

Memorandum

To: ISO Board of Governors
From: Frank A. Wolak, Chairman, ISO Market Surveillance Committee
cc: ISO Officers
Date: May 21, 2007
Re: *Market Surveillance Committee Activities from April 7, 2007 to May 4, 2007*

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

The Market Surveillance Committee (MSC) has been involved in a number of activities over the past month related to the implementation of the Market Redesign and Technology Upgrade (MRTU). Two of these will lead to opinions submitted to the ISO Board for its July 18-19, 2007 meeting. These are: (1) implementing convergence bidding under MRTU and (2) day-ahead and hour-ahead scheduling requirements under MRTU. The other two activities are as also related to MRTU implementation but have a longer time line. These are: (1) impact of California's greenhouse gas emissions control policies on the California electricity market and (2) a backstop capacity product to replace the Reliability Capacity Service Tariff (RCST) under MRTU. The remainder of this memo summarizes each topic.

Convergence Bidding

The Federal Energy Regulatory Commission (FERC) has directed the California ISO to implement convergence bidding within twelve months after the start of MRTU. The convergence bidding design challenge is how to best capture the expected market efficiency benefits of allowing it while limiting the opportunities for market participants to use it to enhance their ability to exercise unilateral market power. The degree of spatial granularity in convergence bids has been the subject of substantial debate among stakeholders. Some generation unit owners have argued that market participants should be allowed to submit both incremental and decremental convergence bids in the day-ahead market at any node in the California ISO control area. Some major California load-serving entities (LSEs) have argued that convergence bidding should be limited to the load aggregation points (LAPs). The MSC has emphasized that there are costs and benefits associated with each proposal. The current approach proposed by the ISO of initially implementing convergence bidding at the LAP level with a timeline for implementing convergence bidding at the nodal level balances these conflicting perspectives.

Scheduling Requirements under MRTU

FERC has also asked the California ISO to consider scheduling requirements under MRTU. MSC has expressed skepticism about the need for day-ahead and hour-ahead scheduling requirements under MRTU if the level of fixed-price forward contracting for energy by California's load-serving entities remains at its current level. For example, there is little need for a requirement that a LSEs schedules 95% of its day-ahead demand forecast in the day-ahead

market if that LSE has fixed-price forward contract coverage of at least of 95% of this day-ahead demand forecast. With this level of fixed-price forward contract coverage, the LSE is completely hedged against short-term electricity price fluctuations and has no financial incentive to schedule less than the quantity of energy covered by these fixed-price forward contracts in the day-ahead market. Thus, a major determinant of the need for a day-ahead scheduling requirement under MRTU is the extent to which California LSEs maintain their current percent of fixed-price forward contract coverage of final demand under MRTU. A number of stakeholders have expressed concerns that the current CPUC RA paradigm does not provide adequate incentives for LSEs to engage in sufficient fixed-price forward contracting for energy. Although the recent FERC Rehearing Order on MRTU reiterated that the ISO must implement interim scheduling requirements until convergence bidding is implemented, several MSC members believe that the value of a scheduling requirement is limited and it may be harmful to wholesale market efficiency if there is adequate fixed price forward contracting by the LSEs. The MSC recommends that significant effort be devoted to ensuring there is adequate fixed-price forward contracting by LSEs. This will allow the ISO to achieve the reliability goals of any scheduling requirement that it implements.

California Greenhouse Gas (GHG) Emissions Policies and the California Electricity Market

Several MSC members have been actively involved in analyzing the potential impact of California's GHG control policies on the performance of the California electricity market. James Bushnell recently briefed several California Air Resources Board (CARB) Commissioners on the likely impact of implementing a load-based GHG policy in California. The MSC is also planning to participate in the May 30, Market Issues Forum on the inter-relationships between California's GHG policies and MRTU. The MSC is also in the process of organizing a technical workshop among stakeholder groups for the first part of June 2007 to discuss methods for best achieving California's GHG goals and maintaining a competitive wholesale electricity market in California.

Backstop Capacity Product under MRTU

The Reliability Capacity Service Tariff (RCST) that retains the must-offer obligation on all generation units located in the California ISO control area is scheduled to end with the start of the MRTU market. Several stakeholder groups and the California ISO operators have expressed concern that there will no longer be a process to ensure that the ISO operators will have the necessary generation capacity available in real-time to ensure reliable grid operation. The major concern is that the resource adequacy plans of the LSEs may not procure sufficient local generation capacity because of changes in system conditions between the time the resources were purchased and the time they are needed to serve demand. For this reason, the ISO is considering a process for creating a backstop capacity product under MRTU similar to the RCST product under the current market design. The MSC will consult with ISO staff and participate in the stakeholder process in the design of this backstop capacity product.