

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

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|---|---|-------------------------------|
| Dynegy Moss Landing, LLC |) | |
| Dynegy Morro Bay, LLC |) | |
| El Segundo Power LLC |) | |
| Reliant Energy Inc. |) | |
| |) | Docket No. EL08-13-000 |
| v. |) | |
| |) | |
| California Independent System Operator Corporation |) | |

**ANSWER OF THE
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION
TO THE COMPLAINT OF DYNEGY MOSS LANDING, LLC,
DYNEGY MORRO BAY, LLC, EL SEGUNDO POWER, INC.,
AND RELIANT ENERGY, INC.**

Pursuant to Rule 206 of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.206, the California Independent System Operator Corporation (“CAISO”) respectfully submits this Answer to the Complaint of Dynegy Moss Landing, LLC, Dynegy Morro Bay, LLC, El Segundo Power, Inc., and Reliant Energy, Inc. (“Energy Companies”). The CAISO is aware that the Commission today issued orders in Docket No. EL05-146 that may moot the Energy Companies’ Complaint. Because the CAISO does not have sufficient time to review the orders and edit this Answer accordingly, the CAISO is filing this Answer without consideration of Commission’s decision to conduct an investigation pursuant to Section 206 of the Federal Power Act concerning the justness and reasonableness of extending the CAISO’s RCST until the earlier of the implementation of MRTU or an alternative backstop capacity procurement mechanism.

I. SUMMARY OF ARGUMENT

In the Complaint, Energy Companies point out that the CAISO's Reliability Services Tariff ("RCST") terminates as of January 1, 2008. After that date, Generators for which the CAISO issues must-offer waiver denials ("MOWDs") will continue to be paid for Energy, Minimum Load Costs, emissions, and start-up costs, but will no longer receive a daily capacity payment. Energy Companies seek a new Reliability Capacity Compensation Mechanism ("RCCM"), effective January 1, 2008. Many elements of the RCCM are essentially identical to the existing RCST, but notably the target capacity price is significantly higher, the daily capacity payment is eliminated, and the CAISO is required to make a three-month RCCM designation to every unit for which it issues a single MOWD on a given day.

Energy Companies fail to show how the must-offer MOWD commitment scheme is unjust and unreasonable. They also fail to show how their specific proposal is just and reasonable. Accordingly, Energy Companies have failed to carry their burden under Section 206 of the Federal Power Act.

The CAISO intends to file a new Interim Capacity Procurement Mechanism ("ICPM") by January 30, 2008. The ICPM will go into effect with the implementation of the CAISO's Market Redesign and Technology Upgrade ("MRTU"), currently scheduled for March 31, 2008. To the extent the Commission finds it appropriate to act now to provide a capacity compensation for Generators that receive MOWDs, the Commission should simply extend the existing daily capacity payment that was approved as part of the RCST Settlement.

The Energy Companies' proposed automatic three-month designation amounts to a mandatory capacity procurement program and would impose an inappropriate burden

on ratepayers, requiring the CAISO to buy and pay for three months of capacity even if it does not need the capacity for that duration and the event that gave rise to the MOWD has ended.¹ RCST was designed to avoid such situations by limiting multi-month designations to situations where the CAISO determined that there was a Significant Event and that an RCST designation was “necessary” for the reasons specified in the tariff. Also, the CAISO was required to take into consideration the duration of the Significant Event in determining whether to make a designation, which would have a minimum term of three months. RCCM provides no such limits. There is no reason to impose on the CAISO and ratepayers capacity the CAISO does not require.

If the Commission decides it is appropriate to adopt a new must-offer compensation program upon expiration of the RCST and pending the implementation of MRTU and the ICPM, the Commission should simply extend the existing daily must-offer capacity payment, which is based on a target capacity price of \$73/kW-year. This RCST daily capacity payment has previously been found to be just and reasonable, and would remain adequate compensation during this few month period. Energy Companies’ arguments to the contrary are unpersuasive.

For example, Energy Companies suggest that it would be unjust and unreasonable for the Commission to retain just the daily must-offer capacity payment because the RCST was the product of a settlement that produced a negotiated package of tariff provisions and that it would be inconsistent for the Commission to allow only one provision to survive into 2008. However, Energy Companies ignore the fact that the Commission did not approve the RCST settlement as a package. The Commission

¹ Indeed, because the RCCM does not provide for the designation of partial units, the capacity could be more than was needed for the event even when the event was ongoing.

specifically stated that it could not consider the settlement as a whole and was addressing each of the settlement provisions on the merits. The Commission expressly found the daily must-offer capacity payment to be just and reasonable compensation for a MOWD. Energy Companies also ignore the fact that they are cherry-picking the RCST Settlement by retaining the provisions they like and modifying other provisions of the Settlement to their benefit (*e.g.*, making three-month designations automatic, nearly doubling the target capacity price).

Additionally, Energy Companies' argument that they would receive insufficient cost recovery is without merit. Indeed, they provide no evidence to show that the existing daily capacity payment and target capacity price fail to provide sufficient cost recovery for the daily service they are providing. The only cost recovery that is required is cost recovery proportional to the service being provided. Under the daily must-offer capacity payment, for each day of a MOWD – one 30th of a month – generators receive one 17th of the monthly target capacity payment, *i.e.*, almost twice the proportional payment. Less than a year ago, the Commission found the target capacity price of \$73/kW-year to be just and reasonable. There is no reason that an extension of that daily capacity payment for a few months suddenly would become unjust and unreasonable.

Finally, the Commission should not use the cost of new entry in any interim capacity compensation program, and the Energy Companies' proposal in this regard should be rejected. Under the Commission's order in the RCST proceeding, the cost of new entry only establishes the upper limit of the zone of reasonableness. The Commission found the RCST target capacity payment of \$73/kW-year to be just and reasonable because it was within the range between the fixed costs of existing generation

that is needed for reliability and the cost of new capacity. The target capacity price used for the daily capacity payment in the Settlement Order therefore remains within that zone of reasonableness. Absent a showing of changed circumstances, Energy Companies' contention that the price is unjust or unreasonable essentially constitutes a collateral attack on the Commission's prior determination.

Moreover, there are no good policy reasons for using the cost of new entry at this time. No other reliability generation in the CAISO service model is paid the cost of new entry. While the CAISO agrees that it may be appropriate to adjust capacity payments in the future in conjunction with implementation of a long-term resource adequacy ("RA") framework designed to elicit investment in generation (or other means to achieve RA) – an issue that is currently being addressed in a proceeding at the California Public Utilities Commission – this does not constitute such a situation. There is only a three month gap between the termination of RCST and the implementation of ICPM. A backstop mechanism that will be in place only for a few months is not intended to, and cannot be expected to, incent new generation. Rather, it will only produce excessive revenues for existing resources.

Furthermore, regardless of the timeframes being considered (i.e., whether the objective is to incent investment), a uniform application of cost of new entry pricing without additional market power mitigation rules could create competitiveness issues. That is because RA requirements are currently set on both a local area and system basis. Many of the local areas are small relative to total CAISO capacity MW (as shown in the Table below) and have a concentration of ownership. Were the backstop mechanism to be designed to send investment price signals, the cost of new entry could be considered as

a possible backstop price only when there is a capacity deficiency in a local area or system zone. The CAISO has defined ten local capacity areas on the grid and only three of these local areas are deficient relative to the RA requirement. One local area is just above the RA requirement. Because most of the capacity in those tight areas is either owned by investor owned utilities or is under multi-year RA contract, there is likely to be no near-term benefits to Energy Companies by applying cost of new entry pricing in such areas. In the remaining load pockets where there is surplus capacity but potentially some concentration of ownership, additional investment does not seem to be needed in the near term. Thus, the cost of new entry backstop pricing is neither needed nor appropriate. Its primary effect could be simply to raise forward RA prices from current levels if there is insufficient competition and in the absence of additional market power mitigation rules. Uniform application of cost of new entry pricing, as Energy Companies propose, is thus inappropriate based on these circumstances and should not be considered at this time.

Also, the CAISO does not believe that cost of new entry is the appropriate price benchmark for MOWD commitments in response to daily or real-time needs. Under the must-offer obligation, the CAISO will issue MOWDs in the day-ahead and intra-day timeframes to non-RA units in response to contingencies not covered in the RA requirements. It is not appropriate to base payments for unplanned, unanticipated, short-term procurement on the cost of new entry because the purpose of this type of procurement is to employ existing units that are available to address short-term contingencies or reliability needs, not to incent new generation. There is no legitimate basis to pay a price based on cost of new entry to existing units under these types of circumstances.

Thus, Energy Companies have provided no reason why the use of a target capacity price less than the cost of new entry is unjust, unreasonable, or even inadvisable. Any interim payment program approved by the Commission should use the target capacity price from the RCST settlement.

II. BACKGROUND

On June 19, 2001, in response to the California electricity crisis, the Commission adopted a series of mitigation measures, including the must-offer obligation.² Under the must-offer obligation, all Generators in California (with certain limited exceptions) must bid their uncommitted capacity into the CAISO's real-time energy market unless they obtain a waiver from the CAISO. If the CAISO issues an MOWD, the CAISO compensates Generators for their Minimum Load Costs, Startup Costs, and Emissions costs.

On August 26, 2005, the Independent Energy Producers filed a complaint in Docket No. EL05-146 to replace the existing must-offer obligation with a tariff-based procurement mechanism entitled the "Reliability Capacity Services Tariff." Following extensive settlement discussions, on March 31, 2006, the Independent Energy Producers Association, the CAISO, the California Public Utilities Commission, Pacific Gas and Electric Company, San Diego Gas & Electric Company, and Southern California Edison Company submitted an Offer of Settlement in order to resolve all issues in that proceeding. Of significance for the issues raised by the Complaint, the Settlement included a new RCST and an additional daily capacity payment for units that are denied must-offer waivers by the CAISO and which are not Reliability Must Run units,

² *San Diego Gas & Elec. v. Sellers*, 95 FERC ¶ 61,418 (2001).

Resource Adequacy Units, or designated under the RCST. All provisions of the CAISO Tariff added by the Offer of Settlement terminate on December 31, 2007.

In a June 2006 Order, the Commission found that “under the current market design, the must-offer obligation does not adequately compensate generators for the reliability services they provide.”³ It concluded that compensation under the must-offer obligation was not just and reasonable.⁴ Because it could not resolve all of the issues raised by the proposed RCST Settlement, the Commission directed a paper hearing.⁵

After a paper hearing, in an Order issued on February 13, 2007, the Commission approved the Settlement with minor modifications.⁶ Consistent with the Offer of Settlement, the CAISO Tariff provides that the RCST and the daily capacity payment expire on December 31, 2007.⁷

Simultaneously with the proceeding concerning RCST, the CAISO has been finalizing its MRTU tariff provisions. MRTU is currently scheduled for implementation on March 31, 2008. As the Commission has observed, the must-offer obligation will terminate with the implementation of MRTU.⁸ The CAISO is therefore in the process of developing an interim capacity procurement mechanism (“ICPM”), which will be needed under MRTU until the CAISO develops a more permanent capacity procurement mechanism in conjunction with implementation of a long-term resource adequacy framework, which is currently being addressed in a proceeding at the California Public Utilities Commission. The CAISO intends to file the ICPM proposal by January 30,

³ *Indep. Energy Producers Assoc. v. Cal. Indep. Sys. Operator Corp.*, 116 FERC ¶ 61,069 at P 35 (2006).

⁴ *Id.* at P 38.

⁵ *Id.*

⁶ *Indep. Energy Producers Assoc. v. Cal. Indep. Sys. Operator Corp.*, 118 FERC ¶ 61,096 (2007) (“Settlement Order”).

⁷ *Id.*

⁸ *Cal. Indep. Sys. Operator Corp.*, 121 FERC ¶ 61,193 at PP 2, 101(2007).

2008, following the CAISO's January Board meeting, to be effective simultaneous with the implementation of MRTU.

On November 30, 2007, the Energy Companies filed the Complaint. Energy Companies point out that, as of January 1, 2008, Generators for which the CAISO issues MOWDs will no longer receive daily capacity payments. Because the Commission has previously found the absence of a capacity payment to be unjust and unreasonable, Energy Companies ask the Commission to institute a new RCCM, effective January 1, 2008. According to Energy Companies, RCCM has the following principal elements, some of which differ from the RCST:

- There is a single RCCM capacity payment (*i.e.*, the daily capacity payment would be eliminated).
- Generators that are providing a reliability service either by being subject to the must-offer obligation (having been denied a waiver) or by being committed by the CAISO to meet specific reliability needs for either system or local reliability purposes would receive the RCCM capacity payment for all of the Eligible Capacity of the Generating Unit for a term of at least three months.
- The RCCM target capacity price is established based on the annualized, total fixed costs of a reference peaker unit that is intended to reflect the cost of new entry, and such target capacity price is subject to a deduction for *ex post* peak energy and ancillary service (non-spinning reserves) rents that would have been realized by the reference unit, adjusted by an availability factor.
- Relying on a 2007 draft CEC study, the RCCM sets the target annual capacity price at \$145.54/kW-year. This updated target capacity price uses the CEC's estimate of the annualized total costs of a simple cycle LM6000 combustion turbine (rather than a frame combustion turbine) as the reference unit, with a heat rate of 9,700 Btu/kWh.
- The RCCM retains RCST cost allocation rules and principles.
- The RCCM would be effective (as final or interim rates) on January 1, 2008, and would terminate (as to services rendered thereafter) on the effective date of any Commission-approved successor to the RCCM,

whether before or after implementation of the Market Redesign and Technology Upgrade (“MRTU”).

The RCCM is similar to a backstop procurement program proposed by the Independent Energy Producers Association in a November 9, 2007 response to the CAISO’s Answer to IEP’s Motion for Reconsideration of the Commission’s grant of an extension of time in the MRTU and RCST dockets, discussed above. The CAISO expects that the Commission has ruled on the propriety of IEP’s response in addressing Docket Nos. ER06-615 and EL05-146 at its December 20, 2007, meeting, but no Commission order is available to the CAISO at the time of this filing.

II. ARGUMENT

Energy Companies propose two fundamental changes to the RCST and the must-offer obligation. First, the daily capacity payment and the Significant Event designations are replaced with an automatic three-month designation every time the CAISO denies a must offer waiver request. Second, the compensation during the three-month designation is to be based on a \$145.54/kW-yr estimated cost of new entry. However, although Energy Companies assert that the daily capacity payment and the \$73/kW year target capacity payment – both of which have previously been approved by the Commission – are unjust or unreasonable, they fail to meet their Section 206 burden of showing that their proposal is just and reasonable. Accordingly, the Commission should reject Energy Companies’ complaint.

A. The Commission Should Not Approve a New, Interim, Compensation Method.

Under Section 206 of the FPA, the Commission, having found the must-offer compensation unjust and unreasonable, may direct a new just and reasonable rate. In this case, the CAISO will be filing before the end of January 2008 a proposal, the ICPM, to

provide just and reasonable compensation to Generators providing backstop capacity. The CAISO will seek authorization to implement ICPM simultaneously with MRTU implementation which is targeted for March 31, 2008.⁹ Any interim program would thus be only for three months. The Commission should not require the CAISO to implement an interim program during that period.¹⁰

As is illustrated by the history of the RCST proceedings and the ongoing stakeholder process to develop an ICPM, stakeholders have a diversity of interests and a wide spectrum of positions with respect to the development of a capacity procurement mechanism. Any interim program is likely to be similarly controversial. Many policy and factual issues would need to be resolved. For example, Energy Companies propose a rate based on the cost of new entry, but the CAISO's experience in the RCST and ICPM proceedings indicates that other parties are likely to oppose the use of the cost of new entry to price backstop capacity, especially during a three-month period.

Under these circumstances, a stakeholder or settlement process likely would not lead to consensus on the issues. Further, there is insufficient time for such a process. The CAISO is already engaged in the stakeholder process for ICPM and stakeholders are polarized on many key issues, which is making the CAISO's task difficult and time-consuming. The CAISO is working diligently to develop a proposal to take to its Board in late January and file with the Commission by January 30, 2008. Because of the importance of reliability and the need to have a backstop mechanism that will work

⁹ As the CAISO indicated in its October 29, 2007 Answer to the Motion of the Independent Energy Producers Association ("Answer to IEP") in Docket Nos. ER06-615 and EL05-146, ICPM is not designed to function under the pre-MRTU market design which includes different features, including a must-offer obligation, that are not present under MRTU.

¹⁰ As the CAISO noted in its Answer to IEP, the CAISO will know after the January meeting of its Board of Governors whether the implementation date for MRTU must be extended. If so, the CAISO will notify the Commission promptly. The CAISO has committed itself to the development of a backstop capacity payment program, prior to the summer months, if MRTU is delayed past the summer of 2008.

effectively under MRTU, the CAISO needs to dedicate sufficient time and resources to developing a well thought-out and well supported ICPM proposal. It would not be appropriate to strip CAISO and stakeholder resources from this effort in order to craft a temporary mechanism that would only be in place for a few months.

As discussed below, the Commission can avoid this diversion of resources by relying on its previous finding that the daily must-offer capacity payment based on a target capacity price of \$73/kW-year is just and reasonable compensation for MOWDs and simply extending that payment until the implementation of MRTU. As described in the CAISO's Answer to IEP, extension of the entire RCST would be inadvisable because, *inter alia*, designations under that program might continue past the implementation of MRTU and would conflict with operations under MRTU. In addition, several tariff provisions would have to be revised because they pertain to activities in 2007 and would be inapplicable in 2008.

B. Energy Companies Have Not Justified an Automatic Three-Month Commitment for a Single MOWD

The Energy Companies' proposed automatic three-month designation is, in effect, a replacement for the current must-offer obligation with a mandatory longer-term capacity procurement program. It would impose an inappropriate burden on ratepayers and would essentially require the CAISO to contract for three months of capacity when it issues a MOWD for one day even if there is no future need for the capacity beyond that one day. The automatic three-month designation of capacity is wholly unrelated to the nature of the event that led to the MOWD in the first place or the expected duration of such event. In short, Energy Companies' proposal essentially amounts to forced contracting for units that do not have Resource Adequacy or RMR contracts.

RCST designations were specifically limited to situations where the CAISO determined that “an RCST designation is necessary to remedy any resulting material difference in ISO Controlled Grid operations relative to the assumptions reflected in the LARN Report for 2006 or relative to the CPUC’s and, if applicable, a Local Regulatory Authority’s development of Local Resource Adequacy Requirements for 2007” “taking into account the expected duration of the Significant Event.” See Section 43.4 of the CAISO Tariff. Further, MOWDs are for a single day and are based on whether or not the CAISO needs a unit to be available *on that day*. The must-offer obligation has operated in this manner for more than half a decade, and, although the Commission may have found the must-offer pricing to be unjust and unreasonable, the Commission has never found the daily MOWD process to be unjust and unreasonable.

Neither have Energy Companies shown it to be unjust and unreasonable, as they are required to do to carry their burden under Section 206. In contrast to RCST and the MOWD process, RCCM would require long-term designations of capacity unrelated to the specific problems (or the expected duration of the problems) the CAISO may encounter or operational needs the CAISO may have. There is no reason for the CAISO to have under multi-month contract, and for ratepayers to bear the burden of, capacity that the CAISO does not require to meet a specific reliability need.

Energy Companies attempt to compare MOWDs with RMR and Resource Adequacy (RA) contracts.¹¹ The comparison is not apt. RMR contracts are annual contracts for the purpose of addressing specific long-term local reliability needs not addressed through RA contracts, and the price received under the RMR contract is cost-based and specific to each unit. In other words, the CAISO needs a particular unit, in a

¹¹ Complaint at 13.

particular location on a long-term basis to maintain reliability. RA contracts enable load serving entities to meet specific capacity obligations imposed on them by their applicable regulatory authority. RA contracts also provide capacity needed to meet known system and local reliability criteria needs as defined by the CAISO's local capacity studies and the requirements of the RA programs of the CPUC and Local Regulatory Authorities. MOWDs, however, address events that are varied, unanticipated and short-term. In other words, MOWDs pertain to occurrences that are not anticipated by the CPUC, Local Regulatory Authorities or the CAISO and which generally last only short periods of a day or days. Multi-month commitments are not required by such events.

Under the RCST, if an MOWD does signify a new longer-term reliability need, the CAISO has the discretion to make a Significant Event designation *if* the criteria specified in the tariff are satisfied. However, in determining whether it should make a prospective designation of capacity for a multi-month period, the CAISO is required to take into account the expected duration of the event, and the event must (1) be something that was not planned for in the CAISO's local reliability study (and the designation must be *necessary* as a result of a material difference in ISO Grid operations than was assumed in such study) and (2) must cause or threaten to cause a failure to meet Applicable Reliability Criteria. In such a case, the Generating Unit would be eligible to receive a longer-term commitment to address the particular reliability problem. Such an event has only occurred twice since the effective date of RCST, and, at this time, the CAISO does not anticipate any such events in the first three months of 2008. There is no basis for additional extended capacity contracts.

C. If The Commission Approves an Interim Pricing Scheme for the Must-Offer Obligation, It Should Simply Extend the Daily Must-Offer Capacity Payment Approved in the RCST Settlement

If the Commission decides it is appropriate to adopt a must-offer capacity payment scheme following termination of the RCST and pending the implementation of MRTU and the ICPM, the Commission should simply extend the Daily must-offer capacity payment that the Commission approved in the RCST Settlement. That daily capacity payment provides more than adequate compensation during this interim period. The currently effective \$73/kW-year target capacity payment that the Commission found to be just and reasonable in its Settlement Order approving the RCST Settlement remains within the range of the two reference points specified by the Commission in that order, *i.e.*, the fixed costs of existing generating units and the cost of new entry.¹²

Energy Companies rely on a draft California Energy Commission (“CEC”) report which indicates that the cost of new entry price for a conventional simple cycle unit is \$145.54/kW-year. The data in that same report show the going forward fixed costs (fixed O&M, insurance and *ad valorem* taxes) of that same type of unit to be \$25.37/kW-year.¹³ Thus, the currently effective target RCST capacity price of \$73/kW-year is well within the range of those two bookend pricing points that the Commission established as the zone of reasonableness in the Settlement Order.

¹² In the Settlement Order, the Commission found that there were two reference levels for determining the price of procuring backstop capacity. At the lower end, the price should cover the fixed costs of existing generation that is needed for reliability. At the higher end, the Commission concluded that the price should not exceed the cost of new entry. Accordingly, the Commission found that a just and reasonable target capacity price lies within the range of \$64/kW-year (a reasonable proxy price for fixed operating costs of existing generation that was based on average non-hydroelectric RMR units) and \$89/kW-year (a cost reflective of the price of new entry). Settlement Order at P 70.

¹³ Using Table 1 from the Affidavit of Ali Amirali, which is attached to the Energy Companies’ Complaint, the going forward costs of a conventional simple cycle unit can be derived as follows: deduct the costs of taxes and capital and financing from the total fixed costs of a conventional simple cycle unit; this results in going forward costs of \$28.45/kW-year for a merchant plant, \$23.72 for an IOU plant, and \$23.94/kW-year for a POU plant; the average of these three numbers is \$25.37/kW-year, which represents the going forward costs of a new conventional simple cycle unit.

In addition, although the annual capacity payment under RCST was negotiated, the Commission recognized in its order on the paper hearing that a payment below the cost of new entry was just and reasonable. In fact, the Commission specifically found the RCST target capacity price to be just and reasonable.¹⁴ Absent a showing of changed circumstances, there is no basis to change the existing level of the daily must-offer capacity payment, especially for a few-month product.

Energy Companies make two unpersuasive arguments why retention of the existing daily capacity payment would be unjust and unreasonable. First, Energy Companies contend that it would be inconsistent with the Commission's policy to consider settlements as a whole to allow only one provision of the RCST Settlement to survive into 2008.¹⁵ This argument is incorrect. Because the settlement was contested, the Commission was required to determine that it was just and reasonable. In specifically stating that it was addressing the settlement provisions on the merits, the Commission concluded it could not consider the settlement as a whole because it was modifying provisions it did not find just and reasonable.¹⁶ Indeed, in its Settlement Order, the Commission expressly found the \$73/kW-year target capacity price "establishes a just and reasonable rate for capacity that the CAISO would purchase as a provider of last resort."¹⁷

Further, although Energy Companies accuse the CAISO of selectively extending a portion of the Settlement, Energy Companies are themselves cherry-picking portions of the Settlement by not only retaining the portions that are most beneficial to them but also

¹⁴ Settlement Order at P 72.

¹⁵ *Id.* at 12.

¹⁶ *Id.* at P 44-45.

¹⁷ *Id.* at P 69.

significantly modifying other provisions to their benefit. They would eliminate the daily capacity payment but retain the designation portion of the settlement – while revising the designation process to make three-month designations automatic and mandatory and almost double the target capacity payment.

Second, Energy Companies state that the CAISO has made no effort to explain “why the daily compensation rate, which may have an effective term of one day, would yield any effective cost-recovery to must-offer Generators.”¹⁸ Neither the CAISO nor the Commission, however, is required to provide Generators with complete cost recovery. The only cost recovery that is required is cost recovery proportional to the service provided. Under the existing daily must-offer capacity payment, for each day of a MOWD – one 30th of a month – generators receive one 17th of the monthly target capacity payment that the Commission has concluded is just and reasonable, *i.e.*, almost twice the proportional payment. Moreover, even though the Commission determined that the daily capacity payment was a just and reasonable contribution to the fixed costs of must-offer Generators (unless the CAISO determined a designation was necessary to address a Significant Event), Energy Companies think it more appropriate that, even if they are subject to a MOWD for a single day, they be paid 25% of the annual fixed costs of a new unit. There is no rational basis for that type of compensation under these circumstances.

D. The Commission Should Not Use the Cost of New Entry For An Interim Compensation Program.

Contrary to Energy Companies’ arguments, there is no legitimate reason for the Commission to use the cost of new entry for an interim capacity compensation program

¹⁸ Complaint at 12.

of this duration – whether the daily capacity payment or any other program is directed by the Commission. Cost of new entry is inappropriate in this instance because the pricing scheme will be in place for only a few months. Moreover, even if new entry was seen as needed, only three of ten local areas are deficient relative to RA requirements, making a uniform application of cost of new entry problematic without other market rules, as discussed below. In the Settlement Order, the Commission stated,

At the lower end, the price should at least cover the fixed costs of existing generation that is needed for reliability. . . . At the higher end, the price should not exceed the cost of new entry that would allow investment in new generation capacity. . . . [We] conclude that a just and reasonable target capacity price lies within the range of between [the average cost of existing reliability generation] and [the cost of new entry].¹⁹

Regardless of Energy Companies' argument, the cost of new entry only establishes the upper limit of the zone of reasonableness. The fleet of generators that has been receiving the just and reasonable daily MOO capacity payment based on a target capacity price of \$73/kW-year is the same fleet of generators that will be receiving any interim compensation between January 1, 2008 and March 31, 2008. The average cost of existing reliability generation is not likely to change materially for the first three months of 2008, and certainly will not be at the level of the cost of new entry. The Commission found the existing payment just and reasonable because it was within the range of the fixed costs of existing generation that is needed for reliability and the cost of new capacity. As indicated above, the target capacity price used for the daily capacity payment in the Settlement Order remains within that range. Absent a showing of changed circumstances, Energy Companies' contention that the amount is unjust or unreasonable is a collateral attack on that prior determination.

¹⁹ Settlement Order at P 70.

Moreover, there are no good policy reasons for using the cost of new entry under these circumstances. No other generation used for reliability purposes is paid the cost of new entry. RA Generators have negotiated contracts, which presumably reflect their existing fixed costs. RMR Generators have cost-of-service contracts based on their actual costs. While the CAISO agrees that it may be appropriate to adjust capacity payments in the future if some form of capacity market is implemented in connection with a long-term resource adequacy framework – an issue that is currently being addressed in a CPUC proceeding – this does not constitute such a situation. There is only a three month gap between the termination of RCST and the implementation of ICPM/MRTU. This is hardly the time period for a phase-in of adjusted backstop capacity prices based on cost of new entry. Obviously, the purpose of a few-month backstop capacity pricing mechanism is not to incent new generation; it is to provide the CAISO with the ability to call on *existing* units not under RA or RMR contracts if the CAISO needs them on a particular day to meet particular reliability needs on that day. During these events, the CAISO should compensate resource owners for the specific service provided. The CAISO also notes that the CPUC-regulated and other load serving entities have already made their year-ahead RA showings (both system and local) for 2008. Thus, the pricing will not be needed for the purpose of incenting forward contracting for 2008.²⁰

Another policy consideration concerns whether, even if a cost of new entry were appropriate under a three-month interim program, a uniform price based on cost of new entry would be appropriate for all types of capacity commitments (*e.g.*, system, local,

²⁰ The CAISO also notes that the CPUC has in place a penalty scheme for load serving entities subject to its jurisdiction that do not satisfy their RA obligations.

zonal, Significant Event, RA deficiency). The CAISO has carefully considered this issue in its ongoing ICPM stakeholder process and answered it in the negative. First, CAISO generally believes that, according to capacity pricing principles, cost of new entry should be considered as a possible backstop price only when there is a capacity deficiency in a local area or system zone and the intent of the mechanism is to incent new generation (which is not the case with a backstop mechanism that will only be in place for a few months). Even then, it may be appropriate to phase in cost of new entry pricing over several years, as was done in some of the eastern ISOs, in order to allow buyers time to make appropriate investment decisions. That has not occurred here. The Table below shows the most recent evaluation of the deficiency or surplus in the 10 local capacity areas that the CAISO has defined for the CAISO grid. Only three of these local areas are deficient relative to the RA requirement and one is just above the RA requirement, based on the reliability needs defined in the CAISO's local capacity studies. This assessment suggests that few locations on the CAISO Controlled Grid would even warrant high backstop prices if a cost of new entry approach were to be applied. Moreover, most of the capacity in those tight areas is either owned by investor owned utilities or is under multi-year RA contract, thereby indicating that even if a cost of new entry approach were to be applied, it would provide no near-term benefits to Energy Companies. In the remaining load pockets, where there is a surplus of capacity, additional investment does not seem to be needed in the near term; so using cost of new entry pricing to spur additional investment would be neither needed nor justifiable for the period under consideration (or any other subsequent development of backstop pricing rules). Using cost of new entry as the backstop price in these circumstances could only serve to

increase the forward RA prices in these areas to the extent any generation owners have market power.²¹

Table -- Comparison of 2008 Locational Capacity Requirement Need and Qualifying Capacity

| Local Area Name^{1/} | Total '2008 LCR Need based on Category C with Operating Procedure^{1/} (MW) | Total Qualifying Capacity^{1/} (MW) | Surplus or (Deficit) (MW) | Surplus or (Deficit) (%) |
|-------------------------------------|--|--|----------------------------------|---------------------------------|
| Humbolt | 175 | 180 | 5 | 3% |
| North Coast/North Bay | 676 | 883 | 207 | |
| Sierra | 2092 | 1780 | (312.00)^{2/} | (15%)^{2/} |
| Stockton | 786 | 536 | (250.00)^{2/} | (32%)^{2/} |
| Greater Bay | 4688 | 6214 | 1526 | 33% |
| Greater Fresno | 2382 | 2991 | 609 | 26% |
| Kern | 486 | 646 | 160 | 33% |
| LA Basin | 10130 | 12093 | 1963 | 19% |
| Big Creek/Ventura | 3658 | 5396 | 1738 | 48% |
| San Diego | 3033 | 2919 | (114.00)^{2/} | (4%)^{2/} |
| Total | 28106 | 33638 | | |

^{1/} Source: CAISO "2008 Local Capacity Technical Analysis Report and Study Results," Updated April 3, 2007, table on page 4 of 85 pages. Data for San Diego local area is from "Report and Study Results Update for San Diego, Updated June 19, 2007, which was filed with the CPUC.

^{2/} Generation deficient Local Capacity Area (or with sub-area that are deficient) – deficiency included in LCR. Generator deficient area implies that in order to comply with the criteria, at summer peak, load must be shed immediately after the first contingency.

²¹ For example, consider a hypothetical scenario in which there is a load pocket with 50% additional capacity (MW) than is needed to fulfill the local RA requirement. There is also substantial concentration of ownership of that capacity because only one or two sellers exist. In that situation, the cost of new entry backstop price would be used not to incent new generation but to provide sellers with a bargaining tool in bilateral RA negotiations with buyers. This occurs because sellers would know that if buyers did not accept the offered forward RA prices, they could rely on the CAISO to procure that capacity through the backstop and at a price at cost of new entry. To mitigate this market power, there would need to be additional rules for backstop capacity pricing, such as an administrative demand curve for capacity that lowered the backstop price in relation to the surplus market supply condition. Such rules have not been proposed by the Energy Companies.

Second, the CAISO does not believe that cost of new entry is the appropriate price benchmark for backstop procurement in response to daily or real-time needs -- which is essentially what Energy Companies are proposing. Under the must-offer obligation, the CAISO has the ability, in the day-ahead and intra-day time frames, to commit additional capacity from non-RA units on a daily basis in response to contingencies not covered in the RA requirements. Such procurement can take place anywhere on the system at any time if a contingency arises or the CAISO perceives a reliability need. In that type of unplanned, unanticipated, short-term procurement, because the purpose of this type of procurement is to utilize available *existing* units to address short-term contingencies or reliability, not to incent new generation, there is no reason to base payments on cost of new entry. There is no legitimate basis to pay a price based on cost of new entry to existing units under these types of circumstances. Even ignoring the fact that new entry could not enter the market in the necessary time frame to provide the service, there is no indication that new units should even enter the market at that particular location for the long-term.

Recognizing that the use of the cost of new entry cannot be justified as an incentive to new Generation in a three month program, Energy Companies contend:

In approving use of [cost-of-new-entry] in the RCST, as distinct from reliance solely on use of the fixed costs of existing generation as a reference point for determining the RCST target capacity price, the Commission made clear that the purpose of the backstop capacity payment is not to incentivize new investment. Rather, the Commission emphasized that “[a] just and reasonable price for backstop capacity should encourage LSEs and generators to engage in longer-term contracting and not rely on the RCST mechanism.” The Commission concluded that “the price for backstop capacity should be high enough so that LSEs do not simply rely on the backstop mechanism to meet their resource adequacy requirements.” The Commission’s rationale supports use of [cost of new entry] as a measure of the target capacity price for capacity compensation

to non-RA and non-RMR generators subject to the Must-Offer obligation.²²

The problem with the Energy Companies' argument is that the Commission *did not* use cost of new entry in approving the RCST Settlement; it approved a target price less than the cost of new entry and expressly recognized that it was doing so in its order.²³ The discussion cited by Energy Companies was responding only to an argument that the target price should not be *limited* to the average cost of existing Generation. Energy Companies present no evidence that the RCST target price – which they now assert is inadequate – has caused any LSEs to rely on must-offer capacity rather than fulfill Resource Adequacy requirements. Indeed, under RCST, the CAISO has not had to designate any units in order to satisfy a deficiency in meeting an RA obligation. Energy Companies offer no reason why the same units that have been paid a capacity price based on a just and reasonable price of \$73/kW-year since June of 2006 should now be paid based on a target capacity price that is almost double that amount.

Next, Energy Companies assert that the fact that the CAISO would only have made one Significant Event unit designation under the RCST for 2006, despite 254 MOWDs (172 Day Ahead), demonstrates that a higher price is necessary in order to discourage the CAISO from relying on MOWDs.²⁴ The failure of the CAISO to make Significant Event RCST designations is totally unrelated to the cost of such designations.

Energy Companies ignore the fact that the Settlement and the Commission-approved tariff provisions implementing the RCST establish specific requirements before

²² Answer at 19, citing Settlement Order P 71 (footnotes omitted).

²³ Settlement Order at P 72.

²⁴ Energy Companies fail to note that the CAISO identified a second Significant Event that would have supported a designation of capacity under the RCST -- and the CAISO was prepared to make such a designation -- but different provisions of the RCST precluded a designation in that instance.

the CAISO can even exercise its discretion to designate a unit. First, there must be a Significant Event – which, for 2006, is defined as an event “that results in a material difference in ISO-Controlled Grid operations relative to what was assumed in developing the LARN Report for 2006 that causes or threatens to cause a failure to meet Applicable Reliability Criteria.” Thus, the mere number of MOWD’s does not – and cannot – establish either that a Significant Event occurred or that RCST designations are necessary. Second, under Section 43.4, the CAISO *may* designate capacity *to provide service* under the RCST following a Significant Event *if* such an RCST designation is *necessary* to remedy any resulting material difference in ISO Controlled Grid operations relative to the assumptions in the LARN Report. These restrictions on the CAISO’s ability to make Significant Event designations were just as important to some parties to the Settlement as the CAISO’s authority to make designations was to the Energy Companies.

Section 43.4 also requires the CAISO to take into account the expected duration of the Significant Event in determining whether or not to make an RCST designation. This is because Significant Event designations have a minimum term of three months (and will be paid monthly capacity payments for every month that they are designated). Under the Significant Event/Repeat MOWD evaluation process, the CAISO is also required to indicate whether any RA resources or RMR units were available and called by the CAISO before it denied a FERC must-offer Generator’s waiver request. Finally, the CAISO must explain why Non-Generation Solutions were insufficient to prevent the use of denials of must offer waivers for local reasons.

Energy Companies have not presented *any* evidence that the CAISO has improperly implemented the Settlement with regard to the designation of RCST units. In particular, Energy Companies do not provide one iota of evidence that the CAISO failed to properly apply the RCST designation criteria set forth in its tariff. Energy Companies do not identify any deficiency in the CAISO's analysis of whether the events included in the reports constituted Significant Events that would have necessitated a designation of capacity, consistent with the criteria identified above. Energy Companies do not explain why it would have been *necessary* to designate any of the units that were denied MOWDs under the RCST in response to a Significant Event. In particular, Energy Companies do not even attempt to explain why any of their units should have received RCST designations. The CAISO believes that its actions have been consistent with the Tariff and the intent of the Settlement.

Energy Companies' assertion of 172 MOWDs is itself misleading. Almost half of the 172 MOWDs were for zonal reasons. However, neither the Settlement nor the CAISO Tariff authorizes the designation of RCST units for zonal reasons.

Further, the RCST Settlement does not contemplate any specific number of designations. Rather, the provision for a daily capacity payment reflects the fact that the Settlement specifically contemplates that MOWDs may continue to be necessary. The CAISO's use of MOWDs consistent with the Settlement does not in any manner indicate that the CAISO needs an incentive to make long-term designations.

In short, Energy Companies have provided no reason why the use of a target capacity price less than the cost of new entry is unjust, unreasonable, or even inadvisable.

Accordingly, any interim payment program approved by the Commission should use the target capacity price from the RCST settlement.

III. CONCLUSION

For the reasons discussed above, the CAISO requests that the Complaint be denied.

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Dated: December 20, 2007

CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing document upon all of the parties listed on the official service list for the captioned proceeding, in accordance with the requirements of Rule 2010 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.2010).

Dated at Washington, D.C. this 20th day of December, 2007.

/s/ Michael E. Ward
Michael E. Ward