at issue, contain "post-Amendment No. 54 CAISO tariff sheets reflecting the modifications to the tariff sections" directed by the July 8 Order. The CAISO submitted its Amendment No. 60 compliance filing on August 10, 2004, and later submitted an Amendment No. 54 compliance filing on September 7, 2004 with the modifications to tariff section 5.11.6.1.1, noted by Duke. Our review of the proposed tariff sheets intended to comply with the Commission's July 8 Order indicates that they are in compliance with the directives of that order.

33. The Commission will review the CAISO's Amendment No. 54 compliance filing in a separate proceeding and there is no need for the CAISO to submit revised tariff sheets in the instant proceeding.

¹⁷ See Attachments C and D to the ISO compliance filing, section 5.11.6.1.1.

¹⁸ Citing *California Independent System Operator Corp.*, 108 FERC ¶ 61,142 (2004) (Order on Rehearing and Compliance on Proposed Tariff Amendment No. 54) (August 5 Order).

C. Supplemental Filing

34. The CAISO submitted a supplemental filing to its compliance filing to further conform to the Commission's July 8 Order.¹⁹ Specifically, the CAISO finalized and filed its revised Operating Procedure M-432 relating to capacity procurement and the process for committing generating units through the must-offer obligation.

35. Powerex states that the Commission should require the CAISO to consider additional factors in its Net Short energy calculation for committing generating units through the must offer obligation.²⁰ Powerex contends that the Net Short calculation should include system imports provided in real-time and out-of-market capacity, which includes hydro generation, muni generation and wind generation. Specifically, Powerex argues that the net scheduled interchange component of the Net Short calculation should be based on the average of system imports.²¹ Powerex also argues that the CAISO should include in its Net Short calculation an historical average estimate of in-state hydro generation and hydro production by season, not just the scheduled hydro generation bid in as ancillary services capacity. Powerex states that it is unreasonable for the CAISO to ignore the significant amount of hydro generation and muni generation that has been historically supplied to the CAISO control area.

36. Powerex and SWP state that it appears the CAISO is using must-offer generators to manage inter-zonal congestion rather than its existing congestion management procedure. SWP claims the use of must-offer generation emerged in testimony and discovery in the cost allocation phase of this proceeding. Powerex contends that this misuse prevents scheduling coordinators from competing to provide inter-zonal congestion relief based on their adjustment bids. As a result, the Commission should not allow the CAISO to use the must-offer obligation to manage day-ahead inter-zonal congestion but, rather, the CAISO should use existing market mechanisms to address its

¹⁹ July 8 Order, 108 FERC ¶ 61,022 at P 106.

²⁰ The CAISO's Operating Procedure describes the calculation of Net Short energy as the (Demand Forecast) + (Capacity Margin) – (Average HA Net Scheduled Interchange) – (Average HA Generation from non-Must Offer units) – (Self Scheduled Must Offer Capacity) – (Must Offer Capacity Required for Local Reliability).

²¹ According to Powerex, the CAISO should calculate both a weekday and weekend average. For the weekday and weekend day, Powerex contends that system imports should be based on the average of the previous three weekdays and weekend days.

needs. Powerex notes that if the Commission finds the must-offer obligation can be used to manage inter-zonal congestion, the CAISO should be required to clarify that all market options are considered (*e.g.*, adjustment bids) before must-offer units are dispatched to relieve congestion.

37. SWP contends that the Operating Procedure does not provide sufficient information to enable market participants to understand how and why non-market, reliability-related costs are incurred or even allocated. SWP states that the supplemental filing is insufficient because it raises some of the same questions requested in discovery. SWP contends that the Commission should require full transparency of the must-offer process to determine the reasonableness of minimum load costs incurred.

Commission Determination

38. The Commission finds that the CAISO has complied with the directive of the July 8 Order by submitting Operating Procedures that explains the CAISO's capacity procurement target and when it commits generating units through the must-offer obligation. Our review indicates that the CAISO has adequately provided market participants with detailed information to further understand the reliability needs driving the must-offer obligation process. With respect to Powerex's position that system imports and out-of-market capacity should be included in the CAISO's Net Short energy calculation, we find the CAISO's method of calculation is reasonable. It is our understanding that the CAISO does not include hydro generation and wind generation in its day-ahead estimates because these generators are considered unreliable resources that have no control of their generating output. As a result, the CAISO cannot reliably depend on whether the capacity will be made available in real-time and, therefore, does not factor these resources into their calculations of Net Short energy.

39. We note that the allegations of utilizing must-offer generators to manage inter-zonal congestion rather than the existing congestion management procedure are outside the scope of this proceeding.

The Commission orders:

(A) The Commission hereby grants in part and denies in part the requests for rehearing, as discussed in the body of this order.

(B) The CAISO is directed to revise its tariff, within 30 days of the date of this order, as discussed in the body of this order.

(C) The Commission hereby accepts the California Independent System Operator Corporation's compliance filing, as discussed in the body of this order.

By the Commission.

(S E A L)

Linda Mitry,
Acting Secretary.