I appreciate the opportunity to submit e-filed comments with attached supporting documentation in Docket No. AD21-10-000 on modernizing wholesale electricity market design.

These e-filed materials are submitted in response both to the Order Directing Reports issued on 21 April 2022 by the Federal Energy Regulatory Commission (FERC) and to the responses to this Order submitted on or before 18 October 2022 by each FERC-jurisdictional Regional Transmission Organization (RTO) and Independent System Operator (ISO).

FERC and the ISOs/RTOs identify many important concerns regarding the design and operation of current U.S. RTO/ISO-managed wholesale power markets. For reasons carefully explained, rigorously justified, and extensively illustrated in my 2021 Wiley/IEEE Press book, and briefly summarized in these e-filed materials, I strongly support FERC’s current efforts to undertake a fundamental reconsideration of the design and operation of these markets.

A brief outline of the topics addressed in this e-filing will next be given.

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Part I. Short bio for L. Tesfatsion.

Part II. Two critical needs facing current U.S. RTO/ISO-managed wholesale power markets are: (i) decarbonization of grid operations (Net-Zero 2050); and (ii) more active demand-side participation (FERC Order 2222).

Part III. Four conceptually-problematic economic presumptions (P1)–(P4) underpinning the legacy DAM/RTM two-settlement system design at the core of current U.S. RTO/ISO-managed wholesale power market operations are greatly hindering attempts to address these two needs.

Part IV. Four counter-claims (CC1)–(CC2) to presumptions (P1)–(P4) are established that highlight critical conceptual problems with each of these presumptions.

Part V. Retention of the legacy DAM/RTM two-settlement system, based on the conceptually-problematic presumptions (P1)-(P4), appears to be causing increasing operational difficulties for U.S. RTO/ISO-managed wholesale power markets: namely, a proliferation of “participation models” functioning as artificial entry barriers; a proliferation of conceptually ill-defined “flexibility products”; a proliferation of out-of-market (OOM) make-whole payments; and growing supplier revenue insufficiency concerns.

Part VI. Key features of my proposed “Linked Swing-Contract Market Design” (Footnote 4) are briefly reviewed, as a TRL-3 demonstration that gradual non-disruptive transition to a conceptually-consistent alternative design – well-suited for support of decarbonized grid operations and active demand-side participation – is both desirable and feasible.

Part VII. The Linked Swing-Contract Market Design permits grid-supported centrally-managed wholesale power markets to operate as flexibility support mechanisms, able to ensure the guaranteed availability of diverse dispatchable power-path production capabilities for possible RTO/ISO dispatch during future operating periods to satisfy just-in-time customer power demands and grid reliability requirements.

Attachment A. Detailed explanations, justifications, and examples for all assertions in Parts II through VII, above, are provided in Attachment A, the supporting document attached at the end of this e-filing. A full citation for this supporting document is given in Footnote 2.
I. Short Bio for L. Tesfatsion

Leigh Tesfatsion received the Ph.D. degree in economics from the University of Minnesota, Mpls., in 1975, with a minor in mathematics. She is currently Research Professor of Economics, Courtesy Research Professor of Electrical & Computer Engineering, and Professor Emerita of Economics at Iowa State University. Her principal current research areas are electric power market design and the development of computational platforms for the careful dynamic performance testing of these designs over successive days of operation. She is the recipient of the 2020 David A. Kendrick Distinguished Service Award from the Society for Computational Economics (SCE) and an IEEE Senior Member. She has served as guest editor and associate editor for a number of journals, including: *IEEE Transactions on Power Systems*; *IEEE Transactions on Evolutionary Computation*; *J. of Energy Markets*; *J. of Economic Dynamics and Control*; *J. of Public Economic Theory*; and *Computational Economics*.


The basic purpose of centrally-managed wholesale power markets operating over high-voltage AC transmission grids is to maintain efficient just-in-time production and transmission of bulk power to satisfy diverse just-in-time customer power demands and grid reliability requirements.

To achieve this dynamic open-ended purpose, central managers must continually protect against *volumetric grid risk*: namely, the possible disruption or collapse of grid operations due to real-time imbalance between the injection of power into the grid and the withdrawal and/or inadvertent loss of power from the grid. Grid power withdrawals occur when the power usage of customers electrically connected to the grid exceeds their use of locally-generated power. Inadvertent grid power losses occur whenever power flows across transmission grid lines.

In response to private economic incentives and public policy mandates encouraging grid decarbonization, U.S. RTO/ISO-managed wholesale power markets are transitioning from a traditionally heavy reliance on fossil-fuel based power generators to a greater reliance on renewable power facilities. The latter facilities include *intermittent power resources (IPRs)*, such as

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5 An *intermittent power resource (IPR)* is here defined to be a grid-connected power resource whose power injections and/or withdrawals are not mediated through some form of aggregator and are not fully controllable by centrally-managed dispatch.
grid-connected wind farms and photovoltaic solar arrays whose weather-dependent power generation is not fully firmed by storage.

The increasing participation of IPRs in U.S. RTO/ISO-managed wholesale power markets, together with recent initiatives such as FERC Order No. 2222 encouraging more active participation by aggregations of distribution-level power resources and customers in these markets, has increased the uncertainty and volatility of grid net load, i.e., customer power withdrawals and inadvertent power losses minus net non-dispatched power injections. Moreover, many IPRs connect to high-voltage AC transmission grids by means of power electronic inverters that convert DC to AC power, a connection technology that differs fundamentally from the traditional connection technology for fossil-fuel based power generators. At higher IPR penetration levels, this new connection technology can pose new types of system security issues.

In consequence, RTOs/ISOs are finding it harder to procure the dependable advance availability of dispatchable power-path production capabilities with sufficiently diverse attributes to maintain reliable real-time balancing of net load. The following Part III identifies four conceptually problematic economic presumptions underpinning day-ahead and real-time market operations in current U.S. RTO/ISO-managed wholesale power markets that are greatly hindering the resolution of this issue.

### III. Four Conceptually-Problematic Economic Presumptions at the Core of Current U.S. RTO/ISO-Managed Market Designs

Attachment A (Support. Doc., Secs. 1–2) provides a careful summary discussion of four conceptually-problematic presumptions reflected in U.S. operation and settlement rules for the daily RTO/ISO management of a Day-Ahead Market (DAM) and a Real-Time Market (RTM). This

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8 In practice, reliable real-time balancing of net load means maintaining net-load balance within acceptable tolerance levels over time.
DAM/RTM Two-Settlement System is a core design feature for all seven current U.S. RTO/ISO-managed wholesale power markets.

The four conceptually-problematic economic presumptions are as follows:

**Problematic Presumption (P1):**

The basic transacted product is grid-delivered energy (MWh), i.e., flows of power (MW) accumulated at designated grid locations during designated operating periods with duration measured in hours (h).

**Problematic Presumption (P2):**

For the careful analysis of supplier revenue sufficiency, it suffices to partition total supplier cost into two components: namely, a “variable” component determined by supplier grid-delivered energy; and a “fixed” component independent of supplier grid-delivered energy.

**Problematic Presumption (P3):**

Grid-delivered energy (MWh) is a commodity whose energy units $u = 1\text{MWh}$ – perfectly substitutable conditional on grid delivery location $b$ and operating period $T$ – should be transacted in a competitive commodity spot market at a uniform per-unit locational marginal price $\text{LMP}(b,T)$ ($/\text{MWh}$) determined in accordance with the competitive (marginal cost = marginal benefit) spot-pricing rule.

**Problematic Presumption (P4):**

Total supplier revenue attained in these competitive commodity spot markets will suffice over time to cover total supplier cost.

Presumptions (P1)–(P4) reflect the misleading view that U.S. RTOs/ISOs are fiduciary managers for weakly-correlated collections of competitive commodity spot markets. The reality is far more daunting.

U.S. RTOs/ISOs are fiduciary “conductors” tasked with orchestrating the availability and subsequent possible dispatch of increasingly-diverse dispatchable power resources to service the just-in-time power demands of increasingly diverse grid-connected customers while meeting just-in-time power requirements for reliable grid operation.
IV. Counter-Claims to the Four conceptually-Problematic Economic Presumptions Outlined in Part III

IV.A Overview

Attachment A (Support. Doc., Secs. 3–4) carefully establishes four counterclaims (CC1)–(CC4) to the four conceptually-problematic economic presumptions (P1)–(P4), making use of basic definitions and lemmas of conceptual interest in their own right. A summary version of these definitions and lemmas is provided in the following three sub-sections.

IV.B Basic Economic Concept Definitions from Attachment A

**Definition D1:** An asset is anything in physical or financial form that can function as a durable store of value.\(^9\)

**Definition D2:** A standard unit of measurement \(u\) is a specified positive amount of some quantity that is commonly used (by law or by convention) to measure the magnitude of general amounts of this quantity in a comparable manner.

**Definition D3:** A \(u\)-asset is an asset that has a standard unit of measurement.\(^{11}\)

**Definition D4:** A commodity is a \(u\)-asset \(Q\) such that, conditional on location and time, each \(Q\)-trader (buyer and/or supplier) considers all \(Q\)-units available for trade to be perfect substitutes; that is, the substitution of any available \(Q\)-unit by any other available \(Q\)-unit does not affect any \(Q\)-trader’s economic valuation of this \(Q\)-unit.\(^{12}\)

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\(^{9}\)See Attachment A (Support. Doc., Sec. 3.2)

\(^{10}\)In principle, an asset can be characterized as a vector of multiple possibly-correlated attributes. For example: \(\text{Apple} =: (\text{location}; \text{time}; \text{weight}; \text{shape}; \text{color}; \text{crispness}; \ldots)\).

\(^{11}\)A \(u\)-asset is a new asset categorization, introduced in Attachment A (Support. Doc., Sec. 3). The set of all \(u\)-assets (Definition D3) is strictly nested between the set of all assets (Definition D1) and the set of all commodities (Definition D4).

\(^{12}\)Attachment A (Support. Doc., Sec. 4.4) establishes that grid-delivered energy is an example of a \(u\)-asset that is not a commodity. Hence, an explicit recognition of this new \(u\)-asset categorization appears to be essential for the careful economic analysis of grid-supported electric power market operations.
IV.C Basic Market Definitions from Attachment A

Definition M1: A market for an asset \( A \) is a \textit{spot market} if transacted amounts of \( A \), payments for these transacted amounts of \( A \), and deliveries of these transacted amounts of \( A \) all occur at a given location and time ("on the spot").

Definition M2: A \textit{commodity spot market} is a spot market for a commodity \( Q \).

Definition M3: (Simplified Form). A \textit{competitive commodity spot market} is a commodity spot market with price-taking buyers and suppliers that implements a competitive (marginal cost = marginal benefit) price-rule to determine market price and quantity outcomes.

Definition M4: A market for an asset \( A \) is a \textit{forward market} if transacted amounts of \( A \) and payment obligations for these transacted amounts of \( A \) are determined in advance of the delivery of these transacted amounts of \( A \).

Definition M5: A \textit{futures market} is a forward market for a commodity \( Q \).

Definition M6: (Simplified Form). Conditional on a given location and time, the \textit{non-avoidable fixed cost (or sunk cost)} \( ($) \) of a supplier \( i \) in the process of selecting a supply-amount \( a \geq 0 \) (measured in \( u \)) for a \( u \)-asset \( A \) with a standard unit of measurement \( u \) is the dollar cost \( SC^o_i ($) \) that supplier \( i \) has incurred to date that cannot be reduced or modified by any current or future decision that supplier \( i \) makes, including a current selection of \( a \).

Definition M7: (Simplified Form). Conditional on a given location and time, the \textit{avoidable fixed cost} \( ($) \) of a supplier \( i \) in the process of selecting a supply-amount \( a \geq 0 \) (measured in \( u \)) for a \( u \)-asset \( A \) with a standard unit of measurement \( u \) is the fixed dollar cost \( AFC^o_i ($) \) that supplier \( i \) will incur if and only if supplier-\( i \) selects a positive supply-amount \( a^* > 0 \).

\(^{13}\)See Attachment A (Support. Doc., Sec. 3.4).
Definition M8: (Simplified Form). Conditional on a given location and time, the variable cost of a supplier \( i \) in the process of selecting a supply-amount \( a \geq 0 \) (measured in \( u \)) for a \( u \)-asset \( A \) with a standard unit of measurement \( u \) is the \( a \)-dependent dollar cost \( VC_i(a) \) ($) that supplier \( i \) would incur for each possible selection \( a \geq 0 \), where \( VC_i(0) = 0 \).

Definition M9: (Simplified Form). Conditional on a given location and time, the avoidable cost ($) that supplier \( i \) would incur from the selection of a supply-amount \( a^* \geq 0 \) (measured in \( u \)) for a \( u \)-asset \( A \) with a standard unit of measurement \( u \) is the summation of supplier \( i \)'s avoidable fixed cost \( AFC_i^o \) ($) and variable cost \( VC_i(a^*) \) ($).

Definition M10: (Simplified Form). A supplier \( i \) participating in a market \( M \) is said to be revenue sufficient if the revenue that supplier \( i \) attains from this market participation is sufficient to cover the avoidable cost that supplier \( i \) incurs from this participation.

IV.D Lemmas from Attachment A\(^{14}\)

Lemma 1: The use of the operator “=” to equate amounts of two \( u \)-assets measured in terms of the same standard unit of measurement \( u \) can result in conceptual error.

Outline of Proof for Lemma 1: By design, the standard unit of measurement \( u \) for a \( u \)-asset \( A \) typically measures the “amount” of \( A \) based on only one attribute of \( A \), such as: weight measured in pounds (lb); energy measured in megawatt-hours (MWh); and economic value measured in U.S. dollars ($). No attempt is made to ensure that \( u \) characterizes the attributes of \( A \) in a physically or economically complete manner. Thus, the “same” \( u \)-amounts for two physically-distinct or economically-distinct \( u \)-assets with the same standard unit of measurement \( u \) can have substantially different physical effects when used within a physical application, and substantially different economic effects when used as consumption goods or as inputs to a production process. //

Lemma 2: The standard use of per-unit (p.u.) calculations in economics and power engineering can mask conceptual error.

Outline of Proof for Lemma 2: Conditional on a given location and time, suppose: (i) assets \( A' \) and \( A'' \) are two \( u \)-assets that share a common standard

\(^{14}\) See Attachment A (Support. Doc., Sec. 3.3).
unit of measurement $u$; (ii) $a'$ is an amount of $A'$ measured in $u$; (iii) $a''$ is an amount of $A''$ measured in $u$; (iv) $a' = a''$ measured in $u$; but (iv) the $u$-units for assets $A'$ and $A''$ are not equivalently exchangeable for a purpose at hand.

For example, the $u$-assets on each side of “=” could be: (a) equal apple amounts (measured in pounds) for two distinct apple varieties that are being offered for sale at a given location and time; or (b) equal energy amounts (measured in MWh) that have been grid-delivered at a designated grid location $b$ during a designated operating-period $T$ as the accumulation of two power-injection sequences with distinctly different physical attributes (e.g., different ramp-rate profiles during $T$, different capacity profiles during $T$, different delivery timing within $T$, ...).

Dividing the $u$-amounts on each side of “=” by a common “base $u$-value” (for example, “1 pound of apples” for the apple example, or “1MWh of energy” for the grid-delivered energy example), one is left with “per-unit” equations such as “$10 = 10$” for the apple example and “$2 = 2$” for the grid-delivered energy example that appear to be correct equations because they are true statements for the Real Number System. Any differences in the full collection of attributes characterizing the two underlying $u$-assets $A'$ and $A''$ that conceptually invalidate the unqualified use of an equality operator “=” in the original versions of these equations – that is, the use of “=” without the qualification “measured in $u$” – are now lost from sight. //

**Lemma 3:** A conceptually-meaningful real-line “quantity axis” cannot be constructed for an asset $A$ conditional on location and time unless asset $A$ is a $u$-asset whose $u$-units are equivalently exchangeable for the purpose at hand, conditional on this location and time.

**Outline of Proof for Lemma 3:** Suppose, first, that an asset $A$ is not a $u$-asset. Then there is no way to measure “amounts” of $A$ along a real-line “quantity axis” by measuring these amounts in terms of a real-valued unit-of-measurement $u$.

Suppose, next, that a $u$-asset $A$ is to be used as an input to some physical and/or economic process $Z$ to take place at a location $b$ at some start-time $t$. However, suppose the $u$-units of $A$ are not equivalently exchangeable for process $Z$. Finally, suppose a process manager is tasked with the construction of a function mapping different amounts of input $A$ (measured in $u$) into corresponding physical and/or economic outcomes for process $Z$, taking as given a particular configuration of all other inputs.
As a first task-step, the manager sets about the construction of a “quantity axis” for $A$ by identifying each real number $r \geq 0$ along the real-line with an amount of $A$ of size $r$ (measured in $u$ units). Unfortunately for the manager, the precise selection of $u$-units comprising each given amount $r$ of $A$ can affect the resulting physical and/or economic outcomes of process $Z$ because, by assumption, the $u$-units of $A$ are not equivalently exchangeable for process $Z$.

Thus, the physical and/or economic outcomes for process $Z$ cannot be expressed as a conceptually well-defined function of the “amount” of input $A$ represented as a non-negative $r$-value along the real line. //

IV.E Counter-Claims (CC1)–(CC4) to Presumptions (P1)–(P4)$^{15}$

Counter-Claim (CC1): Within the context of a grid-supported centrally managed wholesale power market, grid-delivered energy (MWh) is not the basic transacted product. To the contrary, suppliers can provide two distinct types of services:

**Physically-Covered Insurance:** Guaranteed availability of diverse power-path$^{16}$ production capabilities for possible central-manager dispatch during future operating periods to reduce volumetric grid risk;

**Real-Time Power-Path Delivery:** Actual delivery of power-paths in response to dispatch signals received from the central manager during successive operating periods to ensure just-in-time customer power demands and grid reliability requirements are met.

Counter-Claim (CC2): Within the context of a grid-supported centrally managed wholesale power market, the total costs of suppliers must be partitioned into three distinct components – Unavoidable Fixed Cost (“Sunk Cost”), Avoidable Fixed Cost, and Variable Cost – to permit a conceptually sound analysis of their revenue sufficiency.

$^{15}$See Attachment A (Support. Doc., Sec. 4).

$^{16}$A power-path $p_b(T) = (p_b(t) \mid t \in T)$ is a sequence of successive injections and/or withdrawals of power $p_b(t)$ (MW) at a single grid-location $b$ during a designated time-interval $T$. 
Counter-Claim (CC3): Within the context of a grid-supported centrally managed wholesale power market, grid-delivered energy (MWh) is **not a commodity**. Although grid-delivered energy has a standard unit of measurement $u = 1$MWh, market participants do not consider these units $u$ to be perfect substitutes (economically equivalent) conditional on a grid delivery location and an operating-period start-time.

Counter-Claim (CC4): Grid-supported centrally-managed wholesale power markets are necessarily **forward** markets due to the speed of real-time operations. To ensure their revenue sufficiency, suppliers participating in such a market must be permitted to submit **two-part pricing**\(^\text{17}\) supply offers requiring **separate full compensation** for:

1. **avoidable fixed cost** incurred for provision of physically-covered insurance that reduces volumetric grid risk for future operating periods;

2. **variable cost** incurred for actual power-path delivery in accordance with real-time dispatch signals received from the central manager.

An important implication of Lemma 3 and Counter-Claim (CC3), carefully established and illustrated in Attachment A (Support. Doc., Secs. 3–4), is as follows:

**Key Implication 1:** Contrary to the justifications commonly asserted for the current reliance on Locational Marginal Pricing (LMP) for DAM/RTM settlements in all seven U.S. RTO/ISO-managed wholesale power markets, the standard competitive (marginal cost = marginal benefit) spot-pricing rule defined by economists for commodity spot markets cannot be instituted for grid-delivered energy in a conceptually-coherent manner.

\(^{17}\)It has long been recognized by economists that two-part pricing can be used by monopolistic suppliers in **spot-market** settings as price-discrimination instruments permitting extraction of “net surplus” from buyers; see, for example, the discussion of this spot-market issue in Attachment A (Support. Doc., Sec. 4.5). The recommended use of two-part pricing in (CC4) is for an altogether different context: Suppliers participating in **forward** markets can incur **avoidable fixed costs** to guarantee their ability to fulfill a range of possible real-time delivery obligations under contracts with swing (flexibility) in their delivery terms, as well as **variable costs** for actual real-time deliveries; and both types of costs must be fully covered in order for these suppliers to stay in business.
Outline of Proof for Key Implication 1: Consider the following four standard economic functions analytically defined and explained in Attachment A (Support. Doc., Secs. 3.4–3.5):

- Supply functions, in either ordinary or inverse form;
- Supplier marginal cost functions;
- Buyer demand functions, in either ordinary or inverse form;
- Buyer marginal benefit functions.

As explained and illustrated in Attachment A (Support. Doc., Sec. 3.5), a necessary condition for these four types of “marginal” functions dependent on “next unit” calculations to be conceptually well-defined for a transacted asset \( A \), conditional on location and time, is that \( A \) be a commodity. That is, \( A \) must be an asset \( Q \) with a standard unit of measurement \( u \) such that, conditional on location and time, \( Q \)-traders consider all \( Q \)-units \( u \) available for trade to be perfect substitutes (i.e., economically equivalent).

However, as established in Attachment A (Support. Doc., Sec. 4.4), energy \( E^* \) (MWh) scheduled for grid-delivery at a grid-location \( b \) during an operating-period \( T = [t^s, t^e] \) at start-time \( t^s \) is not a commodity because its units (MWh) are not perfect substitutes. To the contrary, the dynamic attributes of the power-path that delivers \( E^* \) at \( b \) during \( T \) as accumulated power (MWh) will typically matter: (i) to distribution-system power customers electrically connected at \( b \); (ii) to power suppliers electrically connected at various grid locations who are dispatched by the RTO/ISO to ensure delivery of \( E^* \) at \( b \) during \( T \); and (iii) to the RTO/ISO itself, tasked with maintaining grid reliability during \( T \).

Key Implication 1 implies that achieving a conceptually-consistent design for U.S. RTO/ISO-managed wholesale power markets will require a fundamental change in their current LMP-based settlement rules. The following Key Implication 2, an implication of Counter-Claims (CC1), (CC2), and (CC4), implies that other fundamental changes might be needed as well.

**Key Implication 2:** Achieving supplier revenue sufficiency for U.S. RTO/ISO-managed wholesale power markets—without the need to rely on out-of-market (OOM) make-whole payments—could require fundamental changes in their current basic product definitions and required supply-offer formulations.
Illustrative Example for Key Implication 2: Let DAM(D+1) denote a co-optimized U.S. RTO/ISO-managed DAM conducted on day D for operating day D+1. Suppose an energy supply offer submitted to DAM(D+1) by a Dispatchable Power Resource (DPR) \( m \) electrically connected at a grid-location \( b_m \) has been cleared to provide energy (MWh) in amount \( E^* =: [p^*_m \times 1h] \) at \( b_m \) during a specific hour \( H^* \) on day D+1, where \( p^*_m \) (MW) lies strictly within DPR \( m \)'s reported feasible power-capacity range \([0, p^\text{max}_m]\).

Then, in order for DPR \( m \) to be revenue sufficient, i.e., in order for DPR \( m \) to receive market-based revenue (\$) from its participation in DAM(D+1) that is sufficient to cover all of the avoidable cost (\$) that DPR \( m \) incurs from this market participation, DPR \( m \) must receive full separate compensation for:

1. all avoidable fixed cost that DPR \( m \) incurs between the close of DAM(D+1) and the start of Hour \( H^* \) on Day D+1 to ensure:
   - \( m \)'s ability to deliver energy at \( b_m \) in amount \( E^* \) during hour \( H^* \);
   - \( m \)'s ability to guarantee the availability of operating reserve (unencumbered generation capacity) at \( b_m \) in amount \([p^\text{max}_m - p^*]\) during hour \( H^* \),

   whether or not the RTO/ISO in fact dispatches DPR \( m \) for the delivery of any power-path at \( b_m \) during hour \( H^* \) on Day D+1;

2. any variable cost that DPR \( m \) incurs for the actual delivery of a power-path at \( b_m \) during Hour \( H^* \) on Day D+1 in accordance with received RTO/ISO dispatch signals, whatever dynamic form this power-path takes.

However, the only market-based revenue that DPR \( m \) is guaranteed to receive from its DAM(D+1) participation is a payment for actual grid-delivered energy at \( b_m \) for hour \( H^* \) – adjusted for any deviation from the DAM(D+1)-scheduled energy amount \( E^* \) – plus an “opportunity cost” payment for operating reserve supplied at \( b_m \) for hour \( H^* \) on day D+1. Both types of payments are based on Security-Constrained Economic Dispatch (SCED) determinations of DAM(D+1)-determined and RTM(H^*)-determined locational marginal prices ($/MWh) for grid-delivered energy at \( b_m \) for hour \( H^* \) on day D+1.

Consequently, considering the multiple types of avoidable fixed cost and variable cost that real-world DPR participants in U.S. RTO/ISO-managed DAMs actually incur,\(^\text{18}\) it is difficult to see how DPR \( m \) would achieve revenue sufficiency from its DAM(D+1) participation except by chance. //

\(^{18}\)See Attachment A (Support. Doc., Appendix A.4) for a listing of empirical examples for each type of cost.
Finally, considered as a whole, the four counter-claims (CC1)–(CC4) imply the need to reconsider with care the role currently played by virtual energy traders in the DAM and RTM processes at the core of current U.S. RTO/ISO-managed wholesale power market operations.

A virtual energy trader participating in a DAM and/or RTM for a future operating period T is a purely financial trader required to liquidate (reduce to zero) all of its buy/sell quantity positions for T prior to the start of T. Thus, virtual energy traders have no physical means (or incentive) to contribute to the reduction of volumetric grid risk for future operating periods. Rather, the only way virtual energy traders can make money in these markets is from energy price arbitrage: namely, buying energy positions low and selling energy positions high.

The standard justification offered for the inclusion of virtual energy traders in U.S. RTO/ISO-managed DAMs and RTMs is that their energy-price arbitrage activities will tend to align the uniform per-unit energy settlement prices – i.e., the DAM and RTM LMPs ($/MWh) – that are determined for common grid delivery-locations and operating periods. For example, it is argued these energy-price arbitrage activities will tend to bring into equality the DAM LMP determined on day D for a grid delivery-location b during some hour H of day D+1 with the RTM LMP determined on day-D+1 for grid delivery-location b during any delivery sub-period τ of H.

However, this price-arbitrage justification is conceptually problematic on two grounds:

(1) There is no conceptually-supportable reason why the DAM/RTM determined compensation for the RTO/ISO-dispatched delivery of a power-path $p_b(T) = \{p_b(t) \mid t \in T\}$ at a grid delivery-location b during an operating period T should consist solely of a uniform per-unit locational marginal price $LMP(b,T)$ ($/MWh) for grid-delivered energy (MWh) at b during T plus an opportunity-cost payment for unencumbered capacity (MW) at b during T calculated in terms of LMP(b,T). Such settlements ignore beneficial and/or adverse effects of the dynamic attributes of the delivered power-path $p_b(T)$ as a whole, such as its capacity profile and ramp-rate profile at b during T.
There is no conceptually-supportable reason why the DAM(D+1)-determined and RTM(τ)-determined locational marginal prices for a common grid delivery-location b and a common delivery sub-period τ of day D+1 should be forced towards common values considered optimal by purely financial traders with no concern either for the avoidable fixed cost of volumetric grid-risk reduction between the close of DAM(D+1) and the start of τ or for the variable cost of actual power-path production and delivery during τ to meet customer demands and grid reliability requirements.

The above concerns regarding the participation of virtual energy traders in current U.S. RTO/ISO-managed DAM/RTM operations are summarized, below, in the form of a third important implication.

**Key Implication 3:** The DAM/RTM participation of virtual energy traders engaging in purely financial arbitrage activities, with no physical ability (or incentive) to reduce volumetric grid-risk or to service customer power demands and grid reliability requirements, could amplify the price distortions already arising in these markets from their reliance on conceptually-problematic LMP settlements, thus further hampering the ability of these markets to ensure grid reliability, supplier revenue sufficiency, and market efficiency.

**Part V. Legacy Core Design: Roadblock for Grid Decarbonization**

Attachment A (Support. Doc., Sec. 5) carefully considers how the retention of the four conceptually-problematic presumptions (P1)–(P4) in the core DAM/RTM design of current U.S. RTO/ISO-managed wholesale power markets appears to be hindering the ability of these markets to transition smoothly to decarbonized grid operations. Four external indicators supporting this concern are identified and considered, as follows:
• Proliferation of participation models acting as artificial entry barriers;
• Proliferation of conceptually ill-defined\(^{19}\) flexibility products;
• Proliferation of out-of-market (OOM) make-whole payments; and
• Growing revenue insufficiency concerns.

More broadly, it is argued that adherence to (P1)–(P4) appears to have resulted in a conundrum with dangerous practical ramifications. Recalling the slow and difficult transition from the earth-centric circular-orbit solar-system model developed by Claudius Ptolemy (circa 100-170 AD), supported by a proliferation of postulated “epicycles,” to the sun-centric elliptical-orbit solar-system model due to Nicolaus Copernicus (1473-1543) and Johannes Kepler (1571-1630), this conundrum can be characterized as follows:

**Ptolemaic Epicycle Conundrum for the Design of Grid-Supported Centrally-Managed Wholesale Power Markets (“Onion Problem”):**

- Fundamental conceptual inconsistencies in the core design principles instituted for such a market result in operational difficulties.
- These operational difficulties are addressed by introducing a new layer of rules (an “epicycle”) around the initial core design principles, which results in further operational difficulties.
- Rule-layer (epicycle) accretion then continues to occur because, ignoring the dictum “Sunk Cost is Sunk,” the correction of the fundamental conceptual inconsistencies in the core design principles is persistently deemed to be too costly to correct.

\(^{19}\)“Products” such as ramping capability (MW/min), capacity (MW), and (grid-delivered) energy (MWh) are in fact the highly correlated (“jointly produced”) attributes of individual power-paths \(\mathbf{p}_m(T) = (p_m(t) \mid t \in T)\) offered for possible RTO/ISO-dispatched delivery by dispatchable power resources \(m\) at their grid-locations \(b_m\) during variously designated operating-periods \(T\). Attempts to transact the correlated attributes of single power-paths in separate markets at separately-determined prices, as if they were independently produced products, is not conceptually supportable.

VI.A Overview

Part VI illustrates how an alternative conceptually-consistent Linked Swing-Contract Market Design, well-suited for the scalable support of increasingly decarbonized grid operations with increasingly diverse types of resource participants, could be implemented for a grid-supported centrally managed wholesale power market. This alternative design is motivated, developed, and tested in my 2021 Wiley/IEEE Press book (Footnote 4).

The Linked Swing-Contract Market Design is based on the following four conceptually-consistent economic principles [EP1]-[EP4] that were presented in preliminary form as Counter-Claims (CC1)-(CC4) in Section IV.E.

[EP1]: Within the context of a grid-supported centrally-managed wholesale power market, grid-delivered energy (MWh) is not a commodity because the cost-benefit valuations that participants assign to any given energy delivery $E^*(\text{MWh})$ at a grid location $b$ during an operating period $T$ typically depend on the dynamic attributes of the power-path that delivers $E^*$ at $b$ during $T$.

[EP2]: Any market process carried out within a grid-supported centrally-managed wholesale power market must necessarily be a forward market process $M(T)$ for a future operating period $T$ due to the speed of real-time grid operations.

[EP3]: Dispatchable Power Resources (DPRs) participating in a forward market process $M(T)$ for a future operating period $T$ within a grid-supported centrally-managed wholesale power market provide two distinct types of services:

- **Physically-Covered Insurance**: Guaranteed availability of diverse power-path production capabilities for possible central-manager dispatch during the future operating period $T$ to protect against volumetric grid risk;

- **Real-Time Power-Path Delivery**: Actual delivery of power-paths in response to central-manager dispatch signals received during operating period $T$ to meet just-in-time customer power demands and grid reliability requirements.
[EP4]: Each DPR in [EP3] can use a two-part pricing contract to submit to M(T) a coupled offer of physically-covered insurance for T and real-time power-path delivery during T that ensures revenue sufficiency for the DPR, as follows:

- The two-part pricing contract can include a DPR-specified offer price to compensate the DPR prior to T for any avoidable fixed cost the DPR must incur to guarantee its offered physically-covered insurance for T;

- The two-part pricing contract can include a DPR-specified performance payment method to compensate the DPR after T for any variable cost the DPR incurs for power-path delivery during T carried out in response to received central-manager dispatch signals.

Consequently, under this alternative design there is no need for separate or co-optimized energy markets. Moreover, there is also no need to rely on out-of-market (OOM) make-whole payments in order to ensure supplier revenue sufficiency.

VI.B Innovative Aspects and Basic Features

One innovative aspect of the Linked Swing-Contract Market Design is the conceptualization of a “power-path” for a grid-supported centrally-managed wholesale power market. This conceptualization permits the design of market rules and contractual bid/offer forms to be considered from the distributed vantage points of market participants as well as the centralized vantage point of the system manager.

**Key Definition:** A power-path \( p_b(T) = (p_b(t) \mid t \in T) \) for a grid-supported centrally-managed wholesale power market is a sequence of injections and/or withdrawals of power \( p_b(t) \) (MW) at a single grid-location \( b \) during a designated time-interval \( T \).

For example, Fig. 1 depicts the dispatchable power-path production capabilities of a dispatchable power resource \( m \) participating at grid-location \( b_m \) in a grid-supported RTO/ISO-managed wholesale power market. The figure highlights one of multiple possible power-paths that \( m \) could deliver to the grid at \( b_m \) during operating period \( T \) in response to dispatch signals received from the RTO/ISO.
Figure 1: One of multiple possible power-paths $p_m(T) = (p_m(t) \mid t \in T)$ consisting of successive injections/withdrawals of power $p_m(t)$ (MW) that a dispatchable power resource $m$ with swing (flexibility) in ramp-rate (MW/min) and power capacity (MW) could be RTO/ISO-dispatched to deliver at its grid location $b_m$ during a future operating period $T$.

A second innovative aspect of the Linked Swing-Contract Market Design is a fundamental change in the envisioned role of the RTO/ISO.

In current U.S. RTO/ISO-managed wholesale power markets, the primary concern of the RTO/ISO is the daily DAM/RTM scheduling of grid-delivered energy for near-term operating periods, supported by ancillary services (e.g., operating reserve, reactive power support for voltage control, ...) and supplemental procurement processes (e.g., residual unit commitment processes, capacity markets, ...).

In the Linked Swing-Contract Market Design, the envisioned primary concern of the RTO/ISO is the advance clearing of reserve offers from dependable dispatchable power resources for possible RTO/ISO dispatch
during future operating periods \( T \) to protect against volumetric grid risk.\(^{20}\) A reserve offer for \( T \) is a contractually expressed offer to provide guaranteed availability of power-path production capabilities for possible RTO/ISO dispatch during period \( T \).

These two design innovations require changes in product definitions, contract forms, settlement rules, and RTO/ISO management practices, but not in real-time operations. Consequently, as demonstrated in Chapter 16 of my 2021 Wiley/IEEE Press book (Footnote 4), these design innovations can be introduced gradually into current U.S. RTO/ISO-managed wholesale power markets without disruption of their real-time operations.

The basic features of the Linked Swing-Contract Market Design are as follows. The design consists of a linked collection of RTO/ISO-managed forward reserve markets \( M(T) \) for future operating periods \( T \). As noted above, reserve for \( T \) consists of the guaranteed availability of diverse power-path production capabilities in advance of \( T \) for possible RTO/ISO dispatch during \( T \), as protection against volumetric grid risk.

More precisely, as carefully explained and illustrated in Chapters 10-11 of my 2021 Wiley/IEEE Press Book (4), the Linked Swing-Contract Market Design posits a collection \( \mathcal{M} =: \{ M(T) \mid T \in \mathcal{T} \} \) of sets \( M(T) = \{ M'(T), M''(T), \ldots \} \) of RTO/ISO-managed forward reserve markets \( M'(T), M''(T), \ldots \) for each operating period \( T \) in a designated operating-period set \( \mathcal{T} \). The forward reserve markets \( M'(T), M''(T), \ldots \) in \( M(T) \) for a given future operating period \( T \) are differentiated by the durations of their look-ahead horizons \( \text{LAH}'(T), \text{LAH}''(T), \ldots \), which can range from years to minutes; see Attachment A (Support. Doc., Sec. 4.2.2, Fig. 5).

The participants in each market \( M(T) \) consist of Load-Serving Entities (LSEs), Intermittent Power Resources (IPRs), and Dispatchable Power Resources (DPRs).

A reserve bid submitted to \( M(T) \) by an LSE \( j \) on behalf of managed customers electrically connected to the grid at a common grid-location \( b_j \) is a demand for power-path delivery at \( b_j \) during \( T \). This demand can take a dispatchable price-sensitive form and/or a fixed (non-dispatchable must-service) form.

\(^{20}\) Volumetric grid risk is systemic risk of grid collapse due to net load imbalance. A systemic risk is a system-wide risk, i.e., a correlated risk arising for system operations as a whole.
The power injections of an IPR \( n \) unfirmed by storage that take place at \( n \)'s grid point-of-connection \( b_n \) during \( T \) are considered to be a fixed power-path delivery that must be forecasted by the RTO/ISO. This forecast is directly entered into the system constraints for the contract-clearing optimization that the RTO/ISO conducts for \( M(T) \): specifically, it is entered into the bus-\( b_n \) power balance constraint for operating period \( T \).

As previously noted, and illustrated in Fig. 1, a reserve offer submitted to \( M(T) \) by a DPR \( m \) is a contractually expressed offer to provide guaranteed availability of power-path production capabilities for possible RTO/ISO dispatch at \( m \)'s grid-location \( b_m \) during \( T \).

Specifically, a reserve offer submitted to \( M(T) \) by a DPR \( m \) is a two-part pricing\(^{21}\) swing-contract \( SC_m \) expressible in the following standardized form:

\[
SC_m(T) = \left( \alpha_m(T), \ T_m^{ex}(T), \ PP_m(T), \ \phi_m(T) \right) \tag{1}
\]

The first component \( \alpha_m(T) \) in (1) is the offer price that \( m \) specifies for \( SC_m(T) \). A non-negative\(^{22}\) offer price designates the amount that must be paid to \( m \) – either directly or in amortized payment-schedule form – if the RTO/ISO clears \( SC_m(T) \) for \( T \). The offer price \( \alpha_m(T) \) permits \( m \) to ensure recovery \( ex \ ante \) (i.e., in advance of \( T \)) for all avoidable fixed cost\(^{23}\) that \( m \) must incur to guarantee its offered availability of power-path production capabilities for possible RTO/ISO dispatch during \( T \), should the RTO/ISO choose to clear \( SC_m(T) \) for \( T \).

The second component \( T_m^{ex}(T) \) in (1) is the set of possible exercise times \( t_m^{ex} \) that \( m \) designates for \( SC_m(T) \) between the close of \( M(T) \) and the start-time for the future operating period \( T \). The number and positioning of

\(^{21}\)As detailed in my 2021 Wiley/IEEE Press Book (Footnote 4), this two-part pricing enables separate time-consistent DPR cost settlements (i) for reduction of volumetric grid-risk provided for \( T \) in advance of \( T \), and (ii) for any RTO/ISO-dispatched power-path delivery occurring during \( T \) subject to RTO/ISO verification subsequent to \( T \).

\(^{22}\)Swing-contract offer prices are not restricted in sign. For example, a DPR \( m \) with a positive minimum sustainable power-injection level could specify an offer price \( \alpha_m < 0 \) in an attempt to ensure the RTO/ISO clears his swing contract \( SC_m \). This negative offer price commits the DPR to pay the amount \(-\alpha_m\) should \( SC_m \) be cleared.

\(^{23}\)See Attachment A (Support. Doc., Appendix A.4) for a listing of different types of avoidable fixed cost that real-world DPRs can incur. These types include: capital investment cost; transaction cost; opportunity cost; and unit-commitment cost.
these exercise times determine whether $SC_{m}(T)$ is a firm contract or some type of option contract (e.g., European, American, Bermudan, ...).

The third component $PP_{m}(T)$ in (1) is the set of power-paths that $m$ is offering for possible RTO/ISO-dispatched delivery at $m$’s grid location $b_{m}$ during $T$. Ideally, $PP_{m}(T)$ should be a “digital twin” expressing the full physical power-path production capabilities of $m$ during $T$. In practice, $PP_{m}(T)$ will typically be an approximation for this digital twin that conveys the key physical attributes of $m$’s offered power-paths.

These key physical attributes must include $m$’s grid delivery location $b_{m}$. Additional attributes can include static features, such as total amount of grid-delivered energy (MWh) and down-time/up-time parameters, as well as dynamic features such as: power capacity (MW) profile during $T$; ramp-rate (MW/min) profile during $T$; and power-factor (kW/kVA) profile during $T$. The forms and ranges of these power-path attributes determine the degree of swing (flexibility) in $m$’s offered reserve.

The final component $\phi_{m}(T)$ in (1) is a performance payment method that maps each power-path $p$ in the power-path set $PP_{m}(T)$ into a real-valued dollar payment $\phi_{m}(T)(p)$ ($) for incurred variable cost. More precisely, $\phi_{m}(T)(p)$ designates the ex-post (i.e., after $T$) compensation for variable cost ($) that $m$ would require for delivery of $p$ during $T$ in accordance with received RTO/ISO dispatch instructions. This variable-cost compensation is subject to post-$T$ verification by the RTO/ISO of $m$’s performance (power-path delivery) during $T$, which is an incentive for $m$ to follow the RTO/ISO’s dispatch instructions as closely as possible.

The performance payment method $\phi_{m}(T)$ can take a wide variety of forms. Ideally, however, it should be expressible in standardized metrics that permit both DPR $m$ and the RTO/ISO: (i) to agree ex ante on the precise nature of DPR $m$’s offered risk-reduction service (dispatchable power-path availability) for $T$; and (ii) to verify ex post the extent to which any contractually-admissible dispatch instructions conveyed by the RTO/ISO to DPR $m$ for period-$T$ performance (power-path delivery) have accurately been followed.

---

24 As shown in Attachment A (Support. Doc., Appendix A.4), these variable costs include payments for inputs (fuel, labor, ...) needed for power-path production, charges for transmission services, and wear-and-tear depreciation of physical equipment.
The RTO/ISO clears a subset of the reserve bids and offers submitted to M(T) to maximize the expected net benefit (benefit minus avoidable cost) of M(T) participants. This contract-clearing optimization problem is conditioned on current state conditions (including market linkages)\textsuperscript{25} and is subject to standard types of system constraints for T such as nodal net-load balancing constraints, nodal/zonal reserve requirements, and line capacity limits. The conceptual and practical advantages of this contract-clearing optimization formulation relative to the SCUC/SCED optimization formulations implemented in current RTO/ISO-managed wholesale power markets are demonstrated by findings from analytical and computational test-cases reported in my 2021 Wiley/IEEE Press Book (Footnote 4).

Finally, to preserve its status as an independent fiduciary, the RTO/ISO allocates all net reserve procurement costs and transmission service costs incurred for M(T) operations back to M(T) participants based on their relative contributions to these costs. The specific cost-allocation rules used by the RTO/ISO for these purposes are carefully presented and motivated in Sec. 6.7 of my 2021 Wiley/IEEE Book (Footnote 4).

VI.C Illustrative Comparisons of Swing-Contract DAMs and Current U.S. RTO/ISO-Managed DAMs

Attachment A (Support. Doc., Sec. 6.3) provides high-level comparisons of the basic design features and the market-clearing optimization formulations for current U.S. DAMs and swing-contract (SC) DAMs, assuming all customer demand takes a fixed-load form for simplicity of exposition. These high-level comparisons are reviewed below.

Figure 2 indicates the main similarities and differences in basic market design features between current RTO/ISO-managed DAMs and the proposed form for Swing-Contract (SC) DAMs.

The main similarities are: (i) Both DAM designs are RTO/ISO managed; (ii) both DAM designs have the same types of market participants; and (iii) both DAM designs are subject to standard types of

\textsuperscript{25}Market linkages refers to the specific linkages established among the collection of markets $\mathcal{M} =: \{\mathcal{M}(T) \mid T \in \mathcal{T}\}$ as a result of the RTO/ISO’s contract-clearing and dispatch decisions in successive operating periods $T$. The RTO/ISO keeps tracks of these linkages by carrying forward on its books an adaptively updated record of its cleared reserve bids/offers and its dispatch decisions.
system constraints, such as nodal power balance constraints, nodal/zonal reserve requirements, and transmission-line capacity limits.

The main differences, listed below in greater detail, involve product definition, contract forms, settlement rules, and RTO/ISO-management practices, not real-time operations. Thus, as demonstrated in Ch. 16 of my Wiley/IEEE Press book (Footnote 4), these market design differences can be introduced gradually into current U.S. RTO/ISO-managed DAMs.

- **SC DAMs** are forward markets for reserve, i.e., power-path availability for possible next-day RTO/ISO dispatch;

- **Reserve offers** are two-part pricing swing contracts (SCs);

- A DPR \(m\) participating in an SC DAM whose reserve offer \(SC_m\) is cleared receives an offer-price payment \(\alpha_m\) (in lump-sum or amortized form) as compensation for the volumetric risk-reduction provided by this cleared reserve offer for next-day operations.\(^{26}\)

\(^{26}\)Note the amount of this risk-reduction depends on the inherent swing (flexibility)
– No performance payment occurs in advance of verified performance (dispatched power-path delivery) during next-day operations;

– Each DPR $m$ can ensure its revenue sufficiency (i.e., market revenue $\geq$ avoidable cost) by appropriate specification of the offer-price $\alpha_m$ and performance payment method $\phi_m$ that $m$ includes in its swing-contract reserve offer $SC_m$; no resort to OOM make-whole payments is needed.

<table>
<thead>
<tr>
<th>Similarities</th>
<th>Current DAM SCUC</th>
<th>Current DAM SCED</th>
<th>SC DAM Optimization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Objective</td>
<td>Min [Start-up/shut-down costs + no-load costs + dispatch costs + reserve costs + constraint penalties]</td>
<td>Min [Dispatch costs + reserve costs + constraint penalties]</td>
<td>Min [Availability cost + performance cost + constraint penalties]</td>
</tr>
<tr>
<td>Unit commitment constraints</td>
<td>Yes</td>
<td>No</td>
<td>Each DPR includes its unit commitment constraints in its submitted swing contract</td>
</tr>
<tr>
<td>Key RTO/ISO decision variables</td>
<td>Unit commitments</td>
<td>Energy dispatch &amp; reserve levels</td>
<td>Which swing-contracts are cleared</td>
</tr>
<tr>
<td>Settlement</td>
<td>No</td>
<td>LMPs calculated as SCED dual variables</td>
<td>Each cleared DPR receives the offer price it has included in its submitted swing contract</td>
</tr>
</tbody>
</table>

Figure 3: Market-clearing optimization formulations: Current U.S. RTO/ISO-managed DAM SCUC/SCED optimizations vs. SC DAM optimization.

Figure 3 provides high-level comparisons of the market-clearing optimization formulations for SC DAMS and current U.S. DAMs. The main similarities are:

of the power-path set $PP_m$ that $m$ has included in $SC_m$; but it is not affected by the RTO/ISO’s dispatch of a specific power-path from this set during next-day operations.
each optimization can be formulated as a *Mixed Integer Linear Programming (MILP)* problem;

the objective function of each optimization includes penalties for constraint violations.

The *main differences* are as follows. In the optimization formulation for an SC DAM(D+1) held on day D for an operating-day D+1:

- the objective function fully incorporates the availability cost (i.e., avoidable fixed cost) and performance cost (i.e., variable cost) of each participating DPR $m$, as reported to the RTO/ISO through the offer price $\alpha_m$ and the performance payment method $\phi_m$ that $m$ includes in its submitted SC reserve offer $SC_m$;

- the system constraints fully incorporate the performance (power-path production) capabilities of each participating DPR $m$, as reported to the RTO/ISO through the power-path set $PP_m$ that $m$ includes in its submitted SC reserve offer $SC_m$;

- the only payment obligations settled in advance of operating-day D+1 are offer-price payments (in lump-sum or amortized scheduled form) for coverage of availability cost (i.e., avoidable fixed cost) incurred by cleared DPRs to ensure the next-day availability of their performance (power-path production) capabilities for possible RTO/ISO dispatch;

- cleared DPRs receive no performance cost (i.e., variable cost) compensation in advance of verified real-time performance (dispatched power-path delivery) during next-day operations;

- “unit commitments” are replaced by “cleared contracts,” and the only binary-valued RTO/ISO decision variables are yes/no contract clearing indicators.

Major extensions of the Linked Swing-Contract Market Design, currently under development, include a fundamental change of variables from active and reactive power $(p, q)$ to current and voltage $(I, V)$ to facilitate a more comprehensive and empirically-compelling representation of participant net benefits and grid reliability constraints (including voltage constraints).\(^{27}\)

---

This extension could permit the fundamental concerns regarding the design of existing U.S. RTO/ISO-managed wholesale power markets summarized above in Parts III–V and the fundamental concerns regarding system security considered by Billimoria et al. (2020) (see Footnote 7) to be addressed in an integrated conceptually-cohesive manner.

VII. Conclusion: Grids as Flexibility-Support Mechanisms

A major theme stressed throughout these e-filed comments is the need to operate grid-supported centrally-managed wholesale power markets as flexibility-support mechanisms: i.e., as mechanisms enabling just-in-time production and transmission of bulk power to satisfy just-in-time customer power demands and grid reliability requirements. The efficient and reliable design of such mechanisms is surely a complex multi-faceted problem.

A physically-feasible alternative might be to transit to a fully storage-supported world. Flexible producer determination of power production levels and flexible customer determination of power usage levels could be supported entirely by local producer and customer storage devices, linked via a supply chain consisting of retail storage-device stores and/or a network of charge/discharge stations.

However, a key economic concern regarding this fully storage-supported world is the potential for substantial inefficiency (wasted resources). Suppose the average state-of-charge (SOC) that producers and customers maintain for their local storage devices over time is uniformly bounded above zero. Then, from a global vantage point, it would appear as if a positive, possibly-large, and possibly growing inventory of (potential) energy were being carried forward through time, forever unused, instead of contributing to the creation of net benefit.

Consequently, at least at present, striving to redesign current grid-supported centrally-managed wholesale power markets to enable them to operate as reliable efficient flexibility-support mechanisms over lower-carbon grids would seem to be the better option. Moreover, this redesign, itself, should be flexible and open to further adaptation. The ultimate goal, surely, must be robust wholesale power market design for transacting in a deeply-uncertain continually-evolving world.
Respectfully,

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ATTACHMENT A: SUPPORTING DOCUMENT
Economics of Grid-Supported Electric Power Markets:
A Fundamental Reconsideration*

Leigh Tesfatsion

Abstract
U.S. centrally-managed wholesale power markets operating over high-voltage AC transmission grids are transitioning from heavy reliance on fossil-fuel based power to greater reliance on renewable power. This study highlights four conceptually-problematic economic presumptions reflected in the legacy core design of these markets that are hindering this transition. The key problematic presumption is the static conceptualization of the basic transacted product as grid-delivered energy (MWh) competitively priced at designated grid delivery locations during successive operating periods, supported by ancillary services. The study then discusses an alternative conceptually-consistent “linked swing-contract market design” that appears well-suited for the scalable support of increasingly decarbonized grid operations with more active participation by demand-side resources. This alternative design entails a fundamental switch to a dynamic insurance focus on advance reserve procurement permitting continual balancing of real-time net load. Reserve consists of the guaranteed availability of diverse power-path production capabilities for possible centralized dispatch during future operating periods, offered into centrally-managed linked forward reserve markets by two-part pricing swing contracts in firm or option form.

Key words: U.S. RTO/ISO-managed wholesale power markets, grid decarbonization, market design, fundamental conceptual issues, alternative linked swing-contract market design, physically-covered insurance, two-part pricing, swing contracts, power-path production capability sets, digital-twin representation

Table of Contents

1 Introduction ................................................. 3
2 Legacy Core Design of U.S. RTO/ISO-Managed Markets ...... 6
3 Essential Economic Concepts. ............................... 12
   3.1 Overview. ............................................. 12
   3.2 Asset Definitions: Unit Measurement Distinctions ........ 12
   3.3 Unit/Per-Unit Calculations Can Mask Conceptual Error . 14
   3.4 Market Analysis: Key Concepts. ........................ 18
   3.5 Competitive (MC=MB) Spot-Pricing Requires
       Priced Assets to be Commodities. ..................... 21
4 Legacy Core Design: Fundamental Conceptual Issues. ....... 27
   4.1 Counter-Claims (CC1)-(CC4) to Design Presumptions. . 27
   4.2 (CC1): Reserve, Not Energy, is the Basic Product. .... 27
   4.3 (CC2): Supplier Cost Analysis Requires 3-Part Partition . 31
   4.4 (CC3): Grid-Delivered Energy is Not a Commodity. .... 36
   4.5 (CC4): Revenue Sufficiency Requires Two-Part Pricing. 38
5 Legacy Core Design: Roadblock for Grid Decarbonization . . 40
   5.1 Overview ............................................. 40
   5.2 Proliferation of Participation Models ................... 40
   5.3 Proliferation of Flexibility Products ................... 41
   5.4 Proliferation of Out-of-Market Make-Whole Payments . 43
   5.5 Growing Revenue Insufficiency Concerns ............... 45
   5.6 Ptolemaic Epicycle Market-Design Conundrum ........... 46
6 An Alternative Linked Swing-Contract Market Design ....... 46
   6.1 Overview ............................................. 46
   6.2 Innovative Aspects and Basic Features ................ 46
   6.3 Current U.S. DAMs vs. Swing-Contract DAMs. .......... 47
7 Conclusion: Grids as Flexibility-Support Mechanisms. ...... 54

Appendices: Quick-Reference Glossaries and Guides. ........ 57
   A.1 Acronyms ............................................. 57
   A.2 Standard Transmission System Terms ................... 58
   A.3 Standard Economic Terms ............................. 59
   A.4 Cost Types for Power Markets: Empirical Examples ..... 61
   A.5 Swing-Contract Market Terms ........................ 62
References ..................................................... 63
1 Introduction

The basic purpose of centrally-managed wholesale power markets operating over high-voltage AC transmission grids is to maintain efficient just-in-time production and transmission of bulk power to satisfy diverse just-in-time customer power demands and grid reliability requirements.

To achieve this dynamic open-ended purpose, central managers must continually protect against volumetric grid risk: namely, the possible disruption or collapse of grid operations due to real-time imbalance between the injection of power into the grid and the withdrawal and/or inadvertent loss of power from the grid. Grid power withdrawals occur when the power usage of customers electrically connected to the grid exceeds their use of locally-generated power. Inadvertent grid power losses occur whenever power flows across transmission grid lines.

In response to private economic incentives and public policy mandates encouraging grid decarbonization [21], U.S. RTO/ISO-managed wholesale power markets are transitioning from a traditionally heavy reliance on fossil-fuel based power generators to a greater reliance on renewable power facilities. The latter facilities include intermittent power resources (IPRs), such as grid-connected wind farms and photovoltaic solar arrays whose weather-dependent power generation is not fully firm by storage.

The increasing participation of IPRs in U.S. RTO/ISO-managed wholesale power markets, together with recent initiatives such as FERC Order No. 2222 [14] encouraging more active participation in these markets by aggregations of distribution-level power resources and customers, has increased the uncertainty and volatility of grid net load, i.e., customer power withdrawals and inadvertent power losses minus net non-dispatched power injections. Moreover, many IPRs connect to high-voltage AC transmission grids by means of power electronic inverters that convert DC to AC power, a connection technology that differs fundamentally from the traditional connection technology for fossil-fuel based power generators. At higher IPR penetration levels, this new connection technology can pose new types of system security issues [4].

In consequence, as reported in [15], RTOs/ISOs are finding it harder to procure the dependable advance availability of RTO/ISO-dispatchable power-path production capabilities with sufficiently diverse attributes to maintain reliable real-time balancing of net load.³

---

¹ Current U.S. RTO/ISO-managed wholesale power markets consist of energy, ancillary service, and capacity markets whose operations over high-voltage AC transmission grids are managed by a Regional Transmission Organization (RTO) or Independent System Operator (ISO); see [16].

² For the purposes of this study, an intermittent power resource (IPR) is defined to be a grid-connected power resource whose power injections and/or withdrawals are not mediated through some form of aggregator and are not fully controllable by centrally-managed dispatch.

³ In practice, reliable real-time balancing of net load means maintaining net-load balance within acceptable tolerance levels over time.
The remaining sections of this study are organized as follows. Section 2 presents a careful summary description of the DAM/RTM Two-Settlement System Design at the core of current U.S. RTO/ISO-managed wholesale power market operations: namely, the daily RTO/ISO-coordinated operation and settlement of a Day-Ahead Market (DAM) and a Real-Time Market (RTM). Section 3 defines and explains basic economic concepts essential for undertaking a fundamental reconsideration of this DAM/RTM Two-Settlement System Design.

The following four conceptually-problematic economic presumptions reflected in the DAM/RTM Two-Settlement System Design are then highlighted and analyzed in Section 4:

**Problematic Presumption (P1):**

The basic transacted product is grid-delivered energy (MWh), i.e., flows of power (MW) accumulated at designated grid locations during designated operating periods with duration measured in hours (h).

**Problematic Presumption (P2):**

For careful analysis of supplier revenue sufficiency, it suffices to partition total supplier cost into two components: namely, a “variable” component determined by supplier grid-delivered energy; and a “fixed” component independent of supplier grid-delivered energy.

**Problematic Presumption (P3):**

Grid-delivered energy (MWh) is a commodity whose energy units \( u = 1 \text{MWh} \) – perfectly substitutable (economically equivalent) conditional on grid delivery location \( b \) and operating period \( T \) – should be transacted in a competitive spot market at a uniform per-unit locational marginal price \( \text{LMP}(b,T) \) ($/MWh) determined in accordance with the competitive (marginal cost = marginal benefit) spot-pricing rule.

**Problematic Presumption (P4):**

Total supplier revenue attained in these competitive commodity spot markets will suffice over time to cover total supplier cost.

Presumptions (P1)–(P4) reflect the misleading view that U.S. RTOs/ISOs are fiduciary managers for weakly-correlated collections of competitive commodity spot markets. The reality is far more daunting: U.S. RTOs/ISOs are fiduciary “conductors” tasked with orchestrating the availability and subsequent possible dispatch of increasingly-diverse dispatchable power resources to service just-in-time power demands of increasingly diverse grid-connected customers while meeting just-in-time power requirements for reliable grid operation.

Section 4 carefully develops and justifies the following four counter-claims (CC1)–(CC4) to the conceptually-problematic presumptions (P1)–(P4):
Counter-Claim (CC1):
Within the context of a grid-supported centrally-managed wholesale power market, grid-delivered energy (MWh) is not the basic transacted product. To the contrary, suppliers provide two distinct types of products:

*Physically-Covered Insurance:* Guaranteed availability of diverse power-path\(^4\) production capabilities for possible central-manager dispatch during future operating periods to reduce volumetric grid risk;

*Real-Time Power-Path Delivery:* Actual delivery of power-paths in response to central-manager dispatch signals received during an operating period to satisfy just-in-time customer power demands and grid reliability requirements.

Counter-Claim (CC2):
Within the context of a grid-supported centrally-managed wholesale power market, the total costs of suppliers must be partitioned into three distinct components – Unavoidable Fixed Cost (“Sunk Cost”), Avoidable Fixed Cost, and Variable Cost – to permit a conceptually-sound analysis of their revenue sufficiency.

Counter-Claim (CC3):
Within the context of a grid-supported centrally-managed wholesale power market, grid-delivered energy (MWh) is not a commodity. Although grid-delivered energy has a standard unit of measurement \(u = 1\text{MWh}\), market participants do not consider these units \(u\) to be perfect substitutes (economically equivalent) conditional on grid delivery location and operating period.

Counter-Claim (CC4):
Grid-supported centrally-managed wholesale power markets are necessarily forward markets due to the speed of real-time operations. To ensure revenue sufficiency, each supplier \(i\) participating in such a market should be permitted to submit a two-part pricing\(^5\) supply offer ensuring full compensation for:

1. any avoidable fixed cost incurred for provision of physically-covered insurance for future operating periods, whether or not supplier \(i\) is subsequently dispatched to provide actual power-path deliveries during these periods;
2. any variable cost incurred for actual power-path deliveries in response to received real-time dispatch instructions.

Section 5 carefully considers how the retention of the four legacy economic presumptions (P1)–(P4) in the core design of current U.S. RTO/ISO-managed whole-

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\(^4\) A *power-path* \(p_b(T) = \{p_b(t) \mid t \in T\}\) is a sequence of injections and/or withdrawals of power \(p_b(t)\) (MW) at a single grid-location \(b\) during a designated time-interval \(T\).

\(^5\) It has long been recognized by economists that two-part pricing can be used by monopolistic suppliers in spot-market settings as price-discrimination instruments permitting extraction of “net surplus” from buyers; see, for example, the discussion of this spot-market issue in Sec. 4.5 below. The recommended use of two-part pricing in (CC4) is for an altogether different context: namely, suppliers participating in forward markets might have to incur avoidable fixed costs to guarantee their ability to fulfill a range of possible real-time delivery obligations under contracts with swing (flexibility) in their delivery terms, as well as variable costs for actual real-time deliveries, and both types of costs must be fully covered in order for these suppliers to stay in business.
sale power markets is hindering the ability of these markets to transition smoothly to decarbonized grid operations. Indeed, this retention appears to have led to a dangerous conundrum. Recalling the slow and difficult transition from the earth-centric circular-orbit solar-system model developed by Claudius Ptolemy (circa 100-170 AD), supported by a proliferation of postulated “epicycles,” to the sun-centric elliptical-orbit solar-system model due to Nicolaus Copernicus (1473-1543) and Johannes Kepler (1571-1630), this conundrum can be characterized as follows:

**Ptolemaic Epicycle Conundrum for Power Markets (“Onion Problem”):**

Current net-load balancing issues are addressed by instituting a new rule-layer (“epicycle”) governing trade and settlement for an additional ancillary-service support product, which in turn gives rise to new net-load balancing issues.

Section 6 briefly reviews the key features of an alternative design for grid-supported RTO/ISO-managed wholesale power markets, consistent with Counter-Claims (CC1)–(CC4), that appears well-suited for the scalable support of increasingly decarbonized grid operations and more active participation by demand-side resources: namely, the **Linked Swing-Contract Market Design** [39]. The latter design calls for a fundamental change in the envisioned main role of the RTO/ISO: namely, a switch from a static focus on RTO/ISO successive scheduling of grid-delivered energy amounts for near-term operating periods, supported by proliferating ancillary services, to a dynamic focus on RTO/ISO advance procurement of physically-covered insurance guaranteeing the availability of diverse power-path production capabilities for possible RTO/ISO dispatch during future operating periods.

Concluding remarks are given in Section 7. Quick-reference glossaries and guides for key terms and concepts appearing in the main text of this study are provided in appendices.

### 2 Legacy Core Design of U.S. RTO/ISO-Managed Markets

The development of the legacy core **Two-Settlement System Design** supporting current U.S. RTO/ISO-managed wholesale power market operations can be traced in a series of reports released by the U.S. Federal Energy Regulatory Commission (FERC), culminating in a 2003 White Paper [8].

In [8], FERC envisions grid-delivered energy (power accumulations) at designated grid delivery (pricing) locations during designated operating periods to be the basic transacted product. These grid-delivered energy amounts are to be determined in accordance with a two-settlement system [32] consisting of a daily bid/offer-based RTO/ISO-managed **Day-Ahead Market (DAM)** operating in tandem with a daily bid/offer-based RTO/ISO-managed **Real-Time Market (RTM)**; see Fig. 1.

The overall goal of the DAM/RTM two-settlement system is to permit energy transactions at designated grid delivery locations during designated operating periods to be efficiently determined by the demand bids and supply offers of energy buyers and suppliers. With this overall goal in mind, the DAM/RTM two-settlement system is designed to be in accordance with the determination of market-clearing prices.
and quantities in *competitive commodity spot markets* to an extent consistent with maintaining the reliable support of a transmission grid susceptible to transmission-line congestion.

The purpose of the RTO/ISO-managed DAM held on each day D is to commit RTO/ISO-dispatchable generation units for day D+1 that permit the RTO/ISO to ensure efficient continual net-load balancing during day D+1.

*Load-Serving Entities (LSEs)*, acting on behalf of managed customers, submit demands bids into the day-D DAM for the purchase of energy at grid delivery locations for each hour H of day D+1. Each such demand bid can take the form of a *fixed (non-dispatched must-service) energy demand*. It can also include or take the form of a *dispatchable price-sensitive energy demand schedule* if: (i) the LSE has installed real-time telemetry permitting the RTO/ISO to incrementally increase or decrease the LSE’s energy demand by dispatch signals; and (ii) the LSE can implement any received RTO/ISO dispatch signals by suitable instructions communicated to its managed customers.

*Generation units* submit supply offers into the day-D DAM for the sale of energy at grid delivery locations for each hour H of day D+1. Each such supply offer can take the form of a *fixed (non-dispatched must-service) energy supply*. It can also include or take the form of a *dispatchable price-sensitive energy supply schedule* if the generation unit has installed real-time telemetry permitting the RTO/ISO to incrementally increase or decrease the unit’s energy supply by dispatch signals.
The RTO/ISO conducts a bid/offer-based SCUC/SCED optimization\textsuperscript{6} for the day-D DAM in combined or consecutive form. This optimization is conditional on current state conditions, submitted bids and offers, and forecasts for IPR injections and/or withdrawals of power at each grid delivery location during each hour H of day D+1. It is also subject to system constraints that include a net-load balancing requirement at each grid delivery location for each hour H of day D+1.

The optimization determines a binary (yes/no) commitment solution for each dispatchable generation unit for each hour H of day D+1 indicating whether or not this generation unit is required to be available for possible RTO/ISO-dispatch during hour H of day D+1. It also determines anticipated dispatch schedules for price-sensitive energy demands and/or supplies at each grid delivery location for each hour H of day D+1.

Settlements for cleared bids and offers are determined by \textit{locational marginal pricing} \textsuperscript{35}; that is, by the pricing of grid-delivered energy (MWh) conditional on grid delivery location and operating period, subject to system constraints. The \textit{Locational Marginal Price} LMP\textsubscript{(b, H, D+1)} ($/MWh) determined in a day-D DAM SCED optimization for scheduled energy deliveries at a grid delivery location \(b\) during some hour H of day D+1, conditional on previous SCUC-determined generation-unit commitments, is the dual variable solution for the net-load balancing constraint at \(b\) for hour H.\textsuperscript{7}

An RTM is a daily collection of sub-markets for near-term future time-periods \(\tau\) with relatively short durations (e.g., 5 minutes). These RTM sub-markets are cleared by RTO/ISO-managed SCED optimizations conditional on previously-determined unit commitments plus RTO/ISO forecasts for fixed (non-dispatched must-service) energy demands and supplies for \(\tau\).\textsuperscript{8}

The purpose of these RTM sub-markets (plus supplemental unit-commitment processes) is to permit the successive updating of previously determined optimal SCUC/SCED solutions to take into account updated RTO/ISO forecasts as well as unanticipated changes in other relevant factors. Any adjustments needed in the scheduled energy deliveries determined in the day-D DAM for some hour H of day D+1, as indicated by the solutions for RTM sub-markets conducted after the close of the day-D DAM but prior to hour H, are settled using the LMPs determined in these RTM sub-markets.

Figure 2 illustrates the determination of an optimal demand-equals-supply (D=S) solution for a given hour H on day D+1 by means of a bid/offer-based RTO/ISO-managed DAM SCED optimization conducted during day D. The depicted optimal

\textsuperscript{6} SCUC is an acronym for \textit{Security-Constrained Unit Commitment}, and SCED is an acronym for \textit{Security-Constrained Economic Dispatch}.

\textsuperscript{7} See [28] for a detailed discussion of the mathematics of LMP determination in U.S. RTO/ISO-managed wholesale power markets.

\textsuperscript{8} RTM SCED optimizations are similar in form to DAM SCED optimizations except that RTMs impose stricter restrictions on the submission of price-sensitive demand bids. For example, ERCOT restricts RTM submission of price-sensitive demand bids to Qualified Scheduling Entities (QSEs) managing QSE-controllable load sources; see [2, Sec. 4.3].
solution for hour H of day D+1 consists of a set of points with a common optimal power level \( p^* = 75 \) (MW) and a range of optimal price levels \( LMP^* \) ($/MWh). This optimal price indeterminacy arises because the demand bids and supply offers submitted to this DAM take a required step-function form that results in flat vertical and horizontal segments for the aggregate demand and supply schedules \( D \) and \( S \). Also, the depicted optimal solution for hour H of day D+1 is not conditioned on grid delivery location because absence of grid congestion is assumed at this optimal solution.\(^9\)

\(^9\) An optimal solution for hour H of day D+1, determined by a day-D DAM SCED optimization formulated as a DC optimal power flow problem for a loss-less grid, will determine a common optimal LMP level (or a common set of optimal LMP levels) at each grid delivery location for hour H if no grid congestion occurs at this optimal solution, i.e., if no transmission line capacity constraint is active at this optimal solution. Conversely, if any transmission line congestion occurs at this optimal solution, some separation of optimal LMP levels (or sets of optimal LMP levels) across grid delivery locations will usually (but not necessarily) occur for hour H. As explained in [24], market efficiency for a market M means that participating buyers and suppliers are extracting maximum possible total net surplus – i.e., total buyer benefit ($) minus total supplier variable cost ($) – from this participation. As shown in [24, Sec. II, Fig. 2], if LMP separation occurs at an optimal solution for hour H of day D+1, the RTO/ISO itself extracts a non-negative (typically positive) “RTO/ISO net surplus” ($) from market operations at this optimal solution. In this case, accurate determination of market efficiency would require accurate determination of the subsequent use made of this extracted RTO/ISO net surplus, and the effects of this use on the welfare of the market participants.
The depicted aggregate demand and supply schedules D and S are constructed from the LSE demand bids and generation-unit supply offers submitted to the day-D DAM by two LSE buyers (B1, B2) and three generation-unit suppliers (S1, S2, S3).

Note the optimal market-clearing outcomes depicted in Fig. 2 are indeed outcomes for an energy market, despite the appearance of power levels (MW) along the quantity axis. These power levels represent possible choices for a maintained power level $p$ (MW) during operating hour $H$ (1h). Hence, choice of a power level $p$ is equivalent to choice of a grid-delivered energy-block $p \cdot 1h$ (MWh).

For later purposes, additional aspects of the U.S. RTO/ISO-managed DAM SCED optimization formulation depicted in Fig. 2 are highlighted below.

- Each price-sensitive energy demand (supply) schedule that is bid (offered) by a buyer (supplier) $k$ into an RTO/ISO-managed DAM held on day D for a particular operating hour $H$ during day D+1 must include $k$’s grid-location $b(k)$ together with a finite number $N_k \leq N$ of (MW/price)-blocks $B_n(k)$, $n = 1, \ldots, N_k$, where $N$ is set by the RTO/ISO: e.g., $N = 10$ in ISO-NE [22] and $N = 9$ in MISO [31].

- Each $B_n(k)$ consists of a range $[p_{k,n-1}, p_{k,n}]$ of power levels along the horizontal power axis satisfying $0 \leq p_{k,n-1} < p_{k,n}$ and a non-negative per-unit energy price $\pi_{k,n}$ ($$/MWh) along the vertical price axis.

- The interpretation of $B_n(k)$ for a buyer (supplier) $k$ is that $\pi_{k,n}$ is the maximum (minimum) per-unit energy price that $k$ is willing to pay (be paid) for procurement (supply) of a next (“marginal”) increment $E_{k,n} = [p_{k,n} - p_{k,n-1}] \cdot 1h$ of grid-delivered energy at $b(k)$ during $H$, given that $k$ has already agreed to procure (supply) grid-delivered energy in amount $p_{k,n-1} \cdot 1h$ at $b(k)$ during $H$.

- If $k$ is a buyer (supplier), the resulting price sequence $(\pi_{k,1}, \ldots, \pi_{k,N_k})$ is required to be non-increasing (non-decreasing).

- The RTO/ISO then constructs and plots an aggregate demand (supply) schedule in the $(p, \pi)$-plane for grid-delivered energy at each grid-location $b$ during $H$ by plotting – in descending (ascending) price order – all of the blocks $B_n(k)$ submitted for $H$ by all of the buyers (suppliers) $k$ at grid location $b(k) = b$.

10 The aggregate demand schedule D in Fig. 2 gives, from left to right, the highest purchase reservation value ($$/MWh) – i.e., the highest maximum willingness to pay ($$/MWh) – for each successive unit (MW) increase in the maintained power level $p$ for $H$, where this highest purchase reservation value is calculated across all buyers (here B1 and B2). Conversely, the aggregate supply schedule S in Fig. 2 gives, from left to right, the lowest sale reservation value – i.e., the lowest minimum acceptable payment – for each successive unit (MW) increase in the maintained power level $p$ for $H$, where this lowest sale reservation value is calculated across all suppliers (here S1, S2, and S3). The optimal (market-clearing) solution points, by definition, are then given by the intersection points of these aggregate D and S schedules with all horizontal and vertical segments included. Compare, for example, the demand bid, supply offer, and market-clearing concepts used by the Midcontinent Independent System Operator (MISO) for its day-ahead and real-time energy markets [31]. For an extended discussion of these fundamental economic concepts, see [38] and [39, Ch. 12].
- **Bottom Line:** Each buyer (supplier) \( k \) participating in this DAM is required to express their willingness to pay (be paid) for procurement (supply) of successive increments \( E_{k,n} \) of energy (accumulated power), to be grid-delivered at \( b(k) \) during \( H \) by means of RTO/ISO-dispatched power-paths, without any way to express preferences regarding the dynamic attributes of these power-paths: e.g., capacity profile, ramp-rate profile, and exact timing within \( H \).

Participants in an RTO/ISO-managed DAM (or RTM) for a future operating period \( T \) are assured, by design, that any grid-delivered energy amounts the RTO/ISO announces have been scheduled for \( T \) are supported by scheduled transmission capacity. Traders who determine and settle physically-covered bulk energy trades for \( T \) through other venues, such as privately-negotiated bilateral trades, must secure transmission-capacity support for these physically-covered trades by self-scheduling them as fixed-form energy bids and offers in a DAM (or RTM) conducted for \( T \). In addition, these traders might need to procure supporting contracts (e.g., Financial Transmission Rights and Contracts-for-Difference) to ensure that the settlement terms they agreed to in these other venues are not disrupted by obligatory DAM/RTM LMP price settlements; see [39, Sec. 13.9].

All seven U.S. RTO/ISO-managed wholesale power markets (CAISO, ERCOT, ISO-NE, MISO, NYISO, PJM, SPP) – depicted in Fig. 3 – are currently operating in accordance with FERC’s proposed Two-Settlement System Design, even though ERCOT (lying entirely within the state of Texas) is not in fact subject to FERC jurisdiction.

Fig. 3 North American RTO/ISO-managed wholesale power markets. (Public domain: [13])
As seen in Fig. 4, these seven RTOs/ISOs operate over a physical high-voltage AC transmission grid consisting of three separately-synchronized parts.

![North American RTOs/ISOs](image_url)

Fig. 4 North American RTOs/ISOs operate over a physical high-voltage AC transmission grid consisting of three separately-synchronized parts. (Public domain image by Jong Suk Kim)

Finally, FERC’s proposed Two-Settlement System Design did not include guidance for provision and settlement of ancillary services.\(^{11}\) Rather, FERC explicitly delegated ancillary service aspects of power system management to the individual states participating in each RTO/ISO \(^{8}\), p. 11. Consequently, as reported in \(^6\), Tables 1-2 and \(^15\), Table 1, p. 6, ancillary service procurement and settlement processes differ widely across the seven U.S. RTOs/ISOs.

### 3 Essential Economic Concepts

#### 3.1 Overview

This section defines, explains, and illustrates economic concepts essential for the careful analysis of grid-supported centrally-managed wholesale power market operations. These concepts will be used throughout the remaining sections of this study.

#### 3.2 Asset Definitions: Unit Measurement Distinctions

**Definition D1**: A standard unit of measurement is a specified positive amount \(u\) of some phenomenon that is commonly used (by law or by convention) to measure the magnitude of general amounts of this phenomenon in a comparable manner.

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\(^{11}\) Ancillary services are support services for grid reliability \(^{15}\), Appendix. Examples include: “black-start” services for restoration of power flow to a collapsed grid; reactive power support for voltage control; and net-load balancing services provided by on-line generation units with unencumbered capacity or by off-line relatively quick-start generation units.
Seven Standard International (SI) Base Units for Physical Phenomena: 
*Length* measured by meter (m); *Mass* measured by kilogram (kg); *Time* measured by second (s); *Electric Current* measured by Ampere (A); *Thermodynamic Temperature* measured by degree Kelvin (K); *Amount of Substance* measured by mole (mol); *Luminous Intensity* measured by candela (cd).

Examples of Units Defined as Functions of SI Base Units: 
- **Pound** (lb) = Unit for Weight: 1lb = 0.45359237kg;
- **Metric Ton** (mt) = Unit for Weight: 1mt = 1000kg;
- **Watt** (W) = Unit for Power: 1W = [1kg][1m]²[1s]⁻³; 1kW = 1000W; 1MW = 1000kW;
- **Volt** (V) = Unit of Electric Potential: 1V = [1W][1A]⁻¹;
- **Hour** (h) = Unit for Time: 1h = 60s;
- **Watt-hour** (Wh) = Unit for Energy: 1Wh = [1W][1h]; 1kWh = 1000Wh; 1MWh = 1000kWh;
- **Hertz** (Hz) = Unit for Frequency: 1Hz = [1 cycle] · [1s]⁻¹.

Other Commonly Used Physical Measurement Units: 
- **Degree Fahrenheit** (°F), a normalized temperature unit such that water freezes at 32°F and boils at 212°F;
- **British Thermal Unit** (Btu), the quantity of heat required to raise by 1°F the temperature of one pound of liquid water currently at the temperature that water has its greatest density (≈ 39°F);
- **Person-Hour**, a unit of human labor defined to be one hour of work by one person.

**Definition D2:** An asset is anything in physical or financial form that can function as a store of value. In principle, an asset can be constructively characterized as a vector of multiple value-relevant possibly-correlated attributes.

- **Asset Example:** Apple := (location; time; weight; shape; color; crispness; ... )
- **Human Asset Examples:** Health; Hand-Grip Strength; Intelligence.
- **Social Asset Examples:** Beauty; Labor Capability; Language Fluency.
- **Physical Asset Examples:** Hardness; Apple; Grid-Delivered Energy; Honey-Crisp Apple; DURACELL AA 1.5v Battery.
- **Financial Asset Examples:** Personal Loan; Bank-Issued Home Mortgage; U.S. Treasury Bill; Common Stock Share.

**Definition D3:** A u-asset is an asset A that has a standard unit of measurement.  

- **Human u-Asset Examples:** Hand-Grip Strength, measured by standardized test score; Intelligence, measured by Intelligence Quotient (IQ).
- **Social u-Asset Examples:** Labor-Capability, measured by person-hour; English Language Verbal Fluency, measured by standardized test score.

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12 A u-asset is a new asset categorization, introduced in the current study. The set of all u-assets (Definition D3) is strictly nested between the set of all assets (Definition D2) and the set of all commodities (Definition D4). As will be carefully discussed in Section 3.5, grid-delivered energy is an example of a u-asset that is not a commodity. Hence, an explicit recognition of this new u-asset categorization appears to be essential for the careful economic analysis of grid-supported electric power market operations.
Physical u-Asset Examples: Apples, measured by the number of apples; Grid-Delivered Energy, measured by Watt-hour (Wh); HoneyCrisp Apples, measured by pound (lb); DURACELL AA 1.5v Batteries, measured by number of batteries.

Financial u-Asset Examples: Common Stocks Listed on the New York Stock Exchange (NYSE), measured by ($/share); Shares of Duke Energy Common Stock (NYSE:DUK), measured by number of shares; U.S. 52-Week Treasury Bills, measured by number of bills; ...

Examples of Assets that are Not u-Assets: Health; Beauty; Hardness.

Definition D4: A commodity is a physically-exchangeable u-asset $Q$ such that, conditional on location and time, each individual $Q$-trader $k$ (buyer and/or supplier) considers all $Q$-units available for trade to be perfect substitutes for each other; that is, to have the same economic value.\footnote{This “same economic value” assigned to all units $u$ of a commodity $Q$ available for trade at a given location and time can differ across the different $Q$-traders. Nevertheless, $Q$-trading is facilitated as follows: Commodity $Q$ can be sold by a $Q$-supplier $i$ to a $Q$-buyer $j$ in bulk (multi-unit) amount $q$ (measured in $u$) at a common per-unit price $\pi$ (measured in $$/u$) as long as $\pi$ does not fall below the common economic value assigned to $Q$-units by supplier $i$ or exceed the common economic value assigned to $Q$-units by buyer $j$.}

Agricultural Commodity Examples: HoneyCrisp Apples measured by pound (lb); No. 1 Hard Red Winter Wheat measured by metric ton (mt).

Industrial Commodity Examples: DURACELL AA 1.5v Batteries, measured by number of batteries; Henry Hub Natural Gas (Louisiana), measured by metric million Btu (mmBtu).

Financial Commodity Examples: Shares of Duke Energy Common Stock (NYSE:DUK), measured by number of shares; U.S. 52-Week Treasury Bills issued 1 January 2003, measured by number of bills.

Examples of u-Assets that are Not Commodities: Hand-Grip Strength; Intelligence; Labor-Capability; English Language Verbal Fluency; Apples; Houses; Grid-Delivered Energy; Fire-Insurance Contracts; Mortgages.

3.3 Unit and Per-Unit Calculations Can Mask Conceptual Error

Preliminaries:

Let $R$ denote the set of real numbers.\footnote{In standard texts on real analysis, the set $R$ is often defined axiomatically as a complete Archimedean ordered field. Alternatively, $R$ is sometimes defined as the end-result of a process taking the following general form: Step-1: Assume the existence of various primitive set-theoretic concepts; Step-2: Use the Step-1 assumptions to develop the set $N = \{1, 2, 3, \ldots\}$ of natural numbers; Step-3: Use the Step-1 assumptions and development of $N$ to develop the set $Z = \{0, 1, 2, -2, 3, -3, \ldots\}$ of integers; Step-4: Use the Step-1 assumptions and development of $Z$ to develop the set $Q = \{m/n \mid m, n \in Z, \text{ and } n \neq 0\}$ of rational numbers; Step-5: Use the Step-1 assumptions and development of $Q$ to develop the set $R = \{r, \ldots\}$ of real numbers.} The standard algebraic operators that act on elements of $R$ include: addition ($+$); subtraction ($-$); multiplication ($\times$); division
The set \( \mathbb{R} \) together with its standard algebraic operators are hereafter referred to as the Real Number System. The International System of Units (SI) is commonly referred to as the Metric System. The Metric System consists of the seven real-valued SI Base Units listed in Section 3.2 together with real-valued units derived from these seven real-valued SI Base Units by means of standard algebraic operators.

The seven SI Base Units \( \{m, kg, s, A, K, mol, cd\} \) are each defined in terms of a latest internationally agreed-upon value for a physical constant pertaining to some physical aspect of the Real World, where these physical constants are assumed to be mutually independent of each other. For example, the SI Base Unit for length is a meter (m), defined in terms of the latest internationally agreed-upon value of the speed of light in vacuum space. The SI Base Unit for mass is a kilogram (kg), defined in terms of the latest internationally agreed-upon value for the Planck constant, \( \hbar \).

The SI Base Unit for electric current is an Ampere (A), defined in terms of the latest internationally agreed-upon value for the electrical charge carried by an electron.

Unit and Per-Unit Calculations Must be Undertaken With Care:
Consider the status (True, False, Undecidable, Undefined, Ambiguous, ...) assigned to each of the following five statements:

**Statement S1:** \( 10 = 10 \)

**Status:** True statement within the Real Number System. Ambiguous statement (10 of what?) within both the Metric System and the Real World.

**Statement S2:** 10 pounds of apples = 10 pounds of apples

**Status:** Undefined statement within the Real Number System (what is a pound? what is an apple?) and the Metric System (what is an apple?). Ambiguous statement about the Real World: no two separate apples are physically identical, and physical differences can affect production cost, eating preferences, and consumption benefits; thus, what type of “equality” is “=” meant to signify?

**Statement S3:** 2MWh = 2MWh

**Status:** Undefined statement within the Real Number System (what is a MWh?). True statement within the Metric System. Ambiguous statement about the Real World (what type of “equality” is “=” meant to signify?).

Regarding Real World ambiguity, consider the following possibilities. The energy (2MWh) on each side of the operator “=” could be stored energy located at a grid location \( b \) at a particular point in time; thus, the operator “=” could represent physical equivalence.

Alternatively, the energy (2MWh) on each side of the operator “=” could represent energy that has been grid-delivered at \( b \) during the course of some operating day \( D \), i.e., the accumulation of a flow of power (MW) injected at \( b \) during \( D \). For example, these power injections might have occurred: (i) throughout all 24 hours of day \( D \) at a constant level 1MW/12; or (ii) only during the first 12 hours of day \( D \) at a constant level 1MW/6; or (iii) every other half hour during day \( D \) at a constant level 1MW/6. The operator “=” could thus signify customer indifference regarding
the exact manner in which energy (2MWh) has been delivered at their bus location \( b \) during operating day \( D \) as an accumulated flow of power.\(^{15}\)

**Statement S4:** 1 DURACELL AA 1.5v Battery = 1 DURACELL AA 1.5v Battery  

**Status:** Undefined statement within both the Real Number System and the Metric System (what is a “DURACELL AA 1.5v Battery”?). Ambiguous statement within the Real World; even for a single brand and type of battery, no two distinct manufactured batteries are ever exactly the same in terms of their physical attributes. Thus, what type of “equality” is “=” meant to signify?

**Statement S5:** Let \( Q \) denote a commodity (Definition D4) with \( Q \)-amounts \( q \) measured in terms of a specific standard unit of measurement \( u \); and let the operator “=” signify “is a perfect substitute for”. Then, conditional on a given location and time, \( 10u = 10u \) for every \( Q \) trader.  

**Status:** Undefined statement within the Real Number System (what is \( u \)?) and the Metric System (what is a commodity?). True statement (standard economic definition of a commodity) for the Real World.

The above statements and status assignments have three important implications, expressed below as Lemmas for later reference.

**Lemma 3.1:** The use of the operator “=” to equate amounts of two \( u \)-assets measured in terms of the same standard unit of measurement \( u \) can result in conceptual error.

**Outline of Proof for Lemma 3.1:** By design, the standard unit of measurement \( u \) for a \( u \)-asset \( A \) typically measures the “amount” of \( A \) based on only one attribute of \( A \), such as: weight measured in pounds (lb); energy measured in megawatt-hours (MWh); and economic value measured in U.S. dollars ($). No attempt is made to ensure that \( u \) characterizes the attributes of \( A \) in a physically or economically complete manner. Thus, the “same” \( u \)-amounts for two physically-distinct or economically-distinct \( u \)-assets with the same standard unit of measurement \( u \) can have substantially different physical effects when used within a physical application, and substantially different economic effects when used as consumption goods or as inputs to a production process. //

**Lemma 3.2:** The standard use of per-unit (p.u.) calculations in economics and power engineering can mask conceptual error.

**Outline of Proof for Lemma 3.2:** Conditional on a given location and time, suppose: (i) assets \( A' \) and \( A'' \) are two \( u \)-assets that share a common standard unit of

\(^{15}\) In Schweppe et al. [34, fn. p. 1153] and Schweppe et al. [35, Appendix F.1], the proposed Frequency Adaptive Power Energy Rescheduler (FAPER) is carefully restricted to energy loads (“energy-type usage devices”) characterized by: (1) a need for a certain amount of energy over a period of time \( T \) in order to fulfill their functions (or purposes); and (2) indifference as to the exact times within \( T \) during which the energy is furnished. Power loads are characterized as the loads of devices requiring power at specific times during a period of time \( T \) in order to full their functions (or purposes). Surprisingly, however, the critical nature of the distinction between energy loads and power loads for the hourly nodal “spot pricing” approach proposed in the main chapters of [35] is not addressed by the authors.
measurement \( u \); (ii) \( a' \) is an amount of \( A' \) measured in \( u \); (iii) \( a'' \) is an amount of \( A'' \) measured in \( u \); (iv) \( a' = a'' \) measured in \( u \); but (iv) the \( u \)-units for assets \( A' \) and \( A'' \) are not equivalently exchangeable for a purpose at hand.

For example, the \( u \)-assets on each side of “\( = \)” could be: (a) equal apple amounts (measured in pounds) for two distinct apple varieties that are being offered for sale at a given location and time; or (b) equal energy amounts (measured in MWh) that have been grid-delivered at a designated grid location \( b \) during a designated operating-period \( T \) as the accumulation of two power-injection sequences with distinctly different physical attributes (e.g., different ramp-rate profiles during \( T \), different capacity profiles during \( T \), different delivery timing within \( T \), ...).

Dividing the \( u \)-amounts on each side of “\( = \)” by a common “base \( u \)-value” (for example, “1 pound of apples” for the apple example, or “1MWh of energy” for the grid-delivered energy example), one is left with “per-unit” equations such as “10 = 10” for the apple example and “2 = 2” for the grid-delivered energy example that appear to be correct equations because they are true statements for the Real Number System. Any differences in the full collection of attributes characterizing the two underlying \( u \)-assets \( A' \) and \( A'' \) that conceptually invalidate the unqualified use of an equality operator “\( = \)” in the original versions of these equations – that is, the use of “\( = \)” without the qualification “measured in \( u \)” – are now lost from sight. //

**Lemma 3.3:** A conceptually-meaningful real-line “quantity axis” cannot be constructed for an asset \( A \) conditional on location and time unless asset \( A \) is a \( u \)-asset whose \( u \)-units are equivalently exchangeable for the purpose at hand, conditional on this location and time.

**Outline of Proof for Lemma 3.3:** Suppose, first, that an asset \( A \) is not a \( u \)-asset. Then there is no way to measure “amounts” of \( A \) along a real-line “quantity axis” by measuring these amounts in terms of a real-valued unit-of-measurement \( u \).

Suppose, next, that a \( u \)-asset \( A \) is to be used as an input for a physical and/or economic process \( Z \) to take place at a location \( b \) at start-time \( t \). However, suppose the \( u \)-units of \( A \) are not equivalently exchangeable for process \( Z \). Finally, suppose a process manager is tasked with the construction of a function mapping different amounts of input \( A \) (measured in \( u \)) into corresponding physical and/or economic outcomes for process \( Z \), taking as given a particular configuration of all other inputs.

As a first task-step, the manager sets about the construction of a “quantity axis” for \( A \) by identifying each real number \( r \geq 0 \) along the real-line with an amount of \( A \) of size \( r \) (measured in \( u \) units). Unfortunately for the manager, the precise selection of \( u \)-units comprising each given amount \( r \) of \( A \) can affect the resulting physical and/or economic outcomes of process \( Z \) because, by assumption, the \( u \)-units of \( A \) are not equivalently exchangeable for process \( Z \).

Thus, the physical and/or economic outcomes for process \( Z \) cannot be expressed as a conceptually well-defined function of the “amount” of input \( A \) represented as a non-negative \( r \)-value along the real line. //

The fundamental problems highlighted in **Lemmas 3.1–3.3** regarding the representation of real-world quantity amounts as points along Cartesian coordinate axes
suggests the desirability of considering alternative constructive mathematical approaches permitting “holistic” representations of real-world phenomena and their interactions.\footnote{See, for example, Sec. 3 titled “Completely Agent-Based Modeling (c-ABM): A Mathematics for the Real World?” in Tesfatsion [41].}

Crucial ramifications of Lemmas 3.1–3.3 specifically for the design and operation of grid-supported RTO/ISO-managed wholesale power markets will be identified and explored in Section 4.

3.4 Market Analysis: Key Concepts

3.4.1 Basic Market Definitions

**Definition BM1:** A market for an asset $A$ is a **spot market** if transacted amounts of $A$, payments for these transacted amounts of $A$, and deliveries of these transacted amounts of $A$ all occur at the same location and time (“on the spot”).

**Definition BM2:** A market for an asset $A$ is a **forward market** if transacted amounts of $A$ and payment obligations for these transacted amounts of $A$ are determined in advance of the delivery of these transacted amounts of $A$.

**Definition BM3:** (Preliminary Simplified Form). Conditional on location and time, the **non-avoidable fixed cost** (“*sunk cost*) ($\$) of a supplier $i$ in the process of selecting a non-negative supply-level $a$ (measured in $u$) for a $u$-asset $A$ is the fixed cost $SC_i^o (\$)$ that supplier $i$ has incurred to date that cannot be modified by any current or future decision that supplier $i$ makes, including selection of $a$.

**Definition BM4:** (Preliminary Simplified Form). Conditional on location and time, the **avoidable fixed cost** ($\$) of a supplier $i$ in the process of selecting a non-negative supply-level $a$ (measured in $u$) for a $u$-asset $A$ is the fixed cost $AFC_i^o (\$)$ that supplier $i$ incurs if and only if supplier $i$ selects a *positive* supply-level $a$.

**Definition BM5:** (Preliminary Simplified Form). Conditional on location and time, the **variable cost** ($\$) of a supplier $i$ in the process of selecting a non-negative supply-level $a$ (measured in $u$) for a $u$-asset $A$ is the $a$-dependent cost $VC_i(a) (\$)$ that supplier $i$ would have to incur for each selection of $a$, where $VC_i(0) = 0$.

**Definition BM6:** (Preliminary Simplified Form). Conditional on location and time, the **total avoidable cost** ($\$) of a supplier $i$ in the process of selecting a non-negative supply-level $a$ (measured in $u$) for a $u$-asset $A$ equals 0 ($\$) if $a = 0$ and equals the summation $[AFC_i^o + VC_i(a)]$ of supplier $i$’s avoidable fixed cost ($\$) and variable cost ($\$) if supplier $i$ selects $a > 0$.

**Definition BM7:** (Preliminary Simplified Form). A supplier $i$ participating in a market $M$ for a $u$-asset $A$ is **revenue sufficient** for $M$ if the total revenue ($\$) that supplier $i$ attains from participation in $M$ suffices to cover the total avoidable cost ($\$) that supplier $i$ incurs from participation in $M$. 
**Definition BM8**: Conditional on location and time, a buyer $j$’s *purchase reservation value* ($\pi_j$) for an item $z$ available for purchase from a supplier $i$ is the maximum payment ($) that buyer $j$ is willing to make to supplier $i$ for item $z$.

**Definition BM9**: Conditional on location and time, a supplier $i$’s *sale reservation value* ($\pi_i$) for an item $z$ that supplier $i$ is offering for sale to a buyer $j$ is the minimum payment ($) that supplier $i$ is willing to accept from buyer $j$ for item $z$.

### 3.4.2 Commodity Market Definitions

**Definition CM1**: A *commodity spot market* is a spot market for a commodity.

**Definition CM2**: A *futures market* is a forward market for a commodity.

**Definition CM3**: Conditional on location and time, a buyer $j$’s *ordinary demand schedule* for a commodity $Q$ with standard unit of measurement $u$ is a function that maps each non-negative $Q$-amount $q$ (measured in $$/u$) into the maximum $Q$-amount $q = D_j^o(\pi_j)$ (measured in $u$) that buyer $j$ is willing to procure at price $\pi_j$.

**Definition CM4**: Conditional on location and time, a buyer $j$’s *benefit function* for a commodity $Q$ with a standard unit of measurement $u$ is a function that maps each non-negative $Q$-amount $q$ (measured in $u$) into the benefit $B_j(q)$ (measured in $\$$) that buyer $j$ would obtain from procurement of $q$.

**Definition CM5**: Conditional on location and time, a buyer $j$’s *marginal benefit function* for a commodity $Q$ with a standard unit of measurement $u$ is a function that maps each non-negative $Q$-amount $q$ (measured in $u$) into the incremental benefit $MB_j(q)$ (measured in $$/u$) that buyer $j$ would obtain from procurement of a next $Q$-unit, given that buyer $j$ has already procured $q$.

**Definition CM6**: Conditional on location and time, a buyer $j$’s *inverse demand schedule* for a commodity $Q$ with standard unit of measurement $u$ is a function that maps each non-negative $Q$-amount $q$ (measured in $u$) into the maximum $Q$-unit price $D_j(q) = \pi_j$ (measured in $$/u$) that buyer $j$ is willing to pay to procure a next $Q$-unit, given that buyer $j$ has already procured $q$.

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17 The following regularity conditions are sufficient to ensure an *inverse demand schedule* $D_j(q) = \pi_j$ for a buyer $j$, as defined in CM6, can be inverted to obtain a well-defined *ordinary demand schedule* $q = D_j^o(\pi_j)$ for buyer $j$ as defined in CM3, and vice versa, where $D_j(q)$ coincides with buyer $j$’s marginal benefit function $MB_j(q)$; see [39, Sec. 9.3.4] for extended discussion. Suppose buyer $j$ has a benefit function $B_j(q)$, defined as in CM4, that is non-decreasing, differentiable, and concave over $q \geq 0$. Buyer $j$’s marginal benefit, evaluated at any $q' \geq 0$, is then the non-negative derivative of buyer $j$’s benefit function $B_j(q)$ with respect to $q$, evaluated at $q = q'$. This mapping $D_j(q')$ of $q'$ into a non-negative incremental benefit evaluation $\partial B_j(q')/\partial q = MB_j(q') =: \pi_j' ($$/u$) is buyer $j$’s *inverse demand schedule* for $Q$. Finally, if buyer $j$’s marginal benefit function $MB_j(q)$ is a strictly decreasing function of $q$ for $q \geq 0$, a common “diminishing marginal returns” assumption for commodity spot markets, it can be inverted over $q \geq 0$ to give a strictly decreasing ordinary...
Definition CM7: Conditional on location and time, a supplier \( i \)'s ordinary supply schedule for a commodity \( Q \) with standard unit of measurement \( u \) is a function that maps each non-negative \( Q \)-unit price \( \pi \) (measured in $/u) into the maximum \( Q \)-amount \( q = S'_i(\pi) \) (measured in \( u \)) that supplier \( i \) is willing to supply at price \( \pi \).

Definition CM8: Conditional on location and time, a supplier \( i \)'s total avoidable cost function for a commodity \( Q \) with a standard unit of measurement \( u \) is a function that maps each of supplier \( i \)'s feasible non-negative \( Q \)-supply levels \( q \) (measured in \( u \)) into the total avoidable cost \( C_i(q) \) (measured in $) that supplier \( i \) would have to incur to supply \( q \).

Definition CM9: Conditional on location and time, a supplier \( i \)'s marginal cost function for a commodity \( Q \) with a standard unit of measurement \( u \) is a function that maps each non-negative \( Q \)-amount \( q \) (measured in \( u \)) into the incremental cost \( MC_i(q) \) (measured in $/u) that supplier \( i \) is willing to be paid for a next \( Q \)-unit, given that supplier \( i \) is currently supplying \( q \).

Definition CM10: Conditional on location and time, a supplier \( i \)'s inverse supply schedule for a commodity \( Q \) with standard unit of measurement \( u \) is a function \( S_i(q) \) that maps each non-negative \( Q \)-unit price \( \pi \) (measured in $/u) that supplier \( i \) is willing to supply at price \( \pi \) for a next \( Q \)-unit, given that supplier \( i \) has already supplied \( q \).

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The following regularity conditions are sufficient to ensure an inverse supply schedule \( S_i(q) = \pi \) for a supplier \( i \), as defined in CM10, can be inverted to obtain a well-defined ordinary supply schedule \( q = S'_i(\pi) \) for supplier \( i \) as defined in CM7, and vice versa, where \( S_i(q) \) coincides with supplier \( i \)'s marginal cost function \( MC_i(q) \); see [39, Sec. 8.2] for extended discussion. Suppose supplier \( i \) has a total avoidable cost function \( C_i(q) \), defined as in CM8, that is non-decreasing, differentiable, and convex over \( q \geq 0 \). Evaluated at any \( Q \)-supply level \( q \geq 0 \), supplier \( i \)'s marginal cost \( MC_i(q) \) (measured in $/u) defined as in CM9 is then the derivative of supplier \( i \)'s total avoidable cost function \( C_i(q) \) with respect to \( q \), evaluated at \( q \geq 0 \). This mapping of \( q \geq 0 \) into a non-negative marginal cost evaluation \( \partial C_i(q)/\partial q =: MC_i(q) =: \pi' (\text{$/u}) \) is supplier \( i \)'s inverse supply schedule for \( Q \). Finally, if supplier \( i \)'s marginal cost function \( MC_i(q) \) is a strictly increasing function of \( q \) for \( q \geq 0 \), a common "increasing marginal cost" assumption for commodity spot markets, it can be inverted over the range \( q \geq 0 \) to give an ordinary supply schedule for supplier \( i \); that is, to give a strictly-increasing function \( S'_i(\pi) \) mapping each non-negative \( Q \)-unit price \( \pi \) (measured in $/u) into a non-negative \( Q \)-supply \( q = S'_i(\pi) \) (measured in \( u \)). In this case, by construction, the \( Q \)-unit price \( \pi' \) that maps into \( q' \) is supplier \( i \)'s marginal cost \( MC_i(q') \) (measured in $/u), evaluated at \( Q \)-supply level \( q' \). Economists studying competitive commodity spot markets typically work with ordinary supply schedules mapping prices into quantities because, as will be seen below in definition CM11, all supplier participants in such markets are assumed to be price-takers. However, in U.S. RTO/ISO-managed wholesale power markets, supply schedules ("supply offers") are typically expressed in inverse form, as mappings from quantities into prices.
3.5 Competitive (MC=MB) Spot-Pricing Requires Priced Assets to be Commodities

CM11 (KEY DEFINITION): Let $Q$ denote a commodity with standard unit of measurement $u$, and let CSM denote a commodity spot market for $Q$. Then CSM is a Competitive Commodity Spot Market (CCSM) if the following conditions hold:19

(CCSM1) The participants in CSM consist of a fixed set of $Q$-buyers $j$ and a fixed set of $Q$-suppliers $i$.

(CCSM2) Each buyer $j$ and supplier $i$ is a price-taker.20

(CCSM3) Each buyer $j$ has a non-increasing ordinary demand schedule $D_j^o(\pi)$ that maps each non-negative $Q$-unit price $\pi$ (measured in $$/u$) into a non-negative $Q$-demand $q_j = D_j^o(\pi)$ (measured in $u$).

(CCSM4) Each supplier $i$ has a non-decreasing ordinary supply schedule $S_i^o(\pi)$ that maps each non-negative $Q$-unit price $\pi$ (measured in $$/u$) into a non-negative $Q$-supply $q_i = S_i^o(\pi)$ (measured in $u$).

(CCSM5) The equilibrium concept for CSM is competitive equilibrium, defined as follows. Let $q = D^o(\pi) = \sum_j D_j^o(\pi)$ denote the (ordinary) aggregate demand schedule for $Q$, and let $q = S^o(\pi) = \sum_i S_i^o(\pi)$ denote the (ordinary) aggregate supply schedule for $Q$. Then a price-quantity pair $e^* = (\pi^*, q^*)$ with $q^* > 0$ is a competitive equilibrium for CSM if $e^*$ is an intersection point of the aggregate demand and supply schedules $q = D^o(\pi)$ and $q = S^o(\pi)$ plotted in the $(\pi, q)$ plane; that is, if $e^*$ satisfies the following condition:

**Competitive (D=S) Market Clearing Condition** at $e^* = (\pi^*, q^*)$ with $q^* > 0$:

$$q^* = D^o(\pi^*) = S^o(\pi^*).$$  \hfill (1)

The following lemma, an immediate implication of definitions CM3–CM10 in Section 3.4.2, establishes an important alternative “marginal pricing” form for the Competitive (D=S) Market Clearing Condition (1).

**Lemma 3.4:** Suppose regularity conditions21 hold such that:

(a) Each buyer $j$ has an inverse demand schedule $D_j(q_j) = \pi$ that can be inverted to give a well-defined ordinary demand schedule $q_j = D_j^o(\pi)$ for buyer $j$, and vice versa, where $D_j(q_j)$ coincides with buyer $j$’s marginal benefit function, i.e., $D_j(q_j) = MB_j(q_j)$.

19 See [39, Ch. 12] for a more detailed illustrated presentation of the standard economic definition of a CCSM, including key related concepts such as net surplus extraction and market efficiency.

20 A participant in a spot market for a commodity $Q$ with a standard unit of measurement $u$ is said to be a price-taker if the participant behaves as if his own market transactions have no effect on the market-determined $Q$-unit price $\pi$ (measured in $$/u$).

21 Regularity conditions ensuring that properties (a) and (b) in Lemma 3.4 both hold are provided in Footnotes 17 and 18.
(b) Each supplier $i$ has an inverse supply schedule $S_i(q_i) = \pi$ that can be inverted to give a well-defined ordinary supply schedule $q_i = S'_i(\pi)$ for supplier $i$, and vice versa, where $S_i(q_i)$ coincides with supplier $i$’s marginal cost function, i.e., $S_i(q_i) = MC_i(q_i)$.

Then the Competitive ($D=S$) Market Clearing Condition (1) in definition CM11 is equivalent to the following marginal-pricing condition:

**Competitive (MC=MB) Spot-Pricing Rule** at $e^* = (\pi^*, q^*)$ with $q^* > 0$: For each supplier $i$ and buyer $j$ such that $q^*_i > 0$ and $q^*_j > 0$,

$$\pi^* = MC_i(q^*_i) = MB_j(q^*_j)$$

(2)

**Outline of Proof for Lemma 3.4:** To see the claimed equivalence, given properties (a) and (b), apply appropriate inverse demand and supply function operations to the terms in condition (1), and apply appropriate ordinary demand and supply function operations to the terms in condition (2). //

A CCSM for which the Competitive ($D=S$) Market Clearing Condition (1) is equivalent to the Competitive (MC=MB) Spot-Pricing Rule (2) will be called a **Marginal-Pricing CCSM**, or MP-CCSM for short. MP-CCSMs have a variety of attractive efficiency and optimality properties. Several of these properties are stated below as lemmas for later reference.

**Lemma 3.5:** An MP-CCSM is a uniform-price market in the following sense. At any competitive equilibrium $e^* = (\pi^*, q^*)$, the same Q-unit price $\pi^* ($/u) is: (a) paid by each inframarginal (cleared) buyer $j$ for each Q-unit that buyer $j$ purchases; and (b) received by each inframarginal (cleared) supplier $i$ for each Q-unit that supplier $i$ sells.

**Lemma 3.6:** All fixed cost for each supplier $i$ participating in an MP-CCSM is sunk cost, i.e., non-avoidable fixed cost.

**Proof for Lemma 3.6:** By definition, an MP-CCSM is a commodity spot market that takes place at a given location and time for a given set of participants whose demand and supply schedules are automatically submitted to the MP-CCSM and instantly cleared (or not cleared) to determine competitive equilibrium outcomes. Thus, no supplier participating in an MP-CCSM is a decision-maker able to avoid (or not avoid) some cost depending on a decision the supplier makes at this given location and time. //

**Lemma 3.7:** Revenue sufficiency holds for an MP-CCSM. That is, at any competitive equilibrium $e^* = (\pi^*, q^*)$ for an MP-CCSM, the total revenue earned by each supplier $i$ is sufficient to cover supplier $i$’s total avoidable cost.

**Outline of Proof for Lemma 3.7:** The equivalent defining conditions (1) and (2) for an MP-CCSM competitive equilibrium $e^* = (\pi^*, q^*)$ imply that the total
(possibly-zero) revenue earned by each supplier \( i \) – whether cleared or not – is sufficient to cover the sum (or integral) of the possibly-zero marginal costs that supplier \( i \) incurs at \( e^* \). By the supplier cost definitions given in Section 3.4.1, the sum (or integral) of marginal costs for a supplier \( i \) at \( e^* \) constitutes the total variable cost incurred by supplier \( i \) at \( e^* \). Moreover, by Lemma 3.6, all fixed cost for supplier \( i \) at \( e^* \) is sunk cost, i.e., unavoidable fixed cost. Thus, the total avoidable cost of a supplier \( i \) at \( e^* \) coincides with supplier \( i \)'s total variable cost. It thus follows from definition BM7 that supplier \( i \) is revenue sufficient. //

**Lemma 3.8:** At any competitive equilibrium \( e^* = (\pi^*, q^*) \) for an MP-CCSM, the total possible Total Net Surplus (TNS)\(^{23}\) extracted by participating buyers and suppliers is the largest possible Total Net Surplus that buyers and suppliers can extract from the underlying commodity spot market CSM. Thus, market efficiency holds for CSM at \( e^* \), in the following sense: At \( e^* \) there is no wastage of opportunity to extract additional net surplus from CSM. //

**Outline of Proof for Lemma 3.8:** See Tesfatsion [39, Ch. 12]. //

Lemma 3.8 implies that defining conditions for an MP-CCSM are sufficient to ensure market efficiency holds for the underlying commodity spot market CSM at any competitive equilibrium \( e^* = (\pi^*, q^*) \). However, these defining conditions are not necessary for the market efficiency of the underlying CSM.

For example, it can be shown that market efficiency holds for the underlying CSM if the Competitive (MC=MB) Spot-Pricing Rule (2) is replaced by any price-rule PR that satisfies the following three price-rule conditions:

- **PRC(a):** All \( Q \)-units traded in CSM under price-rule PR also trade at some competitive equilibrium \( e' = (\pi', q') \) for CSM;
- **PRC(b):** All \( Q \)-units failing to trade in CSM under price-rule PR also fail to trade at the competitive equilibrium \( e' = (\pi', q') \) in PRC(a);
- **PRC(c):** Under price-rule PR, the price paid by a buyer \( j \) to purchase a unit of \( Q \) is the same as the price received by the supplier \( i \) who supplies this unit of \( Q \).\(^{24}\)

\(^{22}\) See footnote-10 in Section 2 and Tesfatsion [39, Ch. 12].

\(^{23}\) By definition, Total Net Surplus attained at any point \( e = (\pi, q) \) is the sum of Total Net Buyer Surplus and Total Net Supplier Surplus attained at \( e \). Total Net Buyer Surplus at \( e \) is the difference between the maximum amount that buyers would have been willing to pay for \( q \) and the amount that they actually pay for purchase of \( q \) at \( e \). Total Net Supplier Surplus at \( e \) is the difference between the payment that suppliers actually receive for sale of \( q \) at \( e \) and the minimum payment that they would have been willing to receive for sale of \( q \).

\(^{24}\) Condition PRC(c) essentially holds for U.S. RTO/ISO-managed DAM/RTM SCED optimizations in the absence of transmission grid congestion because SCED-determined bus LMPs then collapse to a single uniform LMP across the grid. Conversely, when the grid is congested (i.e., when at least one transmission-line capacity constraint is active), at least some LMP separation occurs across the buses of the grid. However, since power injected or withdrawn at any one grid location rapidly affects power flow on all directly or indirectly connected transmission lines, power injections and withdrawals do not in fact constitute a collection of bilateral buyer-supplier trades as presumed in the statement of condition PRC(c).
An example of a price-rule PR for CSM that satisfies PRC(a)–PRC(c), distinct from the Competitive (MC=MB) Spot-Pricing Rule (2), is the $k$-discriminatory-price rule ($k \in [0, 1]$) defined as follows: For any matched buyer-supplier pair for which the buyer’s purchase reservation value $\pi^b$ and the supplier’s sale reservation value $\pi^s$ satisfy $\pi^b \geq \pi^s$, set the strike price for this pair at the weighted-average level $\pi^k = k\pi^b + (1-k)\pi^s$ lying between their reservation values. Thus, the division between buyer and supplier of the net surplus increment $[\pi^b - \pi^s]$ resulting from their trade is determined by $k$; however, the total amount of this net surplus increment is not affected by $k$.

One intuitive argument commonly given in favor of using the Competitive (MC=MB) Spot-Pricing Rule (2) and against the use of a $k$-discriminatory-price rule for a CSM is that competitive spot-pricing provides more incentive to suppliers (buyers) of a commodity $Q$ to use the most efficient available technology for extraction of net supplier (buyer) surplus. For example, suppose a supplier switches to a new technology that strictly lowers his marginal cost of production (hence his sale reservation value $\pi^s$) for each strictly inframarginal unit of $Q$ he sells. Competitive spot-pricing permits this supplier to keep all of his resulting increased net supplier surplus; the $k$-discriminatory-price rule with $k < 1$ does not. An analogous argument holds for a buyer able to switch to a new technology that permits him to increase his marginal benefit (hence his purchase reservation value $\pi^b$) for each strictly inframarginal unit of $Q$ he buys.

However, under either price-rule, a welfare-maximizing supplier or buyer will not switch to a more efficient technology unless the cost of this switch is less than the expected net surplus gain from future market transactions. Yet low-cost or costless technology switching could strongly deter engagement in the costly research and development (R&D) efforts needed to develop more efficient technologies. Clearly, a dynamic joint analysis of market and R&D processes is needed to examine with care the long-run efficiency implications of alternative market price-rules.

A second intuitive argument commonly given in favor of using the Competitive (MC=MB) Spot-Pricing Rule (2) and against the use of a $k$-discriminatory-price rule for a CSM concerns incentives for truthful revelation. Under a $k$-discriminatory-price rule with $k < 1$, a self-interested supplier $i$ would have a strategic incentive to report a higher-than-true supply schedule for his strictly inframarginal $Q$-units in order to receive a higher discriminatory price for these units, thus increasing his true net revenue (i.e., his revenue minus his true variable cost) from the sale of these units. This incentive only disappears when the supplier has shifted up his reported supply schedule to a point that the discriminatory price assigned to each of his strictly inframarginal $Q$-units equals the discriminatory price assigned to the marginal (last) sold $Q$-unit.

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25 The two extremes of the $k$-discriminatory-price rule are of special interest: The 0-discriminatory-price rule awards all generated net surplus to buyers because the price received by suppliers is their minimum acceptable sale price $\pi^s$. Conversely, the 1-discriminatory-price rule awards all generated net surplus to suppliers because the price charged to buyers is their maximum acceptable purchase price $\pi^b$. 
In summary, an MP-CCSM indeed has a number of attractive efficiency and optimality properties. However, the following essential caution – a direct implication of Lemma 3.3 in Section 3.3 – must be kept carefully in mind.

**IMPORTANT CAUTION.** In order for definitions CM3–CM11, the defining conditions for an MP-CCSM, and the MP-CCSM properties formalized in Lemmas 3.5–3.8 to be conceptually meaningful, the transacted asset $A$ must be a commodity $Q$ as defined by D4 in Section 3.2. That is, the transacted asset $A$ must have a standard unit of measurement $u$ such that, at any given location and time, all $A$-traders consider all available units $u$ of asset $A$ to be perfect substitutes (economically equivalent). Otherwise, a real-line “quantity axis” cannot be constructed in a conceptually coherent manner for any of the functional forms appearing in these definitions, conditions, and properties.

All units $u$ of a commodity $Q$ available for trade at a given location and time must by definition be perfect substitutes for each $Q$-trader at this location and time. Important implications of this observation specifically for the existence of demand and supply functions, the core underpinnings of an MP-CCSM, are stated below in the form of two lemmas.

**Lemma 3.9:** Conditional on location and time, any buyer $j$ of a commodity $Q$ that receives one additional $Q$-unit $u$ is completely indifferent with regard to which precise $Q$-unit he receives because, by definition of a commodity, the incremental economic benefit that buyer $j$ gains from the receipt of an incremental “next” $Q$-unit is the same for all available $Q$-units. This indifference is a necessary condition for buyer $j$ to have a conceptually well-defined demand schedule for $Q$ at this given location and time, either inverse or ordinary.

**Lemma 3.10** Conditional on location and time, any supplier $i$ of a commodity $Q$ that supplies one additional $Q$-unit is completely indifferent with regard to which precise $Q$-unit he supplies because, by definition of a commodity, the incremental economic cost that supplier $i$ incurs from the supply of an incremental “next” $Q$-unit is the same for all available $Q$-units. This indifference is a necessary condition for a supplier $i$ to have a conceptually well-defined supply schedule for $Q$ at this given location and time, either inverse or ordinary.

To understand Lemma 3.9 and Lemma 3.10 in more concrete terms, consider the following situation. At a given location and time, an experimental economist plans to use a sealed bag containing a mixture of HoneyCrisp Apples and Dole Mandarin Oranges to construct an ordinary demand schedule for fruit for a human subject called “buyer $j$.” The standard unit of measurement $u$ for fruit is taken to be a piece of fruit; hence, fruit-quantities $q$ are measured by the number of included fruit pieces $u$, and fruit-unit prices $\pi$ are measured by dollars per fruit-piece ($$/u$).

In accordance with condition CCSM3, the experimenter hands buyer $j$ an ordered list of successively higher fruit-unit prices $\pi$ and asks buyer $j$ to report the maximum fruit-quantity $q = D^b(\pi)$ that he would be willing to buy at each listed fruit-unit price $\pi$. At the end of the experiment, one of the listed fruit-unit prices $\pi^*$
will be randomly announced, the bag of fruit will be unsealed, and buyer $j$ will be required to pay $\pi^* \times q^*$ ($\$) for a fruit-quantity $q^* = D^*(\pi^*)$ that the experimenter draws randomly from the unsealed bag.

Unfortunately for the experimenter, suppose buyer $j$ does not consider a Honey-Crisp Apple to be a perfect substitute for a Dole Mandarin Orange; that is, suppose the specific apple-versus-orange attribute of a fruit-piece matters to buyer $j$? In this case, the economic value that buyer $j$ attains from any procured fruit-quantity $q$ will depend on the specific apple-orange composition of $q$.

Consequently, the maximum fruit-quantity $q$ that buyer $j$ is willing to purchase at each listed fruit-unit price $\pi$ will depend on how buyer $j$ resolves his uncertainty regarding two related aspects of the experiment. First, what is the apple-orange composition of fruit-pieces in the sealed bag? Second, given this composition, what will be the likely apple-orange composition of the fruit-quantity $q^*$ that is randomly drawn from the unsealed bag if buyer $j$ reports that $q^* = D^j_j(\pi^*)$ is the maximum fruit-quantity he is willing to purchase at the announced price $\pi^*$?

The bottom line is that an ordinary demand schedule $\text{CM3}$ is not well-defined for fruit for a fruit-buyer $j$ at a given location and time unless buyer $j$ considers all pieces of fruit available for purchase at this location and time to be perfect substitutes. Analogous arguments can be used to demonstrate that an ordinary supply schedule $\text{CM7}$ is not well-defined for fruit for a fruit-supplier $i$ at a given location and time unless supplier $i$ considers all pieces of fruit available for supply at this location and time to be perfect substitutes.

What about inverse demand and supply schedules for fruit, defined in accordance with the standard economic definitions $\text{CM6}$ and $\text{CM10}$ in Section 3.4.2? Here the import of Lemmas 3.9–3.10 is even clearer.

Suppose apples and oranges are not perfect substitutes for a fruit-buyer $j$. How can buyer $j$ express his maximum acceptable purchase price (i.e., his purchase reservation value $BM8$) for a “next” piece of fruit, given he has already procured a fruit-quantity $q$, without knowing: (i) which specific fruit piece, apple or orange, is to be his “next” procured fruit piece; and (ii) what is the specific apple-orange composition of his already-procured fruit-quantity $q$?

Suppose apples and oranges are not perfect substitutes for a fruit-supplier $i$. How can supplier $i$ express his minimum acceptable sale price (i.e., his sale reservation value $BM9$) for a “next” piece of fruit, given he has already supplied a fruit-quantity $q$, without knowing: (i) which specific fruit piece, apple or orange, is to be his “next” supplied fruit piece; and (ii) what is the specific apple-orange composition of his already-supplied fruit-quantity $q$?
4 Legacy Core Market Design: Fundamental Conceptual Issues

4.1 Counter-Claims (CC1)–(CC4) to Design Presumptions

The DAM/RTM Two-Settlement System reviewed in Section 2, originally proposed by FERC [8] in 2003, constitutes the core design of all seven current U.S. RTO/ISO-managed wholesale power markets. As noted in Section 1, this core design reflects four conceptually-problematic economic presumptions, reproduced below in summarized forms:

**Problematic Presumption (P1):** Presumption that the basic transacted product is grid-delivered energy (MWh), i.e., flows of power (MW) accumulated at designated grid locations during designated time-periods (h).

**Problematic Presumption (P2):** Presumption that, for careful analysis of supplier revenue sufficiency, it suffices to partition total supplier cost into only two components: a “variable” component determined by supplier grid-delivered energy; and a “fixed” component independent of supplier grid-delivered energy.

**Problematic Presumption (P3):** Presumption that grid-delivered energy (MWh) is a commodity whose perfectly-substitutable (economically equivalent) units \( u = 1 \text{MWh} \) (conditional on location and time) should be transacted at a uniform per-unit energy price (\$/MWh) determined in a competitive commodity spot market.

**Problematic Presumption (P4):** Presumption that total supplier revenue attained in these competitive commodity spot markets will suffice over time to cover total supplier cost.

Specific conceptually-problematic aspects of each legacy economic presumption (P1) through (P4) will next be taken up in turn.

4.2 (CC1): Reserve, Not Energy, is the Basic Transacted Product

4.2.1 Presumption (P1) Critique: Two Concerns

Presumption (P1) is consistent with the focus of current U.S. RTO/ISO-managed wholesale power markets on amounts of grid-delivered energy bought and sold at designated grid locations during designated operating periods. This section stresses two important conceptual concerns regarding this presumption.

- **Physical Reliability Concern:** Energy transactions in U.S. RTO/ISO-managed wholesale power markets must be supported by the physical operations of underlying transmission grids. The necessary requirements for the reliable operation of these grids over successive operating periods \( T \) cannot be expressed solely in terms of transacted and grid-delivered amounts of energy.

- **Benefit and Cost Valuation Concern:** How power (MW) is injected at designated grid locations during successive operating periods can matter greatly to RTOs/ISOs, power producers, and power customers. Grid-delivered energy amount is only one of many possible valued attributes of this flow of power.
4.2.2 Physical reliability Concern

In order for a transmission grid to operate reliably over time, the grid must be in continual net-load balance. Roughly stated, this means that the injection of power into the grid must balance the withdrawal and/or inadvertent loss of power from the grid at each point in time.

More carefully stated, continual net-load balance for a transmission grid means that Kirchhoff’s Current Law must hold for this grid. Applied to any electrical network at a given point in time, this law asserts the following: The algebraic sum of all currents entering a network node \( n \) must equal the algebraic sum of all currents exiting node \( n \), where current \( I \) is measured in Amperes (A).

U.S. RTO/ISO-managed wholesale power markets operate over high-voltage alternating-current (AC) transmission grids. Consider the analytical modeling developed in [39, Ch. 6 & Sec. 9.2] for an RTO/ISO-managed wholesale power market \( M(T) \) for a future operating period \( T \), where \( M(T) \) operates over a high-voltage AC transmission grid with buses \( b \) in a bus-set \( B \). The participants in \( M(T) \) consist of the following entities. For each bus \( b \in B \),

- a collection \( M(b) \) of dispatchable generation-units \( m \) with unique electrical connection to the transmission grid at transmission bus \( b \);
- a collection \( LS(b) \) of LSEs \( j \), each of whom manages power-usage for a distinct collection \( C_j(b) \) of customers with unique electrical connection to the transmission grid at transmission bus \( b \);
- a collection \( NG(b) \) of non-dispatchable generation-units \( n \) with unique electrical connection to the transmission grid at transmission bus \( b \).

The relative timing of \( M(T) \) and \( T \) are depicted in Fig. 5.

![Fig. 5 Time-line for a grid-supported RTO/ISO-managed wholesale power market M(T) conducted for a future operating period T.](image)

The AC power-flow operations of the transmission grid for \( M(T) \) are approximated in [39, Ch. 6 & Sec. 9.2] as direct-current (DC) power-flow operations. Given this DC power-flow approximation, losses are zero; and Kirchhoff’s Current Law expressed in terms of current \( I \) measured in Amperes (A) can equivalently be expressed in terms of (active) power \( p \) measured in megawatts (MW) using \( p = V_o \cdot I \), where \( V_o \) measured in Volts (V) denotes the constant voltage magnitude assumed for the DC power-flow approximation.26

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26 See [36, Sec. 3.1] for a careful discussion of the standard assumptions used to derive a DC power-flow approximation for the AC power-flow of a high-voltage AC transmission grid.
The net-load balance constraints for this DC-approximated transmission grid for a given operating period \( T \) can then be summarized as follows, where the qualifier \( \text{fixed} \) is used as a short-hand expression for \( \text{non-dispatched must-service} \). For each bus \( b \in \mathcal{B} \) and time \( t \in T \), the total dispatched power injection at bus \( b \) by the dispatchable generation-units \( m \in \mathcal{M}(b) \), plus the total net line-power inflow at bus \( b \) from buses \( b' \) in \( \mathcal{B} \) with \( b' \neq b \), must equal the total forecasted net load at bus \( b \), calculated as the total dispatched customer load at bus \( b \) for customers of the LSEs \( j \in \mathcal{LS}(b) \) plus the total forecasted fixed customer load at bus \( b \) for customers of the LSEs \( j \in \mathcal{LS}(b) \) minus the total forecasted fixed power injection at bus \( b \) by the non-dispatchable generators \( n \in \mathcal{NG}(b) \).

For the purposes of this section, however, it is important to express these net-load balance constraints in their explicit mathematical form [39, Ch. 6 & Sec. 9.2]:

**Net-load balance constraints:** For each bus \( b \in \mathcal{B} \) and time \( t \in T \),

\[
G_b^{\text{dis}}(t) + \text{NLPI}_b(t) = \hat{L}_b(t) + \tilde{NL}^f_b(t)
\]

where:

\[
G_b^{\text{dis}}(t) := \sum_{m \in \mathcal{M}(b)} p_m^{\text{dis}}(t) \quad \text{(total dispatched power injection)};
\]

\[
\text{NLPI}_b(t) := \left[ \sum_{\ell \in \mathcal{L}(b)} w_\ell(t) - \sum_{\ell \in \mathcal{O}(b)} w_\ell(t) \right] \quad \text{(total net line-power inflow)};
\]

\[
\hat{L}_b(t) := \sum_{j \in \mathcal{LS}(b)} \hat{p}_j(t) \quad \text{(total dispatched customer load)};
\]

\[
\tilde{NL}^f_b(t) := \left[ \hat{L}_b(t) - \hat{G}_b(t) \right] \quad \text{(total forecasted net fixed load)};
\]

\[
\hat{G}_b(t) := \sum_{n \in \mathcal{NG}(b)} \hat{p}_n(t) \quad \text{(total forecasted fixed power injection)}.
\]

The important take-away from the net-load balance constraints (3) is that these are not static demand=supply restrictions on transacted amounts of energy (MWh) to be delivered at each bus \( b \in \mathcal{B} \) for operating period \( T \). Rather, they are complicated joint restrictions on power-paths\(^{27}\) for operating-period \( T \).

Specifically, constraints (3) impose joint restrictions on the following four types of power-paths at each bus \( b \in \mathcal{B} \) during \( T \):

- the dispatched power-path \( \hat{p}_m^{\text{dis}}(T) = (p_m^{\text{dis}}(t) \mid t \in T) \) at \( b \) during \( T \) for each dispatchable generation-unit \( m \in \mathcal{M}(b) \);
- the dispatched power-path \( \hat{p}_j^{\text{dis}}(T) = (p_j^{\text{dis}}(t) \mid t \in T) \) at \( b \) during \( T \) for the managed customers of each LSE \( j \in \mathcal{LS}(b) \);

\(^{27}\) Recall from Sec. 1 that a power-path \( p_b(t) = (p_b(t) \mid t \in T) \) is a sequence of power injections/withdrawals \( p_b(t) \) (MW) at a single grid-location \( b \) during an operating-period \( T \).
the forecasted fixed power-path $\hat{p}^b_j(T) = (\hat{p}^b_j(t) \mid t \in T)$ for fixed power withdrawals at $b$ during $T$ by the managed customers of each LSE $j \in LS(b)$;

• the forecasted fixed power-path $\hat{p}^d_j(T) = (\hat{p}^d_j(t) \mid t \in T)$ for fixed power injections at $b$ during $T$ by each non-dispatchable generator $n \in NG(b)$.

As demonstrated in [39, Ch. 7], given mild regularity conditions and a finite-duration operating period $T = [t^l, t^r]$, it is possible to approximate each of these power-paths as closely as desired by a step-function$^{28}$ consisting of a discretized sequence of “energy blocks” $E_k$ for a collection $K(T) = \{k_n \mid n = 1, \ldots, N(T)\}$ of half-open sub-periods $k_n = [k_n^l, k_n^r)$ constituting a suitably-refined partition of $T$. However, as demonstrated in [39, Chs. 7,16] and [26], it is then important to use market optimization formulations expressed in run-time variables to ensure system constraints are imposed with sufficient accuracy. For example, the constraints imposed at the start-time $k_n^l$ of each successive sub-period $k_n$ of $K(T)$ should be expressed in terms of run-time min/max limits on power-capacities and ramp-rates for sub-periods $k_n' \geq k_n$, i.e., min/max limits that are conditional on the state of each market participant at the start-time $k_n^l$ for sub-period $k_n$, given the specific solution trajectory assumed through sub-period $k_{n-1}$.

In addition, it could be advantageous, or even necessary, to use partitions of $T$ with different sub-period durations $\Delta k$ for different types of market participants in order to capture adequately the specific static and dynamic attributes of their power-paths. For a related discussion, see [20, Sec. 3.1.1].

4.2.3 Benefit and Cost Valuation Concern

A more serious conceptual concern regarding presumption (P1) is that it prevents a comprehensive high-fidelity valuation of benefits and costs.

Let $M(T)$ denote an RTO/ISO-managed wholesale power market $M(T)$ operating over a high-voltage AC transmission grid for a future operating period $T = [t^l, t^r]$. Let $p^b_0(T) = (p^b_0(t) \mid t \in T)$ denote a power-path for $T$ that consists of a sequence of power injections and/or withdrawals $p^b_0(t)$ (MW) at a particular grid location $b$ during times $t \in T$. Let $m(b)$ denote an RTO/ISO-dispatchable generation unit electrically connected to $b$ during $T$, and let $C_j(b)$ denote a collection of customers $c_j(b)$ electrically connected to $b$ during $T$ who are serviced by an LSE $j \in LS(b)$.

Suppose $T$ has finite duration; and suppose the power-path $p^b_0(T)$ has a continuous extension over $\hat{T} = [\hat{t}^l, \hat{t}^r]$, the compact closure of $T$. It then follows from the discussion in Section 4.2.2 that $p^b_0(T)$ can be approximated arbitrarily closely over $T$ by a suitably-constructed step function. Plotted in a time-MW plane, this approximating step-function consists of a finite sequence of one or more “energy blocks” $E_k$.

$^{28}$ Step functions are universal approximators for the class of all continuous real-valued functions $f:[a,b] \rightarrow R$ defined over compact intervals $[a,b]$ of the real line. For example, given any such function $f$, and any $\varepsilon > 0$, it is straightforward to establish the existence of a step function $f^\varepsilon:[a,b] \rightarrow R$ with finitely many time-steps for which the maximum absolute approximation error $|f(x) - f^\varepsilon(x)|$ over $x \in [a,b]$ is less than $\varepsilon$. This assertion follows immediately from the Heine-Cantor Theorem, which establishes that any continuous function $f:X \rightarrow Y$ between metric spaces $X$ and $Y$, with $X$ compact, is uniformly continuous.
for a collection $\mathcal{K}(T) = \{ k_n | n = 1, \ldots, N(T) \}$ of half-open sub-periods $k_n = [k^n_s, k^n_e)$ that partition the operating period $T = [t^*, t^*)$.

Consequently, if power-path $p_b(T)$ is dispatched at $b$ during $T$, its total energy delivery at $b$ during $T$ can be calculated in close approximate form by adding up the energy-blocks for its approximating step-function. However, this in no way guarantees that the actual value assigned to $p_b(T)$ by a producer $m(b)$, a customer $c_j(b)$, or the RTO/ISO can be expressed solely as a function of this energy delivery.

A generation unit $m(b)$ dispatched by the RTO/ISO to deliver power-path $p_b(T)$ would presumably care about the dynamic attributes of this power-path as well as its static attributes. For example, $m(b)$ might be concerned about equipment depreciation cost incurred during $T$ from ramping wear and tear, and the fuel costs incurred during $T$ for power production.

Moreover, what each customer $c_j(b)$ would presumably value in advance of $T$ is a guaranteed ability to determine their power withdrawals at $b$ during $T$ in a flexible just-in-time manner to run their personally-owned electrical devices for locally-determined purposes. The value they would attach in advance of $T$ to any one pre-specified power-path $p_b(T)$ would presumably be low, simply because of its inflexibility.

Finally, what the RTO/ISO would presumably value in advance of $T$ is the guaranteed availability of a collection of suitably diverse RTO/ISO-dispatchable power-paths enabling the RTO/ISO to balance uncertain net-power withdrawal at $b$ and other grid locations during $T$ by suitable just-in-time dispatched net-power injections. The value that the RTO/ISO would attach in advance of $T$ to the availability of any one specified power-path $p_b(T)$ would presumably be low, simply due to its inflexibility.

The key implication of the above observations is that the benefits and costs of producers, customers, and the RTO/ISO itself in RTO/ISO-managed wholesale power markets cannot properly be assessed solely in terms of transacted energy amounts.

4.3 (CC2): Supplier Cost Analysis Requires a Three-Part Partition

4.3.1 Conceptual Concerns Regarding Supplier Cost Presumption (P2)

Presumption (P2) has two troublesome aspects. First, it reflects the traditional economic overly-simplistic partition of total supplier cost into only two parts: fixed and variable. Second, its focus on delivered energy amount as the sole determinant of supplier variable cost is based on the conceptually-problematic presumption (P1). These two aspects of (P2) are separately addressed in the next two sub-sections.

4.3.2 Three-Part Partitioning of Supplier Cost

For reasons carefully articulated in seminal work by Baumol et al. [3], the traditional economic partition of total cost into two components, “fixed” and “variable,” is conceptually incomplete and empirically problematic for many U.S. industries. Rather, total cost should be partitioned into three economically-distinct types of costs:
Total Cost \(=\) Sunk Cost + Avoidable Fixed Cost + Variable Cost \(\quad (4)\)

As will be stressed in subsequent sections of this study, the need for the three-part partition (4) is particularly critical for the conceptually-coherent design and operation of grid-supported centrally-managed wholesale power markets.

Consider a Decision-Maker (DM) at a current time \(t\) who must decide now whether or not to commit to undertaking an action of type A at a future time \(t + \Delta t\). The DM’s total cost at time \(t\) can be partitioned into three components – sunk cost, avoidable fixed cost, and variable cost – as follows:

Sunk Cost \(=\) Non-Avoidable Fixed Cost \(\quad (5)\)

\[\text{Sunk Cost } = \text{Cost} \ SC^o \text{ that:} \]
(i) the DM incurs \textbf{whether or not} the DM commits at time \(t\) to undertaking a type-A action at time \(t + \Delta t\);
(ii) \textbf{does not} depend on the specific form of type-A action the DM undertakes, should the DM choose to commit.

Avoidable Fixed Cost \(=\) Cost \( AFC^o \) that:
(i) the DM incurs \textbf{if and only if} the DM commits at time \(t\) to undertaking a type-A action at time \(t + \Delta t\);
(ii) \textbf{does not} depend on specific form of type-A action.

Variable Cost \(=\) Cost \( VC(a) \) that:
(i) the DM incurs \textbf{if and only if} the DM commits at time \(t\) to undertaking a type-A action at time \(t + \Delta t\);
(ii) \textbf{does} depend on specific form \(a\) of type-A action.

Fixed Cost \(=\) [Sunk Cost + Avoidable Fixed Cost] \(\quad (8)\)

Avoidable Cost \(=\) [Avoidable Fixed Cost + Variable Cost] \(\quad (9)\)

For illustration, consider a currently off-line dispatchable thermal generator \(m\) at the start of a day-D U.S. RTO/ISO-managed DAM that the RTO/ISO is conducting to prepare for day-D+1 grid operations. An example of a sunk cost for \(m\) is an amount of money that \(m\) previously spent to purchase a piece of generation equipment that now has no resale value. An example of an avoidable fixed cost for \(m\) is the start-up cost that \(m\) would have to incur in order to transition from its currently off-line state to a synchronized state\(^{29}\) by the start of day D+1 if \(m\) submits an offer into the day-D DAM to provide positive power injection during Hour 1 of day D+1 and the RTO/ISO clears this offer.\(^{30}\) An example of a variable cost for \(m\) is the

\(^{29}\) A thermal generator is said to be in a synchronized state if it is an operating state that permits it to inject power into the grid, even if no such power injection is currently being undertaken.

\(^{30}\) Kirschen and Strbac \cite{23} refer to start-up cost as a “quasi-fixed cost”.

fuel cost $VC_m(p,H,D+1)$ that $m$ would have to incur in order to maintain a specific positive power-injection level $p$ during some hour $H$ of day $D+1$.

Consider, once again, a decision-maker DM at a current time $t$ who must decide now whether or not to commit to undertaking an action of type $A$ at a future time $t + \Delta t$. We conclude this sub-section by expressing several decision principles for DM in terms of the three-part partition (4) for total cost.

By definition, the DM’s sunk cost at time $t$ is unavoidable, hence incurred whether or not the DM agrees to the commitment at time $t$. The DM’s sunk cost at time $t$ should therefore play no role in the DM’s time-$t$ commitment decision.

“Sunk Cost is Sunk” Dictum:

A decision-maker at time $t$ who is required to make a decision at time $t$ should make this decision independently of his sunk cost at time $t$.

Define the DM to be risk-averse$^{31}$ if the DM is not willing to participate:

- in any risky undertaking with zero expected payoff, where the qualifier “risky” means there is some dispersion of positive-probability payoffs around the zero expected payoff, hence a positive probability of a negative payoff;
- in any undertaking (risky or certain) that has a strictly negative expected payoff.

If the DM is risk-averse, the DM should agree to the commitment at time $t$ if the DM believes this would result for sure in a strictly positive net benefit, where:

$$\text{net benefit} = \text{benefit} - \text{avoidable cost}$$

(10)

Note a strictly positive net benefit (10) would permit the DM to pay down at least part of his time-$t$ sunk cost, assuming this sunk cost is positive.

Conversely, a risk-averse DM should agree to the commitment at time $t$ only if the DM’s expected net benefit from this commitment is non-negative, where net benefit is again defined as in (10). Otherwise, commitment at time $t$ would be an agreement to participate in an undertaking with a strictly negative expected payoff.

These observations are summarized in the form of a commitment principle, as follows:

Commitment Principle: A risk-averse DM should agree to commit at time $t$

- if the DM believes this commitment would result for sure in a net benefit (10) for himself that is strictly positive;
- only if the DM believes his expected net benefit from this commitment is non-negative, where net benefit is again defined as in (10).

$^{31}$ In economic theory, survival is often guaranteed a priori, e.g., by postulating zero subsistence needs. The risk aversion of a decision-maker DM is then characterized as a preference attribute of DM: namely, the degree to which DM’s utility function expressing preference orderings over possible payoffs exhibits concave curvature properties. In reality, strictly negative payoffs can pose grave survival risks for any person or commercial entity without deep financial pockets that simply wishes to avoid starvation or insolvency, inducing them to behave in a “risk averse” manner.
Finally, the following rigorous version of definition M10 in Section 3.4.1 will be needed for use in subsequent sections of this study:

**Definition R-M10: (Rigorous Form of Definition M10).** Revenue sufficiency is said to hold for a supplier $i$ participating in a market $M$ if the total revenue earned by supplier $i$ from this market participation is sufficient to cover the total avoidable cost that supplier $i$ incurs from this market participation, where avoidable cost is defined as in (9).

### 4.3.3 Variable Cost Compensation in U.S. RTO/ISO-managed DAM/RTMs

Multiple types of variable costs incurred by power resources participating in U.S. RTO/ISO-managed wholesale power markets are listed in Appendix A.4. In addition to the commonly-considered fuel-cost category, the list includes: labor cost; intermediate good (supply chain) cost; equipment/software rental cost; equipment depreciation cost; transmission service charges; variable-cost offsets for sales of valuable bi-products; and disposal costs for waste bi-products.

The key concern raised in this sub-section is whether the standardized supply-offer forms required in current U.S. RTO/ISO-managed wholesale power markets permit suppliers to receive appropriate conceptually-coherent compensation for their incurred variable costs. As will next be shown, these supply-offer forms force suppliers to express their variable costs as functions of delivered energy (MWh), with no consideration of dynamic power-path implementations. It is difficult to understand how any of the variable-cost categories listed in Appendix A.4 – including fuel cost – can be accurately measured and reported solely as a function of delivered energy, with no consideration of power-path implementation.

As reviewed in Section 2, the core design element for all seven U.S. RTO/ISO-managed wholesale power markets is a bid/offer-based DAM/RTM two-settlement system. In all seven RTOs/ISOs, the DAM SCED optimization conducted during the morning of each day $D$ (conditional on given commitments for generation units) determines scheduled power dispatch set-points (MW) for each committed generation unit at the start of each hour $H$ during the following day $D+1$.

More precisely, apart from ISO New England, these scheduled dispatch set-points determine co-optimized scheduled maintained power levels or maintained power-slope levels (hence scheduled energy deliveries) and scheduled operating reserve (unencumbered generation capacity levels) for each committed dispatchable generation unit for each hour $H$ of day $D+1$. These determinations are subject to sys-

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32 SCED optimizations for U.S. RTO/ISO-managed DAMs and RTM sub-markets are similar, apart from operating-period duration and restrictions on LSE submission of fixed demand bids. For simplicity of exposition, this sub-section focuses solely on DAM SCED optimizations.

33 ISO New England conducts Forward Reserve Market (FRM) auctions for 10-minute contingency reserve and 30-minute supplemental reserve separately from DAM energy scheduling; see, for example, [6, Tables 1-2] and [15, Table 1].
The 24 hourly supply offers that a dispatchable power resource $m$ submits to a day-D RTO/ISO-managed DAM SCED optimization for the 24 hours of an operating day $D+1$ are intended to convey variable cost information about $m$ to the RTO/ISO. As detailed in [38], each of these per-hour supply offers is generally required to take a simple step-function form: namely, a possibly-zero fixed maintained power-level demand $\bar{p}$ for hour $H$ (with no associated price information) plus a small upper-limited number $N$ of successive (MW/price)-blocks $n = 1, \ldots, N$ in the MW-$$/MWh plane indicating $m$’s requested per-unit compensation $$/MWh over successively higher non-overlapping intervals of possible maintained power levels $p$ (MW) for $H$.

Starting at the fixed demand $\bar{p}$ for maintained power, and continuing through some maintained power level $p' > \bar{p}$, the summation of the finite number of (MW/price)-block $$/h-compensations required by $m$ at $p'$, multiplied by $1h$, is then considered to be an approximation of $m$’s non-decreasing variable cost $VC_m(p')$ ($$) for $H$, evaluated at maintained power level $p'$ for $H$. For example, given $N = 3$ and $0 \leq \bar{p} < p_1 < p_2 < p' \leq p_3$, there are three (MW/price)-blocks to consider for the calculation of $VC_m(p')$ ($$): namely, the three (MW/price)-blocks corresponding to the three successive intervals $[\bar{p}, p_1]$, $(p_1, p_2]$, and $(p_2, p']$ of possible maintained-power levels for $H$. Let $\pi_n ($/MWh) for $n = 1, 2, 3$ denote $m$’s requested per-unit compensation for grid-delivered energy for each of these three successive intervals. Then, $m$’s variable cost $VC_m(p')$ ($$) evaluated at the maintained power level $p'$ for $H$ is approximated as:

$$VC_m(p') =: \left[ \pi_1 \cdot [p_1 - \bar{p}] + \pi_2 \cdot [p_2 - p_1] + \pi_3 \cdot [p' - p_2] \right] \times [1h]. \quad (11)$$

The crucial point illustrated by (11) is that the RTO/ISO-managed DAM/RTM two-settlement system forces suppliers to report their variable costs to RTOs/ISOs as functions solely of grid-delivered energy amounts (MWh). In actuality, as indicated by the empirical variable-cost examples given in Appendix A.4 (e.g., depreciation of owned machinery, assessed charges for transmission services, ...), many types of variable costs arise for suppliers in part or in whole from their need to provide real-time RTO/ISO-dispatched deliveries of power-paths during successive

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34 The types of operating reserve procured on a co-optimized basis with energy in U.S. RTOs/ISOs (apart from ISO New England) include Regulation, Spinning Reserve, and Supplemental Reserve. See [15, Sec. IIA & Appendix].

35 As detailed in [2], ERCOT permits Qualified Scheduling Entities (QSEs) to submit hourly supply offers in a three-part form that allows inclusion of some unit-commitment cost information in addition to variable cost information. For example, a supply offer submitted to a day-D ERCOT DAM by a currently off-line QSE for some hour $H$ during day $D+1$ typically consists of three parts: Startup Offer ($$/start); Minimum-Energy Offer consisting of an energy price ($/MWh) and a Low-Sustained Limit (LSL) power level (MW); and a non-decreasing piecewise linear Energy Offer Curve in the MW-$$/MWh plane consisting of a finite collection of linearly-connected power-price points $(p, \pi)$ whose power levels $p$ commence at the LSL level.
operating periods to satisfy just-in-time customer power demands and grid reliability requirements.

4.4 (CC3): Grid-Delivered Energy is Not a Commodity

4.4.1 Overview

Presumption (P3) implies that, within the context of a grid-supported U.S. RTO/ISO-managed wholesale power market, grid-delivered energy (MWh) conditional on grid delivery location and operating period is a commodity whose perfectly substitutable units (MWh) should be bought and sold in a spot market at a competitively-determined uniform market price ($/MWh). The fundamental concern regarding presumption (P3) is its serious conceptual inconsistency with the four Counter-Claims (CC1)–(CC4) in Section 1 that are supported with care in [39] and throughout the present study.

The economic background materials presented in Section 3 are used in the following subsections to carefully explain and critique this conceptual inconsistency.

4.4.2 Grid-Delivered Energy is a u-Asset that is Not a Commodity

This sub-section demonstrates that, in contradiction to presumption (P3), energy (MWh) does not function as a commodity within the context of current U.S. RTO/ISO-managed wholesale power markets. More precisely, a participant in such a market typically does not view a MWh of energy to be a perfect substitute for any other MWh of energy, conditional on delivery location and operating period.

To the contrary, power producers and power customers typically care about the dynamic attributes of the power-paths they use to inject/withdraw power at their grid locations during successive operating periods. For example, power producers dispatched to inject power at a grid location $b$ during an operating period $T$ might reasonably care about equipment wear-and-tear cost incurred due to the fast ramping required to follow received dispatch set-points. And power customers electrically connected to $b$ might reasonably care about the degree of flexibility they have to meet their diverse power requirements during $T$ by just-in-time determined power withdrawals at $b$.

Finally, RTOs/ISOs also typically care about power-paths, not energy deliveries. Given any future operating period $T$, an RTO/ISO needs availability of dispatchable power-paths with diverse dynamic attributes for possible just-in-time RTO/ISO dispatch during $T$ to ensure continual net-load balancing.

Thus, if a producer, customer, or RTO/ISO were asked to assign a monetary value to a specific amount of grid-delivered energy $E^*$ (MWh) at a specific grid location $b$ for a specific future operating period $T$, typically they would not be able to do so without knowing the power-path to be used for this delivery. For example, what value would each of these entities assign to each of the following four power-path
options \( p_b(T) = (p_b(t) \mid t \in T) \) for the injection of power (MW) at a specific grid location \( b \) during a specific future 24-hour operating period \( T \), where each power-path option accumulates to the same amount \( E^* = 12 \) (MWh) of grid-delivered energy:

**Power-Path (a):** Power (MW) is injected at \( b \) at level \( p = 24 \) during the first half-hour of \( T \) and at level \( p = 0 \) during the remainder of \( T \).

**Power-Path (b):** Power (MW) is injected at \( b \) at level \( p = 0.5 \) throughout \( T \).

**Power-Path (c):** Power (MW) is injected at \( b \) at level \( p = 1 \) during every other hour of \( T \), with \( p = 0 \) during the remaining hours of \( T \).

**Power-Path (d):** Power (MW) is injected at \( b \) during \( T \) in a flexible manner that is entirely up to the entity, apart from the requirement that the resulting total energy delivery must equal \( E^* = 12 \) (MWh).

Note that the flexible power-path option (d) would presumably be assigned a higher value than the rigid options (a) through (c). Indeed, option (d) would presumably be assigned at least as high a value as any other power-path option for power injection/withdrawal at \( b \) during \( T \) subject only to the delivered-energy requirement \( E^* = 12 \) (MWh) since option (d) encompasses all such options.

The clear implication of these examples is that the product “grid-delivered energy (MWh) conditional on delivery location and time” does not function as a commodity within the context of U.S. RTO/ISO-managed wholesale power markets. Hence, recalling the important caution CCSM4 carefully justified in Section 3.5, the following constructions essential for locational marginal pricing are conceptually ill-defined for this product: demand schedule (ordinary or inverse); supply schedule (ordinary or inverse); marginal cost function; and marginal benefit function. Attempts to justify LMP settlements for the DAM/RTM two-settlement system by pointing to the efficiency and optimality properties of competitive commodity spot markets satisfying the competitive \((MC=MB)\) spot-pricing rule (2) are therefore not conceptually supportable.

Many products that are not commodities are successfully transacted in real-world markets. Indeed, product innovation commonly occurs through continual striving to produce variations of existing products that permit at least temporary market advantages. Grid-supported centrally-managed wholesale power markets are necessarily forward markets due to the speed of real-time operations. The key to the conceptually-consistent design of such markets is to consider with care how real-world forward markets transact products whose units are not viewed as perfect substitutes by market participants. As will be seen in Section 6, the short answer is appropriate contract design.

### 4.4.3 Conceptually Unsupportable Use of Spot-Market Pricing Results in Time-Inconsistent Settlements

A second fundamental conceptual concern regarding presumption (P3) is that a market process \( M(T) \) conducted within a grid-supported RTO/ISO-managed wholesale power market for an operating period \( T \) cannot be a spot market due to the speed of real-time grid operations. That is, \( M(T) \) cannot coincide with \( T \).
Indeed, the DAM/RTM two-settlement system at the core of each U.S. RTO/ISO-managed wholesale power market is a collection of grid-supported forward markets \( M(T) \) with positive-duration look-ahead horizons \( \text{LAH}(T) \); see Fig. 5. The scheduled generation-unit commitments and dispatch set-points for hour \( H \) of day \( D+1 \), determined in the day-D DAM, are subject to change in supplementary unit-commitment processes and in RTM sub-markets held between the close of the day-D DAM and the start of hour \( H \) on day \( D+1 \).

Nevertheless, the settlements\(^{36}\) for these scheduled next-day unit commitments, generation levels, and operating reserve levels are determined at the end of day \( D \) as if they were actual spot-market transactions carried out on day \( D \); see Fig. 1. This pay-for-performance in advance of actual performance typically results in time-inconsistent\(^{37}\) settlements, i.e., settlements determined and assigned to resources on day \( D \) for unit commitments, energy levels, and operating reserve levels scheduled for day \( D+1 \) that are subsequently adjusted by OOM and RTM LMP payments due to discrepancies that arise between scheduled and actual outcomes on day \( D+1 \).

### 4.5 (CC4): Supplier Revenue Sufficiency Requires 2-Part Pricing

Presumption (P4) implies that the revenues earned by suppliers from participation in a Competitive Commodity Spot Market (CCSM) will suffice over time to cover their total cost, i.e., the sum of their total fixed cost and total variable cost. However, presumption (P4) is false for a CCSM.

The final defining assumption \((A.7)\) given in Section 3.5 for a CCSM implies that all suppliers participating in a CCSM have zero avoidable fixed cost; that is, all of their fixed cost is sunk cost, not avoidable cost. However, there is nothing in the seven defining assumptions \((A.1)-(A.7)\) for a CCSM that guarantees suppliers will be able to cover any or all of their sunk costs.

For example, by derived property CCSM3 in Section 3.5, note that market efficiency holds at any competitive equilibrium point \( e^* = (\pi^*, q^*) \) for a CCSM in the sense that total net surplus at \( e^* \) is as large as possible for the underlying commodity spot market CSM. However, referring to the precise definition of market efficiency given in Footnote 23, it is seen that market efficiency does not guarantee that the revenues received by participating suppliers cover any of their sunk costs.

This is a special case of a broader economic fact: There is no economic efficiency justification for instituting market rules that ensure suppliers are reimbursed for sunk

\(^{36}\) These settlements include out-of-market (OOM) make-whole payments for partial reimbursement of avoidable fixed costs (e.g., start-up costs) for committed generation units plus DAM SCED-determined nodal (dual-variable based) price payments intended to cover the variable costs for scheduled energy and reserve provision.

\(^{37}\) A multi-stage optimization problem that jointly determines an optimal solution \( (s^*_0, s^*_1, \ldots, s^*_N) \) for successive time-periods \( (s_0, s_1, \ldots, s_N) \) is said to be time-inconsistent if re-optimization undertaken at the beginning of some later time-period \( s_n \) with \( 0 < n \leq N \) results in an optimal solution for \( (s_{n+1}, \ldots, s_N) \) that deviates from \( (s^*_0, \ldots, s^*_N) \). See [39, Sec. 10.2].
costs. As stressed by the “Sunk Cost is Sunk” dictum in Section 4.3.2, sunk costs are already incurred costs (using up of resources) that suppliers cannot avoid by current or future decisions; hence, sunk costs should have no effect on these decisions.

Indeed, the only way a supplier \( i \) can ensure coverage of some or all of his sunk cost through a market participation is if he has some type of structural or strategic market advantage\(^{38} \) relative to other actual or potential suppliers that reduces or eliminates the ability of these other suppliers to compete for supplier \( i \)’s customers if supplier \( i \) attempts to charge these customers for sunk costs. Examples of situations giving rise to supplier market advantage include:

- **Regulatory Protection (Entry Barrier):** A supplier might have patent protection for his product that prevents other suppliers from producing this same product.

- **Product Differentiation:** A supplier’s product might have a special attribute (e.g., sale location, flavor based on secret recipe), highly valued by buyers, that differentiates it from all other products currently being supplied in the market and that is hard (or impossible) for other suppliers to copy;

- **Supply-Capacity Constraints:** A supplier might be a monopolist (sole supplier) with respect to “residual demand” customers that other capacity-constrained suppliers are unable to service, enabling him to include “extra” charges in the product price he sets for these customers for coverage of his sunk cost.

Conversely, buyers participating in a “perfectly contestable” market have no incentive to compensate participant suppliers for sunk costs. Roughly defined, a market is said to be perfectly contestable if any participating supplier charging a product price that results in revenues strictly exceeding the product’s avoidable cost of production can be successfully challenged and replaced by an existing or newly entering rival supplier able to charge a lower price for the same product. See Baumol et al. [3].

What about supplier revenue sufficiency as defined in Section 4.3.2; that is, the ability of suppliers to earn sufficient revenues over time to cover their avoidable fixed cost as well as their variable cost? As seen in Section 3.5, suppliers participating in spot markets have no avoidable fixed cost. In contrast, avoidable fixed cost essentially always arises for suppliers participating in forward market settings because avoidable fixed cost includes opportunity cost, i.e., earnings foregone by not committing assets to an alternative next-best use.

As discussed in Section 4.4.3, market processes conducted within the context of RTO/ISO-managed wholesale power markets operating over high-voltage AC transmission grids are necessarily forward markets, not spot markets, due to the speed of

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\(^{38}\) As discussed more carefully in [33], structural market advantage refers to an instituted feature of a market that systematically favors some market participants over others. In contrast, strategic market advantage is an opportunity available to a market participant to influence market outcomes in their favor in an officially unintended manner through some behavioral means. The standard economic term for these types of market advantages is “market power.” However, the use of “market power” in studies of electric power markets could cause confusion.
real-time grid operations. Various types of avoidable fixed cost that arise for suppliers participating in U.S. RTO/ISO-managed wholesale power markets are listed in Appendix A.4. This list includes: capital investment cost; transaction cost; opportunity cost, and unit commitment cost. Specific examples are given for each type of avoidable fixed cost. It is difficult to conceive how these avoidable fixed costs could be expressed in an empirically credible manner as functions solely of grid-delivered energy amounts. Yet, this is what would be needed in order for suppliers participating in RTO/ISO-managed DAMs/RTMs to be assured coverage of their avoidable fixed costs solely through some form of extended LMP pricing mechanism.

Fortunately, this is not necessary. Forward markets instituted in other industries routinely rely on two-part pricing contracts to ensure supplier revenue sufficiency, i.e., supplier revenues sufficient to cover supplier avoidable fixed costs as well as supplier variable costs. Section 6 of this study reviews key features of an alternative Linked Swing-Contract Market Design [39] for RTO/ISO-managed wholesale power markets that demonstrates how two-part pricing contracts could also advantageously be introduced in these markets to ensure supplier revenue sufficiency.

5 Legacy Core Design: Roadblock for Grid Decarbonization

5.1 Overview

U.S. RTO/ISO-managed wholesale power markets are large complex organizations. From an external vantage point, the continued reliance of these markets on the legacy core DAM/RTM two-settlement system design reviewed in Section 2 appears to be greatly hindering these markets from transitioning smoothly to decarbonized grid operations. This section briefly discusses several external indicators in support of this concern; a more detailed discussion of these indicators is given in [39].

5.2 Proliferation of Participation Models

The continued focus of U.S. RTO/ISO-managed Day-Ahead Markets (DAMs) and Real-Time Markets (RTMs) on energy as the key transacted product, as reflected in legacy economic presumption (P1), appears to be resulting in a proliferation of participation models functioning as artificial market entry barriers.39

More precisely, to participate in these DAMs/RTMs, a power resource must be classified in accordance with a designated taxonomy of participation models, each with its own eligibility rules and performance requirements. At the top of this taxonomy are two categorizations: “Energy (MWh)” and “Operating Reserve (MW).” The latter category consists of various forms of unencumbered generation capacity (MW) distinguished by availability characteristics; see Section 4.3.3.

However, this entire DAM/RTM taxonomy is conceptually problematic because, as discussed with care in [39, Sec. 3.2.1], “Energy” and “Operating Reserve” are

39 For example, see the complicated eligibility requirements that power resources must satisfy to participate in MISO DAM/RTM processes as variously defined types of “qualified resources,” covered in MISO’s 278-page Energy and Operating Reserve Markets manual [30].
not conceptually well-defined as independent participation categories for such markets. For example, consider an RTO/ISO-managed DAM SCUC/SCED optimization conducted on day D in order to co-optimize scheduled energy deliveries and scheduled operating reserve for day D+1. As usual, suppose the forecasted net fixed load-profile at a grid bus b (or for a grid zone z) for day D+1 functions as a centroid (i.e., mid-point anchor) for a nodal (or zonal) uncertainty set expressing RTO/ISO-specified operating reserve requirements for day D+1 at b (or for z). Then:

- energy levels determined in the day-D DAM SCUC/SCED optimization for scheduled dispatched delivery at bus b (or within zone z) for day D+1 consist of a collection of RTO/ISO-dispatchable power-paths deemed capable of covering the centroid of the uncertainty set for bus b (or zone z) during day D+1.
- operating reserve levels determined in the day-D DAM SCUC/SCED optimization for scheduled availability at bus b (or zone z) during day D+1 consist of a collection of RTO/ISO-dispatchable power-paths deemed capable of covering the remainder of the uncertainty set for bus b (or zone z) during day D+1.

Thus, there is no fundamental conceptual distinction between optimal scheduled energy dispatch levels and optimal scheduled operating reserve levels for day D+1. Both are collections of RTO/ISO-dispatchable power-paths for day D+1 whose purpose is to ensure the balancing of uncertain net fixed load during day D+1.

### 5.3 Proliferation of Flexibility Products

A related concern is the proliferation of flexibility products as supplemental support for real-time net-load balancing.

U.S. RTO/ISO-managed DAMs/RTMs have traditionally relied on operating reserve products taking the form of unencumbered generation capacity distinguished by speed of availability. At any given time, unencumbered generation capacity is generation capacity that is currently without scheduled dispatch obligations. Thus, operating reserve and scheduled generation dispatch are joint products.\(^{40}\)

Three types of operating reserve procured on a co-optimized basis with energy in U.S. RTO/ISO-managed DAMs (apart from ISO New England) are Regulation, Spinning Reserve, and Supplemental Reserve [15, Sec. II.A & Appendix]. Next-day hourly prices for each operating reserve type, derived as dual variable solutions for hourly reserve requirement constraints incorporated into the system constraints for SCED optimizations, take the form of foregone energy-price (LMP) payments.

As noted in Section 1, net loads for U.S. RTO/ISO-managed wholesale power markets are expected to become increasingly uncertain and volatile as these markets transit to increased reliance on IPRs and more active demand-side participa-

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\(^{40}\) In economics, two or more products are said to be joint products if their production results jointly from the use of common inputs in a production process. Operating reserve and scheduled generation dispatch are rival joint products, meaning that – for any given level of inputs (here generation capacity) – an increase in one of the joint products requires a decrease in the other. The use of a single fuel source to co-generate electricity and steam is an example of a non-rival joint-production process well known to engineers.
tion. Indeed, net loads for CAISO and other U.S. RTOs/ISOs are already exhibiting more frequent and dramatic down/up ramping swings. Consequently, the current heavy reliance on unencumbered generation capacity (MW) for operating reserve is becoming increasingly risky.

Industry and academic researchers are thus exploring the possible introduction of new types of “flexibility products” to facilitate the balancing of more uncertain and volatile net loads. For example, FERC has approved proposed ramp flexibility products for CAISO, MISO, and SPP; see [15, p. 12].

A major concern regarding these developments is that the newly approved RAMP (MW/min) products, together with already instituted CAP (MW) and ENERGY (MWh) products, are not independently produced products that can be separately transacted at separately determined prices in a conceptually consistent manner. To the contrary, they are the correlated attributes of individual power-paths, hence joint products. See Footnote 40.

The conceptually-problematic treatment of RAMP, CAP, and ENERGY as independently produced and priced products presumes the value of a power-path can be appropriately measured by means of separate prices assigned to its attributes, treated as independent products. In actuality, the attributes of a power-path $p_b(T) = (p_b(t) \mid t \in T)$ for an operating period $T$ – such as power-delivery start-time $t \in T$, power capacity (MW) profile, ramp-rate (MW/min) profile, power-factor (kW/kVA) profile, power-delivery duration $\Delta t$, and total grid-delivered energy (MWh) – are correlated jointly-produced attributes. A change in any one attribute of a power-path can necessitate changes in its other attributes.

In economics, hedonic pricing is the pricing of a product on the basis of prices separately assigned to its intrinsic physical attributes as well as to its external circumstances. In some situations it might be desirable to use a hedonic-price approximation for the variable cost $\phi_m(p_m(T))$ ($) that a dispatchable power resource $m$ would incur for RTO/ISO-dispatched delivery during $T$ of each of its offered power-paths $p_m(T)$.

For example, the variable cost $\phi_m(p_m(T))$ might be approximated as a linear combination of contractually-agreed metric functions that separately assign costs ($) for post-$T$ verified power capacity (MW) profile, ramp-rate (MW/min) profile, and total grid-delivered energy (MWh), as follows:

$$\phi_m(p_m(T)) \approx C^{\text{CAP}}(p_m(T)) + C^{\text{RAMP}}(p_m(T)) + C^{\text{ENERGY}}(p_m(T)).$$

(12)

However, it would be conceptually incorrect and highly problematic in practice to ignore that the CAP, RAMP, and ENERGY “products” whose costs are evaluated in (12) are in fact highly-correlated attributes of a single power-path $p_m(T)$. 
5.4 Proliferation of Out-of-Market Make-Whole Payments

U.S. RTO/ISO business practice manuals provide detailed descriptions of business operations for stakeholders and other interested parties. The manuals that focus specifically on the trade and settlement of energy and operating reserve have become extremely complex over the years. Much of this growing complexity has arisen from the need to explain various types of out-of-market (OOM) payments that RTOs/ISOs have instituted for their supplier participants as supplements to their market-determined revenues in an attempt to ensure coverage of their incurred costs.

The names and definitions of these OOM payments are not standardized across the seven U.S. RTOs/ISOs, and their relationship to the OOM payments discussed in FERC Orders is not entirely clear. An essential aspect in need of clarification is the distinction between “uplift” OOM payments and “make-whole” OOM payments.

For example, FERC Order No. 844 [12, Sec. I.2] on “uplift transparency,” released in 2018, directs RTOs/ISOs to provide a more transparent monthly reporting of “uplift payments” characterized as follows:

“RTO/ISO markets can be affected by a number of operational challenges such as unplanned transmission and generation outages and the need to maintain adequate voltage throughout the system. Limitations in the ability of the market software to incorporate all reliability considerations can at times result in prices that fail to reflect some of these challenges. In such situations, certain resources needed to reliably serve load may not economically clear the market and RTOs/ISOs must take out-of-market actions (i.e., operator-initiated commitments) to ensure system needs are met. These actions give rise to uplift costs. ... Uplift payments reflect the portion of the cost of reliably serving load that is not included in market prices.” [pp. 4-7]

Thus, FERC Order 844 characterizes uplift payments as OOM reimbursements to power resources for undertaking RTO/ISO-requested OOM actions deemed necessary to maintain grid reliability.

In contrast, RTOs/ISOs have instituted various types of OOM make-whole payments for suppliers participating in DAMs/RTMs whose market-determined revenues fail to provide coverage for certain types of avoidable fixed cost. Examples include ERCOT’s payments for accumulated power usage (energy) required for start-up, and for the maintenance of an on-line state at a minimum possible maintained power-injection level; see Footnote 35.

A key concern regarding existing OOM make-whole payments is that they do not ensure supplier revenue sufficiency. For example, the OOM make-whole payments that ERCOT awards to suppliers for start-up and for the maintenance of an on-line state by no means provide full coverage for all supplier avoidable fixed costs; see the avoidable fixed cost examples listed in Appendix A.4.

On the other hand, various OOM make-whole payment methods proposed to ensure better coverage of supplier costs have tended to blur the operationally-critical distinctions among sunk cost, avoidable fixed cost, and variable cost discussed in Section 4.3. For example, the Notice Of Proposed Rule-making (NOPR) released by
FERC in 2016 [9], and subsequently withdrawn by FERC in 2017 [10], would have required unit-commitment costs for fast-start resources to be incorporated into the energy and operating reserve prices determined in co-optimized DAMs/RTMs. As reviewed by Hartman [18, pp. 6-7], the original NOPR release encouraged commentators to suggest that unit-commitment costs for other types of generation should be incorporated into these prices as well. Moreover, industry and academic researchers are continuing to explore extended-LMP methods for broader-based incorporation of avoidable fixed costs into DAM/RTM energy prices, i.e., into LMPs ($/MWh).

A key conceptual argument against the incorporation of supplier avoidable fixed costs into DAM/RTM energy prices is as follows. These avoidable fixed costs are insurance costs, not production costs. That is, they are the costs that suppliers incur to be able to fulfill their contractual commitments to provide availability of power-paths for possible RTO/ISO-dispatch during future operating periods. This assured availability, in and of itself, provides a critically important service: namely, reduction of volumetric grid risk for these future operating periods. A supplier should be compensated for providing risk-reduction service (dispatchable power-path availability) for a future operating period T whether or not the RTO/ISO subsequently chooses to dispatch this supplier for actual power-path delivery during T.

However, incorporation of supplier avoidable fixed costs solely into DAM/RTM energy prices for a future operating period T would prevent these suppliers from receiving compensation for period-T risk-reduction services per se. Rather, suppliers would only receive compensation for period-T services if they were dispatched for energy deliveries during T.

Consider the following analogous situation. Suppose a fire-insurance company FIC is interested in providing risk-reduction products to households for some future period T. These risk-reduction products are fire-insurance contracts sold to households in advance of T that promise to provide make-whole house repairs in case of a period-T house-fire. Define company FIC’s insurance pool to be the subset of households that purchase a fire-insurance contract from FIC in advance of T. Suppose company FIC is not permitted to require each household in its insurance pool to pay a common “premium payment” ($) whether or not the household experiences house-fire damage during T.41

To stay in business, company FIC would then be forced to require each household in its insurance pool to pay the full avoidable cost of any house-fire repair that FIC provides to this household during period T. Thus, why limit house repairs to burned houses? The would-be “fire insurance” company FIC is thus incentivized to function as an ordinary “home repair” company with no provision of risk-reduction services.

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41 Suppose: (i) the number N of households in FIC’s insurance pool is large; (ii) each household in this insurance pool has the same small independent probability \( \beta \in (0, 1) \) of experiencing a house-fire during T; and (iii) each household in this insurance pool would have the same house-repair cost HRC ($) in case of a house-fire. Then, by the Law of Large Numbers, the FIC can “almost surely” guarantee full coverage of its actual total house-fire repair cost during T by: (a) requiring each household in its insurance pool to pay a relatively small premium \( \beta \times \text{HRC} \) in advance of T; and (b) offering each household in its insurance pool free make-whole house-fire repair during T.
Finally, various conceptual and practical arguments can be given against the proposed incorporation of supplier avoidable fixed cost into any energy or operating reserve price determined for a co-optimized DAM/RTM. The incorporation of a positive avoidable fixed cost \( c^o \) ($) incurred in advance of an operating period \( T \) into the period-\( T \) price \( \pi_A(T) \) determined for a product \( A \) that would be procured in total period-\( T \) amount \( a(T) \) at price \( \pi_A(T) \) requires changing the recorded book-price \( \pi_A(T) \) to a price level \( \pi'_A(T) := \pi_A(T) + \Delta \pi_A(T) \) such that:

\[
\pi'_A(T) \times a(T) = c^o + \pi_A(T) \times a(T),
\]

hence:

\[
\Delta \pi_A(T) \times a(T) = c^o.
\]

However, as detailed in Section 4.3.2, an avoidable fixed cost is defined to be a cost that: (i) arises from a decision to commit now to undertaking some designated type of action at a future time; and (ii) does not depend on the specific form of the undertaken action. Thus, there is no guarantee that an avoidable fixed cost \( c^o \) incurred in advance of some future operating period \( T \) due to a commitment to be available for possible RTO/ISO-instructed delivery of a currently uncertain amount of product \( A \) during \( T \) can be expressed as a stable function of the actual delivery \( a(T) \) of product \( A \) during \( T \). Consequently, the recorded book-prices \( \pi'_A(T) \) for each operating period \( T \) could be highly unstable, implying there is no practical advantage gained relative to making simple direct OOM make-whole payments \( c^o \).

Second, if the book-price \( \pi'_A(T) \) were instead implemented as the period-\( T \) price of product \( A \) in place of \( \pi_A(T) \), the transacted \( A \)-amount would presumably change from \( a(T) \) to \( a'(T) = a(T) + \Delta a(T) \) for some non-zero increment \( \Delta a(T) \). That is, any attempt to endogenize the needed “price distortion” by incorporating it into a co-optimized DAM/RTM SCUC/SCED formulation in advance of the determination of an optimal solution would typically result in an inefficient distortion of the resulting quantity solution.

Third, as stressed in Section 4.4.2, grid-delivered energy and operating reserve do not function as commodities within the context of a co-optimized DAM/RTM. Hence, the uniform “unit prices” derived in these market processes for grid-delivered energy and operating reserve, conditional on a given delivery location and operating period, are conceptually-problematic constructs with no efficiency or optimality justification. The incorporation of an avoidable fixed cost into such a presumed uniform market price would thus simply result in a double-layered price distortion.

5.5 Growing Revenue Insufficiency Concerns

Revenue sufficiency is said to hold for a supplier \( i \) participating in a market \( M \) if the total revenue earned by supplier \( i \) from this market participation is sufficient to cover the total avoidable cost that supplier \( i \) incurs from this market participation. See the careful definition of this concept provided in Section 4.3.2.
The proliferation of OOM make-whole payments reported in Section 5.4 indicates that U.S. RTO/ISO-managed wholesale power markets are not currently ensuring revenue sufficiency for their participant suppliers. As discussed in previous sections of this study, and addressed in greater detail in [39], this revenue insufficiency appears to be arising as the result of fundamental conceptually-problematic economic presumptions embedded in their legacy core DAM/RTM two-settlement system designs: namely, presumptions (P1)–(P4).

5.6 Ptolemaic Epicycle Market-Design Conundrum

Participation models, flexibility products, OOM make-whole payments, and revenue insufficiency concerns all appear to be proliferating in current U.S. RTO/ISO-managed wholesale power markets. This proliferation suggests these markets could be caught up in a dangerous market-design conundrum, characterized as follows:

Ptolemaic Epicycle Conundrum for Market Design (“Onion Problem”):

- Fundamental conceptual inconsistencies in the core design principles instituted for a market result in operational difficulties.
- These operational difficulties are addressed by introducing a new layer of rules (an “epicycle”) around the initial core design principles, which results in further operational difficulties.
- Rule-layer (epicycle) accretion then continues to occur because – ignoring the “Sunk Cost is Sunk” Dictum in Section 4.3.2 – correction of the fundamental conceptual inconsistencies in the core design principles is persistently deemed to be too costly to correct.

6 An Alternative Linked Swing-Contract Market Design

6.1 Overview

Previous sections of this study support the contention that the four conceptually-problematic economic presumptions (P1)–(P4) reflected in the legacy DAM/RTM two-settlement system design at the core of current U.S. RTO/ISO-managed wholesale power market operations are hindering the smooth transition of these markets to lower-carbon grid operations with increasingly diverse participants.

This section briefly reviews the innovative aspects and key features of an alternative design for grid-supported centrally-managed wholesale power markets, referred to as the Linked Swing-Contract Market Design [39], that appears better suited for the scalable support of these objectives.42

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42 Details regarding the development and testing of the Linked Swing-Contract Market Design can be found in the following studies:[1, 19, 25, 26, 27, 29, 37, 39, 40].
The Linked Swing-Contract Market Design is based on the following four conceptually-consistent economic principles [EP1]-[EP4] that were presented in preliminary form as Counter-Claims (CC1)–(CC4) in Section 1:

[EP1]: Within the context of a grid-supported centrally-managed wholesale power market, grid-delivered energy (MWh) is not a commodity because the cost-benefit valuations that participants assign to any given energy delivery $E^*$ (MWh) at a grid location $b$ during an operating period $T$ typically depend on the dynamic attributes of the power-path that delivers $E^*$ at $b$ during $T$.

[EP2]: Any market process carried out within a grid-supported centrally-managed wholesale power market must necessarily be a forward market process $M(T)$ for a future operating period $T$ due to the speed of real-time grid operations.

[EP3]: Dispatchable Power Resources (DPRs) participating in a forward market process $M(T)$ for a future operating period $T$ within a grid-supported centrally-managed wholesale power market provide two distinct types of products:

- **Physically-Covered Insurance**: Guaranteed availability of diverse power-path production capabilities for possible central-manager dispatch during the future operating period $T$ to protect against volumetric grid risk;
- **Real-Time Power-Path Delivery**: Actual delivery of power-paths in response to central-manager dispatch signals received during operating period $T$ to meet just-in-time customer power demands and grid reliability requirements.

[EP4]: Each DPR in [EP3] can use a two-part pricing contract to submit to $M(T)$ a coupled offer of physically-covered insurance for $T$ and real-time power-path delivery during $T$ that ensures revenue sufficiency for the DPR, as follows:

- The two-part pricing contract can include a DPR-specified offer price to compensate the DPR prior to $T$ for any avoidable fixed cost the DPR must incur to guarantee its offered physically-covered insurance for $T$;
- The two-part pricing contract can include a DPR-specified performance payment method to compensate the DPR after $T$ for any variable cost the DPR incurs for power-path delivery during $T$ carried out in response to received central-manager dispatch signals.

Consequently, under this alternative design there is no need for separate or co-optimized energy markets. Moreover, there is also no need to rely on out-of-market (OOM) make-whole payments in order to ensure supplier revenue sufficiency.

### 6.2 Innovative Aspects and Basic Features

One innovative aspect of the Linked Swing-Contract Market Design is the conceptualization of a “power-path” for a grid-supported centrally-managed wholesale power market. This conceptualization permits the design of market rules and contractual bid/offer forms to be considered from the distributed vantage points of market participants as well as the centralized vantage point of the system manager.
**Key Definition:** A power-path \( p_b(T) = (p_b(t) \mid t \in T) \) for a grid-supported centrally-managed wholesale power market is a sequence of injections and/or withdrawals of power \( p_b(t) \) (MW) at a single grid-location \( b \) during a designated time-interval \( T \).

For example, Fig. 6 depicts the dispatchable power-path production capabilities of a dispatchable power resource \( m \) participating at grid-location \( b_m \) in a grid-supported RTO/ISO-managed wholesale power market. The figure highlights one of multiple possible power-paths that \( m \) could deliver to the grid at \( b_m \) during operating period \( T \) in response to dispatch signals received from the RTO/ISO.

![Power Path Diagram](image)

**Fig. 6** One of multiple possible power-paths \( p_m(T) = (p_m(t) \mid t \in T) \) consisting of successive injections/withdrawals of power \( p_m(t) \) (MW) that a dispatchable power resource \( m \) with swing (flexibility) in ramp-rate (MW/min) and power capacity (MW) could be RTO/ISO-dispatched to deliver at its grid location \( b_m \) during a future operating period \( T \).

A second innovative aspect of the Linked Swing-Contract Market Design is a fundamental change in the envisioned role of the RTO/ISO.

In current U.S. RTO/ISO-managed wholesale power markets, the primary concern of the RTO/ISO is the daily DAM/RTM scheduling of grid-delivered energy for near-term operating periods, supported by ancillary services (e.g., operating reserve, reactive power support for voltage control, ...) and supplemental procurement processes (e.g., residual unit commitment processes, capacity markets, ...).
In the Linked Swing-Contract Market Design, the envisioned primary concern of the RTO/ISO is the advance clearing of reserve offers from dependable dispatchable power resources for possible RTO/ISO dispatch during future operating periods T to protect against volumetric grid risk. A reserve offer for T is a contractually expressed offer to provide guaranteed availability of power-path production capabilities for possible RTO/ISO dispatch during period T.

These two design innovations require changes in product definitions, contract forms, settlement rules, and RTO/ISO management practices, but not in real-time operations. Consequently, as demonstrated in [39, Ch. 16], these design innovations can be introduced gradually into current U.S. RTO/ISO-managed wholesale power markets without disruption of their real-time operations.

The basic features of the Linked Swing-Contract Market Design are as follows. The design consists of a linked collection of RTO/ISO-managed forward reserve markets \( M(T) \) for future operating periods T. As noted above, reserve for T consists of the guaranteed availability of diverse power-path production capabilities in advance of T for possible RTO/ISO dispatch during T, as protection against volumetric grid risk.

More precisely, as carefully explained and illustrated in [39, Chs. 10-11], the Linked Swing-Contract Market Design posits a collection \( \mathcal{M} := \{ M(T) | T \in \mathcal{T} \} \) of sets \( \mathcal{M}(T) = \{ M'(T), M'(T), \ldots \} \) of RTO/ISO-managed forward reserve markets \( M'(T), M'(T), \ldots \) for each operating period T in a designated operating-period set \( \mathcal{T} \). The forward reserve markets \( M'(T), M'(T), \ldots \) in \( \mathcal{M}(T) \) for a given future operating period T are differentiated by the durations of their look-ahead horizons \( \text{LAH}'(T), \text{LAH}'(T), \ldots \), which can range from years to minutes; cf. Fig. 5.

The participants in each market \( M(T) \) consist of Load-Serving Entities (LSEs), Intermittent Power Resources (IPRs), and Dispatchable Power Resources (DPRs).

A reserve bid submitted to \( M(T) \) by an LSE \( j \) on behalf of managed customers electrically connected to the grid at a common grid-location \( b_j \) is a demand for power-path delivery at \( b_j \) during T. This demand can take a dispatchable price-sensitive form and/or a fixed (non-dispatchable must-service) form.

The power injections of an IPR \( n \) unfirmed by storage that take place at \( n \)'s grid point-of-connection \( b_n \) during T are considered to be a fixed power-path delivery that must be forecasted by the RTO/ISO. This forecast is directly entered into the system constraints for the contract-clearing optimization that the RTO/ISO conducts for \( M(T) \): specifically, it is entered into the bus-\( b_n \) power balance constraint for operating period T.

As previously noted, and illustrated in Fig. 6, a reserve offer submitted to \( M(T) \) by a DPR \( m \) is a contractually expressed offer to provide guaranteed availability of power-path production capabilities for possible RTO/ISO dispatch at \( m \)'s grid-location \( b_m \) during T.

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43 Volumetric grid risk is systemic risk of grid collapse due to net load imbalance. A systemic risk is a system-wide risk, i.e., a correlated risk arising for system operations as a whole.
Specifically, a reserve offer submitted to M(T) by a DPR \( m \) is a two-part pricing\(^{44} \) swing-contract \( \text{SC}_m \), expressible in the following standardized form:

\[
\text{SC}_m(T) = \left( \alpha_m(T), \, T_m^{\text{ex}}(T), \, \mathbb{P}P_m(T), \, \phi_m(T) \right)
\]

(15)

The first component \( \alpha_m(T) \) in (15) is the offer price that \( m \) specifies for \( \text{SC}_m(T) \). A non-negative\(^{45} \) offer price designates the amount that must be paid to \( m \) – either directly or in amortized payment-schedule form – if the RTO/ISO clears \( \text{SC}_m(T) \) for \( T \). The offer price \( \alpha_m(T) \) permits \( m \) to ensure recovery \textit{ex ante} (i.e., in advance of \( T \)) for all avoidable fixed cost\(^{46} \) that \( m \) must incur to guarantee its offered availability of power-path production capabilities for possible RTO/ISO dispatch during \( T \), should the RTO/ISO choose to clear \( \text{SC}_m(T) \) for \( T \).

The second component \( T_m^{\text{ex}}(T) \) in (15) is the set of possible exercise times \( t_m^{\text{ex}} \) that \( m \) designates for \( \text{SC}_m(T) \) between the close of M(T) and the start-time for the future operating period \( T \). The number and positioning of these exercise times determine whether \( \text{SC}_m(T) \) is a firm contract or some type of option contract (e.g., European, American, Bermudan, ...).

The third component \( \mathbb{P}P_m(T) \) in (15) is the set of power-paths that \( m \) is offering for possible RTO/ISO-dispatched delivery at \( m \)'s grid location \( b_m \) during \( T \). Ideally, \( \mathbb{P}P_m(T) \) should be a “digital twin” expressing the full physical power-path production capabilities of \( m \) during \( T \). In practice, \( \mathbb{P}P_m(T) \) will typically be an approximation for this digital twin that conveys the key physical attributes of \( m \)'s offered power-paths.

These key physical attributes must include \( m \)'s grid delivery location \( b_m \). Additional attributes can include static features, such as total amount of grid-delivered energy (MWh) and down-time/up-time parameters, as well as dynamic features such as: power capacity (MW) profile during \( T \); ramp-rate (MW/min) profile during \( T \); and power-factor (kW/kVA) profile during \( T \). The forms and ranges of these power-path attributes determine the degree of swing (flexibility) in \( m \)'s offered reserve.

The final component \( \phi_m(T) \) in (15) is a performance payment method that maps each power-path \( p \) in the power-path set \( \mathbb{P}P_m(T) \) into a real-valued dollar payment

\(^{44} \) As detailed in [39, Ch. 10.2], this two-part pricing enables separate time-consistent DPR cost settlements (i) for reduction of volumetric grid-risk provided for \( T \) in advance of \( T \), and (ii) for any RTO/ISO-dispatched power-path delivery occurring during \( T \) subject to RTO/ISO verification subsequent to \( T \).

\(^{45} \) Swing-contract offer prices are not restricted in sign. For example, a DPR \( m \) with a positive minimum sustainable power-injection level could specify an offer price \( \alpha_m < 0 \) in an attempt to ensure the RTO/ISO clears his swing contract \( \text{SC}_m \). This negative offer price commits the DPR to pay the amount \(-\alpha_m \) should \( \text{SC}_m \) be cleared.

\(^{46} \) See Appendix A.4 for a listing of different types of avoidable fixed cost that real-world DPRs can incur. These types include: capital investment cost; transaction cost; opportunity cost; and unit-commitment cost.
φ_m(T)(p) ($) for incurred variable cost. More precisely, φ_m(T)(p) designates the ex-post (i.e., after T) compensation for variable cost ($) that m would require for delivery of p during T in accordance with received RTO/ISO dispatch instructions. This variable-cost compensation is subject to post-T verification by the RTO/ISO of m’s performance (power-path delivery) during T, which is an incentive for m to follow the RTO/ISO’s dispatch instructions as closely as possible.

The performance payment method φ_m(T) can take a wide variety of forms. Ideally, however, it should be expressible in standardized metrics that permit both DPR m and the RTO/ISO: (i) to agree ex ante on the precise nature of DPR m’s offered risk-reduction service (dispatchable power-path availability) for T; and (ii) to verify ex post the extent to which any contractually-admissible dispatch instructions conveyed by the RTO/ISO to DPR m for period-T performance (power-path delivery) have accurately been followed.

The RTO/ISO clears a subset of the reserve bids and offers submitted to M(T) to maximize the expected net benefit (benefit minus avoidable cost) of M(T) participants. This contract-clearing optimization problem is conditioned on current state conditions (including market linkages) and is subject to standard types of system constraints for T such as nodal net-load balancing constraints, nodal/zonal reserve requirements, and line capacity limits. The conceptual and practical advantages of this contract-clearing optimization formulation relative to the SCUC/SCED optimization formulations implemented in current RTO/ISO-managed wholesale power markets are demonstrated by findings from analytical and computational test-cases reported in [39].

Finally, to preserve its status as an independent fiduciary, the RTO/ISO allocates all net reserve procurement costs and transmission service costs incurred for M(T) operations back to M(T) participants based on their relative contributions to these costs. The specific cost-allocation rules used by the RTO/ISO for these purposes are carefully presented and motivated in [39, Sec. 6.7].

6.3 Current U.S. DAMs vs. Swing-Contract DAMs

This section provides high-level comparisons of the basic design features and market-clearing optimization formulations for current U.S. DAMs and SC DAMs, assuming all customer demand takes a fixed-load form to simplify the comparison.

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47 As shown in Appendix A.4, these variable costs include payments for inputs (fuel, labor, ...) needed for power-path production, charges for transmission services, and wear-and-tear depreciation of physical equipment.

48 Market linkages refers to the specific linkages established among the collection of markets \( \mathcal{M} = \{ \mathcal{M}(T) \mid T \in \mathcal{T} \} \) as a result of the RTO/ISO’s contract-clearing and dispatch decisions in successive operating periods T. The RTO/ISO keeps tracks of these linkages by carrying forward on its books an adaptively updated record of its cleared reserve bids/offers and its dispatch decisions.
Figure 7 provides high-level comparisons of the *basic market design features* for SC DAMs and current U.S. DAMs. The *main similarities* are:

- Both DAM designs are RTO/ISO managed;
- Both DAM designs have the same types of market participants;
- Both DAM designs are subject to standard SCED-types of system constraints, such as nodal power balance constraints, nodal/zonal reserve requirements, and transmission-line capacity limits.

The *main differences*, listed below, involve product definition, contract forms, settlement rules, and RTO/ISO managedment practices, *not* real-time operations. Thus, as demonstrated in [39, Ch. 16], these differences could be introduced *gradually* into current U.S. RTO/ISO-managed DAMs.

- SC DAMs are forward markets for *reserve*, i.e., for offered availability of diverse power-path production capabilities for possible next-day RTO/ISO dispatch;
- SC DAM reserve offers are *two-part pricing swing contracts in either firm or option form*;

<table>
<thead>
<tr>
<th></th>
<th>Current DAM</th>
<th>SC DAM</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Similarities</strong></td>
<td>Conducted day-ahead plan for next-day operations</td>
<td>SCUC &amp; SCED</td>
</tr>
<tr>
<td></td>
<td>RTO/ISO-managed</td>
<td>Optimal contract clearing</td>
</tr>
<tr>
<td></td>
<td>Market participants include LSEs, DPRs, &amp; IPRs</td>
<td>Swing contracts are two-part pricing contracts</td>
</tr>
<tr>
<td></td>
<td>Same types of system constraints: Nodal power balance, zonal reserve requirements, line capacity limits, ...</td>
<td>Payment for resource availability now &amp; resource performance ex post</td>
</tr>
<tr>
<td><strong>Differences</strong></td>
<td>Optimization form</td>
<td>Location marginal prices</td>
</tr>
<tr>
<td></td>
<td>Settlement</td>
<td>Swing contracts are two-part pricing contracts</td>
</tr>
<tr>
<td></td>
<td>Market payments</td>
<td>Payment for resource availability now &amp; resource performance ex post</td>
</tr>
<tr>
<td></td>
<td>OOM payments</td>
<td>No make-whole payments</td>
</tr>
<tr>
<td></td>
<td>Info released to participants</td>
<td>Which swing contracts have been cleared</td>
</tr>
</tbody>
</table>

Fig. 7 Basic Market Design features: Current U.S. RTO/ISO-managed DAMs vs. SC DAMs.
A DPR \( m \) participating in an SC DAM held on day D whose submitted reserve offer \( SC_m \) is cleared for day D+1 receives an *offer-price payment* \( \alpha_m \) (in lump-sum or amortized form) as compensation for the reduction of volumetric grid-risk this cleared reserve offer provides for day D+1 operations.\(^{49}\)

For the SC DAM, no performance payment occurs in advance of performance (dispatched power-path delivery) during next-day operations;

A DPR \( m \) participating in an SC DAM can ensure its revenue sufficiency (i.e., market revenue \( \geq \) avoidable cost) by appropriate specification of the offer-price \( \alpha_m \) and performance payment method \( \phi_m \) that \( m \) includes in its submitted reserve offer \( SC_m \); no resort to OOM make-whole payments is needed.

<table>
<thead>
<tr>
<th>Similarities</th>
<th>Current DAM SCUC</th>
<th>Current DAM SCED</th>
<th>SC DAM Optimization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Objective</td>
<td>Min ([\text{start-up/shut-down costs} + \text{no-load costs} + \text{dispatch costs} + \text{reserve costs} + \text{constraint penalties}])</td>
<td>Min ([\text{Dispatch costs} + \text{reserve costs} + \text{constraint penalties}])</td>
<td>Min ([\text{Availability cost} + \text{performance cost} + \text{constraint penalties}])</td>
</tr>
<tr>
<td>Key RTO/ISO decision variables</td>
<td>Unit commitments</td>
<td>Energy dispatch &amp; reserve levels</td>
<td>Which swing-contracts are cleared</td>
</tr>
<tr>
<td>Settlement</td>
<td>No</td>
<td>LMPs calculated as SCED dual variables</td>
<td>Each cleared DPR receives the offer price it has included in its submitted swing contract</td>
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<td></td>
<td></td>
<td></td>
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</tbody>
</table>

**Fig. 8** Market-clearing optimization formulations: Current U.S. RTO/ISO-managed DAM SCUC/SCED optimization vs. SC DAM optimization.

Figure 8 provides high-level comparisons of the *market-clearing optimization formulations* for SC DAMS and current U.S. DAMs. The main similarities are:

- Each DAM optimization can be formulated as a *Mixed Integer Linear Programming (MILP)* problem;

---

\(^{49}\) Note the amount of *this risk-reduction* depends on the inherent swing (flexibility) of the power-path set \( PP_m \) that \( m \) includes in its submitted reserve offer \( SC_m \). However, the amount of this risk-reduction does *not* depend on which power-path the RTO/ISO actually dispatches from this power-path set during day D+1.
– The objective function of each DAM optimization includes penalties for constraint violations.

The main differences are as follows. For an SC DAM contract-clearing optimization conducted on day D for an operating-day D+1:

– the objective function fully incorporates the availability cost (i.e., avoidable fixed cost) and performance cost (i.e., variable cost) of each participating dispatchable power resource \( m \), as conveyed to the RTO/ISO by the offer price \( \alpha_m \) and the performance payment method \( \phi_m \) that \( m \) includes in its submitted swing-contract reserve offer \( SC_m \);

– the only payment obligation determined by the day-D SC DAM that is settled in advance of operating-day D+1 is coverage of the availability costs incurred by dispatchable power resources with cleared reserve offers;

– no performance payments are made to cleared dispatchable power resources in advance of actual performance (dispatched power-path delivery) on day D+1 that has been verified by the RTO/ISO;

– “unit commitments” are replaced by “cleared contracts,” and the only binary-valued RTO/ISO decision variables are yes/no contract-clearing indicators;

– the “unit-commitment constraints” of each participating dispatchable power resource \( m \) are conveyed to the RTO/ISO by the power-path production-capability set \( PP_m \) that \( m \) includes in its submitted swing-contract reserve offer \( SC_m \).

### 7 Conclusion: Grids as Flexibility-Support Mechanisms

The ultimate goal of this study is the development of a conceptually-consistent market design for U.S. RTO/ISO-managed wholesale power markets that is capable of supporting the smooth transition of these markets to greater reliance on renewable power and more active participation by demand-side resources. An essential consideration is whether achievement of this ultimate goal will require fundamental changes in the existing designs of these markets.

This study concludes that fundamental design changes are indeed needed. Multiple conceptually-problematic aspects of the legacy DAM/RTM two-settlement system design at the core of all seven current U.S. RTO/ISO-managed wholesale power markets are identified, analyzed, and illustrated in Sections 2–4. Briefly summarized, these aspects are as follows:

**Key Product-Definition Issues**

1. Conceptually-problematic focus on grid-delivered energy (MWh) as the basic transacted product.

2. Grid-delivered energy strongly fails to satisfy a unit homogeneity requirement essential for the conceptual coherency of Locational Marginal Pricing (LMP).
**Key Settlement-Rule Issue**

(3) Sequential provisional forward-market determination of LMP settlements in advance of final ex-post LMP settlements for actual real-time dispatched performance results in time-inconsistent settlements, hence in unnecessarily complex and confusing settlement rules.

**Key Supply-Offer Formulation Issues**

(4) Suppliers are forced to express their supply costs as functions of grid-delivered energy amounts (MWh).

(5) Suppliers are not required to distinguish carefully between their avoidable and non-avoidable costs.

(6) Suppliers are unable to specify their supply offers in a manner that ensures their revenue sufficiency, i.e., in a manner that ensures their market-attained earnings are sufficient to cover their market-incurred avoidable costs.

Section 5 highlights and discusses four indications that the conceptual design issues (1)–(6) are causing increasing problems for current U.S. RTO/ISO-managed wholesale power market operations. These four troublesome indications are:

- Proliferation of participation models functioning as artificial entry barriers;
- Proliferation of conceptually ill-defined flexibility products;
- Proliferation of out-of-market (OOM) make-whole payments;
- Growing supplier revenue insufficiency concerns.

To illustrate how an alternative conceptually-consistent market design could be implemented for a grid-supported centrally-managed wholesale power market – a design well-suited for the scalable support of increasingly decarbonized grid operations and increasingly diverse participants – Section 6 briefly reviews the key features of the Linked Swing-Contract Market Design developed and tested in studies [1, 19, 26, 27, 29, 37, 39, 40].

Finally, throughout this study, emphasis has been placed on grid-supported centrally-managed wholesale power markets as flexibility-support mechanisms: that is, as mechanisms enabling just-in-time production and transmission of bulk power to satisfy just-in-time customer power demands and grid reliability requirements. As seen, ensuring the efficiency and reliability of such mechanisms is a complex multi-faceted problem.

A physically-feasible alternative might be to transit to a fully storage-supported world. Flexible producer determination of power production levels and flexible customer determination of power usage levels could be supported entirely by local producer and customer storage devices, linked via a supply chain consisting of retail storage-device stores and/or a network of charge/discharge stations.

However, a key economic concern regarding this fully storage-supported world is the potential for substantial inefficiency (wasted resources). Suppose the average
state-of charge (SOC) that producers and customers maintain for their local storage devices over time is uniformly bounded above zero. Then, from a global vantage point, it would appear as if a positive, possibly-large, and possibly growing inventory of (potential) energy were being carried forward through time, forever unused, instead of contributing to the creation of net benefit.

Consequently, at least at present, striving to redesign current grid-supported centrally-managed wholesale power markets to enable them to operate as reliable efficient flexibility-support mechanisms over lower-carbon grids would seem to be the better option. Moreover, this redesign, itself, should be flexible and open to further adaptation. The ultimate goal, surely, must be robust wholesale power market design for transacting in a deeply-uncertain continually-evolving world.
Appendices: Quick-Reference Glossaries and Guides

A.1 Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>AC</td>
<td>Alternating Current</td>
</tr>
<tr>
<td>CAISO</td>
<td>California Independent System Operator</td>
</tr>
<tr>
<td>CFD</td>
<td>Contract-For-Difference</td>
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<tr>
<td>CCSM</td>
<td>Competitive Commodity Spot Market</td>
</tr>
<tr>
<td>CSM</td>
<td>Commodity Spot Market</td>
</tr>
<tr>
<td>D</td>
<td>Commonly used acronym for a day</td>
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<tr>
<td>DAM</td>
<td>Day-Ahead Market</td>
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<td>DC</td>
<td>Direct Current</td>
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<tr>
<td>DM</td>
<td>Decision-Maker</td>
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<tr>
<td>DPR</td>
<td>Dispatchable Power Resource</td>
</tr>
<tr>
<td>ERCOT</td>
<td>Electric Reliability Council of Texas</td>
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<tr>
<td>FERC</td>
<td>Federal Energy Regulatory Commission</td>
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<tr>
<td>FTR</td>
<td>Financial Transmission Right</td>
</tr>
<tr>
<td>h</td>
<td>SI metric symbol for an hour (60s)</td>
</tr>
<tr>
<td>H</td>
<td>Commonly used acronym for an hour</td>
</tr>
<tr>
<td>IPR</td>
<td>Intermittent Power Resource</td>
</tr>
<tr>
<td>ISO</td>
<td>Independent System Operator</td>
</tr>
<tr>
<td>ISO-NE</td>
<td>Independent System Operator for New England</td>
</tr>
<tr>
<td>kW</td>
<td>SI metric symbol for a kilowatt (1000 W)</td>
</tr>
<tr>
<td>kWh</td>
<td>SI metric symbol for a kilowatt-hour (1000 Wh)</td>
</tr>
<tr>
<td>kVA</td>
<td>SI metric symbol for kilovolt-Amperes (1000 Volt-Amperes)</td>
</tr>
<tr>
<td>LMP</td>
<td>Locational Marginal Price (or Locational Marginal Pricing)</td>
</tr>
<tr>
<td>LSE</td>
<td>Load-Serving Entity</td>
</tr>
<tr>
<td>MILP</td>
<td>Mixed Integer Linear Programming</td>
</tr>
<tr>
<td>MISO</td>
<td>Midcontinent Independent System Operator</td>
</tr>
<tr>
<td>MW</td>
<td>SI metric symbol for a megawatt (1000 kW)</td>
</tr>
<tr>
<td>MWh</td>
<td>SI metric symbol for a megawatt-hour (1000 kWh)</td>
</tr>
<tr>
<td>NOPR</td>
<td>Notice Of Proposed Rule-making (FERC)</td>
</tr>
<tr>
<td>NYISO</td>
<td>Independent System Operator for New York</td>
</tr>
<tr>
<td>OOM</td>
<td>Out-of-Market</td>
</tr>
<tr>
<td>OPF</td>
<td>Optimal Power Flow</td>
</tr>
<tr>
<td>PJM</td>
<td>PJM Interconnection</td>
</tr>
<tr>
<td>QSE</td>
<td>Qualified Scheduling Entity (ERCOT)</td>
</tr>
<tr>
<td>RTM</td>
<td>Real-Time Market</td>
</tr>
<tr>
<td>RTO</td>
<td>Regional Transmission Organization</td>
</tr>
<tr>
<td>SCED</td>
<td>Security-Constrained Economic Dispatch</td>
</tr>
<tr>
<td>SCUC</td>
<td>Security-Constrained Unit Commitment</td>
</tr>
<tr>
<td>SI</td>
<td>Standard International (metric system)</td>
</tr>
<tr>
<td>SPP</td>
<td>Southwest Power Pool</td>
</tr>
<tr>
<td>TNS</td>
<td>Total Net Surplus</td>
</tr>
<tr>
<td>W</td>
<td>SI metric symbol for a watt</td>
</tr>
<tr>
<td>Wh</td>
<td>SI metric symbol for a watt-hour</td>
</tr>
</tbody>
</table>
## A.2 Standard Transmission System Terms

<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ancillary service</td>
<td>Service that supports system reliability</td>
</tr>
<tr>
<td>Commitment</td>
<td>Scheduling of a dispatchable power resource for possible future central dispatch</td>
</tr>
<tr>
<td>Dispatch</td>
<td>Signaling a grid-connected power resource to inject/withdraw power</td>
</tr>
<tr>
<td>Energy</td>
<td>Abbreviation for electric energy (MWh)</td>
</tr>
<tr>
<td>Energy loads</td>
<td>Devices needing a certain amount of energy over an operating-period T, but indifferent with regard to exact timing of this energy provision during T.</td>
</tr>
<tr>
<td>Fixed power injection</td>
<td>Non-dispatched must-service power injection into a grid</td>
</tr>
<tr>
<td>Fixed load</td>
<td>Non-dispatched must-service power withdrawal from a grid</td>
</tr>
<tr>
<td>Generation</td>
<td>Production of power either for local behind-the-meter use or for grid injection</td>
</tr>
<tr>
<td>Grid-delivered energy</td>
<td>Energy (MWh) delivered at a location via accumulation of a power-path</td>
</tr>
<tr>
<td>Intermittent power</td>
<td>Power injections/withdrawals not fully under central-dispatchable control</td>
</tr>
<tr>
<td>Intermittent power resource</td>
<td>Grid-connected non-mediated source of intermittent power</td>
</tr>
<tr>
<td>Load</td>
<td>Commonly-used synonym for power withdrawal from a grid; technically, a grid device or grid component to which power is delivered</td>
</tr>
<tr>
<td>Locational marginal price</td>
<td>Energy price conditional on delivery location and operating period</td>
</tr>
<tr>
<td>Make-whole payment</td>
<td>OOM compensation for a market-incurred cost</td>
</tr>
<tr>
<td>Merit-order dispatch</td>
<td>Dispatch in accordance with net benefit contribution</td>
</tr>
<tr>
<td>Must-service</td>
<td>Power withdrawal (injection) that must be balanced by power injection (withdrawal) under normal grid operating conditions</td>
</tr>
<tr>
<td>Net load</td>
<td>Customer load &amp; inadvertent power loss minus net non-dispatched power injection</td>
</tr>
<tr>
<td>Net fixed load</td>
<td>Customer fixed load minus net fixed power injection</td>
</tr>
<tr>
<td>Net reserve cost</td>
<td>Reserve procurement cost minus reserve revenue receipts</td>
</tr>
<tr>
<td>Non-dispatchable power</td>
<td>Power not under RTO/ISO-dispatchable control</td>
</tr>
<tr>
<td>Operating reserve</td>
<td>Generation capacity (MW) unencumbered by energy delivery obligations</td>
</tr>
<tr>
<td>Performance</td>
<td>Delivery of a good or service in response to RTO/ISO-communicated instructions</td>
</tr>
<tr>
<td>Performance cost</td>
<td>Variable cost incurred for providing delivery of a good or service in response to RTO/ISO-communicated instructions</td>
</tr>
<tr>
<td>Power</td>
<td>Abbreviation for electric power (MW)</td>
</tr>
<tr>
<td>Power absorption</td>
<td>Incremental down/up changes in power withdrawal offered into a power system as an ancillary service</td>
</tr>
<tr>
<td>Power imbalance</td>
<td>Discrepancy between grid power injection &amp; grid power withdrawal/loss</td>
</tr>
<tr>
<td>Power injection</td>
<td>Insertion of power into a grid at an electrical point-of-connection</td>
</tr>
<tr>
<td>Power loads</td>
<td>Devices needing power at specific times to fulfill their functions or purposes</td>
</tr>
<tr>
<td>Power-path</td>
<td>Sequence of injections and/or withdrawals of power (MW) at a single grid location during a designated time-interval</td>
</tr>
<tr>
<td>Power-path delivery</td>
<td>Power-path implemented at a designated grid location during a designated time-interval in accordance with central-dispatch instructions</td>
</tr>
<tr>
<td>Power usage</td>
<td>Use of power as an intermediate good to further some end</td>
</tr>
<tr>
<td>Power withdrawal</td>
<td>Extraction of power from a grid at an electrical point-of-connection</td>
</tr>
<tr>
<td>Reserve</td>
<td>Service or product-provision capability that could be used to support grid reliability</td>
</tr>
<tr>
<td>Reserve bid</td>
<td>Contract requesting reserve availability</td>
</tr>
<tr>
<td>Reserve offer</td>
<td>Contract offering reserve availability</td>
</tr>
<tr>
<td>Transmission service cost</td>
<td>Variable cost incurred for grid operation and maintenance</td>
</tr>
<tr>
<td>Uplift payment</td>
<td>OOM compensation for required OOM action to maintain grid reliability</td>
</tr>
</tbody>
</table>
### A.3 Standard Economic Terms

<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>Anything of durable value, whether physical or financial</td>
</tr>
<tr>
<td>Avoidable cost</td>
<td>Cost that can be avoided by not committing to undertake a specified type of action</td>
</tr>
<tr>
<td>Avoidable fixed cost</td>
<td>Avoidable cost not dependent on exact form of action as long as it has specified type</td>
</tr>
<tr>
<td>Benefit (or utility) function</td>
<td>Function measuring the increase in own-welfare attained by a customer from the consumption and/or use of goods and/or services</td>
</tr>
<tr>
<td>Commodity</td>
<td>Asset $Q$ with a standard unit of measurement $u$ such that, at any given location and time, $Q$-traders consider all available $Q$-units $u$ to be perfect substitutes</td>
</tr>
<tr>
<td>Competitive market</td>
<td>Commodity market whose buyers and suppliers are price-takers</td>
</tr>
<tr>
<td>Competitive equilibrium</td>
<td>Competitive market price-quantity outcome s.t. aggregate demand=aggregate supply</td>
</tr>
<tr>
<td>Consumer</td>
<td>Purchaser of goods/services for direct own consumption/use (no resale)</td>
</tr>
<tr>
<td>Contract in firm form</td>
<td>Non-contingent contract whose terms are binding on all parties</td>
</tr>
<tr>
<td>Contract in option form</td>
<td>Holder has the right, but not the obligation, to exercise the contract</td>
</tr>
<tr>
<td>Customer</td>
<td>Purchaser of goods/services either for direct own consumption/use or for resale</td>
</tr>
<tr>
<td>Demand schedule) (inverse)</td>
<td>Schedule expressing the maximum $Q$-unit price a buyer is willing to pay for each additionally demanded unit of a commodity $Q$</td>
</tr>
<tr>
<td>Demand schedule) (ordinary)</td>
<td>Schedule expressing the maximum amount of a commodity $Q$ that a buyer is willing to purchase at each successively-higher $Q$-unit price</td>
</tr>
<tr>
<td>Efficiency</td>
<td>No wastage of resources</td>
</tr>
<tr>
<td>Fixed cost</td>
<td>Cost not dependent on a specific form of action undertaken</td>
</tr>
<tr>
<td>Forward market</td>
<td>Transacted amounts and payment obligations for these transacted amounts occur in advance of the delivery of these transacted amounts</td>
</tr>
<tr>
<td>Futures market</td>
<td>Forward market for a commodity</td>
</tr>
<tr>
<td>Good</td>
<td>Exchangeable physical item whose acquisition provides benefit to the procurer</td>
</tr>
<tr>
<td>Hedonic pricing</td>
<td>Pricing of a product by means of prices separately assigned to its intrinsic physical attributes and/or its external circumstances</td>
</tr>
<tr>
<td>Joint products</td>
<td>Products jointly produced from a given set of inputs</td>
</tr>
<tr>
<td>Law of One Price</td>
<td>In the absence of trade frictions (e.g., differences in trade locations, trade times, and/or trader product information), trader exploitation of arbitrage opportunities will ensure that every unit of a commodity available for purchase (sale) has the same purchase (sale) price,</td>
</tr>
<tr>
<td>Marked efficiency</td>
<td>No wastage of opportunity to increase total net surplus for buyer and supplier participants</td>
</tr>
<tr>
<td>Net benefit</td>
<td>Benefit minus avoidable cost</td>
</tr>
<tr>
<td>Term</td>
<td>Description</td>
</tr>
<tr>
<td>-------------------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Net buyer surplus</td>
<td>Difference between the maximum payment a buyer is willing to make to purchase an item ( z ) and the actual payment the buyer makes to purchase ( z )</td>
</tr>
<tr>
<td>Net supplier surplus</td>
<td>Difference between the actual payment a supplier receives for the sale of an item ( z ) and the minimum payment the supplier is willing to receive for the sale of ( z )</td>
</tr>
<tr>
<td>Opportunity cost</td>
<td>Earnings foregone by not committing assets to an alternative next-best use</td>
</tr>
<tr>
<td>Pareto efficiency</td>
<td>No wastage of opportunity to increase benefit for some at no cost to others by means of a feasible reallocation of resources</td>
</tr>
<tr>
<td>Perfect substitutes</td>
<td>Two items are perfect substitutes (or economically equivalent) for a trader at a given location and time if substitution of either item for the other item does not affect the trader’s economic valuation of this item.</td>
</tr>
<tr>
<td>Price-taker</td>
<td>Trader participating in a market for a good or service who behaves as if his own market transactions cannot affect the market price of this good or service.</td>
</tr>
<tr>
<td>Product</td>
<td>Outcome of a production process</td>
</tr>
<tr>
<td>Production process</td>
<td>Process that transforms inputs into one or more outputs</td>
</tr>
<tr>
<td>Productive efficiency</td>
<td>No physical wastage of production inputs and/or production outputs</td>
</tr>
<tr>
<td>Purchase reservation value</td>
<td>Maximum payment a buyer is willing to make to procure a designated item</td>
</tr>
<tr>
<td>Revenue sufficiency</td>
<td>Supplier revenue is sufficient to cover supplier avoidable cost</td>
</tr>
<tr>
<td>Risk</td>
<td>Possibility of an adverse deviation from an expected outcome</td>
</tr>
<tr>
<td>Risk aversion</td>
<td>Unwillingness to participate in a risky undertaking with zero expected payoff</td>
</tr>
<tr>
<td>Sale reservation value</td>
<td>Minimum payment a supplier is willing to accept to supply a designated item</td>
</tr>
<tr>
<td>Service</td>
<td>Action taken by an entity that provides benefit to another entity</td>
</tr>
<tr>
<td>Spot market</td>
<td>Transacted amounts, payments for these transacted amounts, and deliveries of these transacted amounts all occur at the same location and time (“on the spot”).</td>
</tr>
<tr>
<td>Strategic market advantage</td>
<td>Unintended opportunity for a participant to exploit market rules to gain advantage.</td>
</tr>
<tr>
<td>Structural market advantage</td>
<td>Instituted market feature that systematically favors some participants over others</td>
</tr>
<tr>
<td>Sunk cost</td>
<td>Unavoidable fixed cost</td>
</tr>
<tr>
<td>Supply schedule (inverse)</td>
<td>Schedule expressing the minimum ( Q )-unit price a supplier is willing to accept in payment for each additionally supplied unit of a commodity ( Q )</td>
</tr>
<tr>
<td>Supply schedule (ordinary)</td>
<td>Schedule expressing the maximum amount of a commodity ( Q ) that a supplier is willing to sell at each successively-higher ( Q )-unit price</td>
</tr>
<tr>
<td>Systemic risk</td>
<td>System-wide risk, i.e., correlated risk arising for system operations as a whole</td>
</tr>
<tr>
<td>Transaction cost</td>
<td>Avoidable fixed cost incurred to organize a production process</td>
</tr>
<tr>
<td>Two-part pricing</td>
<td>Separately-requested compensation for avoidable fixed cost and variable cost</td>
</tr>
<tr>
<td>( u )-asset</td>
<td>An asset with a standard unit of measurement ( u )</td>
</tr>
<tr>
<td>Variable cost</td>
<td>Avoidable cost dependent on a specific undertaken action (e.g., production level)</td>
</tr>
<tr>
<td>Volumetric grid risk</td>
<td>Systemic risk arising for a grid due to possible net load imbalance</td>
</tr>
</tbody>
</table>
A.4 Cost Types for Grid-Supported RTO/ISO-Managed Wholesale Power Markets: Empirical Examples

Types of Avoidable Fixed Cost:

1. **Capital Investment Cost.** Land acquisition, building construction; equipment purchases. Financed by *internal financing* (i.e., funds on hand), or by *external financing* taking two possible forms:
   - **Direct Financing:** Sell *newly issued* securities in primary security markets to lenders willing to invest in risky assets (i.e., assets with chance of loss) that also offer a sufficiently high chance of gain;
   - **Indirect Financing:** Obtain loans from financial intermediaries, typically secured by some form of collateral, that then result in amortized streams of payment obligations.

2. **Transaction Cost.** Insurance, building code compliance, licensing fees, employee search. Transaction costs are typically financed by internal financing.

3. **Opportunity Cost.** Expected net earnings from a best possible alternative use of assets, e.g., use of generation units directly (behind the meter) for local purposes.

4. **Unit Commitment Cost.** Start-up, no-load, minimum-run, and/or shut-down cost that are incurred for ensuring the availability of power-paths for possible RTO/ISO dispatched delivery during a future operating period but are not dependent on the specific form (if any) of this delivered power-path.

Types of Variable Cost:

1. **Fuel Cost.** Charges for pulverized coal, natural gas, nuclear, petroleum, and/or refuse-derived fuels as inputs to power production.

2. **Labor Cost.** Salaries/wages for: legal/tax advice; advertisement; planning; supervision; trading-desk operations; maintenance; and repair.

3. **Intermediate Good (Supply-Chain) Cost.** Rail/barge/pipeline/truck transport charges for fuel deliveries; replenishment of used-up supplies.

4. **Equipment/Software Rental Cost.** Rental charges for office equipment, cars, and software licenses.

5. **Depreciation of Owned Machinery.** Generation unit wear-and-tear due to start-up, normal, and/or shut-down ramping required to follow RTO/ISO-signaled dispatch set-points during successive operating periods.

6. **Assessed Charges for Transmission Services.** Transmission grid operation and maintenance (O&M) costs allocated across market participants.

7. **Variable-Cost Offsets from Sales of Valuable Bi-Products.** Revenue offset to variable cost of a product due to joint production, e.g., co-generation of valuable heating services along with power by Combined Heat and Power (CHP) units.

8. **Disposal Cost for Waste Bi-Products.** Cost incurred by power plants (e.g., nuclear) to dispose of solid-waste output resulting from plant operations.
### A.5 Swing-Contract Market Terms

#### Term Description

<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Acronyms &amp; Generics:</strong></td>
<td></td>
</tr>
<tr>
<td>D</td>
<td>Generic symbol for a day</td>
</tr>
<tr>
<td>DPR</td>
<td>Dispatchable Power Resource</td>
</tr>
<tr>
<td>H</td>
<td>Generic symbol for an hour</td>
</tr>
<tr>
<td>IPR</td>
<td>Intermittent Power Resource</td>
</tr>
<tr>
<td>L</td>
<td>Look-ahead horizon between close of M(T) and start of T</td>
</tr>
<tr>
<td>LSE</td>
<td>Load-Serving Entity</td>
</tr>
<tr>
<td>M(T)</td>
<td>Swing-contract market for a future operating period T</td>
</tr>
<tr>
<td>m</td>
<td>Generic symbol for a DPR</td>
</tr>
<tr>
<td>n</td>
<td>Generic symbol for an IPR</td>
</tr>
<tr>
<td>p</td>
<td>Generic symbol for a power level (MW)</td>
</tr>
<tr>
<td>p</td>
<td>Generic symbol for a power-path</td>
</tr>
<tr>
<td>pb(T)</td>
<td>Generic symbol for a power-path ( (p_{b}(t) \mid t \in T) )</td>
</tr>
<tr>
<td>r</td>
<td>Generic symbol for a ramp-rate (MW/min)</td>
</tr>
<tr>
<td>SC</td>
<td>Swing contract taking the general form ( SC = (\alpha, T_{ex}, PP, \phi) )</td>
</tr>
<tr>
<td>( SC_{m}(T) )</td>
<td>SC submitted by a DPR ( m ) to a swing-contract market ( M(T) ) for T</td>
</tr>
<tr>
<td>( t_{ex} )</td>
<td>Exercise time in an exercise set ( T_{ex} )</td>
</tr>
<tr>
<td>( t_{ex}^{m}(T) )</td>
<td>Exercise time in an exercise set ( T_{ex}^{m}(T) )</td>
</tr>
<tr>
<td>T</td>
<td>Operating period with start-time ( t^{s} ) and end-time ( t^{e} )</td>
</tr>
<tr>
<td>( \alpha_{m}(T) )</td>
<td>Offer price ($) for a swing-contract ( SC_{m}(T) )</td>
</tr>
<tr>
<td>( \Delta T )</td>
<td>Duration of operating period ( T ), measured in real hourly units (e.g., 0.6h)</td>
</tr>
<tr>
<td>( \phi )</td>
<td>Performance payment method for a swing contract SC that maps ( PP ) into payments</td>
</tr>
<tr>
<td>( \phi_{m}(T) )</td>
<td>Performance payment method for a swing contract ( SC_{m}(T) ) that maps each power-path ( p_{m}(T) \in PP_{m}(T) ) into a dollar payment ($)</td>
</tr>
</tbody>
</table>

| Sets & Subsets: | |
| B | Index set for the buses \( b \) of a transmission grid |
| Cj(b) | Collection of customers serviced by load-serving entity \( j \in LS(b) \) |
| L | Index set for the distinct bus-to-bus line segments \( \ell \) of a transmission grid |
| \( L_{j}(b) \subseteq L \) | Subset of transmission-grid line segments originating at bus \( b \) |
| \( L_{j}^{e}(b) \subseteq L \) | Subset of transmission-grid line segments ending at bus \( b \) |
| LS | Index set for the load-serving entities \( j \) participating in a swing-contract market |
| \( LS(b) \subseteq LS \) | Subset of load-serving entities in \( LS \) that service power customers at bus \( b \) |
| M | Index set for DPRs \( m \) participating in a swing-contract market |
| \( M(b) \subseteq M \) | Subset of DPRs \( m \) in \( M \) that are electrically connected at bus \( b \) |
| NG | Index set for non-dispatchable generation units \( n \) participating in a swing-contract market |
| \( NG(b) \subseteq NG \) | Subset of \( n \) in \( NG \) that are electrically connected at bus \( b \) |
| PP | Set of dispatchable power-paths \( p \) offered by a swing contract SC |
| \( PP_{m}(T) \) | Set of dispatchable power-paths \( p_{m}(T) \) offered by a swing contract \( SC_{m}(T) \) |
| \( P_{m} \) | Set of feasible sustainable power levels \( p \) (MW) for \( m \) |
| \( RR_{m} \) | Set of feasible ramp-rates \( r \) (MW/min) for \( m \) |
| \( T_{ex} \) | Set of possible exercise times \( t_{ex}^{m}(T) \) for a swing-contract SC |
| \( T_{ex}^{m}(T) \) | Set of possible exercise times \( t_{ex}^{m}(T) \) for a swing contract \( SC_{m}(T) \) |
References


