Impact of Convergence Bidding on Real-Time
Imbalance Energy Offset
Comments of Morgan Stanley Capital Group
May 11, 2011

Morgan Stanley Capital Group, Inc (MSCG) has reviewed the Issue Paper and Straw Proposal published on April 27, and listened to the stakeholder call on May 4, regarding the problem of large increases in charges to the Real-Time Energy Offset (neutrality) Account beginning February 1, 2011. We would offer the following observations:

- MSCG does not believe that the case has yet been made that convergence bidding is the primary cause of the large monthly charges to the neutrality account. Correlation is not causation.
    1. First, it is our understanding that charges in some months preceding the implementation of convergence bidding were of similar size and direction.
    2. Second, anecdotally, we understand that the charges for the third month of convergence bidding were of the opposite sign. Thus, even if the charges seen in the first two months of convergence bidding could be conclusively attributed to convergence bidding, it is not clear that there is a consistent systemic bias towards such bids always causing large positive additions to the neutrality account.
    3. Third, it seems likely that load forecasting biases are contributing to the systemic bias whereby real-time LMPs are consistently higher than those in HASP. This consistent bias appears to be the underlying cause of any exploitable discrepancy, and so should be the target of any "fix" that is needed.
    4. Other factors, such as the increase in the price cap to $750 and then $1000 may also be contributing factors.
- "Clawbacks" are not supportable where no allegation of market manipulation or other improper conduct is indicated as the underlying cause. Nor are they supportable when applied only to a subset of market participants (non-LSE convergence bidders). The proposal to apply the "clawback" only to convergence bidders who pair balanced and offsetting internal virtual demand bids with physical/virtual import positions is likely to prevent "legitimate" hedges. Finally, one of the core purposes of convergence bidding is precisely to use such transactions to identify arbitrage opportunities and by exploiting them, converge the prices. It doesn't make sense to penalize transactions that serve a "textbook" purpose of convergence bidding.
- The new "flexible ramping product", scheduled for near-term implementation, may substantially help reduce any directional bias, and should be allowed to go into effect and be evaluated before any other changes are made.

Summary: While MSCG would agree that a consistent systemic bias adding $25 million/month to loads' costs is a serious issue that needs addressing, two months evidence is not sufficient to establish that such bias exists. Furthermore, even to the extent that such bias does indeed exist, the root cause has yet to be established; indeed, there is much circumstantial evidence that factors other than convergence bidding may be significant or even primary causes. We recommend continued monitoring and analytically rigorous assessment of the underlying cause of the problem, and ultimately, if needed, a precisely targeted solution that fixes the root cause. At this time, we cannot support a "temporary" fix that creates other problems in its own right, may be addressing a problem that does not actually exist, and if such problem indeed exists, may not accurately address the underlying cause.

Thank you for the opportunity to comment on the issue. If there is any desire for follow-up questions or discussion, please contact Steve Huhman at (914) 225-1592, or via e-mail at Steven.Huhman@morganstanley.com