

Comments on CC DEB initiative December 21, 2017 Stakeholder Call

Department of Market Monitoring

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The Department of Market Monitoring (DMM) of the California ISO had the opportunity to listen to and participate in the December 21, 2017 Stakeholder Call on Commitment Cost and Default Energy Bid Enhancements (CC DEB). During the call, the ISO presented a framework for the planned Revised Draft Final Proposal. While the framework included some clarifications and changes which improved prior proposals, the framework presented has numerous crucial flaws, several of which are discussed below.

In these comments, we limit comments to the specific issues covered in the ISO's December 21, 2017 stakeholder call. In September 2017 DMM submitted an extensive list of questions and concerns about the ISO's prior Draft Final Proposal.¹ DMM has received informal answers to some of these questions. Based on these responses, DMM continues to have many concerns and questions about the ISO's proposal. DMM respectfully requests that the ISO provide a written response to DMM's September 2017 questions prior to or as part of the ISO's next Revised Draft Final Proposal.

Updating gas prices used in real-time market

DMM continues to believe that using the most up to date price information from gas trading activity is the best way to reflect gas market conditions in Default Energy Bids and in bid caps for commitment costs. The ISO already uses gas price information available in the morning to update parameters for the day-ahead market. A similar system for updating reference levels for real-time markets should be feasible based on same-day and intra-day gas price trading data available at the start of each operating day. DMM proposed this concept early in the design of the CC DEB initiative.² Using information from transactions on a given day is more likely to accurately reflect gas market conditions than any of the ISO's proposals. This would have provide significant benefits in terms of market efficiency, market power mitigation and reliability (in the event of sudden and significant changes in gas markets).

Reasonableness threshold and ex ante verification

Part of the ISO proposal is to allow individual resources to request adjustments to their reference levels. Reference levels include default energy bids (DEBs) and commitment cost proxy calculations, and are used as floors for bid mitigation. If the requested adjustment falls under the ISO's calculated "reasonableness threshold" then the adjusted reference level would be used in the market. If not, it would be subject to ex post review and possible compensation through uplift.

In the presentation on the stakeholder call, the ISO suggested setting the reasonableness threshold by using gas and fuel prices at 110% of estimated cost for most circumstances. The exception would be on Mondays. The ISO proposes that on each Monday the reasonableness threshold for gas powered resources would use a fuel cost that was 125% of estimated cost.

¹http://www.caiso.com/Documents/DMMComments_CommitmentCosts_DefaultEnergyBidEnhancementsDraftFinalProposal.pdf

² *Comments on the Commitment Costs and Default Energy Bid Enhancements – Issue Paper*, Department of Market Monitoring, December 2016, p.3: <http://www.caiso.com/Documents/DMMComments-CommitmentCostsandDefaultEnergyBidEnhancementsIssuePaper.pdf>.

The ISO stated on the call that these numbers for reasonableness thresholds were based on DMM analysis. The analysis appears to be a graph that happened to have indicators at 110% and at 125%. In the graph used on the ISO's slide, most observations are below one or both of those indicators. However, that graph covers a limited period. DMM has published more up to date graphs that show evolving distributions of fuel prices.³

The gas price multipliers proposed for the threshold will be routinely too high, and occasionally too low. High transaction prices on many days are well below 110% of the next day price. When prices do go up significantly, they tend to reach beyond 110%, and often beyond 125%. When it is too high, this will impose unnecessary costs on the market. When it is too low, the market will not be able to achieve efficient dispatch. Dispatching inefficiently on days when fuel prices are high or fuel is scarce can have adverse consequences for reliability of both the electric and gas systems. Avoiding these inefficiencies should be a primary reason to pursue the CC DEB policy. If the ISO cannot construct a policy that is able to respond to those kinds of conditions, the ISO should delay taking the policy to the Board.

The ISO proposes that on each Monday, the reasonableness threshold for gas powered resources would use a fuel cost that was 125% of estimated cost. A resource that was identified as having market power on that day would be able to submit bids using 125 percent of their estimated fuel cost as the basis for calculating their reference level bid. Due to gas trading conventions, the first trade day of the week does have greater variation between next day index prices and same day transaction prices.⁴ However, allowing resources with market power to receive 125% of costs on every Monday is not a reasonable design response to this problem. This approach would give a safe harbor for generators with potential market power to routinely bid higher on "Market Power Mondays" even when this is not justified by actual gas prices.

Instead, a more targeted approach for setting the reasonableness threshold is to use data for "Monday Only" transactions or actual trading prices available the morning of each operating day as has been proposed by DMM. If the ISO were to use data from trades on the same day, they could track when prices are actually going up and respond appropriately by setting a higher reasonableness threshold on those days.

After the fact review/ex post verification

The ISO proposed on the call that all after-the-fact review of requested reference level adjustments be based on actual incurred costs. These reference level adjustments would apply to resources that have been determined to have market power. Allowing resources with market power to recover any incurred costs presents several behavioral issues that can lead to market inefficiency. In previous comments during this initiative, DMM explained how it is inappropriate to give guaranteed recovery of actual costs to market participants that have market power.⁵ This, plus the ISO's proposed resource specific

³ *2017 Third Quarter Report on Market Issues and Performance*, Department of Market Monitoring, December 2017, p.74: <http://www.caiso.com/Documents/2017ThirdQuarterReport-MarketIssuesandPerformance-December2017.pdf>.

⁴ The first trade-day of the week is usually a Monday, but can be a different day if, for example, Monday is a holiday.

⁵ *Phase 2 of Comments on the Commitment Costs and Default Energy Bid Enhancements – Issue Paper*, Department of Market Monitoring, December 2016: http://www.caiso.com/Documents/AdditionalDMMComments_CommitmentCosts_DefaultEnergyBidEnhancementsIssuePaper.pdf.

feedback loop, would allow participants with market power to feed artificially high prices into reference levels and then into the market.

During the call the ISO stated that using incurred costs for ex-post review will keep the CC DEB policy in line with ex-post review required under FERC Order 831. Linking reference level ex-post review and Order 831 would reduce implementation complexity for the ISO, but it is inappropriate and irrelevant. FERC Order 831 specifically deals with conditions under which fuel costs rise to levels that cannot be included under a \$1000/MWh bid cap. This is an extreme circumstance, especially for California.

Moreover, the discussion in FERC Order 831 on incurred costs applies to market energy bids. The Order does not opine at all on whether or not a cost incurred by a resource that has been determined to have market power should be allowed to be recovered and eventually used as a reference level. Using an ex-post review policy designed for extreme circumstances and for energy bids for resources that do not have market power is not appropriate for cost recovery for resources that have market power under otherwise normal fuel conditions.

Additionally, the cost recovery procedure proposed in the current initiative will include commitment costs. FERC Order 831 does not apply to commitment costs. Validation of reference levels for resources with market power as proposed in CC DEB does not fall under FERC Order 831 at all. The ISO's proposal to allow any incurred cost to serve as validation for reference level adjustments is fundamentally flawed. FERC Order 831 does not imply that FERC will find this flawed proposal just and reasonable.

Reference level adjustment requests over reasonableness threshold

In the presentation, the ISO did not clearly explain how it would treat reference level adjustment requests that exceed the reasonableness threshold. The initial slides stated that these higher bid requests would be included in the market at the threshold.⁶ The slides also stated that the unadjusted reference level would be used.⁷

A few days before these comments were due, the ISO updated the slides to indicate that adjustment requests above the threshold would be entered into the market software at the threshold. This policy increases the importance of the ISO calculating reasonableness thresholds that accurately reflect actual market conditions, as discussed in both sections above.

Bid caps and mitigation levels:

Part of the framework that was discussed on the call would allow resources with market power to bid commitment costs up to 125% of their reference levels in the initial period of the dynamic mitigation of commitment cost bids. Energy bids for resources that have been identified as having market power are adjusted to 110% to account for some variability in costs. Costs that are included in commitment costs – such as major maintenance adders -- are definitively less volatile than costs that go into marginal energy production. Because of that fact, the ISO has not justified allowing resources with market power to submit commitment cost reference levels at 125% of estimated costs. This is especially true because the estimated costs would already include reference level adjustments to fuel prices that could be 10% or more of estimated fuel costs. DMM recommends that any adder used for commitment cost

⁶*Presentation – Commitment Costs and Default Energy Bid Enhancements*, California ISO December 2017, Slide 10: http://www.caiso.com/Documents/Agenda_Presentation_CommitmentCosts_DefaultEnergyBidEnhancements_Dec212017.pdf

⁷ *Presentation – Commitment Costs and Default Energy Bid Enhancements*, California ISO December 2017, Page 8: http://www.caiso.com/Documents/Agenda_Presentation_CommitmentCosts_DefaultEnergyBidEnhancements_Dec212017.pdf

reference levels for resources that are identified as having market power should be significantly below 25%.

The ISO has also proposed that the cap for commitment cost bids for resources not identified as having market power will start at 200% of estimated costs. The cap will be increased from 200% to 300% in about 12-18 months unless the ISO determines that this increase should not occur and files with FERC to prevent the increase. DMM opposes the inclusion of an automatic increase of the cap in the policy. Including future adjustments to parameters as part of policy makes it more difficult to carefully evaluate the effectiveness of the policy and to find the best value for those parameters. This problem is amplified by the fact that the ISO has not defined the study to evaluate the functioning of dynamic commitment cost mitigation. This creates the potential for an inadequate study designed quickly to meet the deadline defined in the original policy.

A cap of 300% is no less arbitrary than one of 200%. Neither of these numbers seems to be based on a particular expected result or need. DMM recommends that the ISO establish the bid cap in the tariff at 200%, and leave open the possibility that a new stakeholder process could be launched to investigate changing the bid cap at some point in the future. This would allow stakeholders to demonstrate and justify the parameters for a reasonable level after they have some experience with the design of these new market features. A new stakeholder process is also more likely to result in a thorough evaluation of the functioning of the mitigation design.

The DMM and MSC encouraged an approach similar to this during the RIMPR policy on lowering the bid floor.⁸ In its opinion on this issue, the MSC suggested that changing the bid floor should depend on the ISO showing the benefits of the initial move and identifying the issue driving the need for a further change. DMM supports a similar standard being employed for moving the bid caps for commitment costs. Any changes to the bid caps should follow from an analysis of the functioning of mitigation. DMM suggests that the ISO describe the analysis that it proposes to use to determine whether the mitigation works well. Before changing the commitment cost bid caps or otherwise implementing a new policy, the ISO should be able to describe some criteria that will be used to determine how well the policy is working and whether changes are necessary.

Day ahead startup costs

The ISO suggested on the call that SCs would be allowed to submit startup cost (SUC) bids for each hour of the IFM. However, the IFM will only consider the bid used in the first hour for which a bid is submitted. If the resource is committed in day-ahead, the SUC values passed to the RTUC for real-time market commitment decisions would be the IFM values submitted for individual hours. In other words, the bids would be locked in real-time at values that were never considered by the market. Instead of preventing manipulation, this would actually create a new avenue for manipulation. It would just force market participants to plan manipulation one day in advance.

One type of potential manipulation involves short start resources increasing BCR in real-time. To do this, a short start resource bids the true costs in the day-ahead market for hour-end 1. Then the SUC is raised to something higher, say 200%, for the rest of the day. The IFM will start the resource at the market's preferred time according to the HE1 bid. In real-time, the resource switches the bids to something below 200% for the hour before its day-ahead startup. This increases the probability that the

⁸ *Opinion on Integration: Market and Product Review, Phase 1*, Market Surveillance Committee, December 2011: http://www.caiso.com/Documents/MS_C_Final_Opinion_RenewableIntegrationMarket-ProductReviewPhase1.pdf

startup will get shifted to an earlier real-time hour. This then moves the BCR allocation of the startup cost into real time, but this would shift only a minimal amount of revenue into real-time. In the case where the day-ahead schedule was profitable on the whole, this is likely to increase the resource's overall compensation without significantly altering the resource's schedule.

The reason to lock the bids for the period of the day-ahead commitment relates to the bids having been used in the market that issued that commitment. Locking bids at the value used in the day-ahead market for a day-ahead commitment gives the real-time market the option to make the same decision that was made by the day-ahead market. If the bids are not actually locked at the values used by the day-ahead market, this becomes problematic. In that case, the real-time market is faced with new decisions that are not the same as the day-ahead decisions.

Other details

During the call the ISO suggested that part of the reason for setting the bid cap for commitments costs for resources with market power at 125% is to help account for risk margins. This needs further clarification and justification.

The ISO made statements on the call about not using shift factors to establish counterflow dispatch against constraints for measurement of commitment cost market power. These kinds of details are critical for defining the ISO's policy proposal for dynamic commitment cost mitigation. However, many such details remain unclear. DMM recommends that the ISO mathematically define the proposal for dynamic commitment cost mitigation and provide a more detailed description in its draft final proposal.

Conclusion

The Commitment Cost and Default Energy Bid Enhancements policy needs significant work beyond what was presented on the December 21, 2017 stakeholder call. DMM believes that the policy can be adapted to make the necessary changes and looks forward to continuing to develop the policy in conjunction with stakeholders and the ISO.