

I regret that I could not attend the meeting today. Thank you for the opportunity to comment in writing.

I wish to comment on item 6, Summer 2006 Operational Requirements and Procedures for SP26, and item 7, Day-Ahead Scheduling Requirement and Convergence Bidding.

As an introduction, it is encouraging that all of these discussions are taking place at a meeting of the CAISO's Market Surveillance Committee. As a creation of the movement to encourage competition in the electric power industry, the CAISO should approach to any reliability or operational problem with a goal to turn the problem into an opportunity that its market participants can compete to resolve. The CAISO does not exist merely to keep the lights on; it exists to keep the lights on through market mechanisms.

The CAISO has an opportunity to put this principle into effect in its Summer 2006 Operations. Events from last year have made clear that the ability to import power into Southern California from the north can be severely constrained. The loss of the Pacific DC Intertie – which occurs fairly frequently - imposes two huge operational challenges. It requires the CAISO to replace a sizeable block of import power and, because it overloads the parallel Path 26, it can render operating reserves in Northern California useless. In regards to this outage, one thing is irrefutable: reserves held in Southern California are more valuable than those held in Northern California. Whatever actions the CAISO takes to factor this outage into its day-to-day operations must lead to a market result that confirms this fact.

A host of issues complicate this problem. The CAISO views the loss of the DC as a 20-minute problem, as WECC criteria indicate that the overload on Path 26 must be eliminated in 20 minutes. Consequently, the CAISO is reluctant to purchase enough 10-minute reserve to fully address what it considers as a 20-minute problem. The problem this approach creates is that it now seems the CAISO has three products – two ten-minute-deployable operating reserve products (spinning and non-spinning reserve), and a twenty-minute deployable imbalance energy product – that it expects to use for exactly the same reliability problem, namely, to reduce flows on Path 26 after the loss of the Pacific DC Intertie. The CAISO does not compensate these products in the same manner; it pays the ten-minute products a capacity payment, but does not pay the 20-minute product a capacity payment, even though it expects to use that product effectively as contingency reserve to address the loss of the Pacific DC Intertie. By deciding how much of the 10-minute products to buy relative to the overall capacity requirement in SP26, and by avoiding paying the 20-minute product a capacity payment, the CAISO is in complete control of any market signal regarding the value of capacity reserves in SP26. The twenty-minute product is essentially also contingency capacity reserve, i.e., capacity that the CAISO will be relying on to reduce flows on Path 26 just as much as the 10-minute operating reserve products, but because this product will not transact within the Ancillary Services markets, it will not be paid a capacity payment, unlike the 10-minute products. It is logical for the CAISO's Ancillary Services markets to produce different prices for spinning and non-spinning reserve, as the quality of and requirements

to provide those services differ, but it is not logical for the CAISO to use a third reliability product for which it is not willing to pay a capacity payment. A better market outcome would be for the CAISO, consistent with the design of its markets, to pay a capacity payment to all of the capacity it will be relying on for contingency reserve.

The CAISO is also considering raising the operating level of units in SP26 – and reducing the operating level of units in NP26 – to create additional transfer capability on Path 26 and reduce the overload that will occur when the DC is lost. This is a prudent operating measure, but it is unclear what effect this action will have on the imbalance energy market. The CAISO has indicated both (1) that it believes this energy is extra-marginal energy that would not set the market clearing price, and (2) that when it performs this action the prices in Northern and Southern California should diverge to reflect this action. The right answer must be the latter one. This action amounts to pre-emptive congestion management, and, just like congestion management performed in the day-ahead or real-time markets, this pre-emptive congestion management must result in different prices in Northern and Southern California that reflect the higher value of transfer capability into – and generation in – Southern California.

In light of the principle advanced in the introduction, any comparison between the day-ahead scheduling requirement and convergence bidding has a self-evident outcome. The 95 percent forward scheduling requirement is a command-and-control measure, whereas convergence bidding is a market solution that provides more benefits than the 95 percent forward scheduling requirement. Convergence bidding creates liquidity and competition that drive the day-ahead and real-time prices together. When day-ahead and real time prices converge, market participants have no reason not to participate in the day-ahead market, which is exactly where a prudent system operator wants its market participants to transact their business to promote reliability (which is the same position espoused by the CAISO in Amendment No. 72). Convergence bidding makes explicit the arbitrage that market participants have incentives to engage in through implicit means if explicit means are not available to them. Convergence bidding also provides market participants a tool to manage risk. It is no coincidence that every other ISO that runs an LMP-based two-settlement market, as the CAISO hopes to do in MRTU, offers convergence bidding, and it is no coincidence that the market monitors in these other ISOs “vigorously support the use of convergence bidding.”<sup>1</sup> I believe the Market Surveillance Committee recognizes the superior benefits that convergence bidding offers to the 95 percent scheduling requirement, and I hope the Committee will urge the CAISO to incorporate this mechanism into its MRTU design.

Again, thank you for the opportunity to provide these comments.

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<sup>1</sup> *California Independent System Operator Corp.*, 112 FERC ¶ 61,013 at 175 (2005).