



Memorandum

To: The ISO Board of Governors
From: Frank A. Wolak, Chairman, Market Surveillance Committee of ISO
cc: ISO Officers
Date: October 12, 2005
Re: *MRTU Conceptual Filing*

The Market Surveillance Committee has been following and providing periodic comments on the comprehensive market redesign proposed under the Market Redesign and Technology Upgrade (MRTU) project since the ISO initiated this project. The MSC recently completed an opinion commenting on seven of the more than twenty aspects of the MRTU design that have been under discussion with stakeholders since the ISO's May 13 conceptual filing. The MSC has long-supported a different approach from the ISO on several of these seven issues, so it is not unexpected that there are remaining points of disagreement between the MSC and ISO staff. The MSC continues to support the transition to a locational marginal pricing (LMP) market for California. For the reasons outlined in the opinion, the MSC believes that its recommendations increase the likelihood that consumers, producers and the ISO operators will realize the maximum benefits from a LMP market in California. However, we do not believe any of the concerns expressed in the MSC opinion are reasons to delay the MRTU process. We urge the ISO Board to give the ISO management its approval to move forward with MRTU.

There are four major points of disagreement between the MSC recommendations and the current MRTU proposal. Some of these are fundamental while others can be addressed during Release 2 of MRTU. The MSC has consistently advocated against the inclusion of bid adders in the mitigated bids of units subject to local market power mitigation because these bid adders can significantly degrade overall market efficiency. The MSC has also been a consistent advocate for allocating as opposed to auctioning Congestion Revenue Rights (CRRs) and for simplified mechanisms for allocating CRRs on the grounds that they are more transparent and lower cost than the more complex multi-round nomination process proposed by the ISO. The MSC has also been a persistent supporter of a prospective local market power mitigation mechanism for both energy and ancillary services, but is concerned that it is too risky to make competitive path assessments without the benefit of actual market outcomes under a locational marginal pricing (LMP) market. An issue on which an ISO Board decision is not being requested at this time is the simplified Hour Ahead Scheduling Process (HASP). Ever since it was introduced by the ISO, the MSC has been concerned that there may be adverse unintended consequences associated with eliminating a formal hour-ahead price-setting and settlement mechanism. The experience in late 2004 with the Real Time Market Application (RTMA) with the bid-or-better pre-dispatch process for imports and exports has only increased our concerns with the HASP mechanism.

Despite the concerns with the MRTU conceptual filing expressed in our opinion, we still strongly support moving forward with a LMP market for California. We continue to endorse the following paragraph taken from an MSC opinion completed on April 7, 2003.¹

¹ Comments on Locational Marginal Pricing and the California ISO's MD02 Proposals, April 7, 2003, (available from <http://www.caiso.com/docs/2003/04/07/2003040713192323878.pdf>).

"LMP is a small, but important, part of a well-functioning wholesale market for electricity. Demand-responsiveness to both locational and temporal price differences is another important source of benefits from a wholesale electricity market. LMP is a necessary step towards achieving this long-term goal. In the short-run, the phased implementation of LMP (as proposed by CAISO) carries little potential costs and provides several short-term benefits. These benefits include: (1) the ability to secure effective local market power mitigation tools from FERC, (2) reduction in undesirable trading strategies (e.g., the "dec game"), (3) greater transparency, efficiency, and reliability in system operation, (4) improved demand responsiveness (given the ability of dispatchable loads to bid and respond as generation and receive the LMP), and (5) greater granularity in the costs of transmission congestion to aid the transmission planning process."

We continue to believe that an effective local market power mitigation mechanism is essential to the success of an LMP market in California. This is why we support a cautious approach to including transmission paths in the set of competitive paths and would like the ISO to have one year of experience with only the existing three zonal interfaces and interties into California as the only competitive transmission paths. Following this year, the ISO would be free to apply its competitive path methodology to all transmission paths to determine which ones will be deemed competitive during subsequent years.

Although we are confident that a LMP market can deliver benefits to California consumers and ISO operators, the market design must be tailored to capture these benefits. If properly designed, a LMP market can improve wholesale market efficiency and system reliability in California relative to the existing zonal market design. The motivation for our comments on the seven aspects of the MRTU conceptual filing is to increase the likelihood that a LMP market would benefit system reliability and market efficiency in California. We look forward to working with the ISO to address the concerns expressed in this opinion as it moves forward with a LMP market for California. All of these concerns can be addressed within the context of the existing ISO MRTU proposal. Therefore, none of the changes we are recommending should be interpreted as a reason for the ISO Board not to move forward with MRTU as soon as possible.