CALIFORNIA ISO

California Independent
System Operator

Memorandum

To: ISO Board of Governors

From: Market Surveillance Committee of ISO

cc: ISO Officers; Board Assistants

Date: November 5, 2004

Re: ***Summary of Forthcoming MSC Opinions***

This is a status report. No Board action is required

The MSC is currently working to finalize opinions on three issues:

1. Honoring Existing Transmission Contract (ETC) Rights
2. Alternatives to Implementing a Locational Marginal Pricing (LMP) Model, and
3. Market Power Mitigation under LMP

This memo provides a brief summary of the issues addressed in each of these opinions.

Honoring Existing Transmission Contract (ETC) Rights

The CAISO has proposed an approach to honoring existing transmission contracts (ETCs) under its Market Redesign and Technology Upgrade (MRTU). In brief, the ISO proposes to reserve all ETC capacity on the interties, while within California the ISO will reserve only the capacity that is scheduled in the day-ahead market. It is important to preserve the contract rights of ETCs as California moves to a LMP market design. It is less clear what these rights represent in an LMP setting, since the contracts were negotiated in a zonal market. The CAISO proposal attempts to preserve the rights of ETC holders while preserving the workability of the LMP market design. In particular, allowing ETC holders to reserve full capacity *within* California would create potentially serious constraints on the transmission network. The "perfect hedge" option proposed by CAISO would allow ETC holders to make adjustments to their day-ahead schedules in the real-time market *without* financial consequences.

Alternative to Implementing a Locational Marginal Pricing (LMP) Model

The seller's choice long-term contracts signed by the California Department of Water Resources have the potential to create a serious liability for California consumers under LMP. Consequently, the CAISO is considering alternatives to a LMP market designs that limits this liability. We have previously stated our strong support for the ultimate implementation of LMP because of its economic efficiency and reliability benefits. Consequently, we view all alternatives to LMP as inferior to the proposed LMP market design. The CAISO has proposed the Transitional Alternative Pricing and Settlement Proposal (TAPAS) as their preferred backup to LMP. In brief, we view the TAPAS proposals and the current market design as viable transitional market designs. One controversial issue surrounding TAPAS is that it does not make constrained-down payments (CDPs) to generation units that must have their schedules reduced due to intra-zonal congestion. As the report by Charles River Associates points out, this practice is not incentive compatible (i.e., generators will have an incentive to under represent their costs to the ISO in their bids or to deviate from dispatch instructions). In our view, CDPs are likely to be awarded to generation in pockets where they enjoy local market power. Thus, at least some, if not a large proportion, of the CDPs can thus be viewed as compensation for market power. Consequently, we support the TAPAS design without CDPs.

Market Power Mitigation under LMP

In this opinion, we (once again) stress the importance of market power mitigation measures in an LMP market. Nodal prices provide increased opportunities for the exercise of local market power, which require effective monitoring and mitigation. Three recent FERC rulings –requiring a market-clearing price for RUC capacity, allowing suppliers to receive RUC capacity payments *plus* energy payments, and the rejection of the must offer requirement – provide increased opportunities for suppliers to exercise local market power. For this reason, we encourage the CAISO to carefully consider the RUC capacity procurement process. Specifically, we encourage the CAISO to consider eliminating the RUC process and instead procure needed ancillary services in the day-ahead market to meet the CAISO's demand forecast. In addition, we question the efficacy of both local and system-wide Automatic Mitigation Procedures (AMP). Specifically, we are concerned that these mitigation measures essentially sanction the exercise of market power at levels below the relatively generous AMP conduct and impact levels. Instead, we believe the CAISO should (1) define a set of system conditions when an individual market participant possesses market power, (2) use proxy bids based on exogenous cost estimates, and (3) determine market-clearing prices with these proxy bids. We believe this alternative market power mitigation measure will much more closely approximate a competitive market outcome than the current AMP mechanism.