December 12, 2016

COMMENTS ON BEHALF OF THE CITIES OF ANAHEIM, AZUSA, BANNING, COLTON, PASADENA, AND RIVERSIDE, CALIFORNIA ON THE COMMITMENT COSTS AND DEFAULT ENERGY BID ENHANCEMENTS ISSUE PAPER

In response to the ISO's request, the Cities of Anaheim, Azusa, Banning, Colton, Pasadena, and Riverside, California (collectively, the "Six Cities") submit the following comments on the ISO's Commitment Costs and Default Energy Bid Enhancements Issue Paper posted on November 18, 2016 (the "Issue Paper"):

<u>The ISO Should Phase the Initiative and Prioritize Enhancements that Support Recovery of Supplier Costs</u> - - The Issue Paper includes discussion of potential bidding rule enhancements that fall into two broad categories, (i) potential enhancements that will support recovery of supplier costs, and (ii) potential enhancements that will allow suppliers increased bidding flexibility under competitive conditions to express their willingness to supply energy. The Issue Paper identifies the two broad categories of potential enhancements in the chart at page 4. For the reasons described below, the Six Cities urge the ISO to phase this initiative to distinguish between the two categories of enhancements and to prioritize potential enhancements that support recovery of supplier costs. By reference to the chart at page 4 of the Issue Paper, the Six Cities recommend that Phase 1 of this initiative consider enhancements covered by the top right quadrant of the chart, and that potential enhancements covered by the bottom left quadrant of the chart be considered in a second phase following completion of Phase 1.

Phasing this initiative will facilitate more expeditious consideration of enhancements that will improve the ability of suppliers to recover their costs when gas prices are volatile. There are several such potential enhancements that are straightforward and relatively easy to implement. In contrast, the Issue Paper identifies a number of complex and challenging issues, such as the appropriate structure of conduct and impact tests for market power, that would have to be addressed in connection with a broader expansion of bidding flexibility for commitment costs. The ISO should focus on the more straightforward measures first and then deal with the more complex issues thereafter.

The Six Cities' recommendation to prioritize enhancements that support recovery of supplier costs is generally consistent (subject to a significant exception) with the comments on the Issue Paper submitted by the ISO's Department of Market Monitoring on November 29, 2016 (the "DMM Comments"). The DMM Comments also suggest a phased approach to consideration of enhancements under this initiative and recommend specific measures for implementation by the fall of 2017. The Six Cities specifically support the following enhancements summarized at page 3 of the DMM Comments:

1) Using on a permanent basis the weighted average of trade prices on the InterContinental Exchange ("ICE") available prior to the Day-Ahead market run

for establishment of the gas price component of the Commitment Cost bid cap and Default Energy Bids;

2) Using trading information from ICE for the first trade day of a week for the gas price component of the Commitment Cost bid cap and Default Energy Bids;

3) Updating real-time gas indices between 8:00 a.m. and 9:00 a.m. using prices for gas trades observed during earlier hours of the same day; and

4) Developing detailed guidelines for after-the-fact recovery of commitment costs and incremental energy costs not recovered through market revenues (although, as discussed below, the Six Cities do not agree with DMM's proposed disallowance of cost recovery for unavoidable gas penalties).

In addition, the Six Cities support subsequent consideration of a process for allowing suppliers to request use of a gas price in excess of the updated index prices (plus the 25 percent headroom for commitment costs and 10 percent headroom for Default Energy Bids), as recommended at page 4 of the DMM Comments.

With regard to the updates identified in bullets 1) through 3) above, the Six Cities support the DMM's suggestion that the ISO have authority to suspend the update mechanism if ISO monitoring reveals that updated outcomes are anomalous by comparison to pre-established metrics. *See* DMM Comments at 8, 10, and 13. To address the issue identified in "Option 7" and "Option 8" on page 13 of the DMM Comments, the Six Cities support symmetrical application of the update mechanisms; *i.e.*, updated prices should reflect gas price decreases as well as gas price increases. However, the Six Cities do not support the "Option 10" suggestion described at pages 13-14 of the DMM Comments. Allowing the ISO open-ended authority to increase gas price indices at whatever times and by whatever amounts the ISO sees fit would undermine transparency of bidding rule application and eliminate any ability to predict applicable caps.

<u>There Must Be an Opportunity for Recovery of Unavoidable Penalties or Charges Triggered by ISO Dispatch Instructions</u> - - The Six Cities have a significant disagreement with one aspect of the DMM Comments. DMM states at page 14 of its Comments that gas penalties, imbalance charges and "cash out" costs should not be included in calculation of bid caps "because these do not typically represent hourly marginal costs and cannot be reasonably estimated in advance." As discussed in detail below, when gas penalties and imbalance charges may be triggered by ISO dispatch instructions, there is no legitimate basis for denying cost recovery for penalties that are incurred to comply with ISO dispatch instructions and cannot be avoided.

Generators at times are faced with the Catch-22 choice of failing to follow ISO dispatch instructions or incurring unavoidable penalties if they do follow the ISO's instructions. For example, the SoCal Gas balancing requirements are tied to stages of Operational Flow Orders ("OFOs") and include escalating penalties and narrowing tolerance bands for balancing gas burn with scheduled deliveries as the OFO Stage increases. On days when OFOs are in effect, ISO

Real-Time Dispatch can cause a resource to incur a financial penalty due to use of natural gas outside the applicable tolerance band.

The ISO's current commitment cost recovery provisions are not sufficient to allow reasonable recovery of costs incurred to comply with ISO dispatch instructions when penalties are triggered. The risk of unavoidable penalties is a consequence of ISO Real-Time dispatch directives (as opposed to Self-Schedules or Day-Ahead economic awards), especially Real-Time dispatches occurring after 3:00 p.m. The last regular trading cycle for natural gas (known as the "Intraday 3 Cycle") closes for the flow day at 5:00 p.m. The time required to locate trading counter-parties and complete trades becomes longer and more difficult as the flow day advances, and a two-hour transaction time (*i.e.*, between 3:00 and 5:00 p.m.) is necessary as a practical matter for last minute trades. If, but only if, a resource has the ability to withdraw gas under firm storage contracts, additional gas may be available until 9:00 p.m. on the flow date. Thus, arranging for delivery of additional gas to cover an ISO Real-Time dispatch order is significantly hampered after 3:00 p.m. and impossible after 9:00 p.m. daily. As a result, late-day dispatches by the ISO create a substantial risk of non-avoidable penalties when OFOs are in effect, and even the 150% commitment cost allowance currently applicable to use-limited resources may not be adequate to cover the balancing penalties plus other commitment costs.

Gas-fired resources cannot address this risk by over-procuring gas supplies, because there also may be penalties that apply to over-deliveries of gas. If a resource owner assumes a unit will run and buys additional gas to meet the daily balancing requirement, and the unit does not run, the resource owner is exposed to the potential of penalties for exceeding the high side of the daily balancing tolerance range that prohibits a resource owner from delivering too much gas. For Day-Ahead schedules, arranging for gas supplies within the allowed minimum and maximum amounts is possible. The ISO's Real-Time dispatches and the resulting gas burns are the unknown.

The Six Cities recommend that gas-fired resources be permitted to include amounts to reflect the risks of imbalance penalties in their commitment cost bids and (for mitigated resources) Default Energy Bids ("DEBs") for hours beginning with HE 16:00 on days when OFOs are in effect. The incremental bid amounts would be modest for the lower OFO stages but would increase for higher OFO stages. For example, based on a hypothetical heat rate of 10,000 mmBTU/kwh, the potential bid adders would range from $2.50/MWh at OFO Stage 1 to $500/MWh for an Emergency Flow Order violation.

The Six Cities understand that some entities have expressed concern that allowing direct recovery of natural gas penalties may undermine the deterrent effect of the penalties and thereby reduce reliability of the gas system. However, restricting the inclusion of potential imbalance penalties to commitment cost bids and DEBs for hours after 3:00 p.m. on days when OFOs are in effect will allow suppliers the opportunity to recover penalties only for hours when they have no practical ability to avoid the penalties and, therefore, should have little or no adverse impact on the deterrent effect of the penalties. Allowing adjustment of commitment cost bids and DEBs under the narrow circumstances proposed also will reduce the likelihood of dispatches that would result in gas overburns, which would enhance gas system reliability. To deter abuse of the opportunity to include potential penalty costs in commitment cost bids and DEBs, the ISO should have the authority to require resources that increase their commitment cost bids by a penalty adder to document their exposure to potential penalties and should make clear that including a penalty cost bid adder when a resource is not at risk of incurring penalties will constitute a violation of the market conduct rules.

If the ISO does not allow adjustment of commitment cost bids and DEBs for mitigated resources after 3:00 p.m. on OFO days, gas imbalance penalties that could not be avoided should be recoverable as part of an after-the-fact cost recovery filing with the FERC. Exposing generators to non-avoidable and non-recoverable costs incurred to comply with ISO dispatch instructions is not only confiscatory but also has the potential to adversely affect electric system reliability. Unless suppliers have the opportunity to include the risk of non-avoidable penalties in their commitment cost bids and DEBs, the opportunity to request after-the-fact recovery of costs should include the ability to request recovery of gas penalties that were incurred to respond to ISO Real-Time dispatch instructions and could not be avoided.

<u>Responses to Questions Posed in the Issue Paper</u> - - The Six Cities' comments above respond to the following two questions set forth in the Issue Paper:

- Do stakeholders still feel that when mitigated they are at risk of being reflected in the markets to a lower price level than their own cost expectations? Issue Paper at 27.

- Should the California ISO consider introducing fuel price adjustments to its reference level calculations to reduce the risks that suppliers' (*sic*) will not have mitigated prices that reasonably reflect their cost expectations? Issue Paper at 35.

The Six Cities' answer to both of the questions above is "yes," and the comments set forth above describe the remedial action supported by the Six Cities for the first phase of this stakeholder initiative. At this time the Six Cities take no position with respect to the other questions included in the Issue Paper.

Submitted by,

Bonnie S. Blair
Thompson Coburn LLP
1909 K Street N.W., Suite 600
Washington, D.C. 20006-1167
bblair@thompsoncoburn.com
202-585-6905

Attorney for the Cities of Anaheim, Azusa, Banning, Colton, Pasadena, and Riverside, California