

Addendum to the Opinion on the California ISO's Market Redesign And Technology Upgrade (MRTU) Conceptual Filing

by

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1. Introduction

During the public call on April 26, 2005 when we adopted our "Opinion on the California ISO's Market Redesign and Technology Upgrade (MRTU) Conceptual Filing," several questions about the opinion were raised by stakeholders that we believe require further clarification. This addendum discusses these issues.

First, on pages 4 and 5, we stress the need for load-serving entities (LSEs) to purchase their energy and ancillary services needs in the forward market for delivery to locations in the California ISO control area where these products can actually be used to serve the energy and ancillary services needs of the LSE that purchased them. We also emphasized that in a nodal-pricing market the California Public Utilities Commission (CPUC) can more precisely specify the delivery points and delivery quantities for both energy and ancillary services that the LSEs must purchase in the forward market, rather specify delivery anywhere within a congestion zone such as NP15, SP15, or ZP26, as is the case for the current zonal market design. This is one attractive feature of a locational marginal pricing (LMP) market design. It allows LSEs to specify physically feasible delivery points for its forward contracts to clear against. As noted in the Opinion, if a supplier fails to take the actions that allow the LSE to purchase the contracted quantity of energy at that location, the seller of the forward contract bears the cost of the extremely high short-term prices at that location. In addition, we believe that those LSEs that do not make their forward purchases in a physically feasible manner should bear the potentially higher costs of an increased short-term energy and ancillary services demands that result from this decision. Moreover, these LSEs should be unable to transfer some of these costs to other LSEs as is the case under the current zonal market design.

Despite our strong desire for the CPUC to ensure that the LSEs that it regulates make physically feasible forward market purchases of energy and ancillary services, we do not mean to imply that these LSEs should rely on the LMPM mechanism to procure these products. If there is effective competition among suppliers to provide the necessary local energy and ancillary services, they should be purchased in forward contracts clearing against these locations in the California ISO control area. We do, however, note that the Federal Energy Regulatory Commission (FERC) needs to provide adequate local market power mitigation in areas with severe local market power and high barriers to entry to ensure that consumers pay just and reasonable prices for the needed local energy and ancillary services whether or not they are purchased in the forward or short-term market. Unlike

unconstrained areas, a longer time horizon between contract negotiation and delivery will not appreciably expand the pool of potential suppliers in load centers where the barriers to new entry are substantial. Absent effective LMPM, consumers in these areas will almost certainly face unjust and unreasonable prices for energy and ancillary services.

Price responsive final demand is even more valuable within these local regions than in less constrained areas of the California ISO control area. The CPUC should make it a high priority to provide incentives for consumers to become active wholesale market participants. If large customers have a financial incentive to become price-responsive, this can only improve the performance of the short-term energy and ancillary services markets.¹ However, we caution that in areas with little or no competition for supply, price-responsive demand, while extremely valuable, is not by itself sufficient to ensure just and reasonable prices. Although the presence of price responsive final demand can limit the amount of local market power a supplier can exercise, it does not eliminate the need for a prospective LMPM mechanism.

A second question concerns the meaning of our statement on page 4 that “having adequate installed capacity to service demand does very little by itself to prevent the exercise of market power in the short-term energy and ancillary services markets.” Our point is that generation capacity that is purchased by an LSE and that carries a weak or non-existent performance requirement, as is typically the case for capacity purchased through an installed capacity market, is of little value in limiting the exercise of market power in the short-term energy and ancillary services market. Forward market purchases should require a commitment for *performance*. Such performance would include the supply of energy, but to a lesser extent will include the purchase of ancillary services, options, and other forms of "stand-by" performance that may be required in order to operate the system reliably.

Simply making a payment to a generation unit owner for their installed capacity with the only obligation that the unit bid into the short-term energy or ancillary services market if the unit is available to supply energy does not, in our view, purchase the necessary performance commitment to limit the ability of this supplier to exercise unilateral market power in the short-term energy and ancillary services markets. As we note in the opinion, it is difficult, if not impossible, to determine if a unit has failed to comply with the requirement to bid into the market if it is available, and the penalties associated with failure to comply are often insufficient to deter this behavior given the increased profits that are available to the supplier from exercising unilateral market power in the spot market. As noted in the opinion, it is virtually impossible for an entity besides the owner of the generation unit to determine whether or not that unit is truly available to operate. The advantage of buying a performance guarantee, such as a forward contract for energy or an option contract to provide energy if the short-term price is above some level, is that the supplier bears the responsibility for any unit outages. Because of the price guarantee implicit in this forward contract or option, the purchaser is indifferent to the short-term energy or ancillary services price changes that result from a generation unit outage, regardless of the cause. As a consequence, the seller of either contract has a strong financial incentive to make their unit

¹ It is important to note that price-responsive demand can take the form of participating load that is actively bidding into the energy or ancillary services markets and the more passive form of simply reducing consumption upon notification of the price level. Because the infrastructure and transactions costs involved in actively participating, we expect that the passive form of price-response would achieve more widespread participation.

available to provide the contracted energy or ancillary services when it is truly available to do so.

Page 2 of the opinion states that, "we believe it may be more cost-effective for the ISO to formulate a long-term solution to the pre-dispatch of intertie bids before committing to a design for the HASP." During the public call, the CAISO noted that it was necessary to file the HASP design in May in order to obtain FERC conceptual approval of this major market design element in July in order to meet the February 2007 MRTU implementation date. The CAISO argued that doing so would not foreclose modifications to the proposed settlement of inter-tie bids under HASP. However, we note that a commitment to HASP may foreclose options outside of the HASP framework, such as an hour-ahead energy and ancillary services market. The CAISO is undertaking a stakeholder process over the next several months to address the inter-tie issue and will file any proposed changes to the settlement of interties *under HASP* when it submits its MRTU Tariff filing in November if 2005. Therefore a delay in HASP could possibly lead to a more cost-effective long-term solution to the intertie bidding problem, but would also increase the likelihood of a delay in the implementation of MRTU.