

# Memorandum

**To:** The ISO Board of Governors  
**From:** Dr. Frank Wolak, Chairman, Market Surveillance Committee of ISO  
**cc:** Terry Winter, CEO;  
Charlie Robinson, VP, Legal and Regulatory;  
**Date:** July 14, 2003  
**Re:** *The Market Surveillance Committee Meeting of July 8, 2003*

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**This is only a status report. No Board action is requested.**

The MSC meeting for the month of July was conducted at the ISO Folsom offices on July 8, 2003. All four of the committee members were in attendance. Several ISO staff and stakeholders attended the public session.

## Public Session

The meeting opened with public comments. Tony Braun of CMUA and Zora Lazic of CERS spoke. Mr. Braun highlighted the concerns of the municipal utilities with the ISO's proposal for dealing with existing transmission contracts (ETCs). Ms. Lazic described the seller's choice deliverability conditions in the CERS contracts and expressed concerns about the impact of these requirements on the total price of power delivered under these contracts in a locational marginal pricing (LMP) regime.

During the public session of the meeting the following items were discussed.

### 1. Market Update

Greg Cook of the Department of Market Analysis briefed the MSC on the market activities for the months of April through June of 2003.

### 2. Relationship of Integrated Forward Market and RUC

The MD02 currently proposes a sequential procurement through RUC. It was discussed whether changes were required on the current RUC design. The ISO staff raised the following questions to the MSC.

What are the MSC concerns with the current ISO RUC design (as presented to the ISO Board)?

Should RUC capacity payment be rescinded when called for energy?

Should the design be an auction or paid as- bid?

Should RUC optimize the purchase of capacity and energy (or concentrate on capacity purchases with a Rational Buyer view to energy purchase when it is cheaper to purchase energy)?

What are the relative advantages and disadvantages of sequential vs. simultaneous IFM/RUC?

Does the MSC want to file an MSC opinion recommending improvements to the RUC Design?

The options were discussed in detail. The MSC prefers simultaneous procurement to sequential procurement for the following reasons.

(1) Simultaneous procurement will always yield lower or the same total bid-based costs (relative to sequential RUC) for procuring the ISO's total energy and ancillary services requirements subject to the all of the ISO's operating constraints.

(2) Simultaneous procurement avoids the problems created by sequential markets that reflect differing amounts of system operating constraints in the market prices. Under sequential procurement the day-ahead energy and capacity prices do not reflect the ISO's requirements to have sufficient capacity and import energy available to operate the system in real-time. These capacity and energy requirements are purchased in a pay-as-bid RUC process after the day-ahead market has cleared. This creates opportunities for ex post regret by market participants, which in turn, creates incentives for market participants to alter their bids and schedules in the day-ahead market to sell in the RUC process. Simultaneous procurement of the ISO's capacity and import energy requirements in the day-ahead market along with all other ISO-operating constraints eliminates the possibility of ex post regret and the incentive for suppliers to distort their bidding and operating behavior in the day-ahead market to exploit the sequential RUC process. However, simultaneous procurement requires the ISO to incorporate its energy and capacity reliability requirements in the day-ahead market price, rather than purchase incremental energy and capacity to meet these requirements in the RUC process after the close of the day-ahead market. The reformulating this sequential process into a single simultaneous day-ahead price-setting process has not been vetted with market participants.

(3) The combination of the pay-as-bid nature of the RUC process and the market-clearing price payment mechanism for the day-ahead market increases the likelihood that suppliers selling energy or capacity in the day-ahead market or the RUC process will regret the sales they have made after learning the day-ahead energy and capacity prices and the payment they could have received selling capacity or energy in the RUC process. This creates incentives for suppliers to alter their bids into the day-ahead market and RUC process in order to sell their energy and capacity at the high possible price, which can degrade system reliability.

(4) The ad hoc nature of the sequential RUC process increases the likelihood that FERC will make changes that increase the opportunities for suppliers to exercise market power. One of FERC's recommendations to the MD02 design process was to create a day-ahead market that recognized and priced all of the ISO's operating constraints. The sequential RUC process does not recognize and price the ISO's capacity and import energy requirements in the day-ahead market. These are ignored in the ISO's current day-ahead market design.

(5) The simultaneous RUC process would considerably simplify the operation of the day-ahead market and the design of the software to operate it.

The MSC is willing to provide an example of how its recommended simultaneous RUC process would work. However, the MSC does not want to issue opinion if it would only de-rail or slow up the implementation of the MD02 design. ISO's current conceptual filing should allow the ISO to implement day-ahead and hour-ahead markets that reflect all operating constraints in the pricing process, as would be the case with a simultaneous RUC process

### **3. Review ISO ETC proposal in MD02**

The current ISO ETC proposal was discussed. Tony Braun outlined his concerns with the current proposal and requested that the ISO proposal honor all contractual rights ETC holders currently have. The MSC asked Tony

Braun to elaborate on specific aspects of the ISO's proposal that he found objectionable. The MSC also asked for his suggestions for addressing his concerns. The MSC also asked for stakeholder comment on these issues.

MSC believes the current ISO proposal for integrating ETCs into its markets has substantial potential to increase the efficiency of the ISO's market, to the benefit all California consumers and electricity suppliers. Based on their discussion with Tony Braun, the MSC felt that his concerns could be addressed within the context of the current MD02 ETC proposal. The MSC also felt that his concerns regarding the cost allocation of the ISO's ETC proposal would require substantial input from the California Public Utilities Commission and other California parties to reach a satisfactory resolution.

The MSC discussed filing an opinion on this issue, and requested that further clarification from Tony Braun and other stakeholders on their concerns with the ISO's ETC proposal be submitted prior to the finalization of an opinion.

#### **4. Review ISO inter SC trade mechanism and its relation to CERS long term contracts deliverability**

The ISO staff briefed the MSC on the current proposal for inter SC trades to accommodate the CERS and other bilateral contract deliverability and pricing provisions in a nodal pricing system.

The MSC discussion first centered on whether these deliverability requirements would change any physical flows, or only result in changes in the financial obligations of buyers and sellers of wholesale energy. The MSC acknowledged that the first-order impact of the must-take CERS contracts and the proposed LMP mechanism in the ISO's proposed market design was the result of the supplier's option delivery point feature in these contracts, which should primarily influence payments to suppliers from LSEs, with only secondary impacts on actual power flows. The primary challenge associated with incorporating these contracts into an LMP market design is caused by the fact that the congestion zones that existed at the time the contracts were negotiated are no longer relevant to an LMP market. The MSC felt that the ultimate solution to this problem would come from negotiations between the state of California, the contracting parties and FERC. It would be extremely difficult if not impossible to modify the ISO market design rules and still preserve the beneficial aspects of an LMP market to address these problems.

Finally, the MSC questioned the need for the ISO to offer an inter-SC trading service under the MD02 design. MD02 gets rid of the balanced schedule requirement on SCs, which makes inter-SC trades purely financial transactions. The MSC felt that if the ISO offered an inter SC trading platform it should be priced separately to recover the costs only from market participants that used the service.

#### **5. Update on Amendment 50 FERC ruling: Mexican Generation & AMP for DEC Bid**

The ISO staff briefed the MSC on the implementation of the Amendment 50 FERC ruling and the accompanying Automatic Mitigation Mechanism (AMP) for DEC bids implemented effective July 1, 2003. Jing Chen of the DMA made a presentation comparing the AMP thresholds for INC and DEC bids. The MSC expressed concern about the large difference between the INC and DEC threshold values at the upper end of the supply curve for in-state generation capacity. Several members also reiterated their concerns about the ability of the AMP mechanism to limit all but very extreme cases of the exercise of market power in the INC and DEC directions.

### **Executive Session**

During the executive session the current investigation activities of ISO were discussed. The MSC was also briefed on market power implications of WAPA becoming a control area. The MSC has decided to respond to the Federal Register Notice of Intent with a letter by August 8<sup>th</sup>, as requested in the Federal Register.