ONE HUNDRED SEVENTH CONGRESS

Congress of the United States

House of Representatives

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February 19, 2002

MEMORANDUM FOR MEMBERS OF THE GOVERNMENT REFORM SUBCOMMITTEE ON ENERGY POLICY, NATURAL RESOURCES AND REGULATORY AFFAIRS

FROM: Doug Ose

SUBJECT: Briefing Memorandum for February 22, 2002 Hearing, "California Independent System Operator: Governance and Design of California's Electricity Market"

On Friday, February 22, 2002, at 9:00 a.m. in room 1450 of the Sacramento County Board of Supervisors Chambers, the Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs will hold a hearing to review efforts by the California Independent System Operator (CAISO) to make necessary reforms to California's electricity market. The hearing is entitled "California Independent System Operator: Governance and Design of California's Electricity Market."

Governance of the CAISO

The 1996 electricity deregulation legislation, AB 1890, set specific standards for a stakeholder board of governors for the CAISO. In the midst of the California energy crisis, the stakeholder board became unwieldy and paralyzed by self-interest. On November 1, 2000, the Federal Energy Regulatory Commission (FERC) ordered that the stakeholder board shall be replaced with a non-stakeholder board within 90 days. FERC proposed that the new board shall consist of seven voting members, including the President of the CAISO. The six other board members would be chosen by the then-current board from a pool of candidates selected by an independent consultant. The independent consultant would be selected by the then-sitting President of the CAISO. FERC required that the new board members shall include people with expertise in corporate leadership and have experience in the operation and planning of transmission systems.

After taking comments on the proposed board structure, FERC issued a December 15, 2000 order requiring that the CAISO board shall be replaced, based on the design it outlined in the November 1, 2000 order. FERC also stated that it was not reasonable for the State of California to select all of the board members; instead, the State may have a role in board selection as long as it could assure that the board remained independent.

On January 17, 2001, the California State Legislature passed and Governor Gray Davis signed AB5X, giving the Governor power to select a new board. Governor Davis promptly dissolved the CAISO stakeholder board and selected a new board which consisted of five members, three of which are State employees and one of which is a close political confidant of the Governor. None of the board members had prior experience in the operation and planning of transmission systems.

Governor Davis' action is in clear violation of FERC's November 1 and December 15, 2000 orders as well as FERC's groundbreaking December 1999 Order 2000. In Order 2000, FERC established the rules that govern Independent System Operators (ISOs) and Regional Transmission Organizations (RTOs). Order 2000 established that independence of an ISO/RTO is essential. It states:

> The [RTO] must be independent of any market participant. The [RTO] must include, as part of its demonstration of independence, a demonstration that it meets the following: (i) the [RTO], its employees, and any non-stakeholder director must not have financial interests in any market participant; (ii) the [RTO] must have a decision-making process that is independent of control by any market participant or class of participants; (iii) the [RTO] must have exclusive and independent authority under section 205 of the Federal Power Act ... to propose rates, terms, and conditions of transmission service.

On October 9, 2001, FERC commissioned an operational audit of the CAISO, which was awarded to Vantage Consulting Inc. On January 25, 2002, FERC made public the results of the audit. The audit conclusively states that the current CAISO board of governors is not independent of State control. Furthermore, it states that perceived lack of board independence is at the root of other problems in California's electricity markets. Two revealing sentences from the audit give an indication of the situation:

> *The new board of governors members were essentially drafted by the Governor for this assignment, and have no prior utility experience ... From that time on, suppliers, LSE's (Load Serving Entities) and other control areas assumed that all actions of the CAISO were directed and/or approved by the Governor's office or his appointees.*[1]

The lack of independence of the board of directors led to a myriad of other problems, most importantly of which was the breakdown of the stakeholder process. The audit states:

> *The overwhelming consensus of the other stakeholders is that the board is not independent. Their perception, whether real or not, is that the Governor has complete control over the board and thus the actions of the CAISO. This perceived lack of*

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[1] Vantage Consulting Inc., p 30.

independence is one of the primary reasons for the demise in the effectiveness of the stakeholder process.[2]

The audit recommends a process for choosing a new board. The process involves a professional search firm choosing 12 candidates that are qualified professionals without any financial or political ties to any market participant (including the State of California). Of the 12, the current board would select three and the stakeholders would select three. The President of the CAISO would serve as the seventh member of the board.

Market Design

Almost all interested parties and academics agree that the California electricity market is dysfunctional and in need of reform. In fact, very few market design reforms have taken place since the California energy crisis began in 2000. The most significant change was FERC's June 19, 2001 Market Mitigation plan, which set price caps on wholesale power sold in the Western region and placed a "must offer" requirement on generators in the region. FERC's mitigation plan, in conjunction with significant conservation by Californians, low demand due to slowing economic activity, cool weather, and adequate rainfall, resulted in lower energy costs in the Summer and Fall of 2001. FERC's Market Mitigation plan is set to expire on September 20, 2002.

To address market reform, on December 19, 2001, FERC ordered the CAISO to complete a congestion management plan and reform the day-ahead energy market by May 1, 2002. On January 8, 2002, the CAISO introduced the general outlines of its Market Design 2002.

On February 7, 2002, the CAISO board of governors declined to approve the direction of the CAISO's Market Design 2002. The board directed the CAISO to consult with and incorporate the ideas of various State entities, such as the Public Utilities Commission, the California Energy Commission, Department of Water Resources, and the California Power Authority. In a recent filing to FERC, the CAISO suggested that an extension of the May 1, 2002 deadline would be appropriate.

In January 2002, FERC hosted a technical conference to discuss standardized market design. FERC has not made any official statements as to its views on standardized market design; however, it is widely anticipated that FERC will issue guidelines on the matter this spring. The Subcommittee expects FERC Chairman Pat Wood's testimony to address this issue at the hearing.

The invited witnesses for the hearing include: Pat Wood, Chairman, FERC; Terry Winter, President and CEO, CAISO; Rod Wright, California State Assembly; Anthony Pescetti, California State Assembly; Richard Drum, Vice President General Counsel, PJM Interconnection L.L.C.; Jan Smutny-Jones, Executive Director; Independent Energy Producers; Jim Fieder, Chairman, California Municipal Utilities Association; and Walter Drabinski, President, Vantage Consulting Inc.

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[2] Vantage Consulting Inc., p 31.