California Independent
System Operator Corporation

Memorandum

To: ISO Board of Governors

From: Frank A. Wolak, Chairman, ISO Market Surveillance Committee

Date: October 26, 2010

Re: ***MSC Activities from August 23, 2010 to October 15, 2010***

This memorandum does not require Board action.

The Market Surveillance Committee (MSC) has been involved in three sets of activities over the past two months: (1) participating in the formulation of the capacity payment mechanism (CPM) backstop procurement process and preparing an opinion on this topic that was approved by the MSC on October 18, 2010; (2) holding a public meeting on October 8, 2010 to discuss the CPM proposal, enhancements to the ISO's local market power mitigation mechanism, and the ISO's process for increasing the spatial granularity of pricing to loads; and (3) individual members participated in meetings with the California Public Utilities Commission staff, stakeholder meetings, and discussions with stakeholder groups on these and other market design changes and market performance issues.

Opinion on the ISO's Capacity Procurement Mechanism Process

This opinion comments on the ISO's capacity procurement mechanism proposal, which is the successor to the backstop interim capacity procurement mechanism.[1] The capacity procurement mechanism has many features of the interim capacity procurement mechanism. Most notably, both mechanisms procure generation capacity that is not currently designated as resource adequacy capacity to meet certain specified operating needs for which there is insufficient resource adequacy capacity. Capacity designated through the capacity procurement mechanism would have obligations similar to resource adequacy capacity in terms of being available to the ISO for scheduling and dispatch during the period covered by the capacity procurement mechanism designation. The ISO is proposing that the capacity procurement mechanism be a permanent mechanism to procure capacity from existing generation units.

This opinion considers the three major aspects of the capacity procurement mechanism proposal: (1) whether the ISO should have a permanent backstop capacity procurement mechanism, (2) the terms and conditions under which it should make backstop capacity purchases, and (3) the price

[1] The MSC's full opinion on the ISO's capacity procurement mechanism is included with the ISO's Board materials on this topic.

it should pay for this capacity. The MSC strongly supports the need for the ISO to have the authority to make backstop capacity purchases. The circumstances under which the ISO can procure backstop capacity under the capacity procurement mechanism proposal represents, in our opinion, a reasonable method to balance the need to maintain reliable system operation against the need to limit the amount of intervention by the ISO in market mechanisms. Although we generally support the ISO's proposal, the MSC would prefer that the capacity procurement mechanism payment be set above going-forward fixed costs in areas where the local capacity requirement is greater or equal to the amount of available capacity. Because the ISO must file a replacement for the current interim capacity procurement mechanism in a timely manner, and this modification may require a potentially lengthy stakeholder process to design a scarcity pricing mechanism for the capacity procurement mechanism product, the MSC understands why scarcity pricing of capacity procurement mechanism may be impractical at this time.

October 8, 2010 Market Surveillance Committee Meeting

The October 8, 2010 MSC meeting covered three topics. The first was the issue of how generation resources needed to support renewable integration would be compensated. The MSC felt that this topic would be a productive forum for discussing the long-term resource adequacy issues and role of the ISO's capacity procurement mechanism proposal in California's resource adequacy process. To stimulate discussion between the MSC and stakeholders, the MSC asked Ellen Wolfe of Resero Consulting and Jeffrey Nelson of Southern California Edison to give presentations on these topics.

A number of important issues were raised in the discussion during and after these presentations. First, many stakeholders were concerned that the current resource adequacy process may not be properly compensating some generation units for the reliability services that they currently provide. In particular, the current resource adequacy process focuses on the procurement of generic generation capacity, but a world with an increasing share of renewable generation will require more ramping and load-following services. Stakeholders were concerned that units with these attributes may not be appropriately compensated for these attributes. A second issue is the apparent price discrimination between new and existing generation capacity in the current resource adequacy process.

A number of stakeholders were concerned that the current resource adequacy process kept the price paid for existing generation capacity below the price of new generation capacity and this could have long-term reliability consequences, because existing generation units would have little incentive to upgrade their facilities to provide the new reliability products that the ISO needs to manage intermittent resources at least cost. This topic closed with a discussion of the ISO's capacity procurement mechanism proposal and how it fit into the larger resource adequacy process. The MSC found this portion of the meeting very helpful in preparing its capacity procurement mechanism opinion.

The second topic was possible enhancements to the ISO's local market power mitigation mechanism. Department of Market Monitoring (DMM) staff briefed the MSC and stakeholders on the timing of process for preparing proposed enhancements to the current local market power mitigation mechanism and submitting them to the ISO Board. The remainder of the DMM presentation was devoted to describing the existing proposals for allowing bid-in demand and convergence bidding to be incorporated into the local market power mitigation mechanism. A

potential new ISO proposal for accomplishing this was also presented to the MSC and was compared to the DMM proposal for incorporating bid-in demand and convergence bidding. This was followed by a discussion of the relative merits of the various proposals among MSC members and stakeholders.

The final topic was introducing greater spatial scheduling and pricing granularity to loads into the ISO market-. A summary of the stakeholder process for considering this issue was presented and a brief overview of the costs and benefits of introducing greater spatial granularity pricing was presented by ISO staff. Frank Wolak then presented an empirical analysis of ISO prices under the new market design that demonstrated that the annual costs to consumers of introducing greater spatial granularity in pricing to loads are likely to be small for all consumers located in the major population centers of the state, but the potential benefits from dynamic pricing and energy efficiency investments to these consumers are likely to be much greater. This was followed by a discussion among MSC members and stakeholders of the relative merits of introducing greater spatial granularity in pricing.

California Public Utilities Commission and Stakeholder Meetings

Individual MSC members continue to engage with the ISO stakeholder process, the California Public Utilities Commission staff and stakeholders in general on issues currently under consideration by the ISO. On September 17, Frank Wolak participated in the ISO‘s 20% RPS Study stakeholder meeting. On October 4, Frank Wolak met with CPUC staff to discuss increasing the spatial pricing granularity to loads, the capacity procurement mechanism process, and renewable generation integration. Individual MSC members also participated in a number of stakeholder phone calls over the past two months to discuss market design and market performance issues.