

Memorandum

To: Board of Governors

From: Greg Cook, Manager, Tariff & Regulatory Policy Development
Chuck King, Vice President, Market Development & Program Management

Date: March 1, 2007

Re: *Market Initiatives Ranking Methodology*

This memorandum does not require Board action.

EXECUTIVE SUMMARY

The CAISO often receives requests from market participants for market initiatives or features that go beyond the functionalities to be implemented upon MRTU start-up. In the past, the CAISO would evaluate each project internally based on a number of factors including direction from regulators, its impact to the market and reliability, the effect on market participants as well as the resource commitments that the project required. In this way the CAISO would develop an informal "ranking" and a general timeframe for developing future market initiatives.

Last year the Board of Governors requested that a more formal process be developed to incorporate a benefit/cost/risk analysis to these potential post-MRTU-startup features and functions. This memo summarizes the transparent process that has been developed, with stakeholder input, by which the CAISO would apply a high-level cost benefit analysis using a standard set of criteria to "rank" initiatives.

The tool being introduced today embodies a more standardized and formal process to determine the relative importance of each potential market enhancement. The Board of Governors and market participants will be able to clearly see how these decisions are made and understand the rationale why, after the MRTU markets are in operation, the CAISO would be developing and implementing certain features and market enhancements before others.

It is important to note that enhancements to the MRTU markets that are clearly mandated by regulatory authorities will generally fall outside of this ranking process. For example, based on FERC's September 21, 2006 order, the CAISO is directed to implement convergence bidding within 12 months after the effective date of MRTU implementation.

The current list of potential market design enhancements, including those specific changes requested by individual stakeholders, is maintained in the CAISO's "Market Initiatives Roadmap" located on the CAISO website (refer to Attachment A for the most recent list). The implementation of this ranking process enables the CAISO, in conjunction with stakeholders, to prioritize projects so that our collective resources can be used as effectively and efficiently as possible to implement projects determined to be the most beneficial to the CAISO's customers and the market as a whole. The methodology also facilitates a more targeted discussion of stakeholders' opinions on the prioritization of issues based on the ranking criteria that have been collectively selected. Ultimately, this process has been designed to provide the CAISO Governing Board with a more detailed description of the potential costs, benefits, and risks of specific projects in the post-MRTU-startup world.

STAKEHOLDER ENGAGEMENT AND INPUT

On July 18, 2006, the CAISO held a stakeholder meeting to discuss its initial ranking criteria proposal. The CAISO received valuable input on modifications to that initial proposal to both simplify and improve the methodology. Following the stakeholder meeting, the CAISO received written comments from several stakeholders. A revised proposal was posted on the CAISO website and presented at a stakeholder meeting held on August 17, 2006. Additional stakeholder comments were gathered after that meeting and a final proposal was created. Attachment B is a matrix which includes all of the stakeholder comments and the CAISO responses.

BENEFITS AND FEASIBILITY CRITERIA

The Market Initiatives Ranking methodology seeks to balance the benefits to market participants with the costs for implementing potential market design changes. It is a stable, simplified approach to ranking proposed market initiatives. Each new initiative is evaluated against a set of criteria and ranked on its impact in each category. This methodology is targeted to apply only to projects that are initiated by stakeholders or the CAISO. In other words, initiatives that are based on a FERC order for example, are excluded from this process.

The criteria, described below, are divided into two general categories: benefit and feasibility. Each of these criteria has a weight associated with it, based on its relative importance. The weighting is a scale from 1 to 10 with 10 being the highest weight. For example, "Grid Reliability" is assigned a weight of 10 because it is a core function of the CAISO while "Process Improvement", an important but not critical criterion is ranked substantially lower as a 5. Refer to Attachment C, "CAISO Prioritization Criteria" to view each of the criteria and its respective weighting factor.

The benefit criteria are designed to capture proposed market initiatives' impact on the CAISO's strategic objectives as outlined in the 5 year business plan. Each of the five benefit criteria is described below.

1. Promotes Grid Reliability - This criterion is a core function of the CAISO and has been assigned a weight of 10.
2. Improves CAISO Market Effectiveness - Another core objective, also assigned a weight of 10. This criterion focuses on short-term energy and reserve market efficiency.
3. Promotes Efficient Infrastructure Development- This is critical for reliable operation of the grid and was assigned a weight of 10.

4. Fulfills a Stakeholder Desire - Market Initiatives with a wide range of support should be given a high priority, thus this criteria also is weighted at 10.
5. Provides a Process Improvement (to the CAISO and Market Participants) – This is less critical than the other benefit criteria and was assigned a weight of 5. It is related to cost reductions which are captured in the feasibility criteria below.

The feasibility criteria are designed to establish the impact of implementing proposed design changes on Market Participants and the CAISO. All of the criteria were assigned a weighting of 7 except for “CAISO Implementation Costs” which was given a 10 because it ultimately impacts costs for all market participants. These six criteria are listed below.

1. Market Participant Implementation Cost
2. Market Participant Impact on Systems and Resources
3. Impact on Market Participant Ongoing Operating Costs
4. CAISO Implementation Cost
5. CAISO Implementation Impact on Systems and Resources
6. Impact on CAISO Ongoing Costs

METHODOLOGY

The ranking methodology is performed in two steps:

1. High Level Prioritization – The CAISO will conduct a high level assessment of proposed market initiatives on the Market Initiatives Roadmap by applying a simplified ranking process of three benefit and two feasibility criteria. In this iteration of the ranking process, each initiative will be graded “High”, “Medium” or “Low” based on the results of their criteria ranking. Refer to Attachment D for a table describing the high level criteria. The high level benefit criteria are “Grid Reliability”, “Improving Market Efficiency”, and “Desired by Stakeholders” as described above. The high level feasibility criteria utilize two measures: “Market Participant Implementation Impact” and “CAISO Implementation Impact”. Each of these measures combines cost and resource impact feasibility criteria from the detailed list above for Market Participants and the CAISO respectively.
2. Evaluation of High Priority Initiatives - After determining the results of the high level prioritization the high priority initiatives move to second evaluation phase in which more rigorous criteria are utilized as described above (in the “Benefits and Feasibility Criteria Section”) and illustrated in Attachment C. Those proposed market initiatives that are ranked highest will be considered for the earliest implementation. Once the prioritization is complete, the CAISO will conduct an assessment of CAISO and market participant resource availability and devise an implementation plan. The implementation plan will include a timeline for future market design releases based on packages of the desired market design enhancements. Once conceptual market designs are developed, the CAISO, using more specific information based on precise design characteristics, will again apply the ranking criteria and provide this information to the Board of Governors at the time Board approval is requested.

NEXT STEPS

In the coming months, the Market Initiatives Roadmap will be updated to encompass all of the post-MRTU startup issues. Once that list is complete, consistent with our methodology the CAISO will perform an initial high level ranking of the initiatives, followed by the more detailed prioritization process. This information will be shared with stakeholders for their comment and then presented to the Board of Governors.