

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION
Pacific Gas And Electric Company,)
San Diego Gas & Electric Company) Docket No. ER96-1663-000
and Southern California Edison Co.)
)

SUPPLEMENTAL COMMENTS OF THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA I. INTRODUCTION

On April 29, 1996, Pacific Gas and Electric Company ("PG&E"), San Diego Gas & Electric Company ("SDG&E"), and Southern California Edison Company ("Edison") ("the Companies" or "applicants") filed before the Federal Energy Regulatory Commission ("FERC") a Joint Application for Authority to Sell Electric Energy at Market-Based Rates Using a Power Exchange ("application"). The application describes the way prices will be determined for sales through the Power Exchange ("PX") and the structure and governance of the PX. SDG&E and Edison filed a Supplement to the market power showing in the application on May 29, 1996. On July 19, 1996, PG&E filed a PG&E-specific analysis of market power issues.

On June 13, 1996, the Public Utilities Commission of the State of California ("CPUC") intervened in this proceeding and represented to the FERC that the CPUC would submit our comments in early August, 1996, after receiving comments from the California parties on the Companies' application in this docket.

Having now reviewed the parties' comments, the CPUC submits the following supplemental comments regarding the Companies' application.(1)

By this application, filed pursuant to the CPUC's restructuring order in Decision 95-12- 063 (December 28, 1995) as modified in D.96-01-009 (January 10, 1996) ("Policy Decision",) PG&E, SDG&E, and Edison submit to the FERC a proposal to establish a power exchange.

II. BACKGROUND

The Policy Decision called for the creation of a transparent, visible spot market for electric generation and specified that operating control over all transmission assets be divorced from the underlying pattern of ownership and vested in the hands of an independent system operator ("ISO"). Policy Decision, mimeo at 11. The spot market was termed the Power Exchange ("PX"). Its purpose is to foster and sustain the development of a transparent spot market for the generation of electricity. The PX will have no financial interest in any source of generation, load, or in any other market participant; nor will it have any ownership ties to the ISO. The PX will forecast the loads of California customers not met by direct access contracts. The PX will function as a clearinghouse by providing a transparent auction for generation with hourly or half-hourly price signals. Policy Decision, mimeo at 12.

The PX will be subject to FERC jurisdiction and regulatory oversight under the Federal Power Act ("FPA"). Section 205(c) of the FPA requires "every public utility" to file with the Commission "schedules showing all rates and charges for any transmission or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services."

The applicants are public utilities subject to this requirement. Section 201(e) defines a "public utility" to be "any person who owns or operates facilities subject to the jurisdiction of the Commission" under Part II of the FPA. Under Subsection 201(b)(1), the Commission's jurisdiction under Part II of the FPA extends to "the transmission of electric energy in interstate commerce" and "sale of electric energy at wholesale in interstate commerce," as well as "all facilities for such transmission or sale of electric

energy."

Pursuant to Section 205(c), the Applicants will file with the Commission its and related contracts, rules, and protocols by which they will make wholesale sales through the services provided by the PX. Filings with the FERC also will be made for all agreements pertaining to sales made through the PX. The PX itself will also be a public utility under Section 201(e) of the FPA, subject to FERC's regulatory oversight. The PX will own and operate "facilities for [the jurisdictional] transmission or sale of electric energy": including its bidding, bid-evaluation, settlement, billing, and communications systems; its contracts with buyers and sellers of energy; and its corporate organization, accounts, and other books and records. Application at 18-20.

The CPUC Policy Decision in December, 1995 directed the applicants to work with each other and other parties to develop the ISO and PX. Applicants used the WEPEX process to obtain stakeholders' advice.

Compared to the companion application to transfer control of facilities to an Independent System Operator ("ISO"), (Docket No. EC96-19-000), the PX application has drawn relatively little comment, aside from comments on the market power showings. Based on its staff's participation in the WEPEX process and the comments on the PX both at the FERC and the CPUC, the CPUC hereby comments in Docket No. ER96-1663 on three issues: 1) governance and structure of the PX board; 2) the unbundling of spin (and other ancillary services) from the provision of energy by the PX; and 3) pricing of energy for the PX during over-generation conditions.

III. GOVERNANCE AND STRUCTURE OF THE PX

The CPUC Policy Decision called for the separation of the PX and ISO. The Policy Decision asked utilities to work with interested parties to establish the governance and structure of the PX. The proposed governance and structure for the PX in the application was the result of a large degree of consensus among the WEPEX participants.

According to the application, the PX will be organized as a not-for-profit, public-benefit California corporation. Responsibility for policy and decision-making is vested in the PX's Governing Board of 17 Directors, subject to regulatory review by the FERC. The board will delegate to a Chief Executive Office ("CEO") general responsibility for day-to-day operations. The bylaws of the PX will designate five different classes for the purpose of selecting directors. The five different classes and their allocation of the total 17 seats on the board are shown in Table 1 of the application. The purpose of selecting directors by different categories is to provide a board composition that will reflect a broad and balanced representation of the different entities expected to participate in the PX market. A two-thirds vote is required to pass most board measures. This provision, as well as the distribution of votes across the five classes, makes it difficult for a single class to block or veto action, or for two classes to form a sufficient majority to make decisions. (See application at 30.)

The CPUC is concerned with the extent to which the proposed governance and structure of the PX allow it to be truly independent from the market participants represented on its board. To ensure independence of the PX, the CPUC considered recommending strict conflict of interest standards for board members as well as for PX employees.

However, imposing conflict of interest standards on board members themselves could result in mandatory abstentions and undermine the ability of the balanced board composition to protect against any one class vetoing a decision and any two classes imp on the board. Consistent with our recommendation for the ISO, we recommend that conflict of interest standards apply to employees of the PX, to the extent they are hired from market participants during a transition period.

Given the fact that up to 11 entities with ties to generation interests can be represented on the PX board (out of 17 directors), the CPUC is concerned that these interests might have an incentive to collude in decisions that could foster high prices for the power exchange. The CPUC therefore recommends that the FERC limit the number of generation-related interests to eight seats on the board and also to separate buyers and sellers by class. We believe that this is the simplest way to prevent collusion, by removing the practical ability of generation interests to impose a decision on the rest of the board. While generally the CPUC is reluctant to interfere with decisions which resulted from the WEPEX collaborative process, there are two compelling reasons which support recommending a structural

change in PX board composition.

First, it appears that the applicants made a unilateral change in the allocation of seats from the distribution agreed to by the WEPEX participants. In the earlier allocation, sellers and buyers were represented **separately**. Combining the divergent interests of buyers and sellers into a single class, as applicants have done in Table 1 to the application, could weaken their respective representations as well as undermine the concept of balanced board composition.(2)

Second, the CPUC has a vital interest in ensuring the PX price is not subject to manipulation by generators, since under its Policy Decision the utility distribution companies will be able to pass along those costs to their ratepayers as prima facie reasonable. For these reasons, the CPUC recommends that buyers and sellers should be separated by class and that the board should be limited to a total of eight generation-related entities to remove the **ability** of generation-rela in decisions that affect pricing. CPUC further recommends that the PX board composition should be subject to a probationary period (applicants recommend that the composition be subject to change after the first three years, and then after every five years). The CPUC recommends that the board composition for the PX be reviewed after one year and then subject to change after every two years to reflect changes in market conditions. Finally, the CPUC recommends that the PX (and the ISO) board meetings be publicly noticed and open to the public. Both CPUC and FERC staff should have the opportunity to attend both the PX and ISO board meetings to observe whether the board composition of both the ISO and PX adequately protects the public interest.(3)

IV. THE PX SHOULD UNBUNDLE THE PRICE OF ENERGY FROM THE PRICE OF ANCILLARY SERVICES

As the control operator for the WEPEX grid, the ISO will have primary responsibility for assuring that enough ancillary services ("AS") are provided to ensure reliable operation. The application allows generators to "self-provide," i.e., provide their pro-rata share of some AS, rather than buy these services from the ISO (although the application does not precisely explain which services can be provided this way). The comments discuss whether the PX should be allowed to self-provide spinning reserves ("spin") by holding some of the capacity of the winning PX bidders idle.(4) The CPUC's Division of Ratepayer Advocates ("DRA") has raised two specific concerns about such an outcome: (1) that it is inefficient, because it pays all generators for spinning reserve ("spin") whether or not they actually provide it; and (2) that it is potentially anti-competitive because it results in a bundled PX price, i.e., an energy price that in fact is **acombed** energy-plus-spin price. The CPUC agrees with DRA's concerns.

The applicants do not address the bundling problem of charging for spin and energy together in one price. A bilateral-markets schedule coordinator generator providing its own spin, and wanting to buy some portion of energy only from the PX, would be forced nonetheless to pay for the PX's self-provided spin since the latter was included in the PX market-clearing price.

In fact, this price bundling frustrates one of the key underlying intentions of the Policy Decision. The Policy Decision stressed the important role the PX price will play in allowing both customers and generators to make informed choices about participating in the PX market versus the bilateral contracts market. The resulting choices of both buyers and sellers back and forth between the two markets secures for both the benefits of competition and acts as a check upon anti-competitive threats in either. However, the bundling of the PX price impedes informed decisions. As noted above, it may discourage bilateral-markerticipating in the PX. Similarly, it makes it difficult for customers to comparison-shop between the PX and the bilateral-contracts market, as bundled arrangements typically do (and often are intended to do).

The Commission in Order 888(5) explicitly calls for the unbundling of AS from the provision of transmission service; in fact, it explicitly notes that a utility "may not tie the purchase of one to the purchase of the other." Order 888, mimeo at 246. Order 888 justifies this prohibition on the grounds that customers may be able to procure generation-related AS, like spin, more economically themselves.

As noted above, the PX's bundling of spin with energy through self-provision creates exactly that problem for those that want to buy energy only or AS only from the PX. As Order 888 states,

"[u]nbundling ancillary services will promote competition and efficiency in their supply...Once they are unbundled a more competitive market may emerge to supply such services." Order 888, mimeo at 244.

The PX, by self-providing spin, and insulating that spin from competitive challenge by tying its sale price to the sale price of energy, will tend to impede the development of a competitive AS market.(6)

RECOMMENDATION: The FERC should support the clear unbundling of spin (and other AS) from the provision of energy by the PX. The FERC should encourage the PX to develop new product services (unbundled or re-bundled and transparently priced) in response to market conditions, with review of pricing by FERC after one year.

V. PRICING OF ENERGY IN THE PX DURING OVER-GENERATION CONDITIONS

A third key issue identified by the comments concerns the correct way to price energy in the Exchange when the utilities are operating under so-called "over-generation" conditions caused by the priority given "must-take" resources.

Conditions periodically exist on the California Companies' systems in which various operational and contractual constraints cause generation to exceed load during off-peak hours. Special efforts then must be made to curtail generation to accommodate these so-called "minimum-load" conditions. Analogous conditions could occur under electric restructuring. The CPUC's Policy Decision designates some of the Companies' generation as "must-take". Must-take generation consists of the IOUs' nuclear-power production, QF energy received by the IOUs, and the amount of energy they are obligated to take under existing inter-utility power-purchase agreements.

Under the proposed protocols for overgeneration, must-take generation, plus whatever energy is produced by plants on-line for reliability reasons ("reliability must-run" generation), and by hydro facilities as part of efforts to prevent water spilling over dams ("hydro-spill" generation), takes priority over other generation for serving ISO control area load. As a result, as load declines over the day and from season-to-season, the ISO's protocols call for it first to reduce PX generation schedules (other than must-run) to balance supply and demand. Non-PX (bilateral contracts) generation schedules are reduced next, if further reductions are necessary to match generation with load.

In the event load falls to or below scheduled generation (the combined must-take and related priority generation), an **over-generation condition** exists, and the ISO must begin measures to begin curtailing that generation. It is important to understand that although the must-take generation is not bid into the PX, it is deemed to be sold through the pool at the PX market-clearing price ("MCP") for purposes of determining stranded cost hours, the bid price of the marginal PX generator, i.e., the last generator scheduled, determines the MCP. But since all other PX schedules will have been reduced to zero by the time over-generation is invoked, the question arises as to what is the appropriate price to apply to the must-take and related generation (which will continue to be sold by the PX) during over-generation conditions.

The PX Application answers this question by stating that "[t]he market-clearing prices will be deemed to be zero whenever the ISO's over-generation protocols are invoked" (application at 52). The CPUC points out that it is not clear in the new market structure how often over-generation protocols will need to be invoked. For example, the PX structure allows for demand-side bids. The presence of such bids might make load sufficiently responsive to the price of energy that all of the must-take would be sold before the PX price falls to zero. In other words, market-clearing price for energy might be greater than zero and protocols for curtailing must-take generation would not have to be invoked. In the event demand response is not sufficient to clear the market the CPUC supports the applicants' suggestion that the PX price should be deemed to be zero if over-generation protocols are invoked and must-take generation has to be curtailed. However, in its review of the Phase II filings, the CPUC will examine closely the protocols for curtailing must-take generators during over-generation. In particular, it will need to assure itself that the amount of energy being produced by those resources after curtailment is reasonable in light of the minimum operating levels of those plants and the zero price assigned to that energy.

VI. CONCLUSION

The CPUC supports the application before the FERC and believes that with the changes recommended herein the PX has potential to provide the transparent spot market for the generation of electricity necessary to promote both wholesale and retail competition in the electric industry. It will, of course, be necessary to carefully review the Phase II filings to ensure that the ultimate design of the PX meets CPUC's concerns as expressed herein and in the Policy Decision and whatever changes the FERC may deem necessary.

The names and addresses of persons to whom communications in this docket should be addressed are:

Mary F. McKenzie John Scadding
Public Utilities Commission Public Utilities Commission
of the State of California of the State of California
505 Van Ness Avenue 505 Van Ness Avenue, 3-E
San Francisco, CA 94102 San Francisco, CA 94102
(415) 703-2760 (415) 703-1175

Respectfully submitted,
PETER ARTH, JR.

EDWARD W. O'NEILL

MARY F. MCKENZIE

By: /s/ MARY F. MCKENZIE

Mary F. McKenzie
505 Van Ness Avenue
San Francisco, CA 94102
(415) 703-2760

Attorneys for the Public

Utilities Commission of

August 14, 1996 the State of California

CERTIFICATE OF SERVICE

I hereby certify that I have this day caused the foregoing document to be served upon all known parties in this proceeding by mailing by first-class mail a copy thereof properly addressed to each such party.

Dated at San Francisco, California, this 14th day of August, 1996.

/s/ MARY F. MCKENZIE

Mary F. McKenzie

(1)The CPUC expects to file its additional supplemental comments with respect to the Companies' market power analyses in October, 1996.

(2) See, e.g. Comments of the Metropolitan Water District of Southern California Regarding the Joint Application of the Companies for a Declaratory Order, an ISO, and a Power Exchanges," May 24, 1996 in Docket No. ER96-1663-000.

(3)In providing observers or attending, the CPUC would not be actively supervising either entity.

(4)The result of such self-provision is to raise PX energy, since additional generation must be scheduled to replace the capacity set aside for spin. The spin in other words, is paid for through a higher energy price.

(5)In Order 888, Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services By Public Utilities; Recovery of Stranded Costs By Public Utilities and Transmitting Utilities, Docket Nos. RM95-8-000 and RM94-7-001, Order No. 888, 75 FERC [#182](#); 61,080, Fed. Reg. Vol. 61 21540, (April 24, 1996) ("Order 888").

(6)The CPUC notes that neither its recommendation for Order 888 bars the PX from providing a re-bundled product for two (or more) transparently priced products if the customer wants it.