Memorandum

To: ISO Board of Governors

From: Keith Casey, Vice President, Market & Infrastructure Development

Date: December 10, 2014

Re: **Briefing on commitment costs policy initiative**

This memorandum does not require Board action.

EXECUTIVE SUMMARY

This memorandum updates the Board on the status of Management's efforts to adopt policies that increase the opportunity for market participants to recover certain gas flow penalty costs related to starting-up or running a generator at minimum operating levels.

In May 2012, the Board approved new provisions that allow market participants to recover additional start-up and minimum load costs. One of the adopted policies was to allow generators to recover gas flow penalty costs assessed by natural gas pipeline companies. Under the approved policy, a generator would be allowed to recover these costs if the ISO dispatched the generator when additional gas could not be nominated to avoid operational flow order penalties. During the tariff development process, several stakeholders raised significant concerns that this provision could undermine the penalties' effectiveness in maintaining reliable operations of the gas pipelines. As a result, Management filed the tariff amendment with FERC in the fall of 2013 without the gas penalty cost provision to allow for additional time to consider additional changes that would mitigate any reliability impacts on the gas pipelines.

Management reopened the stakeholder process and conducted outreach to interstate and intrastate pipelines to consider potential solutions. However, Management has not been able to find a path forward that fully addresses stakeholders' concerns. In addition, several gas industry changes such as more frequent gas nominations, changes to gas pipeline flow penalty structures, and significant improvements in electric and gas industry coordination are underway that will impact the need and potential design of provisions to allow for gas flow penalty cost recovery. Accordingly, Management is deferring further action on this particular aspect of the 2012 policy changes and will monitor changes in the gas industry before reconsidering how, or even whether, natural gas pipeline penalties should be considered for cost recovery in the ISO market.

DISCUSSION AND ANALYSIS

In its May 2012 meeting, the Board approved Management's proposal to add the following cost categories to daily proxy cost calculation for startup and minimum load costs: (1) the volumetric components of the grid management fees; (2) the bid segment fee; and (3) a major maintenance expense component. The Board also approved the proposal to reduce the level of the registered cost cap for scheduling coordinators opting to use the registered cost option rather than the proxy cost option from 200% of projected proxy costs to 150%. Finally, the Board approved the ISO's proposal to allow penalties for violating natural gas pipeline balancing orders (as well as emissions costs for nitrogen oxide and sulfur oxide) to be recovered from the ISO's bid cost recovery mechanism. During the tariff development stakeholder process following the Board approval, serious concerns were raised by gas pipelines companies and some stakeholders that the ISO's proposal to allow gas penalty recovery would undermine natural gas system reliability. Because of these concerns and the need to take additional time to work with interstate pipeline companies and other stakeholders, Management filed its commitment cost tariff amendment with FERC without including a proposal for recovery of gas pipeline penalties.

Management engaged in outreach efforts with gas pipeline companies and other stakeholders to consider modifications to its proposal to find an approach that stakeholders would find acceptable. However, these efforts have not been successful. In addition, FERC, within the past year, has indicated that policy changes are likely necessary to address gas and electric system coordination. Similarly, the CPUC is also working on gas and electric system coordination issues. In response, Southern California Gas Company is in the process of modifying its tariff at the CPUC to adopt a penalty structure that is more aligned with Pacific Gas & Electric Company's structure. Given these significant changes underway, Management believes that it is appropriate to defer consideration of gas penalty cost recovery provisions until they can be better assessed in light of any new provisions to improve gas and electric system coordination.

POSITIONS OF THE PARTIES

Stakeholders have indicated that they support looking at gas issues more comprehensively rather than focusing narrowly on certain issues, and therefore generally support the ISO's proposal to defer action on this initiative.

The ISO held a stakeholder call on November 21, 2014 to discuss its intent to defer any further action and close this initiative. Following the call, written comments were received from three stakeholders.

First, NRG does not object to the ISO's proposal to defer action on natural gas pipeline penalties. However, NRG believes the issue should not be deferred indefinitely. Rather, it stated the ISO should take up the issue of natural gas pipeline penalties as part of its "bidding rules initiative" and urges the ISO to launch that initiative as soon as possible. The ISO agrees with NRG's comments and believes that these issues should be dealt with in a more comprehensive fashion. The ISO will be exploring ways to provide additional bidding flexibility in the bidding rules initiative, which commenced in early December.

Second, PG&E supports Management's proposed plan for deferral, but recommends that the ISO address these matters as soon as possible in 2015. As part of this future effort, PG&E supports continued consideration of allowing recovery of pipeline noncompliance charges under limited situations and only when CAISO-to-pipeline "coordination" has occurred.

Third, the Cities of Anaheim, Azusa, Banning, Colton, Pasadena, and Riverside, California (collectively, the "Six Cities") do not support closing this initiative. Six Cities believes that the commitment cost recovery provisions that were recently filed at FERC are insufficient to allow reasonable recovery of costs incurred to comply with ISO dispatch instructions when gas flow penalties are triggered. Six Cities requests that the ISO consider actions it may be able to take immediately to address the problem from the alternative direction of making it feasible for generators to avoid penalties in the first instance. Six Cities also suggests that the ISO modify the bidding rules for commitment costs to allow resources that are at risk of incurring penalties to increase their bids to levels that would manage the risk. The ISO is sensitive to the concerns raised by Six Cities and will discuss these issues in the bidding rules initiative. Furthermore, the ISO will evaluate whether there are some changes that could be implemented sooner than other elements of the bidding rules initiative, such as allowing market participants to bid different commitment costs in the
real-time market than they bid in the day-ahead market. However, it is important that these issues be carefully considered. Provisions that may help generators avoid incurring gas penalties may also give rise to undesired collateral effects such as reduced operational flexibility for the ISO or significant price increases.

CONCLUSION

We are moving into an era of greater scrutiny of gas and electric coordination and greater understanding of the dependencies of gas and electric markets, generally, as well as greater scrutiny concerning how natural gas costs are recovered in electricity markets. Management believes that consideration of an amendment to the ISO tariff to allow for gas pipeline penalty recovery should be deferred until policy changes related to gas and electric coordination are resolved. Accordingly, Management is deferring further action on this particular aspect of the 2012 policy changes and will monitor changes in the gas industry before reconsidering how, or even whether, natural gas pipeline penalties should be considered for cost recovery in the ISO market.