

May 4, 2018

**COMMENTS OF THE CITIES OF ANAHEIM, AZUSA, BANNING, COLTON,
PASADENA, AND RIVERSIDE, CALIFORNIA ON THE CONGESTION REVENUE
RIGHTS AUCTION EFFICIENCY TRACK 1B STRAW PROPOSAL**

In response to the CAISO's request, the Cities of Anaheim, Azusa, Banning, Colton, Pasadena, and Riverside, California (collectively, the "Six Cities") provide their comments on the April 19, 2018 Congestion Revenue Rights Auction Efficiency Track 1B Straw Proposal (the "Track 1B Straw Proposal"):

The Six Cities Do Not Support CAISO's Proposal to Reduce Payments to CRR Holders on a Constraint-by-Constraint Basis.

In section 4.1 (General Discussion) of the CAISO's Track 1B Straw Proposal, the CAISO makes the following statement:

The CAISO has argued that congestion revenue rights are essential to long-term participation in its market and to enable forward contracting by providing a means for market participants to lock in the cost of transmission service on a forward basis. Congestion revenue rights effectively provide the financial equivalent of monthly or annual firm point-to-point physical transmission service under the pro forma OATT. Either approach—whether based on financial rights or physical scheduling rights—enables market participants to obtain certainty regarding the cost of the transmission service.

The Six Cities agree with the CAISO's position that the fundamental reason and purpose for the CRR market should be to allow market participants to obtain certainty regarding the cost of their transmission service, or equivalently, that market participants should have the opportunity through the allocation and/or auction processes to proactively hedge their congestion risks and protect against extreme congestion events affecting cost of delivery of physical power. As such, the Six Cities generally support CAISO's proposals that recognize and reinforce this fundamental purpose (*i.e.*, effective hedging and cost certainty). Likewise, the Six Cities generally oppose any proposals that degrade this fundamental purpose of the CRR market.

In the Track 1B Straw Proposal, the CAISO has proposed to reduce CRR payments after-the-fact based on an "effectiveness on constraints" accounting methodology (*see* section 5.2.1). The CAISO argues that this is equivalent to dynamically derating CRRs, is surgical in nature, and adheres to fundamental cost-causation principles. While the Six Cities take no position on the first two points, the Cities strongly object to the characterization that the CAISO's proposed CRR adjustments reflect cost causation. The CAISO itself states that the fundamental reason for CRR payment shortfalls (at any specific constraint) is due to the CRR allocation or auction releasing more capacity over that constraint than is actually available in the Day-Ahead Market. Track 1B Straw Proposal at 25. Thus, the root cause of revenue imbalances is excess capacity

used in modeling exercises that support the CRR allocation or auction processes. Market participants who abide by the CAISO's allocation and auction rules are not "causing" revenue shortfalls attributable to modeling inconsistencies, as the market participants have no control over the amount of capacity being used in these processes. Rather, the imperfect nature of the modeling process itself (which is to some degree unavoidable) and theoretically, some may say arbitrarily, established transmission capacity amounts actually represent the true cost causation driver.

While the Six Cities firmly believe that market participants are not fundamentally responsible for the revenue shortfalls resulting from modeling inconsistencies, it is the market participants themselves who will most definitely suffer from the unintended consequences that the CAISO's Track 1B revenue balancing proposal will cause. At a minimum, the adoption of this proposal will by definition result in after-the-fact uncertain congestion revenue payments, which in turn implies that this proposal degrades the fundamental purpose of the whole CRR market. More specifically, it will no longer be possible for a market participant to guarantee that a physical power delivery path is 100% hedged, nor is it clear that a participant will even be able to tell what the potential reduced CRR value might be.

Additionally, as the CAISO itself points out, auction revenue will very likely decrease to some extent, since auction bids may be reduced to reflect the uncertain value of the obtained CRRs. Essentially, the CAISO is proposing to solve the revenue inadequacy problems that arise from the imperfect nature of the modeling processes by penalizing market participants with uncertain and unpredictable revenue streams that (at least in the case of LSEs) most likely will not fully cover their congestion rent exposure in the Day-Ahead Market. For these reasons, the Six Cities must oppose the Track 1B Straw Proposal.

The Six Cities Continue to Support the Willing Seller/Willing Buyer Construct Proposed by Southern California Edison Company and the Department of Market Monitoring.

Payments to holders of auctioned CRRs that exceed auction revenues continue to impose massive uplift costs on CAISO load. In the fourth quarter of 2017, such uplift costs were approximately \$61 million, bringing the total ratepayer losses from the CRR auctions since the market began in 2009 to approximately \$730 million by the end of 2017. *See* the CAISO Department of Market Monitoring Q4 2017 Report on Market Issues and Performance dated February 14, 2018, at pages 28-29. Although the CAISO's Track 1B Straw Proposal could reduce payouts to holders of auctioned CRRs, it would do so at the cost of undermining congestion cost hedges for physical deliveries of energy, as described above. Moreover, the Track 1B Straw Proposal still would not address the fundamental flaw with the CRR auction design, *i.e.*, the forced sale of auctioned CRRs by ratepayers who have no ability to avoid obligations to holders of auctioned CRRs or to ensure that the revenues paid by purchasers of auctioned CRRs bear a reasonable relationship to payments ratepayers may be obligated to make to such purchasers. The primary focus for this stakeholder initiative should be correction of that fundamental flaw.

The Six Cities continue to support proposals by Southern California Edison Company ("SCE"), the Department of Market Monitoring ("DMM"), and other stakeholders to pursue

modifications to the design of the CRR auctions so as to include participation by willing buyers and willing sellers only, eliminating any obligation for LSEs (or any other non-willing participants) to make up shortfalls between auction revenues and payments to holders of auctioned CRRs. Market participants that wish to participate in CRR auctions (whether for purposes of hedging or for speculation) would have the ability to do so.

Critics of the willing seller/willing buyer construct argue that it is inconsistent with the FERC's open access policy, apparently based on concern that there may not be sufficient participation in a voluntary auction to enable desired hedging for physical transactions, especially for smaller market participants. There is no apparent connection between the FERC's open access transmission policy and the use of CRR auctions by purely financial participants to extract hundreds of millions of dollars from load serving entities. The FERC's *pro forma* Open Access Transmission Tariff provides for access to the transmission system to facilitate physical deliveries of energy. Moreover, the FERC has never said that the open access policy requires access to the transmission system for free, much less at enormous cost to other transmission users. For these reasons, the Six Cities are disappointed that the CAISO appears to have dismissed the willing seller/willing buyer construct based on a premise that has limited, if any, validity.

The Six Cities Suggest an Alternative Approach for Funding Revenue Inadequacy and Ensuring Revenue Neutrality.

The CAISO states at page 22 of the Track 1B Straw Proposal that “*Under full funding, a congestion revenue right holder that has measured demand can receive a net lower payment than another market participant that holds an identical congestion revenue right but does not have measured demand . . . because the ISO allocates any revenue shortfall associated with the congestion revenue rights to measured demand.*” The Six Cities absolutely agree with this statement, and additionally believe that it identifies the root issue that actually needs to be dealt with in this market redesign process. Specifically, in the CRR market as it is currently implemented, revenue shortfalls continue to occur, and these shortfalls are being solely allocated to Measured Demand (predominantly retail loads and customers). This raises a seemingly obvious question: why must all revenue shortfalls (or surpluses) be solely allocated to Measured Demand? If it is to be argued that the current CRR allocation and auction market should continue to exist in some reasonably similar form, why is it that all of the participants in the market should not share in the responsibility of addressing periodic (or consistent) revenue shortfalls? On what basis should entities with Measured Demand be solely responsible for the overall risk of revenue inadequacy, when all market participants clearly enjoy the opportunities to benefit from the potential positive net revenue streams that the current CRR market design provides?

The Six Cities recognize that the current CRR market design is imperfect and appreciate the continued efforts by the CAISO to refine the allocation and auction processes that help reduce the chronic revenue inadequacy issues, while remaining true to the fundamental purpose of allowing market participants to lock in the cost of transmission service on a forward basis. The Cities expect and believe that these efforts should continue. However, in the meantime, the Six Cities believe that the fundamental issue surrounding how the revenue inadequacy is funded

must be reexamined. More specifically, the Cities believe that all market participants should potentially bear the costs associated with ensuring that the overall market remains revenue neutral. Furthermore, these costs should be borne by the entities that are primarily responsible for the revenue deficiency on a macro scale; *i.e.*, the market participants who on a net revenue basis extract the largest amount of revenue from the overall CRR market should be primarily responsible for truing up any overall revenue shortfalls, if and when they occur.

The following discussion presents an alternative proposal for how revenue inadequacy could be funded in the CRR markets. This proposal is based on the concept that all market participants in the CRR allocation and/or auction markets both incur costs and receive revenues according to their cumulative CRR positions and if applicable, Measured Demand. Conceptually, at a high level, these costs and revenues can be categorized as follows:

Costs:	Congestion rent (load)	Rents paid by Measured Demand
	Congestion rent (CRRs)	Payments made to the CAISO for the DA congestion obligations from negative CRR positions
	Auction costs	Payments made in the CAISO auctions
Revenues:	CRR revenues	Payments made by the CAISO to a holder of CRR instruments
	Auction revenues	Auction payments received for holding negative CRR positions

In principle, a net revenue position for any time period of interest can be computed for every market participant by subtracting the sum of these costs from the sum of these revenues. Additionally, the sum of these net revenue positions across all market participants should in turn quantify the overall revenue adequacy (or inadequacy) of the CRR market. For example, define NRP_{ij} to be the net revenue position of the i^{th} market participant during month j , where the NRP represents the sum of this participant's revenues minus costs. Then for month j , if across all n market participants

$$\sum_{i=1}^n NRP_{ij} = X > 0$$

the overall market will have a net revenue deficiency of X dollars, which in turn must be allocated back across some subset of market participants in order to achieve revenue neutrality.¹ One particularly simple yet appealing way this might be done would be to allocate this deficiency proportionally across all market participants with positive net revenue positions. Note that the sum of the net revenue positions across all market participants with positive positions must by definition be $\geq X$, so sufficient net revenue payments must always exist to balance out any global revenue inadequacy.

¹ The situation of $X > 0$ results in a revenue deficiency for the market as a whole, because the CAISO will have paid more to market participants than payments received from market participants.

The above described proportional reallocation proposal is not the only conceivable methodology for maintaining revenue neutrality, but it does exhibit many desirable features – some of which are as follows:

- All market participants can be called upon to contribute to paying for any market revenue inadequacy, as opposed to just market participants with Measured Demand (as the current market design now imposes). Thus, all market participants who have the opportunity to benefit from participating in the CRR markets would share in the responsibility for maintaining revenue neutrality.
- Any market participant with a negative NRP would be automatically excluded from having to pay any additional revenues (*i.e.*, uplift costs) towards achieving revenue neutrality. One would expect that most of the time these entities would be LSEs who are short CRRs and elect to not participate in any auction process. Thus, these entities would no longer be forced to act as unwilling/default counter-parties to an auction process that they do not wish to take part in, given that they have already paid their required congestion rents for their Measured Demand.
- Currently, LSEs may be discouraged from participating in the auction processes where they may overpay for their needed congestion rights AND simultaneously have to pay back-stop uplift costs to ensure revenue neutrality. However, under a NRP / Proportional Allocation approach, an LSE that participates in the auctions and experiences a negative NRP as a result of this participation would no longer be required to also pay uplift costs. Hence, in principle, addressing revenue inadequacy through a NRP / Proportional Allocation approach should actually encourage more LSEs to participate in the auction processes.
- As already stated, the fundamental purpose of the CRR markets is to allow market participants to lock in their transmission costs on a forward basis for transmission of physical power. This proposed cost sharing approach supports this fundamental purpose. Market participants that consistently extract substantially more revenue from the CRR markets (in proportion to the costs they incur) should in principle pay more towards ensuring global market revenue neutrality, since these participants are extracting rents that significantly exceed their hedging needs. In fact, these participants are often not forward hedging congestion costs associated with Measured Demand at all, but are rather arbitragers providing some additional amount of market liquidity via speculative transactions. If these entities participate in the CRR markets, they should also share responsibility for the cost burden associated with maintaining overall revenue neutrality.
- The NRP / Proportional Allocation approach outlined above is straightforward and should require only minimal changes to CAISO software, enabling implementation by

January 1, 2019. Furthermore, in contrast to the CAISO's Track 1B Straw Proposal, the CAISO should be able to provide an analysis based on historical data estimating the impacts of the NRP / Proportional Allocation approach.

Clearly there may be refinements proposed to this NRP / Proportional Allocation approach.² However, the key issue here is that the current methodology of allocating all revenue deficiencies to Measured Demand can no longer be justified and is plainly unreasonable and unfair. A more appropriate allocation methodology must be adopted, specifically one where the costs and benefits of market participation are more appropriately shared by all market entities, and no entity is automatically forced to be a consistently unwilling default participant assigned to back-stop costs in a market paradigm simply because it has Measured Demand.

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² For example, the time period for computing each participant's NRP could be longer than one month (*e.g.*, quarterly, to align with CRR seasonal definitions), and/or some form of annual true-up might be proposed for better aligning each participant's cost burden to the longer-term revenue deficiency (should such a deficiency persist).