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Cobalt Capital Partners V, LLC, Mountaineer Power, LLC, SESCO CALISCO, LLC, and XO Energy CAL, LP (together, the “Financial Marketers”) appreciate the opportunity to submit these comments on the “Impact of Convergence Bidding on Interties, Draft Final Proposal,” dated July 29, 2011 (the “Draft Final Proposal”).<sup>1</sup> For the reasons set forth below, the Financial Marketers do not support the Draft Final Proposal to eliminate convergence bidding at the interties. The fundamental market flaws that create the price differentials between hour ahead scheduling process (HASP) and real-time dispatch (RTD) are not insurmountable and deserve further study. Instead of eliminating this market, the Financial Marketers request that CAISO continue to work with its stakeholders to find a solution that would allow reduce or remove the HASP and RTD price differential while maintaining convergence bidding on the interties.

### **Background**

On April 27, 2011, CAISO issued an issue paper and straw proposal entitled “Impact of Convergence Bidding on Real-Time Imbalance Energy Offset” (the “First Straw Proposal”).<sup>2</sup> In the First Straw Proposal, CAISO noted that prices for intertie supply, which settles in the HASP, were generally lower prices for internal demand, which settles in RTD, and that this price differential provided arbitrage opportunities between intertie supply and internal demand. Therefore, the First Straw Proposal proposed a new settlement rule that would reverse HASP to RTD revenues for the balanced portion of a Scheduling Coordinator’s portfolio.

On May 18, 2011, CAISO issued a second straw proposal entitled “Redesign of the Imbalance Energy Offset Revised Options for an Intermediate Term Real-Time Straw Proposal

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<sup>1</sup> California ISO, “Impact of Convergence Bidding on Interties, Draft Final Proposal,” available at [http://www.caiso.com/Documents/Real-time%20imbalance%20energy%20offset%20\(2011\)%20-%20papers%20and%20proposals/DraftFinalProposal-Real-TimeImbalanceEnergyOffset.pdf](http://www.caiso.com/Documents/Real-time%20imbalance%20energy%20offset%20(2011)%20-%20papers%20and%20proposals/DraftFinalProposal-Real-TimeImbalanceEnergyOffset.pdf) (July 29, 2011) (the “Draft Final Proposal”).

<sup>2</sup> California ISO, “Impact of Convergence Bidding Real-Time Imbalance Energy Offset, Issue Paper & Straw Proposal,” available at [http://www.caiso.com/Documents/Real-time%20imbalance%20energy%20offset%20\(2011\)%20-%20papers%20and%20proposals/IssuePaperandStrawProposal-Real-TimeImbalanceEnergy-fset.pdf](http://www.caiso.com/Documents/Real-time%20imbalance%20energy%20offset%20(2011)%20-%20papers%20and%20proposals/IssuePaperandStrawProposal-Real-TimeImbalanceEnergy-fset.pdf) (April 27, 2011).

and Solution” (the “Second Straw Proposal”).<sup>3</sup> In the Second Straw Proposal, CAISO stated that it had been working on “operational improvements to address the HASP and RTD price differential” and that “[t]hese efforts have resulted in a significant reduction in real-time imbalance energy offset costs.”<sup>4</sup> Therefore, the Second Straw Proposal concluded that it would be “prudent to take additional time to develop a more comprehensive intermediate term solution instead of moving ahead with the proposed short-term settlement rule.”<sup>5</sup>

On June 10, 2011, CAISO issued a third straw proposal entitled “Impact of Convergence Bidding on Interties, Revised Straw Proposal” (the “Third Straw Proposal”).<sup>6</sup> In the Third Straw Proposal, CAISO outlined three proposals:

- While the stakeholder process continues to address issues with convergence bidding on the interties, the ISO will retain the threshold for making an emergency filing of the proposed settlement rule;
- The ISO proposes to remove interties as eligible convergence bidding nodes under the current market design;
- The ISO proposes additional rules to deter implicit virtual bidding at the interties.<sup>7</sup>

On July 29, 2011, CAISO issued the Draft Final Proposal, in which CAISO abandons the proposed settlement rule and the operational improvements and “proposes to not allow interties to be eligible nodes for convergence bidding under the current market design.”<sup>8</sup> The Draft Final Proposal does acknowledge that CAISO could allow the status quo: “The ISO does recognize that another potential option is to make no changes to the market design, but this would require market participants to accept the current issues identified with the existing market design.”<sup>9</sup>

### Comments

The Financial Marketers object to the Draft Final Proposal to not allow interties to be eligible nodes for convergence bidding under the current market design. The Financial Marketers suggest that CAISO revisit the Second Straw Proposal, in which CAISO recognized that operational improvements to address the HASP and RTD price differential resulted in a significant reduction in real-time imbalance energy offset costs. As stated above, the Second Straw Proposal concludes that it would be “prudent to take additional time to develop a more

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<sup>3</sup> California ISO, “Redesign of the Imbalance Energy Offset Revised Options for an Intermediate Term Real-Time Straw Proposal and Solution,” available at [www.caiso.com/2b82/2b82a00c59940.pdf](http://www.caiso.com/2b82/2b82a00c59940.pdf) (May 18, 2011).

<sup>4</sup> *Id.* at 3.

<sup>5</sup> *Id.*

<sup>6</sup> California ISO, “Impact of Convergence Bidding on Interties, Revised Straw Proposal,” available at [http://www.caiso.com/Documents/Real-time%20imbalance%20energy%20offset%20\(2011\)%20-%20papers%20and%20proposals/RevisedStrawProposalImpactofConvergenceBiddingonInterties.pdf](http://www.caiso.com/Documents/Real-time%20imbalance%20energy%20offset%20(2011)%20-%20papers%20and%20proposals/RevisedStrawProposalImpactofConvergenceBiddingonInterties.pdf) (June 10, 2011).

<sup>7</sup> *Id.* at 3.

<sup>8</sup> Draft Final Proposal at 14.

<sup>9</sup> *Id.*

comprehensive intermediate term solution instead of moving ahead with the proposed short-term settlement rule.”<sup>10</sup> Instead of taking this prudent step, the Draft Final Proposal would serve to eliminate the nascent market for convergence bidding at the interties.

It is unclear to the Financial Marketers why CAISO is now taking the position that the best option would be to eliminate convergence bidding at the interties. The Draft Final Proposal summarily dismisses what once appeared to be promising options to allow continued convergence bidding at the interties. For example, the Draft Final Proposal rejects the settlement rule proposed in the First Straw Proposal because it is not perfect: “the ISO has concluded that [the settlement rule] is not a viable intermediate option because the settlement rule does not address the core market design issues due to liquidation/settlement timing or the enforcement of dual constraints.”<sup>11</sup> Although the settlement rule may not address the “core market design issues,” it could serve as an intermediate tool that would allow both convergence bidding at the interties and CAISO to examine the underlying “core market design issues” that cause the pricing differentials.

Furthermore, the Draft Final Proposal adopts the expedient position to eliminate convergence bidding on the interties, in part, because the “process has not yielded a proposal that has broad stakeholder support.”<sup>12</sup> The process may not have yielded a consensus as to an intermediate proposal that would reduce or eliminate the arbitrage opportunities due to the HASP and RTD price differential, but the process also did not yield a consensus that convergence bidding should be eliminated at the interties. Many stakeholders, both in oral comments at meetings and in written comments to CAISO, acknowledged both the benefit and value in convergence bidding at the interties and the problems associated with the HASP and RTD price differential. Indeed, if the process yielded any consensus whatsoever, that consensus was likely an acknowledgment by stakeholders of the problem and a willingness to work with CAISO to reduce or remove that problem.

Finally, the Draft Final Proposal fails to acknowledge the significant benefits that convergence bidding provides to market performance. The Federal Energy Regulatory Commission (“FERC”) has recognized that convergence bidding helps to prevent the exercise of market power:

As discussed in previous orders, convergence bidding improves market performance in several ways. Convergence bidding has the effect of expanding the number of competitors and the number of bids into the day-ahead market. By expanding the number of offers to buy and sell in the day-ahead market, convergence bidding helps to prevent the exercise of market power. Without convergence bidding, participants with market power may have the ability to price discriminate between the day-ahead

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<sup>10</sup> Second Straw Proposal at 3.

<sup>11</sup> Draft Final Proposal at 12.

<sup>12</sup> *Id.* at 6.

and real-time markets, resulting in a forward price that is systematically different than the expected real-time price.<sup>13</sup>

The FERC order further recognized that convergence bidding, if properly done, reduces the price differences between the real-time and day-ahead markets:

Convergence bidding reduces the price differences between the real-time and the day-ahead markets, thus reducing the incentive for buyers or sellers to forego bidding physical schedules in day-ahead markets in expectation of better prices in the real-time markets. Additionally, incorporating convergence bidding into the CAISO's tariff will facilitate the CAISO's management of grid operations by allowing it to distinguish clearly between physical bids and bids submitted for financial purposes.<sup>14</sup>

Despite the potential benefits of improving day-ahead and real-time price convergence and reducing the exercise of market power, the Draft Final Proposal would eliminate convergence bidding after several years of attempting to implement the limited convergence bidding that currently exists. CAISO has not demonstrated that the current market flaws cannot be reduced or removed, particularly given that “[c]onvergence bidding has proven to be a valuable market design feature in other LMP-based electricity markets.”<sup>15</sup>

In short, the Financial Marketers cannot support Draft Final Proposal to eliminate convergence bidding at the interties. The Financial Marketers recognize that the fundamental market design flaws that create the HASP and RTD price differential will be addressed in the Renewable Integration: Market and Product Review Phase 2 stakeholder initiative, but CAISO can and should take steps now to address the price differential in a manner that would allow continued convergence bidding at the interties.

For any questions regarding these Comments of the Financial Marketers on the CAISO Draft Final Proposal on Convergence Bidding on Interties, please contact the following:

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<sup>13</sup> *Cal. Indep. Sys. Operator Corp.*, 116 FERC ¶ 61, 274, at 62,187 (2006).

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*