

Congestion Revenue Rights Auction Efficiency Track 1B Draft Final Proposal, Addendum, and Second Addendum

Department of Market Monitoring June 12, 2018

The California ISO Department of Market Monitoring (DMM) appreciates the opportunity to comment on the ISO's Congestion Revenue Rights Auction Efficiency Track 1B Draft Final Proposal, Addendum, and Second Addendum.¹ DMM is providing comments on measures the ISO has decided to take to the ISO Board as part of the Track 1B initiative, as well as measures the ISO is declining to present to the Board at this time.

I. Comments on measures the ISO has decided to take to the Board as part of Track 1B

The ISO proposes to conduct an *ex post* targeted reduction of CRR payouts on a constraint by constraint basis. In combination with the ISO's Track 1A proposal, this will provide a measure of protection against the risks imposed on transmission ratepayers by the CRR auction and will likely reduce the current level of ratepayer losses. Relative to other potential methods of allocating revenue inadequacy, the Track 1B constraint-specific allocation reduces the incentive to target specific modeling discrepancies. Therefore, DMM supports the Track 1B constraint-specific allocation as an improvement over the currently implemented method of allocating revenue inadequacy to measured demand.

During its June 7, 2018 meeting, the Market Surveillance Committee (MSC) proposed an allocation method in which revenue inadequacy would be allocated to all CRRs in proportion to their CRR payments.² This is similar to the revenue inadequacy method used in PJM. DMM supports the ISO's proposed constraint-specific allocation over the less targeted method recommended by the MSC to allocate revenue inadequacy to all CRRs. The more socialized PJM method of allocating revenue inadequacy to all CRRs would have significantly less benefits than a constraint-specific allocation because the PJM method leaves intact substantial incentives for financial entities to target specific modeling discrepancies in the CRR auction.

¹ *Congestion Revenue Rights Auction Efficiency Track 1B Draft Final Proposal*, May 11, 2018:
<http://www.caiso.com/Documents/DraftFinalProposal-CongestionRevenueRightsAuctionEfficiencyTrack1B.pdf>;

Congestion Revenue Rights Auction Efficiency Track 1B Draft Final Proposal Addendum, May 25, 2018:
<http://www.caiso.com/Documents/DraftFinalProposalAddendum-CongestionRevenueRightsAuctionEfficiencyTrack1B.pdf>;

Congestion Revenue Rights Auction Efficiency Track 1B Draft Final Proposal Second Addendum, June 11, 2018:
<http://www.caiso.com/Documents/DraftFinalProposalSecondAddendum-CongestionRevenueRightsAuctionEfficiencyTrack1B.pdf>

² *CRR Issues and Responses*, James Bushnell, Market Surveillance Committee, June 7, 2018:
http://www.caiso.com/Documents/Presentation-CongestionRevenueRightsAuctionEfficiency1B-June7_2018.pdf

The ISO's May 25 addendum proposed treating flow and counterflow differently in the proposed methodology for allocating revenue inadequacy. This differing treatment would result in different effective prices for the same underlying constraint depending on whether the flow from a CRR over the constraint has a positive or negative megawatt value. DMM is not convinced that having different prices for the same underlying commodity is a good idea.

The ISO argues that this treatment would be consistent with what would happen if they ran another optimization with a simultaneous feasibility test. But the ISO is not actually running another optimization, so it unclear how this argument supports the different treatment of flow and counterflow. However, DMM believes that the significance of resolving this issue is minor compared to the benefits that a constraint-specific allocation would provide relative to the more socialized approaches of allocating revenue inadequacy to measured demand or to all CRRs.

II. Comments on issues the ISO is declining to take to the Board

While the 1A and 1B proposals would provide some measure of protection, they still do not address fundamental flaws of the CRR auction.³ DMM continues to hope and recommend that the ISO address these flaws in the Track 2 comprehensive CRR auction design changes. But in discussing alternatives in the Track 1B proposal, the ISO makes several statements that suggest the ISO will not consider moving the auction towards a market for CRRs or other hedging contracts based on trading between willing counterparties. The ISO cites arguments raised by stakeholders and the MSC against moving to a market between willing counterparties. DMM does not think these points have been sufficiently discussed.

By prematurely accepting these points as raising insurmountable barriers to moving toward a market based on trading between willing counterparties, the ISO may preclude any productive discussion about market design changes that will adequately address the auction's fundamental flaws. DMM's comments therefore address concerns cited by the ISO as reasons not to pursue alternatives to the CRR auction based on trading between willing counterparties.

Specifically, the points discussed here are:

- Transmission ratepayers are not natural sellers of basis risk hedges, as the MSC contends.
- No one has provided any reasonable theoretical or empirical support to justify using ratepayer auction losses as a subsidy to other market participants who may buy or sell energy contracts.

³ DMM has described these flaws in multiple venues including its *Comments on the CRR Auction Analysis Working Group*, Department of Market Monitoring, January 16, 2018: <http://www.caiso.com/Documents/DMMComments-CRRAuctionAnalysisReportWorkingGroup.pdf>.

- The main issue for the ISO to resolve is whether and how the ISO should facilitate the trading of contracts to hedge locational basis risk.

Going forward, DMM believes a more thorough vetting of these issues is necessary for the ISO to uphold its commitment made to the Board to seriously consider market alternatives to the CRR auction.

Transmission ratepayers are not “natural sellers” of CRRs

The ISO’s Market Surveillance Committee (MSC) argues that because transmission ratepayers receive the “excess” congestion rent not paid to allocated CRRs (i.e. they have a long position related to locational price differences) that they are natural sellers of price swaps that hedge congestion risk. The MSC argues that sales of CRRs in the auction by the CAISO actually reduces risk for ratepayers.⁴ As explained below, these arguments are flawed. Transmission ratepayers are not the natural sellers of swaps to hedge basis risk.

The MSC’s argument assumes that the only relevant risk is an uncertain stream of congestion rent income. Their argument does not consider that ratepayers have other costs (beyond what may be hedged through forward contracts and allocated CRRs) that are negatively correlated with the congestion rent. But congestion rent is the difference between payments made by energy buyers and payments to energy sellers. The costs paid by ratepayers for spot market energy purchases are clearly negatively correlated with their congestion rent income. Therefore, the ratepayer’s congestion rent income hedges the ratepayers’ own spot market costs. Requiring ratepayers to sell CRRs removes this hedge and increases risk on ratepayers. When the ISO sells ratepayer-backed CRRs it is not reducing overall risks – it is simply transferring risks to ratepayers.

Further, even if transmission ratepayers were net long on congestion price differences (i.e. would benefit from the impact of congestion on energy prices they pay), the argument that the auction design reduces ratepayer risks by replacing an uncertain stream of income with a fixed payment in the auction is incorrect. If someone offers a known payment now to replace an unknown payment, then accepting the known payment would be less risky. But the CRR auction design does not give this type of offer to ratepayers. Instead, the design replaces uncertain spot market payments with a different uncertain auction payment.⁵ Just because the auction payment is a single payment does not mean it is not risky. The payment is still

⁴ The MSC opinion asserts that “The ISO, or indirectly the ratepayers who are residual claimants to congestion revenues, are therefore in a unique position to provide CRRs to market participants. They are the natural counter-parties since they have the opposite revenue stream.” MSC Opinion, p.4.

⁵ The auction actually gives transmission ratepayers the obligation to pay CRR holders which in theory nets out against the congestion rent income. Ratepayers have to make these payments whether or not there is an offsetting stream of congestion rent income. Obviously, to the extent there is not an offsetting stream of congestion rent income, or to the extent that the stream of income is not negatively correlated with the payments to CRRs, paying CRRs increases the risks faced by ratepayers (again, assuming no other relevant spot market risks).

uncertain and ratepayers cannot control at what price they will “accept” auction payments in exchange for obligations to make payments at the spot market prices.

The MSC argument that transmission ratepayers are the natural sellers of basis swaps considers only a subset of ratepayer spot market exposures and simply assumes that the auction payments are not risky even though the auction payments are uncertain. Transmission ratepayers are not the natural sellers of swaps to hedge basis risk.

Arguments that CRR auction revenue shortfalls are justified because they help to reduce forward contract prices are flawed

Several stakeholders have argued that the transmission ratepayer losses in the CRR auction do not constitute an actual “loss to load.”⁶ They argue that ratepayer losses reduce the costs of the auction participants who are buying the CRRs to hedge basis risk related to forward contracting. These participants buying the CRRs as hedges, the argument goes, can then lower their forward contract prices by the amount of ratepayer losses (which are profits for the auction participants). Thus the ratepayer losses are made up for by lower forward contracting costs and the market may actually be better off. This argument is not based on sound economic reasoning.

First, as a practical matter, most of the ratepayer losses are paid to CRRs that are unlikely to be used for hedging forward contract basis risk.⁷ The ratepayer losses on CRRs not hedging forward contract basis risk cannot reduce forward contracting costs in the way described above.

Second, and more to the point, having ratepayers lose money on CRRs to lower the costs of forward contracting is a cross subsidy. One should not generally expect that subsidizing factor costs to reduce product costs will increase market efficiency, in the absence of an externality or other market failure. Generally one should expect that such cross subsidization would distort prices in the forward contracting market and decrease market efficiency. Further, one cannot assume that the reduction in forward contracting costs will be commiserate with ratepayer losses. The effect that subsidizing CRRs has on forward contracting costs depends on the

⁶ See *California ISO CRR Market*, presented by Kolby Kettler, April 10, 2018, pp. 3-5: <http://www.caiso.com/Documents/Presentation-KolbyKettlerVitol-Apr102018.pdf>.

⁷ See *Joint reply commenters’ request for leave to submit reply comments and reply comments*, Docket No. ER18-1344, Affidavit of Doug Boccignone, May 25, 2018, p. 7 (p. 40 of filing): <https://elibrary.ferc.gov/IDMWS/common/opennat.asp?fileID=14930322>

Mr. Boccignone’s analysis of 2017 auction CRRs found that “...over ninety percent (90.3%) of the auction CRRs are held by parties that account for less than four percent (3.9%) of the volume of all reported CAISO EQR energy transacted in 2017. More than seventy-two percent (72.4%) of the CAISO auction CRRs are held by entities that, according to the EQRs, had no CAISO energy transactions”

distribution of the subsidy among market participants, and the structure and elasticities of the forward contracting market.

DMM has not seen anyone present an argument for how subsidizing CRRs with ratepayer funds corrects for a market failure in the forward contracting market or otherwise increases market efficiency. Nor has DMM seen any analysis showing that the actual ratepayer losses from the CRR auction have reduced forward contracting costs much less how they increase market efficiency. DMM does not believe the intent of the CRR auction was (or should be) to provide subsidized insurance for basis risk. However, even if one believes a subsidy is needed or beneficial, the CRR auction appears to be a non-targeted and very inefficient way to go about administering such a subsidy.

The main issue for the ISO to resolve is whether and how the ISO should facilitate the trading of contracts to hedge basis risk

The CRR auction design forces ratepayers to offer financial contracts and increases risks borne by ratepayers. The current auction design subsidizes CRRs with ratepayer funds. As explained above, subsidies that lower the price of CRRs reduce market efficiency. But some may worry that the costs of participating in a market for contracts to hedge locational basis risk would be too high in the absence of the current subsidies provided by the CRR auction design. That is, the costs of trading would stop otherwise valuable trades from occurring. It might be possible that intervening with a subsidy could reduce trading costs.

Relevant policy questions to address in a stakeholder initiative on CRR auction reform include:

- Should the ISO intervene, potentially with subsidies, to help facilitate the trading of basis swaps?
- Or, should the ISO not intervene in the forward markets?
- If intervention is thought to be needed, how best can the ISO design a targeted intervention that will facilitate trading without creating massive rent seeking opportunities?
- If subsidies are needed, who should fund subsidies?

The current CRR auction design is a non-targeted intervention subsidized by transmission ratepayers that creates huge opportunities for financial entities to extract rents from the wholesale market system without any resulting benefits in terms of actual hedging.