California Independent
System Operator Corporatio

Memorandum

To: ISO Board of Governors

From: Frank A. Wolak, Chairman, ISO Market Surveillance Committee

Date: May 13, 2008

Re: ***Market Surveillance Committee Activities from March 7, 2008 to May 8, 2008***

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

The MSC held a joint MSC/Stakeholder meeting on April 11, 2008. The MSC has also worked with CAISO staff on several issues, participated in stakeholder conference calls and attended stakeholder meetings during the past two months. This memo summarizes these activities.

On May 7, 2008, the MSC adopted three opinions on market design policy issues that are being brought to the Board this month for a decision. The first opinion comments on the Integrated Balancing Authority Area (IBAA) proposal. The second opinion discusses the Exceptional Dispatch proposal. The final opinion comments on the DEC Bidding Activity Rule proposal. These opinions will be included in the package of material that CAISO Management is providing to the Board on each of these topics.

Market Surveillance Committee/Stakeholder Meeting on April 11, 2008

Two topics were discussed at the April 11, 2008 meeting.

Integrated Balancing Authority Areas

The vast majority of the meeting was taken up with a discussion of the CAISO's IBAA proposal for MRTU. This proposal is designed to achieve day-ahead schedules at the inter-ties of neighboring control areas to the CAISO that are more representative of real-time power flows between the CAISO and neighboring control areas. CAISO staff first presented the original IBAA proposal that had six pricing locations outside the CAISO control area. This proposal was compared to the existing radial approach to modeling injections into and withdrawals from the CAISO control area. The six pricing location proposal was also compared to a single pricing location proposal. The final proposal considered was the full physical modeling and pricing of locations inside the neighboring IBAA. This is the CAISO's preferred solution. But this proposal requires the neighboring IBAAs to share information with the CAISO on the day-ahead schedules of generation resources and loads, the configuration of the transmission network, and import and export schedules for this IBAA with neighboring control areas besides the California ISO. Because the SMUD/WAPA/TID/MID IBAA is unwilling at the present time to share this information with the CAISO operators, this solution is not considered a viable option by the CAISO. The current radial injections approach to modeling is not a viable option under MRTU because it is unlikely to achieve the goal of day-ahead inter-tie schedules that are representative of real-time flows.

The remainder of the CAISO staff presentation focused on the six pricing location approach and a single pricing location approach. The superiority of the six pricing location approach relies on market participants truthfully revealing to the CAISO operators the source of the energy they supply to the CAISO and the sink for the energy they purchase from the CAISO. Because a number of stakeholders and members of the MSC have expressed skepticism that market participants would reveal the true source of supply of energy or sink for energy, they did not believe that this advantage of the CAISO's proposal will be realized in practice. Instead, market participants would have an incentive to designate the highest priced sources and the lowest priced sinks, regardless of the true source and true sink. For this reason, the CAISO staff discussed the single pricing location approach.

Scott Harvey of LECG reviewed the experience of the Eastern ISOs with proxy bus pricing with neighboring control areas. He first defined proxy buses and how they were used. He then described how the New York ISO and PJM used proxy buses to model and price power flows between neighboring control areas. He then discussed the experience of PJM with multiple proxy buses. Specifically, he stated that when PJM used multiple proxy buses with neighboring areas, market participants schedule injections at the high-priced locations and withdrawals at the low-priced locations, regardless of the true point of injection or withdrawal. This occurred despite PJM's best attempts to verify the true source of injections and withdrawals. Harvey concluded that the experience of the Eastern ISO demonstrates that it is virtually impossible for an ISO to determine the true source of supply of an injection into the ISO control area or the true sink for a withdrawal from the ISO control area. For this reason he recommended that the CAISO consider adopting a single pricing location for the SMUD/WAPA/TID/MID IBAA. Several members of the MSC agreed with Harvey's recommendation.

Eric Hildebrandt of the Department of Market Monitoring (DMM) then gave a presentation on how DMM would monitor the accuracy of day-ahead inter-tie schedules versus real-time flows. He emphasized that if the CAISO decided to go with the six pricing location approach, it should have the flexibility and discretion to switch quickly to the single pricing location approach if the expected benefits of the six hub approach were not realized. Hildebrandt presented a number of indices and metrics that DMM would monitor to determine whether the purported benefits had been realized, or if the market inefficiencies were so great that the CAISO should switch to the single pricing location approach.

The remainder of this segment of the meeting was taken up with discussion between stakeholders, CAISO staff, and MSC members, on details of the six pricing location approach and the single pricing location approach.

Exceptional Dispatch Market Power Mitigation under MTRU

The second topic discussed was the need for a market power mitigation mechanism for Exceptional Dispatch (ED) instructions under MRTU, and whether, in some cases, supplemental payments should be made to Exceptionally Dispatched resources subject to mitigation that do not have contracts that provide revenues toward fixed cost recovery, such as a Resource Adequacy (RA) or Reliability Must Run (RMR) contract or an Interim Capacity Procurement Mechanism (ICPM) designation. Since late 2007, the MSC has been involved in the discussions with DMM staff on a market power mitigation mechanism for generation units called under the CAISO's Exceptional Dispatch authority. Under the current MRTU tariff, a generation unit owner called under the CAISO's Exceptional Dispatch authority receives the higher of its bid price, the locational marginal price at its location, or its default energy bid for the amount of energy it supplies under an Exceptional Dispatch instruction. The DMM is concerned that a generation unit owner that knows one of its units is needed for an Exceptional Dispatch instruction could submit a bid at the CAISO offer cap and be paid as bid for this energy. Consequently, the DMM is in the process of formulating a market power mitigation mechanism for preventing generation unit owners from exploiting the significant local market power they might have as a result of a transmission or generation outage that results in a significant number of Exceptional Dispatch calls for a generation unit. At the same time, CAISO's Market and Product Development (MPD) group has been conducting a stakeholder process to examine options for augmenting the mitigation rules with supplemental revenues towards fixed cost recovery, as described above.

Jim McClain of MPD reviewed the history of the ED process. He summarized the CAISO's market power mitigation proposal for ED instructions and discussed a number of options for determining the payment a supplier would receive for responding to ED instruction under the market power mitigation mechanism. These included providing a Bid Adder on a mitigated Bid or allowing for unmitigated "as-bid" payments subject to a revenue cap based on the ICPM monthly payment, followed by mitigation for the remainder of the month. He then summarized the stakeholder comments on the various payment options. This presentation was followed by a discussion between stakeholders, CAISO staff, and MSC members on the strengths and weaknesses of the various payment options and the need to mitigate ED instructions.