

Memorandum

To: ISO Board of Governors

From: Benjamin F. Hobbs, Chair, ISO Market Surveillance Committee

Date: May 21, 2014

Re: Briefing on MSC Activities from March 8, 2014 to May 8, 2014

This memorandum does not require Board action.

Over the period covered by this memorandum, the Market Surveillance Committee adopted a draft formal opinion on the flexible resource adequacy criteria and must offer obligation (FRACMOO) initiative. The opinion was adopted on March 11, 2014 and was submitted to the Board of Governors at its March meeting.

During this period, MSC members also interacted with staff and stakeholders on several ISO initiatives. MSC member Dr. Scott Harvey was a speaker at the California ISO Pricing Forum, held April 22, 2014, which was also attended by MSC member Dr. Shmuel Oren. The MSC is planning to prepare and submit formal opinions on two ISO initiatives for the Board of Governors for the July or subsequent meeting. These include initiatives on reliability services, the flexible ramping product, and commitment costs enhancements.

The MSC will hold a general session meeting at Folsom on May 19, 2014 in which the following topics will be addressed:

- ISO market prices;
- Resource adequacy resource availability incentive mechanism, which is part of the reliability services initiative;
- Potential changes to commitment cost pricing to address issues arising from the volatility of natural gas prices;
- Market power mitigation in the energy imbalance market (EIM); and
- Benefit-cost analysis of EIM implementation.

The remainder of this briefing is devoted to a summary of the FRACMOO opinion and its three major conclusions.

Opinion on Flexible Resource Adequacy Criteria and Must Offer Obligation Initiative

In the Market Surveillance Committee update that was submitted to the Board for the March, 2014 meeting, I briefly summarized the activities of the committee that lead to the development of the opinion up to the time of posting of the draft. Since the submission of that report, the Opinion was formally adopted at the March 11 Committee general session meeting in Folsom, and was then presented by Dr. Oren to the Board at its March 19-20 meeting.

In its opinion, the MSC summarized the proposed FRACMOO framework as being aimed at addressing operational challenges involved in integrating the rapidly increasing amount of renewable resources into the California electricity resource mix, the retirement of once-through cooling generation capacity and expected rapid increase in distributed generation. The MSC views the FRACMOO framework as a first step aimed at enabling the implementation of the CPUC Decision 13-06-024 (June 27, 2013) which established interim flexible capacity procurement obligations as part of the CPUC's resource adequacy program. This ruling and its implementation represent an interim step toward a comprehensive solution, referred to as the joint CAISO/CPUC Multi-Year Reliability Framework. This framework will include the establishment of a multi-year resource adequacy forward procurement process by the CPUC, along with a California ISO market-based backstop capacity procurement mechanism. Furthermore, the ISO is in the process of developing a short-term flexible ramping product in its real-time markets. The MSC is involved in discussions with stakeholders and staff on these critical follow-throughs to the FRACMOO initiative, and anticipates preparing formal opinions for submission to the Board this year.

In the adopted FRACMOO opinion, the MSC notes that while the FRACMOO proposal states a commitment to a holistic approach that is consistent with the Joint Reliability Plan, the proposal is focused on a narrow and focused implementation that will expedite the inclusion of flexibility criteria in the resource adequacy process. This focus resulted from a lengthy stakeholder process that concluded with a substantial limiting of the scope of the proposal, relegating some issues involved in developing a holistic approach to separate stakeholder initiatives.

The MSC recognized in its opinion that the ISO's proposal was intended to be a pragmatic and narrowly focused approach to expediting procurement of flexible capacity through the resource adequacy process as an interim solution to addressing operational challenges in the near term. The experience gained from implementing this approach will likely be useful in the on-going process of fashioning a holistic approach to flexible capacity procurement and offer incentives. The opinion concluded with three general recommendations and conclusions.

First, there is some technical uncertainty about how much flexible capacity is needed and how much will become available in the process. It is not expected that the requirement will be binding right after implementation, but it is possible that if more is required than is needed to operate the system, then payments will be higher than necessary once the flexible resource adequacy showing requirement becomes an obligation (in 2015) and if the procurement requirement begins to bind. The MSC concludes that what is learned in 2014 and subsequent years could lower this risk. The need is to ensure that the 2015 and subsequent flexible capacity requirements take into account the actual amount of flexibility available from all sources in meeting the ramps used to define the procurement targets so that the mandatory targets are in line with actual system needs for flexibility from resource adequacy resources.

Second, in order to avoid higher than anticipated costs for meeting the requirement, if early experience with the flexible resource adequacy procurement begin to suggest potential shortages of flexible resource adequacy, the ISO needs to work with stakeholders to understand the reasons, if any, that the energy market is not eliciting the needed supply and that potentially flexible capacity is not available for procurement for that purpose or is only available at a substantial premium. This is necessary so that the ISO or the CPUC can address those causes so that flexible resource adequacy procurement costs are not inflated by unnecessary barriers or costs to supplying flexible capacity in the resource adequacy process.

Third, the opinion closed with a recommendation that short-term markets should be the primary source of economic incentives for providing flexibility to the ISO system. There are two reasons for this recommendation. First, short-term energy, reserves, and flexi ramp markets respond by providing energy precisely when needed during ramp periods, and thereby avoid the very serious conceptual and practical problems of trying to accurately evaluate the contribution of, for instance, imports, storage, start-limits, energy-limits, and other attributes in resource adequacy markets. Second, whether there is a market failure in those short-term markets that would yield too little flexibility is not well understood. The MSC observed that there are several changes that are being made or could be made to the ISO market to ensure that flexible resources are appropriately incented. These include creation of a flexi ramp product; separation of day-ahead and real-time bid cost recovery; moving to 15 minute markets for interchanges under FERC Order 764; geographic expansion of the energy imbalance market; decreasing the use of out-of-market dispatch; and expanding scarcity pricing through appropriate reflection of energy imbalance and other constraint violation penalties in locational marginal prices. If these changes are successful and if flexible resource adequacy requirements are not overstated relative to actual system need, the MSC anticipates that in the long run that flexible resource adequacy capacity will receive little or no premium in the resource adequacy markets.