November 30, 2007

California ISO
151 Blue Ravine Road
Folsom, California 95630

Attention: Convergence Bidding Stakeholder Team

The California Energy Resources Scheduling division ("CERS") of the California Department of Water Resources is providing these initial comments as part of CAISO's on-going stakeholder process concerning convergence bidding.

As CAISO is well aware, CERS is party to several long-term power purchase agreements that were at issue in the Seller's Choice proceeding (FERC Docket No. 04-104). Under CAISO's original MRTU market design proposal for Inter-SC trades, the delivery point flexibility inherent in these contracts created a serious threat that California ratepayers would be exposed to large, unhedgeable congestion costs. However, through a lengthy and successful CAISO stakeholder process and a successful settlement process at FERC, CERS and its counterparties, with CAISO's assistance and cooperation, were able to settle the Seller's Choice issues largely through the "Physical Validation Rule." By developing and adopting the Physical Validation Rule for all Inter-SC trades at nodes, CAISO provided an important tool to all market participants, including CERS and its counterparties, to validate that a delivery at a generation node is actually feasible in the Day-Ahead market.

CERS understands that CAISO is now considering the implementation of convergence (or "virtual") bidding as part of MRTU Market Release 1A in order to comply with FERC orders, which require CAISO to implement convergence bidding within one year of the new MRTU market design going live. CERS also understands that CAISO is considering whether to permit convergence bidding at every node or instead limit it to the Load Aggregation Points ("LAPs") for the three Investor Owned Utilities. As discussed in the remainder of this letter, CERS encourages CAISO to implement convergence bidding only at the LAP level, at least initially, because nodal convergence bidding threatens to undermine the careful balance achieved in the Seller's Choice Settlements and in turn to once again expose California ratepayers to unhedgeable congestion costs.

Specifically, based on the materials CAISO has published to date, it appears that suppliers could use convergence bidding strategies at nodes to undermine the Physical Validation Rule. For Example, convergence bidding may allow suppliers to circumvent the Physical Validation Rule by allowing an Inter-SC trade at a node that otherwise would fail the Physical Validation Rule as infeasible. Then CERS and its scheduling agents would be obligated to settle that Inter-SC trade at the nodal price, even though
under the terms of Physical Validation Rule and the Seller’s Choice Settlements, such infeasible trades were intended to settle at the applicable EZ Gen Hub price. This change could have significant financial consequences to the California ratepayers who pay the costs of CERS’ contracts.

This concern can be avoided if CAISO follows a “go slow” approach and initially implements convergence bidding only at the LAP level. Such an approach also makes sense for a number of other reasons. Since the entire MRTU market system is complex and will be brand new, it would be beneficial to CAISO and all market participants to let the market operate for an extended period of time without the additional complexity of nodal convergence bidding. During this period, CAISO could collect and analyze nodal bid and price data to see if the suggested benefits of nodal convergence bidding are even necessary. A longer transition period would also permit CAISO time to correct any bugs in the market design and software system.

At its recent convergence bidding stakeholder meeting, CAISO indicated that it intends to continue the stakeholder process on permitting convergence bidding at nodes through next August. CERS intends to participate in this process to ensure that its Seller’s Choice Settlements, which were a linchpin to CAISO moving forward with MRTU, are not unnecessarily undermined.

At the recent stakeholder meeting, CAISO also announced that if it does permit nodal convergence bidding while the Seller’s Choice contracts remain in force, its preferred solution to the problem identified above is the implementation of bid restrictions after certain triggers are met. CERS is studying the various options CAISO put forward as solutions to the Seller’s Choice problem created by allowing convergence bidding at nodes and will provide further comment through the on-going stakeholder process.

Based on its preliminary review, CERS believes that the proposed bid restriction solution would be problematic for several reasons. First, any bid restriction must not be discriminatory under the Federal Power Act. Likewise, under the terms of at least one of the Seller’s Choice Settlements, a market rule that disadvantages one particular supplier as compared to other similarly situated market participants would jeopardize the settlement. Second, even if the bid restrictions could be targeted at certain market participants and still pass muster under the FPA and the Seller’s Choice Settlements, it would be difficult, if not impossible, to determine if the targeted supplier had contracted with other market participants to place convergence bids at the nodes in question on its behalf. Third, if the bid restrictions were targeted to only the certain nodes which may serve as the delivery point under CERS’ contracts, then a determined supplier could place convergence bids at closely related nodes in order to impact the feasibility of the Inter-SC trade submitted at the “delivery point” node. Such bidding behaviors would likely be hard to detect.
CERS thanks you for this opportunity to provide comments on this important issue and looks forward to working collaboratively with CAISO and the other stakeholders to reach a workable solution that facilitates CAISO's efforts to improve its market design while at the same time does not undermine the Seller's Choice Settlements.

Sincerely,

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