

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

**California Independent System         )  
Operator Corporation                     )**         **Docket No. ER11-3149-000**

**ANSWER OF THE  
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION  
TO COMMENTS**

Pursuant to Rule 213 of the Federal Energy Regulatory Commission's (Commission) Rules of Practice and Procedure, 18 C.F.R. § 385.213 (2010), the California Independent System Operator Corporation (ISO) hereby files an answer to comments submitted by Powerex and Calpine Corporation to the ISO's March 21, 2011 filing in the above-captioned docket. No intervener, not even Powerex or Calpine, opposes the ISO's proposed tariff change.<sup>1</sup> Rather, Powerex and Calpine inappropriately seek to broaden the scope of this proceeding, asserting that a more comprehensive review of bid cost recovery is warranted at this time. Powerex asks the Commission to mandate a technical conference to consider all possible issues regarding the overall bid cost recovery mechanism, and identifies two specific issues it seeks to have addressed in a technical conference. Powerex, however, fails to provide

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<sup>1</sup> Six parties filed comments in support of the ISO's proposed tariff changes: San Diego Gas & Electric Company; Southern California Edison Company; The Cities of Anaheim, Azusa, Banning, Colton, Pasadena, and Riverside, CA; Public Utilities Commission of the State of California; Pacific Gas and Electric Company; Northern California Power Agency. Eight parties filed simple interventions, without any objection to the proposed rule changes: J.P. Morgan Ventures Energy Corporation, *et al.*; Alliance for Retail Energy Markets; Modesto Irrigation District; The Cities of Anaheim, Azusa, Banning, Colton, Pasadena, and Riverside, CA; City of Santa Clara, California and the M-S-R Public Power Agency; Dynegy Power Marketing Inc., *et al.*; California Department of Water Resources State Water Project; GenOn Parties; and NRG Companies.

any evidence that the ISO's proposed rule change is not just and reasonable without a comprehensive review of the bid cost recovery rules. Calpine also asserts that a more comprehensive review of the bid cost recovery mechanism should be conducted, but instead suggests that it be conducted during the upcoming stakeholder process, claiming that the complexity of the bid cost recovery mechanism in and of itself is an issue. Calpine also fails to bring forth any evidence that the bid cost recovery mechanism must be simplified before accepting the proposed rule change as just and reasonable.

Indeed, Powerex and Calpine do not provide any evidence that justifies delaying the acceptance of the ISO's proposed tariff amendment. The expansion of the scope of this proceeding, as suggested by Powerex and Calpine, would only serve to delay implementing a remedy to the issue identified in the March 21 filing. The Commission should accept the ISO's proposed tariff amendment as it provides an immediate just and reasonable remedy to a specific market issue that, if left unaddressed, may undermine the role of the ISO's day-ahead market and could result in significant overpayment of bid cost recovery to market participants.

## **I. BACKGROUND**

Since April 1, 2009, the ISO has been operating under its new locational marginal price (LMP)-based markets. On March 21, 2011, the ISO proposed to amend its tariff to modify a market settlement rule to remedy observed market behavior causing an unexpected market outcome under the existing tariff rules. The ISO requested expedited consideration and waiver of the sixty day notice requirements.

The ISO's bid cost recovery mechanism was created to ensure that when the ISO commits a resource, that resource will at least recover its fixed start-up and minimum load costs. When a resource's energy market revenues are insufficient to cover those costs, the bid cost recovery mechanism provides a resource with a make-whole payment. Under the ISO's existing bid cost recovery tariff rules, the ISO subtracts (nets) the market revenues a resource receives from its accepted bid costs to ensure that the bid cost recovery mechanism compensates it for unrecovered costs, but does not result in over payment of submitted start-up, minimum load, and submitted energy bid costs. The current tariff rules require the ISO to consider market revenues for the delivered portions of the day-ahead schedule in calculating the market revenues the resource earned from the integrated forward market (IFM), which is part of the day-ahead market.

As discussed in its March 21, 2011 filing, the ISO has recently observed the use of a specific bidding practice that forces the ISO to schedule a resource in the IFM at a high MW level and then dispatch the resource at a much lower level in the real-time market. Under the current settlement system, this bidding practice results in significant overpayment of bid cost recovery. The bidding practice has been in effect for the past seven months, resulting in an increase in bid cost recovery payments of over fifty percent in certain months. While the amount of overpayment of bid cost recovery is relatively small compared to the overall \$8 billion market, the amount of bid cost recovery associated with the bidding practice represents 43 percent of \$132 million (\$57 million) in total bid cost recovery payments from August 2010 through February 2011.

The ISO thus proposed to modify Section 11.8.2.2 of its tariff to remedy this market issue. This section currently requires the ISO, for purposes of bid cost recovery, to calculate IFM market revenues based on delivered portions of the day-ahead schedule. The ISO's proposed revision specifies that, for resources that are dispatched at lower levels in the real-time than in the day-ahead, calculation of IFM market revenues used to offset bid costs will be based on scheduled portions, as opposed to delivered portions. The proposed rule change applies only in cases when a resource's real-time market dispatch is lower than its day-ahead market schedule. The ISO also proposed amendments to clarify how the delivered portions of a resource's schedules or dispatches are determined. These clarifications help eliminate any potential ambiguity regarding the bid cost recovery calculations.

As set forth in the ISO's March 21 filing, the ISO has requested expedited consideration of the proposed amendment, and proposed to conduct a stakeholder process to provide stakeholders an opportunity to raise any further changes or refinements to the proposed tariff amendments.<sup>2</sup>

## **II. ANSWER**

On April 4, 2011, six parties filed interventions and comments in support of the ISO's proposed tariff amendment and the proposed stakeholder process to follow the Commission's acceptance of the tariff amendment. Eight parties filed simple interventions without any opposition to the proposed changes. Powerex and Calpine, while not opposing the ISO's proposed tariff changes, filed comments asking that the Commission expand the scope of this proceeding to address additional issues unrelated

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<sup>2</sup> See *March 21 Filing*, Docket No. ER11-3149, Transmittal Letter at pp. 1-2.

to the adverse market behavior the IFM market accounting rules incentivized, the only issue the ISO seeks to address in this proceeding. The ISO submits this answer to Powerex's and Calpine's comments.

**A. There is No Basis to Expand this Proceeding, Which is Narrowly Tailored to Address the Observed Market Behavior that that Exaggerated Bid Cost Recovery Payments.**

Powerex candidly acknowledges that it does not oppose the ISO's proposed tariff amendments, and in fact supports the ISO's efforts to respond to identified problems with existing tariff mechanisms that may cause or contribute to unintended market results.<sup>3</sup> Powerex, however, objects to what it perceives to be a piecemeal approach to addressing problems caused by one aspect of the bid cost recovery design, rather than taking a more comprehensive approach to address a number of known bid cost recovery-related issues.<sup>4</sup> Powerex thus requests that the Commission delay acceptance of the proposed rule change, and convene a technical conference, to comprehensively address all of its issues with the current bid cost recovery design.<sup>5</sup>

Notably, however, Powerex fails to raise any evidence, or make any argument, in support of a conclusion that the proposed rule itself is not just and reasonable on its own merits, or that the proposed rule requires further vetting through a technical conference before acceptance. Nor does Powerex provide any evidence to support the notion that the entire bid cost recovery mechanism is flawed and requires redress prior to accepting the ISO's proposed rule change. The first priority in this matter should be to ensure that the market rules that incentivized the adverse market behavior be

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<sup>3</sup> Powerex Comments at p.1.

<sup>4</sup> *Id.* at pp. 5-7.

<sup>5</sup> *Id.* at 5.

eliminated as soon as possible. No intervenor opposes the proposed rule change as a first step for doing so. Prompt action is necessary both to revise the tariff prospectively to remove a resource's ability to benefit from the observed bidding practice, and to avoid material adverse impact to the markets. If left unaddressed, the current market rule will incentivize market behavior that exacerbates the overpayment of bid cost recovery uplift, far exceeding the intended purpose of the bid cost recovery mechanism. The upcoming stakeholder process will give stakeholders, including Powerex, an opportunity to raise any further proposed changes or refinements.

Calpine similarly asserts that the ISO's proposed amendment is a temporary fix that does not address the underlying complexity of bid cost recovery. However, like Powerex, Calpine fails to offer any evidence that the rule is not just and reasonable. Calpine also fails to raise any evidence to support the notion that its proposal to simplify the rules would even address the market issue identified, or that simplification is necessary to address any other issue. Calpine asserts that there are numerous legitimate reasons for a resource to be dispatched below the day-ahead schedule.<sup>6</sup> Calpine further asserts that the complexity of the existing bid cost recovery rules could discourage parties from bidding into the ISO market in support of integration of renewable resources.<sup>7</sup> Calpine's comments are misguided for several reasons.

First, the ISO's proposed rule change does not complicate the existing bid cost recovery rules and instead, is a narrowly-tailored rule that allows for a more simplified accounting rule for IFM market revenues. Second, the rule does not discourage resources from being scheduled in the day-ahead and dispatched to lower levels in the

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<sup>6</sup> Calpine Comments at p. 6.

<sup>7</sup> *Id.* at pp. 5-6.

real-time. Rather, it is designed to discourage the particular bidding behavior that exaggerates minimum load costs, forces the ISO to schedule the resource at maximum capacity in the day-ahead, and then further forces the ISO to dispatch the resource to minimum load based on its submitted bids. It is the combination of these actions that led to the exaggeration of the bid costs recovery, and it is this behavior the rule is designed to address. As demonstrated by Mr. Rothleder in ISO Exhibit No. 1 pp. 34-48, the revised rule continues to allow parties dispatched to levels below their day-ahead schedules an opportunity to recover their bid costs.

Furthermore, forcing the ISO to conduct a comprehensive review of all the bid cost recovery rules during the proposed narrow stakeholder process is unnecessary, infeasible and premature. A comprehensive review is unnecessary because, as noted above, neither Calpine nor Powerex provide any basis to conclude that the current bid cost recovery mechanism, or the proposed rule change, is not just and reasonable. It is infeasible because a 90-120 day stakeholder process would simply not afford sufficient time to consider every possible proposed rule change that parties may wish to raise regarding the entire bid cost recovery design. This would divert the focus away from the remedies sought in this proceeding, to completely unrelated issues.

Finally, the ISO is in the midst of considering market rule changes for the integration of variable energy resources in anticipation of significant entry of such resources in the upcoming years. While currently, there is no apparent overall flaw with the bid cost recovery rules, it will be appropriate to review and modify these rules further in the context of the evolving overall market design as the ISO seeks to integrate variable energy resources. The ISO is already evaluating its payment and cost

allocation rules to ensure resources adequately recover their costs for providing service and that any such costs incurred are equitably allocated to market participants. Forcing a comprehensive review of the current bid cost recovery rules prior to this effort is premature, as the market rules will certainly evolve from their current state. Rather, the ISO must and will continue to work with its stakeholders to ensure that the bid cost recovery rules support the integration of renewables. This will require closer evaluation of the current rules and possibly result in changes to both the payment and allocation rules, which the ISO will file with the Commission upon completion of that process.<sup>8</sup>

The scope of this proceeding should remain limited to address the issue at hand – remedying the observed market behavior that exaggerates bid cost recovery payments.

**B. A Technical Conference is Unnecessary to Address the Unopposed Rule Change, and would Obstruct the ISO's Efforts to Immediately Remedy the Market Behavior that Exaggerates Bid Cost Recovery Payments.**

Aside from its efforts to force a complete overhaul of the bid cost recovery mechanism, Powerex also raises two specific issues it seeks to inject into this proceeding, and asks that they be specifically dealt with in a technical conference. As discussed further below, a technical conference is not necessary to address either of these issues and would only serve to delay the implementation of a remedy to the identified bidding strategy.

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<sup>8</sup> See Stakeholder Initiative webpage: <http://www.caiso.com/27be/27beb7931d800.html>



**1. The Netting of Market Revenues across Markets will be Addressed in the Upcoming Stakeholder Process.**

The first new issue Powerex seeks to inject into this proceeding is that of netting market revenues across markets and products. Calpine also comments on this issue, but more appropriately asks that the Commission direct the ISO to address the issue in its upcoming stakeholder process proposed in this proceeding.

The ISO agrees with Calpine that the ISO's proposed rule change to account for market revenues in the IFM based on scheduled portions of the day-ahead schedule, as opposed to delivered portions as currently required, raises the question of whether or not there is a need to consider a further enhancements or modifications of the market rule requiring netting of market revenues across markets and products. Such potential additional enhancements are precisely why the ISO proposes a stakeholder process following the acceptance of the tariff amendment to remedy the unintended market issue. Powerex fails to demonstrate that the proposed stakeholder process will not effectively address additional enhancements.

Contrary to Calpine's assertions, however, there is no indication that the rule change the ISO proposes in this proceeding poses would result in adverse unintended consequences to market liquidity, thereby limiting the ISO's ability to integrate renewable resources. Calpine fails to provide any evidence of such risk or any basis to prevent the Commission from accepting the ISO's tariff amendment. Indeed, Calpine offers no evidence that the proposed rule change has such adverse impacts or is otherwise not just and reasonable, and instead suggests that the entry of more variable resources may increase the potential for such limitations.<sup>9</sup>

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<sup>9</sup> Calpine Comments at p. 6.

As noted by Calpine, the ISO previously raised the issue of netting market revenues across markets in Phase 1 of the current policy initiative targeted to address the integration of renewable resources into the ISO markets, for reasons unrelated to the proposed market rule changes. The ISO understands, however, that the proposed rule changes may, in a sense, accelerate the need to consider this issue in light of the market revenue accounting rule changes. There will be an opportunity now to address the very issue of the consequences of netting across markets in combination with the proposed rule changes. The Commission should allow the stakeholder process to unfold unencumbered by any forgone conclusions suggested by Calpine or Powerex that the netting across markets must be eliminated in light of the rule change. Moreover, given that the ISO anticipates it will address the issue of netting across markets in the proposed upcoming stakeholder process, there is no need to set a technical conference to address this issue.

**2. The ISO has Already Launched a Stakeholder Process to Address the Pricing of Physical Exports, an Issue Completely Unrelated to the Issue in this Proceeding.**

The second issue Powerex seeks to inject in this proceeding is whether or not physical exports should be afforded bid cost recovery. This is entirely unrelated to the market issue the ISO seeks to address with its proposed rule change. Instead, the issue results from the enforcement of two different intertie constraints in the scheduling and pricing run under convergence bidding. The ISO has already launched a stakeholder process to resolve the issue of exports obtaining bid cost recovery. There is no reason to interject this unrelated issue here to expand the scope of this proceeding. This would merely delay the ISO's proposed remedy to the identified market issue to the potential detriment of the market.

The issue of whether or not physical exports should be afforded bid cost recovery arises from the implementation of convergence bidding, and the requirement under convergence bidding that the ISO enforce both the physical-only and the physical plus virtual constraint in the scheduling run.<sup>10</sup>

The ISO has been analyzing the frequency and magnitude of the issue caused by enforcing both constraints, in response to comments from market participants. This issue was discussed at length during the market performance and planning forum on March 23, 2011. There, the ISO discussed with stakeholders its observations and noted its intent to launch a separate process to evaluate possible rule changes.<sup>11</sup> After hearing further concerns from participants during the meeting, the ISO accelerated its efforts and on April 15, 2011, launched an expedited stakeholder process to address the root cause of the issue and find a solution that eliminates the current price exposure for exports. This stakeholder process will evaluate the root causes and yield the appropriate solution, which may or may not be the provision of bid cost recovery for physical exports. This expedited process should be allowed to proceed without pre-determining the root cause of the issue.

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<sup>10</sup> See ISO tariff Section 31.8. The ISO enforces the physical constraint in the scheduling run to ensure there is sufficient physical capacity to accommodate the physical schedules and the ISO is able to coordinate checkout of interchange schedules with neighboring balancing authorities. In the pricing run the ISO enforces, and thus prices, exports based on physical plus virtual constraints to ensure that the pricing run reflects the cost of congestion posed by the combination of physical and virtual bids at the interties. Consequently, at times exports can be subjected to prices higher than the prices submitted in their bid curve.

<sup>11</sup> See Presentation for March 23 Meeting: <http://www.caiso.com/2b49/2b497625426e0.pdf>.

**C. The ISO Agrees that the Mere Registration of Costs at Two Hundred Percent of Proxy Costs does Not Indicate Any Problematic Market Behavior.**

Calpine raises a concern that because the problematic bidding practice described by the ISO in its filing included the registration of minimum load costs to two-hundred percent of proxy costs may cast a “dark shadow” on such a practice.<sup>12</sup> The ISO agrees that there may be legitimate reasons for choosing this option and that is why it has included this option under its tariff. The ISO did not intend to suggest that this action alone constituted a problematic bidding strategy. Rather, as the ISO explained, it is the registration of costs along with the complete bidding practice in the day-ahead market and the real-time market that led to the unintended adverse market outcome of exaggerated bid cost recovery payments.

Therefore, the ISO reconfirms that there is nothing inherently problematic about the use of registered costs for these market bids, and that it does not believe that the mere registration of minimum load costs at two hundred percent of proxy costs as grounds for suspicion of improper market behavior. The ISO further clarifies that the use of registered costs in lieu of proxy costs continues to be permissible under the ISO Tariff. Indeed, this is a further illustration of the ISO’s attempts to narrowly tailor its rule changes to identify the adverse bidding practice, and not undo the just and reasonable rates already established in its tariff.

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<sup>12</sup> Calpine Comments at p. 10.

### III. CONCLUSION

Powerex and Calpine seek to inject issues into this proceeding that are unnecessary, and that could only serve to delay mitigation of the identified market issue and adoption of revised market rules to avoid further adverse market outcomes. For the reasons provided herein, the Commission should accept the ISO's filing without further conditions.

Respectfully submitted,

**By: /s/ Anna McKenna**

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Dated: April 19, 2011

## CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing document upon all of the parties listed on the official service lists for the above-referenced proceedings, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated at Folsom, CA this 19<sup>th</sup> day of April, 2011.

*Anna Pascuzzo*

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