California Independent
System Operator Corporation

Memorandum

To: ISO Board of Governors

From: Frank A. Wolak, Chairman, ISO Market Surveillance Committee

Date: May 10, 2010

Re: ***MSC Activities from March 3, 2010 to April 28, 2010***

This memorandum does not require Board action.

The Market Surveillance Committee has been involved in three activities over the past month: (1) providing informal comments on how the California Air Resources Board determines the greenhouse gas emissions content of electricity imports under AB 32, (2) review of the ISO's local market power mitigation mechanism under the new market design (3) commenting on the ISO's commitment costs.

Informal Comments on State Proposal for Treatment of Imports under AB 32

Members of the MSC provided informal comments, not an official MSC opinion, on proposals under consideration by the California Air Resources Board for the treatment of non-California electricity generation for the first-seller system under AB 32. Specifically, we provided recommendations regarding the applicability and determination of default emission rates for electricity imports under AB 32.

In order to characterize California's responsibility for carbon emissions in the electricity sector, it is necessary to assign an emissions rate to electricity imports. Because the power sector outside of California will generally operate so that the cheapest energy sources are dispatched to meet demand outside of California, the increase in out-of-state emissions due to the California's imports is the emissions associated with the marginal, most costly power sources that are dispatched to meet the sum of out-of-state load plus California's demand for imports. These generation resources are not necessarily those that actually contract to export power to California. However, if first-sellers of imported power are assigned a lower emissions rate and if low-carbon generators are designated as the source of imports, then this provides an incentive for California retailers to purchase from these sources rather than from higher emission generators, but with no change in total emissions in the Western Electricity Coordinating Council (WECC). For this reason, unless a source of imports can be shown to be incremental (i.e., it would not otherwise have operated), a default emissions rate equal to the marginal emissions rate for the western power market outside California should be assigned.

This logic implies a high standard for allowing an electricity import to receive a lower emission rate than the default value. The MSC members proposed a two-stage test for determining whether an import supplied under a long-term contract should receive a lower emissions rate. First, the contract should force a cleaner generator with a higher marginal cost than marginal cost/market price outside of California to operate. Second, the long-term contract should force construction of a cleaner generating unit that would not otherwise have been built and that does not displace some other clean generation as a result of being built.

Finally, the MSC members emphasized that any system for assigning responsibility for emissions from imports procured from both long-term contracts and the ISO's short-term markets should not present artificial barriers to power trading, because California is critically dependent on power imports.

Review of ISO's Local Market Power Mitigation Mechanism

The MSC has been asked by the Federal Energy Regulatory Commission to evaluate the ISO's current methodology for mitigating local market power under the new market design. To that end, the MSC is currently engaged in a review of the operation of ISO's market power mitigation mechanism and market power mitigation mechanisms in other ISOs in the United States and around the world.

The ISO's Commitments Costs Proposal

The MSC members provided feedback to ISO staff working on refinements to the ISO's start-up and minimum load costs proposal presented at March 19, 2010 MSC meeting. The new California market commits generating units based on their start-ujp and minimum load cost elections that must be in place for six months. Generation unit owners argued that this market rule has caused their resources to be committed and de-committed more frequently than good utility practice would dictate, to be held at minimum operating levels for longer than the owner wanted which causes extra wear and tear on their generating units, uses up fixed numbers of unit starts and emissions allocations, and makes it difficult for unit owners to recoup their operating costs.

In order to try to alleviate these issues, the ISO is considering changes to start-up and minimum load bidding restrictions. This initiative is renamed "Changes to Bidding and Mitigation of Commitment Costs" to reflect the fact that we will also addresses issues around the transition costs associated with multi-stage generating units. The MSC has provided comments on these proposals to ISO staff working on these issues.