

**BEFORE
THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

Order Instituting Rulemaking to)
Integrate and Refine Procurement Policies)
And Consider Long-Term Procurement) R. 10-05-006
Plans)
_____)

**CALIFORNIA INDEPENDENT SYSTEM OPERATOR
COMMENTS ON CONVERGENCE BIDDING**

California Independent System Operator (“ISO” or “California ISO”) submits this filing in response to the July 1, 2010 Administrative Law Judge’s Ruling on Convergence Bidding—Track III. Specifically, the ISO wishes to respond to several of the questions identified in the July 1, 2010 ruling to provide the Commission and the parties to this proceeding with a better understanding of the benefits of the ISO’s convergence bidding design and to encourage the Commission to allow the IOUs to participate.

Threshold Questions

1. Why should or should not the IOUs participate in the convergence bidding market? Please specify the potential costs and benefits to both ratepayers and shareholders.

Convergence bidding is an important market enhancement that enables market participants to hedge their physical market positions and arbitrage differences in day-ahead and real-time prices. The addition of convergence bidding into the California ISO wholesale energy markets will provide a number of benefits toward market efficiency. These benefits include better price convergence between the day-ahead and real-time markets, more efficient dispatch of resources, the mitigation of supplier market power and a general increase in market liquidity. Allowing IOU participation in convergence bidding is an important step towards achieving these

market efficiencies as a deep and liquid market for convergence bidding for both supply and demand is essential for these benefits to be fully realized. Not allowing the IOUs to participate will require other market participants to take the positions necessary to converge prices and to counteract potential gaming strategies that may be exercised by suppliers. Although those positions will at least partially be taken by other market participants, allowing the IOUs to participate at a significant level will provide greater liquidity and increase market efficiencies.

2. What risks will ratepayer and shareholders face if IOUs do participate in the convergence bidding market?

No comment

3. What risks will ratepayers and shareholders face if IOUs do not participate? What are the risks, if any, to ratepayers if the IOUs do not participate in the convergence bidding market and only traders and generators participate?

No comment

Risk and Benefit Assessment

4. What tools and framework are needed by the IOUs to measure and analyze their overall portfolio risk from participating in the convergence bidding market?

No comment

5. How should the Commission measure the risk level associated with IOU participation in convergence bidding?

No comment

6. How should the Commission measure the benefits level associated with IOU participation in convergence bidding?

No comment

Participation Standards

7. If the Commission does allow IOU participation in the convergence bidding market, what upfront standards should the Commission establish in this instant proceeding under the statutory obligation of Pub. Util. Code § 454.5?

No comment

8. What reporting requirement, if any, should the Commission require of the IOUs? Please be specific regarding the content and frequency of submission of reports, and provide a sample template.

No comment

9. Should the Commission impose any limits on how much of the IOUs' daily energy procurement costs in the Day Ahead Market be from the Convergence Bidding market (total dollars, total MW, percent of MW, etc)? If so, how should the Commission establish these transaction limits? If not, why not?

No comment

10. Should the IOUs use ratepayer funds, shareholder funds, or a combination when participating in convergence bidding? How could the Commission construct a shareholder-ratepayer incentive mechanism? What are the advantages and disadvantages of requiring a shareholder-ratepayer risk and reward sharing mechanism for IOU participation in the convergence bidding market?

No comment

11. If ratepayer funds are used, should the Commission impose a limit on the amount of losses that an IOU incurs? If so, how should this limit be established (dollar losses, percentage loss, over what time frame, etc.)? If so, once the limit is reached, what are the appropriate recourses for the Commission to take (e.g. suspension of convergence bidding procurement authority, fines, increased support from shareholder funds, etc.)?

No comment

12. Should there be a threshold level at which losses or profits from convergence bidding would trigger a different allocation of losses and rewards between ratepayers and shareholders?

No comment

Interactions with Other CAISO Products

13. Please explain the similarities and/or differences between Congestion Revenue Rights (CRRs), current IOU hedging instruments, and convergence bidding.

The California ISO releases short-term and long-term congestion revenue rights (CRRs) as a feature of its new market design that has been in effect since April 1, 2009. CRRs are

released annually and monthly through an allocation process and auctions. Load serving entities are allocated CRRs annually and monthly at no cost based on the quantity of load they serve. CRRs provide a hedge against congestion costs by providing payments or assessing charges to holders of such rights based on the direction of congestion reflected in locational marginal prices (LMPs) between different defined locations on the ISO grid. The receipt of revenue related to CRR holdings allows market participants to manage their exposure to day-ahead congestion costs in the market. If congestion is flowing the same direction as the CRR the owner of that CRR will receive a payment. If it is flowing the opposite direction then the owner has an obligation to pay.

Convergence bidding, on the other hand, enables market participants to hedge their physical market positions and arbitrage differences in day-ahead and real-time energy prices. Virtual bidders typically seek profit from price differences between the day-ahead and the real-time markets; thus, if price differentials grow larger, virtual bidding activity should counteract these differences by pressuring day-ahead and real-time market prices to move closer together.

Some additional differences between convergence bidding and CRRs are that convergence bids can be submitted every day for each hour of the day-ahead market versus CRRs which are allocated monthly and annually and are also available through monthly and annual auction process. Convergence bidding involves placing financial bids at particular pricing nodes in the day-ahead market, which if cleared in the day-ahead market are then liquidated in the opposite position in the real-time market with the market participant earning or paying the difference between the day-ahead and real-time price at the location of the bid. In contrast, CRRs are used to hedge the congestion portion of the LMP and CRR owners are paid or charged the cost of congestion depending on the direction the congestion is flowing and the source and sink of the CRR. Lastly, convergence bids compete economically with physical bids in the day-ahead market and may set the LMP. By contrast, the CRRs are not a part of the daily market. Rather

prices that come out of the day-ahead market will dictate the revenues a CRR may earn or be charged.

14. What positive and/or negative impacts could IOUs' participation in convergence bidding have on their CRR hedging activities? Can convergence bidding create or relieve virtual load-pockets in the day-ahead market?

No comment

15. Can convergence bidding be used by market participants to increase the value of CRRs in an anti-competitive manner?

In theory, CRR holders that are also convergence bidders could use convergence bids at particular locations to strategically increase their CRR payments. This is a well documented and understood concern that has been addressed by the California ISO as well as by other ISOs through the use of a CRR settlement rule that reverses any profits made in this circumstance. The California ISO's convergence bidding market design includes provisions to net market results across all hours of each day corresponding to a participant's CRR. For each congested constraint that is found to be affected by a participant's convergence bids, the rule will consider the aggregate (net) impact of this congestion on a participant's CRRs during each hour. If it is determined that a market participant's convergence bids were used to artificially increase day-ahead congestion, CRR payments to that market participant will be reduced. While the settlement rule will be applied to each business entity separately, business entities with multiple Scheduling Coordinator (SC) IDs will have the settlement rule applied on an aggregate basis to their entire portfolio of CRRs and convergence bids. Therefore, with this rule in place, convergence bidding cannot be used to increase the value of CRRs in an anti-competitive manner. This rule is also reflected in the convergence bidding tariff language on file at the Federal Regulatory Energy Commission, which approved the rule in concept in its "Order Granting Motion for Extension of Time and Addressing Convergence Bidding Design Policy Filing," 130 FERC ¶ 61,122 (2010).

16. Will IOU participation in convergence bidding increase, decrease or leave unchanged Day Ahead and Real Time Locational Marginal Prices? Please explain why and how.

The inclusion of convergence bidding in the ISO markets should allow for more efficient resource commitment in the day-ahead market which will result in day-ahead market outcomes that more closely resemble real-time conditions and therefore minimize price differences between day-ahead and real-time. This more accurate day-ahead market outcome will provide efficiencies in the commitment of resources that should reduce price volatility and reduce the overall cost to serve load. The IOU participation in convergence bidding will add to the liquidity of the market and allow more efficient market outcomes.

17. How could IOU participation in the convergence bidding market contain the CAISO's Day-Ahead and Real-Time Uplift costs?

No comment

18. Why should the Commission allow the IOUs to participate in nodal convergence bidding when all other load is scheduled at the LAP level?

The California ISO's convergence bidding market design allows market participants to submit virtual supply and demand bids at the nodal level. The IOUs should be able to take positions at load nodes along with other market participant. Without having the ability to bid at the nodal level, the IOUs would not be able to effectively counter financial (virtual) positions taken by another market participant at a load node which could result in a loss of market efficiency.

19. What steps should the Commission take to ensure that an IOU's participation in the virtual bidding market does not benefit the IOU's affiliates in energy or other CAISO products?

No comment

20. Should the Commission address any other issues that are relevant and need to be considered here?

No comment

C. CONCLUSION.

The ISO believes that it is important for the IOUs and their ratepayers to allow the IOUs to participate in convergence bidding both at the nodal and aggregated locations. This will provide the greatest opportunity for the benefits of convergence bidding to be achieved.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on July 19, 2010, I served, by electronic and United States mail, a copy of the foregoing California Independent System Operator Comments on Convergence Bidding.

Executed on July 19, 2010
at Folsom, California

/s/ Jane L. Ostapovich //

Jane L. Ostapovich
An Employee of the California
Independent System Operator