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METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

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To: Board of Directors (Water Planning and Resources Committee --Information)
(Electric Industry Restructuring Ad Hoc Committee --
Information)

From: General Manager
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Subject: Report on recent Federal Energy Regulatory Commission decisions regarding
proposals for restructuring of California's electric utility industry

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RECOMMENDATION:

For information only.

EXECUTIVE SUMMARY:

Late last year the Federal Energy Regulatory Commission (FERC) issued two orders on the applications filed by California's investor-owned utilities (IOUs) for the establishment of an independent system operator (ISO), and a power exchange (PX). In the first order, the Commission gave preliminary approval for the IOUs' proposed framework for the PX and the ISO, and provided guidance for the development of major issues regarding the PX and ISO to be provided in a subsequent, detailed filing due March 31, 1997. Additionally, the Commission found that the Oversight Board created by AB 1890, the electric restructuring bill unanimously passed by the California legislature last year, improperly infringed upon the Commission's jurisdiction under the doctrine of federal pre-emption. In the second order, FERC found that the IOUs indeed had market power (significant ability to manipulate the market price) as argued by stakeholders such as Metropolitan, and directed the IOUs to submit detailed proposals for mitigation of such power. The ISO and PX are currently anticipated to commence operation on January 1, 1998.

DETAILED REPORT:

On November 26 and December 18, 1996, the Federal Energy Regulatory Commission (FERC) issued orders regarding the applications jointly submitted by Pacific Gas and Electric Company (PG&E), Southern California Edison Company (Edison), and San Diego Gas & Electric Company (SDG&E) (collectively, the IOUs or the Companies) to establish an independent system operator (ISO) and a power exchange (PX). As this Board has been advised in prior board letters, last April the Companies filed joint applications at FERC for transfer of operational control of their transmission facilities to an ISO to ensure "independent" operation of, and non-discriminatory access to, the power transmission grid within California and beyond. They also proposed establishment of a PX to conduct an auction for the spot electric energy market on an hour-ahead and day-ahead basis, to facilitate efficient trading of power generation. Additionally, they submitted a third filing which sought the Commission's determination that certain identified facilities were transmission facilities to be transferred to the operational control of the ISO. The Companies' proposals for an ISO and PX were made pursuant to a December 1995 order of the California Public Utilities Commission (CPUC), which also mandated direct access for IOU retail customers and allowed IOU recovery of assets rendered uneconomic in the transition to a competitive retail market, among other things. The CPUC ordered that the industry commence operation in accordance with its decision by January 1, 1998, which the California legislature reaffirmed in AB 1890.

The Commission approved on a preliminary basis the Companies' proposed overall framework, as supplemented and amended by AB 1890, for conveying operational control of certain facilities to an ISO as well as ultimately granting authority to sell electric energy at market-based rates using a PX. Metropolitan, Los Angeles, Burbank, Pasadena, the State Water Contractors, Inc., and the California Department of Water Resources (CDWR) were among numerous entities which filed motions to intervene. All of the motions to intervene were granted. Since the PX and ISO applications filed by the Companies last April lacked detail, FERC's order also provided guidance for the development of major issues, and identified certain areas that the Companies, and in some cases, the ISO, are directed to address in detailed "Phase II" filings which must be submitted by March 31, 1997. The Phase II filing will contain the proposed tariffs, rules, protocols, and contracts for operation of the ISO and PX. Those issues of specific concern to Metropolitan, and other major issues, are discussed below.

AB 1890 provided for the creation of an Oversight Board, which was intended to appoint the members of the ISO and PX Governing Boards, and to hear appeals from decisions of the ISO Governing Board. Additionally, AB 1890 specified that members of the Governing Board must be California residents. While FERC acknowledged California's achievement in being the first state to enact a comprehensive restructuring plan and indicated its intent to give "great weight to the views expressed in the California legislation", it found that AB 1890's creation of a permanent role for the Oversight Board was pre-empted under the Federal Power Act because it conflicted with FERC's exclusive obligations. The Commission therefore limited the Oversight Board to merely serving a start-up function in appointing the initial members of the PX and ISO Governing Boards, subject to FERC approval, and did not allow the Oversight Board to hear appeals of the ISO Governing Board decisions. Additionally, the Commission found AB 1890's California residency requirement for ISO and PX Governing Board membership was unduly discriminatory to non-California stakeholders.

FERC directed the ISO to submit Bylaws which would, among other things, discuss governance. The Commission stated two "overriding principles" for the voting structure of the ISO and PX: (1) no class should have the ability to block or veto an action, and (2) no two classes should be able to form a sufficient majority to make decisions. While the stakeholders have to date expended considerable effort in trying to reach a consensus on representation on the Governing Board, they have not been successful. However, it appears that each of the stakeholder classes identified in AB 1890 will have at least one representative on the respective Boards. The IOUs and the California Municipal Utility Association (CMUA) will forward different proposals to the Governor and/or the Oversight Board; unlike the IOUs' proposal, the CMUA will recommend that the public power transmission owner class be split into municipal and other publicly owned utilities that provide retail service, and governmental entities, which includes CDWR, Metropolitan, the Western Area Power Administration, and the City and County of San Francisco. If CMUA's proposal is accepted, Metropolitan will have a much better opportunity to obtain direct representation of CDWR's and its interests.

One of the issues of most importance to Metropolitan is the treatment of existing contracts once the ISO commences operation. FERC directed the Companies to file a complete list of all contracts, and explain how the ISO will accommodate existing contract obligations and how it will reconcile conflicting protocols and practices. In particular, FERC requested that the Phase II filing discuss how existing firm entitlement will be handled where transmission congestion occurs, and what priority such entitlement will have when compared with other energy scheduled through the PX and ISO. Although the municipal utilities and the IOUs have extensively discussed proposed principles for treatment of existing contracts, to date they have been unable to reach agreement. Metropolitan's position has been guided by your Board's legislative policy principles to protect existing contracts and avoid cost-shifting.

On transmission pricing, although FERC gave conditional and preliminary approval of the Companies' proposal for a utility specific transmission access fee, it also directed the Companies to provide complete cost allocation, cost-of-service and rate design information, and clarified that stakeholders have the right to challenge the proposal once such detailed information is submitted. While FERC also gave tentative acceptance of the IOUs' congestion pricing proposal, it also required the Companies to demonstrate that market power in the energy market can be mitigated, and that the proposal is consistent with FERC's transmission pricing policy principles. Finally, and in response to stakeholder concerns, including those raised by Metropolitan, the Commission directed that the ISO have a more significant role in transmission expansion decisions than that proposed by the IOUs.

On December 18, 1996 FERC issued an order regarding market power analyses submitted to the Commission by the Companies, and addressing corresponding concerns raised by stakeholders, including Metropolitan. Under prior FERC decisions, no entity may sell energy at market based rates (such as that proposed to be sold by the Companies through the PX) unless such entity can demonstrate an absence of market power (significant ability to manipulate the market price). In sum, the Commission agreed with the CPUC that the Companies indeed have market power, found their

mitigation proposals and their market power analyses deficient, and directed the Companies to address specific issues, the most important of which are discussed below.

The Commission agreed with Metropolitan in concluding that the studies contained incorrect assumptions in: (1) including more capacity than appears reasonable given existing available transmission capacity; (2) overstating the operating limits of various transmission lines by failing to consider different generation and load conditions; (3) failing to consider conditions beyond those based on historical data; and (4) inappropriately expanding the relevant geographic market. Each of the foregoing understated the Companies' apparent market power. FERC also found that the Companies' mitigation plans lacked specificity, and directed the Companies to provide detailed information regarding their proposed implementation.

FERC generally gave approval to the bidding procedure and utility specific transmission access fee proposed by the Companies and established in AB 1890 for the first two years of ISO operation. However, in response to issues raised by Metropolitan and a number of other intervenors, FERC noted a number of important concerns, and directed the Companies to provide detailed justification for their proposed treatment of (reliability) must-run and (regulatory) must-take resources. In particular, the Commission directed that the ISO, and not the Companies, determine which generating units are truly must-run, and when they must be scheduled and dispatched.

Finally, with respect to ancillary services (services required to ensure the reliability of the transmission grid), the Commission: directed that the cost of all ancillary services be "unbundled" or separated from the cost of energy; required that the Phase II filing address the feasibility of and operating guidelines for transmission users' "self-providing" such services; and required that further information be provided regarding the interplay between the ISO and the PX with respect to ancillary services. Significantly, FERC specifically recognized a point advanced by Metropolitan and CDWR, that "Interruptible load may sometimes be an efficient and effective substitute for supplemental operating reserves." Since both the Colorado River and California Aqueducts are capable of dropping significant amounts of load when required for system reliability, we hope to obtain additional recognition of, and economic credit for, this important benefit to the transmission grid.

Metropolitan staff anticipates receipt of the draft Phase II filing on or about February 12, 1997 and comments are due to the applicants on March 5, 1997. Our staff has been actively involved in attending and participating in meetings of the definition teams, steering committee, trust advisory committee, filing review group, and other related meetings to ensure our interests are heard and, to the extent possible, protected as the filing is developed by the IOUs. We will further report to your Board once we have had the opportunity to analyze the draft filing.