



# Memorandum

To: ISO Board of Governors  
From: Frank A. Wolak, Chairman of the Market Surveillance Committee  
James Bushnell, Market Surveillance Committee Member  
cc: ISO Officers  
Date: March 2, 2006  
Re: *Issues Relating to Raising the Level of the Bid Cap to \$400/MWh*

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Questions have been raised about the basis for the Market Surveillance Committee's November 2005 recommendation to raise the bid cap on the ISO's real-time energy market.<sup>1</sup> The three specific issues we have been asked to address are: (1) how specific generation unit heat rates figured into our analysis, (2) the linking of the real-time bid cap to natural gas prices, and (3) the recent Federal Energy Regulatory Commission (FERC) decision regarding the west-wide bid cap and the bid cap on ancillary services.

## **1. Unit Heat Rates and Total Capacity at or above Certain Heat Rates**

When the MSC drafted its opinion, we did not rely upon specific ISO numbers about the exact amount of generation capacity in the California ISO control area with heat rates at or above specific levels. Recent debates about what the exact amount of capacity with heat rates above certain levels (such as 17.5 MMBTU/MWh) highlight the fact that there are many credible ways to derive such data. Both the ISO's numbers and other estimates can plausibly be considered accurate. In fact, it is possible for a rather wide range of heat rates to be justified by suppliers or other parties, depending upon varying definitions, sources of data, and operating conditions of the generation units. This reinforces our belief that it is difficult (and potentially counter-productive) for parties to attempt to estimate the exact incremental cost of specific generators and to try to enforce bid caps or price caps according to these estimates. The system-wide bid cap in the ISO real-time market has traditionally been viewed as a "damage control" cap that is in place to limit the consequences of any transitory supplier market power that may periodically arise.

The cap has not been designed or intended to function as a frequently binding limit set exactly equal to the incremental cost of specific generation units. When the incremental cost of certain generation units can plausibly be characterized to be close to this limit, the bid cap creates incentives for both buyers and sellers to focus their energies on demonstrating and even altering market conditions to justify one cap level or another. We believe such efforts are better spent trying to create the transmission and generation infrastructure and system conditions to support a workably competitive and reliable wholesale market.

## **2. Indexing the Bid Cap to Gas Prices**

When our opinion was first drafted, there was concern that gas prices could exceed \$12/MMBTU in the western U.S., and they did in fact exceed \$14/MMBTU before receding to current levels. In our opinion

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<sup>1</sup> "Raising the Level of the Bid Cap on the Real-Time Energy Market in California," Market Surveillance Committee of the California ISO, November 9, 2005, available at <http://www.caiso.com/14c2/14c2901e13630.pdf>.

we stated that we did not support lowering the cap in the event that gas prices fell. First, there is a reasonable chance that gas costs will reach higher levels again if there is a significant supply disruption or substantial increase in demand. Second, almost all stakeholders in the California market have placed a high value on regulatory certainty and stability when describing their ability to participate and invest in the California market. A cap that is intended to move frequently up and down in response to natural gas prices indices would undermine that stability. This is in part due to a third argument against indexing the bid cap to gas prices, that it could foster instability in the gas market.

When electricity price-caps are frequently binding and also linked to the prices of other inputs, market participants (both buyers and sellers) have a much stronger incentive to influence the prices of those inputs. There is substantial evidence that these kinds of incentives disrupted the natural gas and the South Coast Air Quality Management District (SQACMD) emissions credit markets during late 2000-01. It is important to remember that, although California's three large investor-owned utilities claim to be almost completely hedged in their electricity purchases over the next several years, they are much more reliant upon short-term markets for their purchases of natural gas. Thus a disruption of the natural gas market for the sake of tighter price controls in the electricity market is likely to be a poor trade-off for California consumers.

Last, we again note that the imbalance energy bid cap is currently scheduled to increase to \$500/MWh in 2007. The current level represents a transition between the previous level of \$250/MWh and \$500/MWh. Further experience with the current level can help to provide information about the effectiveness of the current market structure and market power mitigation rules before the transition to MRTU and the higher cap takes effect. Ultimately, the appropriate long-term level of the price cap will depend upon what form of resource adequacy policies are adopted.

### **3. The West-Wide Cap Level and Bid Caps on Ancillary Services**

In response to the tariff filing by the ISO requesting an increase in its real-time energy bid cap to \$400/MWh, the FERC also raised the bid caps in the ISO ancillary services markets to \$400/MW and also raised its west-wide spot energy market bid cap to \$400/MWh. The raising of the ancillary services cap to match the real-time market bid cap strikes us as a prudent move, as the sale of ancillary services does in most instances preclude a generator from selling imbalance energy. Thus energy sales represent the opportunity costs of selling ancillary services and it is appropriate that the two markets share a comparable bid cap. Further, the ISO has experienced bid insufficiency in some of its ancillary services markets, and a lower cap in the ancillary services market relative to real-time energy may have exacerbated that problem.

Finally, the decision to raise the west-wide price cap on spot transactions is neither surprising or of great impact to California. This cap was applied only to short-term transactions within certain types of jurisdictions. It was relatively straightforward for entities outside the ISO to circumvent this cap if they wished to do so.

### **4. Conclusion**

Although natural gas prices are currently in the \$6/MMBTU to \$7/MMBTU range, these prices have been and continue to be extremely volatile. Consequently, we believe that the bid cap on the real-time energy and ancillary services markets should remain at its current level of the \$400/MWh.