September 6, 2013

COMMENTS ON BEHALF OF THE CITIES OF ANAHEIM, AZUSA, BANNING, COLTON, PASADENA, AND RIVERSIDE, CALIFORNIA ON THE ENERGY IMBALANCE MARKET 3rd REVISED STRAW PROPOSAL

In response to the ISO's request, the Cities of Anaheim, Azusa, Banning, Colton, Pasadena, and Riverside, California (collectively, the "Six Cities") submit the following comments on the ISO's August 13, 2013 Energy Imbalance Market 3rd Revised Straw Proposal ("the 3rd Revised Straw Proposal").

Alignment of EIM Costs with Benefits - - In previous comments in this stakeholder process, the Six Cities have urged the ISO to develop an approach for allocating Energy Imbalance Market ("EIM") costs that aligns those costs with the benefits resulting from implementation of the EIM. The "costs should align with benefits" concept is one formulation of the cost causation principle. The Six Cities have urged the ISO to develop a robust methodology for determining EIM benefits as well as a methodology for identifying all costs arising from implementation of the EIM, including incremental uplift costs occurring in any participating BAA. The EIM costs should be allocated in proportion to the EIM benefits.

The alignment of EIM costs with benefits should seek to achieve two objectives. First, the market participants in one BAA should not be forced to bear extra or incremental costs in order to produce benefits for the market participants in a different BAA. That is, the EIM should "do no harm" to the participants in any BAA. The Six Cities view compliance with the "do no harm" principle as a fundamental requirement for an acceptable EIM design.

While the "do no harm" rule is a necessary element of the EIM design, it is not by itself sufficient to satisfy the cost causation principle. Assuming that EIM implementation produces overall benefits that exceed overall costs, the cost causation principle and fundamental fairness also require that participants in the different BAAs bear shares of overall EIM costs that are roughly proportional to the shares of overall EIM benefits they receive. If, hypothetically, implementation of the EIM resulted in overall benefits of $200 million, with $150 million (75%) accruing to participants in BAA 1 and $50 million (25%) accruing to participants in BAA 2, the cost causation principle requires allocation of approximately 75% of the EIM costs to BAA 1 and approximately 25% of the BAA costs to BAA 2.

Some of the cost allocation approaches described in the 3rd Revised Straw Proposal appear to focus on the "do no harm" objective. For example, in the 3rd Revised Straw Proposal, as in the 2nd Revised Straw Proposal, the ISO proposes to allocate congestion costs to the BAA in which the transmission constraint giving rise to the congestion is located. It is not clear, however, that it will be possible to isolate all of the impacts of congestion within a BAA and assign the associated costs to that BAA. As the ISO noted at page 22 of the matrix of comments and ISO responses on the first Revised Straw Proposal, "EIM is a single, integrated real-time market, and resources in any area within the EIM footprint may meet needs for real-time imbalance energy of congestion management in another area within the footprint, within the available transmission capacity." Given the integrated nature of the EIM, attempting to segregate the full costs for managing congestion by BAA may not be attainable.

The ISO's proposed approach for the allocation of neutrality uplift costs based in part on energy transfers among EIM BAAs follows to some degree the concept of assigning costs in proportion to benefits, but only very roughly. The neutrality costs transferred from one EIM BAA to another under the proposed allocation process may be either more or less than the benefits the transferee BAA received as a result of the energy transfers. The 3rd Revised Straw Proposal still lacks a commitment and a process for conducting a comprehensive assessment of all costs and all benefits resulting from implementation of the EIM and assuring that responsibility for costs is reasonably aligned with receipt of benefits as required by the cost causation principle.

<u>Effects on Uplifts Associated With Virtual Bids</u> - - In previous sets of comments, the Six Cities and other stakeholders have raised concerns that the inherent differences in the Day-Ahead Market, in which virtual bids will be submitted, and the EIM Real-Time Market, in which virtual bids would be settled, inevitably will give rise to uplift costs. The 3rd Revised Straw Proposal appears to address the effects of EIM implementation on virtual bids that are affected by constraints within an EIM BAA (*i.e.*, external to the ISO transmission grid). With respect to other virtual bids, however, the 3rd Revised Straw Proposal points to the ISO's efforts to improve the accuracy of the ISO's Day-Ahead modeling process and promises to consider changes to the allocation of convergence bidding uplifts resulting from constraints within the ISO if the efforts at improved modeling are insufficient.

There is no reason to anticipate that improvements in the modeling of the Day-Ahead process will be sufficient to offset potential impacts of the inherent differences between the Day-Ahead market in the ISO BAA and the EIM covering the expanded EIM area. Even if the new and improved Day-Ahead model reflects with reasonable accuracy the anticipated transmission conditions, loads, and resource utilization within the ISO and in neighboring BAAs operating separately, the implementation of the EIM will change the resource utilization pattern in Real-Time. Indeed, that is the stated purpose of the EIM. And because the EIM will function as a single integrated real-time market, changes from the Day-Ahead model are likely to affect nodes internal to the ISO separate and apart from the effects of constraints in an EIM BAA. The ISO cannot ignore the effects of implementing the EIM on the outcomes of the virtual bidding process even within the ISO BAA. To the extent implementation of the EIM gives rise to additional uplifts associated with virtual bidding, such uplifts must be recognized as costs of the EIM that are allocated in proportion to the benefits of EIM participation. Alternatively, such uplifts reasonably could be allocated to virtual bidders. It would be patently inconsistent with the cost causation principle, however, to allocate such uplift costs to ISO load.

<u>Local Market Power Mitigation</u> - - The Six Cities generally support the ISO's proposal to apply a modified version of the Local Market Power Mitigation ("LMPM") methodology currently in effect for the ISO to mitigate bids of resources participating in the EIM. However, at page 28 of the 3rd Revised Straw Proposal, the ISO indicates that it plans to apply LMPM to a resource only if that resource is necessary to address a constraint within the same BAA. The Cities oppose that aspect of the ISO's LMPM proposal. The Six Cities understand the ISO's proposed limitation on the application of LMPM to reflect the general principle that each BAA participating in the EIM is responsible for resolving congestion within that BAA prior to the EIM optimization. Conditions may change, however, causing unanticipated congestion in Real-Time, and a resource may be dispatched to relieve congestion not only

within the BAA in which the resource is located but also in any other EIM BAA. Under the ISO's proposal, a resource with market power relative to a constraint located in a different BAA could be dispatched at an unmitigated bid price to relieve that constraint. Permitting the exercise of market power, even if the affected BAA has not been successful in resolving congestion, is not acceptable. Bids by resources with market power relative to any constraint - - wherever located - - should be mitigated.

Commitment Costs - - In the 3rd Revised Straw Proposal (as in the 2nd Revised Straw Proposal), the ISO proposes to charge an EIM BAA for Bid Cost Recovery for commitment costs only if the EIM BAA has agreed to allow the ISO to commit resources within the EIM BAA. The Six Cities oppose this aspect of the proposed EIM design. The ISO's matrix of comments and responses on the 2nd Revised Straw Proposal provided no justification for the ISO's proposed treatment of commitment costs. However, the ISO suggested during the August 20th meeting on the EIM that the proposed treatment of commitment costs is premised on a theoretical reciprocity of resource commitment by EIM BAAs that do not allow the ISO to commit resources within their BAAs. As described below, it appears highly unlikely that resource commitments to support the EIM will be symmetric. Under these circumstances, the ISO's proposed treatment of commitment costs will impose a disproportionate and unfair burden on ISO load.

Under the proposed EIM design, the ISO will commit resources to meet the imbalance needs of the entire ISO/EIM area. Within the ISO BAA, Resource Adequacy Resources that are able to do so must participate in the Real-Time Market and, therefore, will be subject to commitment to meet EIM requirements. The ISO as Market Operator, however, will not have authority to commit resources within an EIM BAA unless the EIM BAA agrees to allow such commitment. There does not appear to be any obligation for an EIM BAA to commit resources within its area to support EIM needs. Moreover, since participation in the EIM is voluntary for resources within an EIM BAA, it appears that neither the EIM BAA nor the ISO (with the EIM BAA's permission) could commit resources within an EIM BAA without the agreement of individual resources.

Given the apparent differences in the availability requirements applicable to resources within the ISO BAA versus resources within EIM BAAs, there is no reasonable basis for an assumption that resource commitments within EIM BAAs will be balanced in comparison with commitments of resources within the ISO BAA. It is far more likely that the ISO will use its greater authority to commit resources within the ISO to support the needs of EIM BAAs. Under these circumstances, it is unreasonable to allow EIM BAAs to effectively opt out of paying for commitment costs of resources committed to meet their needs.

In the context of developing a methodology for compliance with California's Greenhouse Gas regulations, the ISO has indicated that it is possible to identify which resources are used to meet the needs of which BAA. It therefore should be possible for the ISO to identify which resource commitment costs are incurred to meet the needs of EIM BAAs and to assign those costs to the appropriate BAA. To the extent an EIM Entity can demonstrate that it has incurred commitment costs in order to meet EIM requirements in the ISO BAA, it would be appropriate to allocate such costs to the ISO BAA.

Greenhouse Gas Costs for ISO Resources Used to Serve Load Outside of California - - The method for identifying and tracking greenhouse gas ("GHG") compliance costs described in the 3rd

Revised Straw Proposal generally appears reasonable. The Six Cities, however, request clarification of one statement included in the discussion of GHG compliance. The 3rd Revised Straw Proposal states at page 79 that "[l]oad in EIM Entity BAAs outside California will not be assessed GHG emission costs." The ISO assumes that resources located within California that have a GHG compliance obligation will incorporate the GHG emission costs into their energy bids. *See* 3rd Revised Straw Proposal at page 78. If energy produced by a resource located within California provides the marginal source of supply for load outside the ISO BAA, such external load should be responsible for paying the full offer price for such marginal resource, including any emissions costs implicitly incorporated in the bid price. The Six Cities request confirmation that the ISO expects load outside the ISO BAA to pay emissions costs to the extent such costs are incorporated in the energy bids for California resources used to serve load external to the ISO BAA.

Transmission Charges - - The 3rd Revised Straw Proposal maintains the ISO's recommendation that transmission for EIM dispatch, at least for an initial implementation period, not be subject to a transmission charge. A number of stakeholders have identified concerns with this proposal, including discrimination among resources participating in the EIM versus other resources and the potential that the availability of free transmission in the EIM may discourage Day-Ahead scheduling. As one possible way of addressing such concerns, the 3rd Revised Straw Proposal suggests at pages 73-74 that Transmission Access Charges and Wheeling Access Charges might be applied only to loads within the ISO BAA and to wheeling schedules (not including exports or EIM energy transfers). The Six Cities oppose any narrowing of the current application of transmission access charges but do not take a position at this time regarding application of transmission charges to EIM transfers. If implementation of the EIM goes forward without transmission charges for EIM transactions, however, the ISO must be alert for potential market distortions and prepared to act promptly to address any that appear.

Adequacy of Measures to Prevent Leaning - - The 3rd Revised Straw Proposal includes several measures to discourage leaning by one EIM BAA on the capacity resources of another participating BAA. As noted in the Six Cities' previous comments on the 2nd Revised Straw Proposal, the Cities support the ISO's proposal to apply a flexible capacity requirement for each BAA participating in the EIM. The Cities also support the proposal to apply a graduated penalty for underscheduling of load. However, the Cities remain concerned that the "anti-leaning" measures proposed to date may not be adequate to avoid diminution of reliability within the ISO. Several commenters have suggested that in addition to a penalty for underscheduling of load, there also should be a penalty for overscheduling by resources. This seems particularly necessary when the ISO has no plans to assess the likely availability of resources included in the base schedules submitted by EIM BAAs (3rd Revised Straw Proposal at page 7), and there is no difference in the price for settlement of instructed imbalance energy versus uninstructed imbalance energy (Comments/Response matrix for the 2nd Revised Proposal at page 56). Although the Six Cities appreciate that resource adequacy procurement is outside the scope of the Real-Time market, it is not inconsistent with the Real-Time focus of the EIM to include measures to encourage resources to perform as represented in the base schedule or, for those participating in the EIM, as directed by the ISO as Market Operator.

Recovery of Stranded Costs from Withdrawing Participants - - In their comments on the 2nd Revised Straw Proposal, the Six Cities requested an explanation for how EIM costs would be recovered in the event the EIM terminates or one or more EIM Entities choose to withdraw. The ISO's response at page 56 of the Comments/Response matrix for the 2nd Revised Proposal simply asserts that start-up costs are recovered through the initial implementation agreement, and on-going costs will be covered by the

EIM administrative rate. The ISO's response implies that there could be no unrecovered or "stranded" costs resulting from withdrawal of an EIM BAA, but that premise does not seem self-evident. At a minimum, the EIM design should include a provision for analysis to determine whether any stranded costs will occur as a result of withdrawal of a BAA from the EIM and make clear that any stranded costs identified will be the responsibility of the withdrawing BAA.

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