

# Comments on the Congestion Revenue Rights Auction Efficiency Track 1 Draft Final Proposal

## Department of Market Monitoring February 28, 2018

The California ISO Department of Market Monitoring (DMM) appreciates the opportunity to comment on the ISO's *Congestion Revenue Rights Auction Efficiency Track 1 Draft Final Proposal* (Track 1 proposal).<sup>1</sup> Under its Track 1 proposal, the ISO would:

- change Congestion Revenue Rights (CRR) modeling disclosures so that auction participants would have more difficulty exploiting differences between the CRR auction model and day-ahead market model;
- limit CRR auction purchases to node combinations more likely to be associated with hedging forward contract basis risk; and
- reduce the amount of contracts ratepayers are forced to offer in the *annual* auctions.

While the ISO's proposals are clearly a serious attempt to stem ratepayer losses in the CRR auction, the proposal may only have moderate effects on ratepayer losses and could potentially make the problems worse. The intended effects of the Track 1 proposal are unlikely to be achieved because the underlying problems of the auction design are not addressed.

DMM has described the underlying problems and flaws in the CRR auction design in detail in prior comments.<sup>2</sup> Since these underlying flaws will continue to exist in the ISO's Track 1 proposal, the proposal will be ineffective at resolving ratepayer losses and inadequate for addressing the fundamental market design flaws. DMM recommends that the ISO instead propose a design that addresses the fundamental auction design flaws – such as the SCE proposal<sup>3</sup> – as soon as possible.

Because the ISO plans to extend its CRR structure to the extended day-ahead market, failure to address these auction design flaws now could adversely impact the ISO's regional expansion initiatives. The ISO auction design in effect forces transmission ratepayers to offer financial swaps. This exposes transmission ratepayers to potentially large losses that are funded by the congestion rents that these ratepayers would otherwise receive from their transmission assets. Extending this flawed design to other balancing authority areas will unnecessarily prevent their transmission ratepayers from receiving all of their day-ahead market congestion rents.

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<sup>1</sup> *Congestion Revenue Rights Auction Efficiency Track 1 Draft Final Proposal*, February 8, 2018:

<http://www.caiso.com/Documents/DraftFinalProposal-CongestionRevenueRightsAuctionEfficiency-Track1.pdf>.

<sup>2</sup> *Comments on the CRR Auction Analysis Working Group*, Department of Market Monitoring, January 16, 2018:

<http://www.caiso.com/Documents/DMMComments-CRRAuctionAnalysisReportWorkingGroup.pdf>.

<sup>3</sup> *SCE CRR Proposal*, Southern California Edison, December 11, 2017:

<http://www.caiso.com/Documents/SCEComments-CRRAuctionAnalysisReport.pdf>.

### ***Changing modeling disclosure may exacerbate CRR auction problems***

The ISO proposes to stop disclosing the exact modeling used in the CRR auctions to auction participants. The CRR auction design suffers from a public-private estimation problem. The single estimated transmission model used in the CRR auction will be different than the multiple hourly transmission models used in the day-ahead market over a month or quarter. Auction participants can currently compare their private estimates of the day-ahead market transmission models to the public estimate defined by the CRR auction model, allowing participants to lower their auction payments and extract value from the auction. The ISO proposes to stop disclosing the exact CRR model in order to make it more difficult for auction participants to find opportunities to extract value from model differences.

However, the ISO's proposal to not disclose the exact CRR auction model will not change the fact that the auction model will differ from the day-ahead models. Auction participants who can better estimate how, or have better insights into how, the ISO will model transmission in the auction will have an advantage over other participants. Because auction participants who are better at estimating the day-ahead models are likely to also be better at estimating how the ISO will create the auction model, the ISO's proposal to not disclose the auction model will likely increase the information advantage of these participants. This will further undermine price based competition and increase the rewards to this non-price competition. As a result, the ISO's proposal may actually increase ratepayer losses from the CRR auction.

### ***Limiting source and sink pairs may be ineffective at decreasing ratepayer losses***

The ISO proposes to limit allowable CRR source and sink pairs in the auction. The node pair limits are meant to align the CRR sales with source and sink pairs more likely to be used for hedging forward contract basis risk. The node pair limits are also meant to limit the ability of auction participants to target specific illiquid transmission elements or modeling discrepancies.

Even though the ISO would restrict source and sink pairs, the underlying auction would still use a transmission model offering contracts backed by ratepayers without reservation prices. Auction participants could still create portfolios of CRRs that mimic source and sink pairs that the ISO proposes to not allow.

As a result, even with the proposed limits on source and sink pairs, auction participants could still create portfolios of CRRs that give them approximately the same exposures to the illiquid transmission elements and modeling discrepancies that the source-sink limits seek to stop. While the limits on source and sink pairs make gaining exposures to particular areas of the transmission system more difficult, this difficulty also works to reduce competition even further than the current auction.

Given that the ISO would still be offering contracts backed by ratepayers, reducing competition would work to increase ratepayer losses. The net effect that restricting source and sink pairs

would have on ratepayer losses is not clear, but DMM notes that this aspect of the proposal could actually increase ratepayer losses from the auction over time.

### ***Lowering annual transmission limits will significantly affect CRR allocation***

The ISO proposes to decrease the percent of expected transmission capacity modeled in the annual allocation and auction processes from 75% to 45%. When the ISO performs the annual CRR process, the ISO knows less information about what the potential day-ahead transmission models will look like than when the ISO performs each monthly CRR process. The ISO reasons that reducing the CRRs sold in the annual auction and moving more CRR sales to the monthly auction will reduce ratepayer losses because the monthly auctions would have more accurate modeling than the annual auctions.

Lowering the line ratings in the annual processes may not significantly affect auction results. In 2017 about 60% of total ratepayer losses from the CRR auctions came from annual auction CRRs while 40% came from the monthly auction CRRs. On average, ratepayers were paid 41 cents in the auction for every dollar they had to pay out on annual auctioned CRRs. Ratepayers were paid on average 50 cents per dollar on monthly auctioned CRRs.

While the ISO will have better information about day-ahead market transmission models when the ISO runs the monthly auction, the ISO still cannot make the auction model the same as the day-ahead models. Auction participants will also have better information about potential day-ahead transmission modeling in the monthly auction that they can use to take advantage of model differences between the monthly auction model and the day-ahead market models. Therefore, moving more CRR sales from the annual to monthly auction may not improve auction outcomes.

The ISO's presentation shows that reducing the annual CRR process line ratings to 45% reduces cleared allocated CRRs to 23% of nominations from 49%.<sup>4</sup> This is a significant impact on the allocation process. Reducing the quantity of CRRs that LSEs can receive in the annual allocation process will force LSEs to wait until each monthly auction to receive a much larger share of their CRRs. This will create unnecessary uncertainty for LSEs over the extent to which they will be able to use their share of total day-ahead market congestion rents to hedge their basis risk from forward power purchases.

The ISO presentation also shows that the effects on cleared CRRs bid in the auction is much smaller than the reduction to nominated allocated CRRs. By attempting to make this incremental fix to the auction, the ISO will definitely create a large and potentially adverse impact on the allocation process. The ISO does not provide support for why such a significant

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<sup>4</sup> *Congestion revenue rights auction efficiency: Track 1 draft final proposal presentation*, February 13, 2018: <http://www.caiso.com/Documents/Presentation-CongestionRevenueRightsAuctionEfficiency-DraftFinalProposalTrack1.pdf>.

effect on the allocation of CRRS to LSEs is needed for such a limited potential effect on ratepayer losses from the auction.

### ***CRR auction design could impact ISO's regional expansion initiatives***

The CRR auction has cost California transmission ratepayers over \$85 million per year on average since 2009 – and over \$100 million in 2017. If the ISO does not address the fundamental flaws in the CRR auction design, the risk of these losses could impact the ISO's regional expansion initiatives. This is because the ISO has indicated that it plans to create a CRR design for the extended day-ahead market that is "similar to ISO balancing area".<sup>5</sup>

The ISO auction design in effect forces transmission ratepayers to offer financial swaps. This exposes these ratepayers to potentially large losses that are funded by the congestion rents that these ratepayers would otherwise receive from their transmission assets. Extending this flawed design to other balancing authority areas will unnecessarily prevent their transmission ratepayers from receiving all of their day-ahead market congestion rents.

Therefore, extending the ISO's flawed auction design to other balancing areas would reduce the benefits these areas would receive from the ISO's extended day-ahead market and could adversely impact entities' decisions to join. Developing a CRR auction design that addresses the fundamental flaws would allow the ISO to extend its CRR market design to the extended day-ahead market without adversely impacting regional expansion.

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<sup>5</sup> 2018 Policy Initiatives Roadmap, January 12, 2018, p. 21:  
<http://www.caiso.com/Documents/2018FinalPolicyInitiativesRoadmap.pdf>.