Review of RMR and CPM
Straw Proposal and July 11, 2018 working group
Comments by Department of Market Monitoring
August 17, 2018

Overview and background

DMM appreciates the opportunity to comment on the ISO's *Review of Reliability Must Run and Capacity Procurement Mechanism Straw Proposal* and July 11, 2018 policy development meeting.

All ISOs need mandatory backstop procurement authority. Backstop procurement serves two functions: reliability and market power mitigation. An ISO must be able to procure and compensate capacity needed to ensure local and system reliability. Furthermore, since capacity needed to ensure reliability has market power, such compensation must be subject to mitigation to ensure just and reasonable rates.

In the CAISO, backstop capacity procurement is one piece of the larger capacity procurement framework, which also includes resource adequacy (RA). A coordinated effort between the CAISO, CPUC and stakeholders to reform RA is already underway in CPUC proceeding R.17-09-020. DMM appreciates the need for comprehensive RA/CPM/RMR reform. However, comprehensive reform will take some time -- perhaps at least 1 to 2 years. The ISO's RMR/CPM Review initiative is an intermediate step to broader reforms of the resource adequacy framework. Therefore, DMM believes the CAISO should move forward expeditiously to develop needed reforms in its annual backstop procurement on a more accelerated timeline than will be required for broader changes in California's resource adequacy process

DMM recommends that the CAISO act expeditiously in this initiative to consolidate annual backstop procurement into a single mechanism. Combining RMR and CPM into one annual backstop mechanism could improve the incentives for generation owners to participate in the RA process and be an important initial step in improving the cost effectiveness and efficiency of the CAISO and CPUC's capacity procurement and compensation processes. Ideally, the CAISO should be prepared to file and implement reforms that address the fundamental flaws with the CPM/RMR mechanisms if needed in time for backstop procurement designated for 2019.

Reforming compensation of annual backstop procurement

Annual CPM and RMR currently have different compensation structures and terms. Differences between CPM and RMR compensation and the voluntary nature of CPM have enabled owners of resources with market power to choose the annual backstop procurement mechanism that is most favorable to them. Recently some resource owners have favored RMR over CPM. Enabling suppliers to hold out for higher compensation undermines the CPM process, and by extension, the RA market.

Compensation for backstop procurement of resources with market power should limit the potential for a resource to receive more profit than it would earn from competing in competitive markets. Paying a resource more than it would receive in a competitive market undermines RA processes and rewards (instead of mitigates) market power.

Going Forward Fixed Cost (GFFC) plus a reasonable net profit would provide fair compensation to resources contracted for backstop capacity. If a unit needed for reliability would truly retire or mothball if not contracted by the CAISO, then compensating the unit based on its GFFC plus any additional net profit would be more profitable for the unit than if it was actually retired or mothballed. GFFC-based compensation also avoids market distortions that may incent resources to seek a backstop capacity contract rather than participating in the RA process.

Two approaches for GFFC-based compensation warrant consideration:

- Compensate resources GFFC plus a reasonable fixed profit and credit net market revenues back to ratepayers; or
- Compensate a resource at its GFFC and allow it to keep net market revenues.

Current RMR compensation is fundamentally flawed and should be replaced with GFFC-based compensation under a single annual backstop procurement framework. RMR Condition 2 compensation is based on a resource's Annual Fixed Revenue Requirement (AFRR). Paying AFRR constitutes compensating a resource with market power for sunk costs and therefore sends an inefficient investment signal for longer term substitutes.

Specifically, paying a required resource based on AFRR creates the incentive to build new supply or transmission capacity whose annualized costs would be greater than the existing resource's GFFC but less than the existing resource's AFRR. Investing in the new capacity would be inefficient relative to only incurring the GFFC of the existing resource. DMM provided an example of how providing compensation based on AFFR would encourage uneconomic and inefficient investments in alternatives using approximate values for AFRR and GFFC for the Metcalf Energy Center, which received an RMR designation for 2018.[1]

[1] *Motion to Intervene and Protest of the Department of Market Monitoring of the California Independent System Operator*, ER-641-000, February 2, 2018, pp. 10-11. http://www.caiso.com/Documents/Feb2_2018_DMMIntervention_Protest-RORCPM_ER18-641.pdf

Compensating RMR Condition 2 based on AFRR is also unjust for consumers, who pay the full AFRR but incur limited opportunity for market revenue crediting due to restrictions on dispatch.

RMR Condition 1 compensation is also flawed. There is no methodology or even principles upon which RMR condition 1 compensation is determined. Compensation must be negotiated or litigated on a case-by-case basis.

Reforming annual CPM provisions

Annual CPM provisions also have shortcomings. But several changes could be made to improve CPM and reduce or eliminate opportunities for resource owners to choose between CPM and RMR compensation. DMM recommends that the CAISO consider the following set of potential enhancements to annual CPM that could facilitate the elimination of RMR as a secondary annual backstop mechanism:

- Make CPM acceptance mandatory
- Make targeted changes to the CPM compensation structure
- Grant limited exceptions to the all hours must offer obligation

Making CPM acceptance mandatory largely eliminates the need for RMR. The ISO proposes to change the CPM pricing formula used for resources that file at FERC for a CPM price above the CPM soft-offer cap price. CPM pricing in these instances would change from AFRR to GFFC plus a 20% adder. This change in compensation would be an improvement. However, under this proposed framework, units would keep all net market revenues in addition to fixed cost payments received from the CAISO.

As noted above, DMM believes compensation under a single annual backstop procurement mechanism should be based on GFFC plus a reasonable net profit. The current proposal to guarantee resources a profit of 20% of GFFC while also allowing these resources to keep net market revenues may be excessive. Furthermore, when the current CPM soft-offer cap is paid to a resource for all 12 months of an annual CPM, this compensation is likely to significantly exceed the annual GFFC of many resources. Therefore, as part of this initiative, the ISO should reconsider the soft-offer cap price for annual CPMs.

Additional changes could be made to CPM contracts that compensate resources for multi-year maintenance or environmental retrofits, if those items are deemed necessary over the period the unit is needed for reliability.

There is a tradeoff between paying for capital expenditures and keeping a resource running only as long as it is needed for reliability. A resource receiving a CPM designation may only be needed for reliability during a small fraction of the CPM designation time period. However, if the resource was to regularly offer in the market and get dispatched it could require large capital expenditures to operate reliably.

Examples of these types of resources are older resources like those for which RMR condition 2 was originally intended, or non-economic units with minimal remaining life. A limited exception to the CPM must offer obligation can reduce procurement cost, while still addressing a specific reliability need. In many cases, easing the must offer obligation will be more cost effective than having the unit undergo major maintenance when it is only projected to be needed for 1-2 years.

Broader RA reform

Aside from the changes to CPM described above, modifications to the timing of annual CPMs will need to be considered. A new timeline will need to be worked out for studying and awarding CPM contracts. DMM believes it would be better to address those issues in conjunction with reforms to the broader RA process. Immediately making the changes outlined above could improve the annual backstop procurement mechanism and increase participation in the RA process while the ISO works with the CPUC on broader RA reforms.