

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE  
STATE OF CALIFORNIA**

Order Instituting Rulemaking to Consider Refinements to and Further Development of the Commission's Resource Adequacy Requirements Program.

Rulemaking R.05-12-013  
(December 15, 2005)

**COMMENTS OF THE  
CALIFORNIA INDEPENDENT SYSTEM OPERATOR  
ON PROPOSED DECISION**

Pursuant to the November 19, 2009 Ruling Extending Time For Comments and Replies by the Assigned Administrative Law Judge for the California Public Utility Commission ("CPUC"), the California Independent System Operator Corporation ("ISO") submits the following comments on the Proposed Decision issued on November 3, 2009 in this proceeding.

**I. INTRODUCTION**

As the ISO discussed in its comments previously filed in this proceeding, the overarching goal of the proceeding should be to develop a long-term Resource Adequacy ("RA") program that will facilitate open and efficient competition to produce the optimal, cost-effective mix of infrastructure investments sufficient to meet end-use demand at stable and reasonable prices and reliably provide for the operating requirements of the ISO balancing authority area.<sup>1</sup> The ISO believes that the long-term RA framework should (1) permit meaningful competition among generation (including new entry), demand response (including energy efficiency) and transmission projects to solve reliability concerns, and (2) enable these options to be compared using

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<sup>1</sup> ISO Comments February 29, 2008, pp. 2-7; ISO Reply Comments March 14, 2008, pp. 1-8; ISO Comments October 1, 2008, p. 4.

transparent market-based mechanisms so that investors will come forward with high-quality offers, and the most cost-effective alternatives can be selected. Most importantly, the ISO believes that a transparent, competitive, market-based framework for long-term RA can be structured in a manner that is fully compatible with the Commission's regulation of procurement by its jurisdictional load-serving entities and which supports the state's environmental policy goals.<sup>2</sup>

The Proposed Decision moves constructively toward the aforementioned goals. Based on a comprehensive review and assessment of the effectiveness of the current RA program, the Proposed Decision identifies several shortcomings in the program, including the following: 1) the RA program does not meet the long-term reliability objective of facilitating development of new generating capacity; 2) reliability, least cost, and equitable cost allocation objectives would be better achieved through a multi-year forward RA commitment; 3) greater price transparency and symmetry of information available to market participants are needed to promote appropriate investment decisions, mitigate market power, and reduce transaction costs; 4) the backstop procurement mechanism that complements the RA program should be more durable and not rely primarily on the investor owned utilities ("IOUs"); and 5) the current RA program fails to support the policy of a competitive wholesale generation market in which merchant generation owners compete with IOUs.<sup>3</sup> In order to address these shortcomings, the Proposed Decision recommends adoption of a multi-year forward RA capacity commitment process as the central improvement to the RA program, while

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<sup>2</sup> ISO Comments October 1, 2008, pp. 4-5.

<sup>3</sup> Proposed Decision, pp. 40-41.

maintaining today's bilateral trading approach by which load-serving entities procure RA capacity to meet their requirements.<sup>4</sup>

The ISO believes that the Proposed Decision provides a framework for developing major and much needed enhancements to the current RA program. As discussed below, the ISO agrees with the Proposed Decision that adoption of a multi-year forward commitment of RA capacity resources is necessary to support long-term resource adequacy by fostering investment in new generation and competition between new investment and existing resources to provide RA capacity. Due to the numerous details that will need to be worked out in order to implement multi-year forward RA requirements for all load-serving entities, the ISO urges the CPUC to initiate the next phase of this process as early as possible. Although the Proposed Decision targets implementation to be no sooner than RA compliance year 2012,<sup>5</sup> the ISO believes that implementation *by* compliance year 2012 could be feasible and would be preferable to a later implementation date, and to that end recommends that the CPUC incorporate 2012 as the goal of the successor proceeding to implement the new RA framework. The ISO does not agree, however, that maintaining the current bilateral contracting approach for procuring RA capacity represents the best choice among the options to improve the RA program for the long-term and facilitate development of new capacity consistent with Public Utilities Code Section 380.

## **II. MULTI-YEAR FORWARD COMMITMENT**

The Proposed Decision recommends adoption of a multi-year forward capacity procurement obligation that will be applicable to all jurisdictional load-serving entities

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<sup>4</sup> *Id.* at 67-68.

<sup>5</sup> *Id.* at 79.

and will include compliance demonstrations three, four, and five years in advance of the RA compliance years. In the compliance demonstrations, the load-serving entity will be required to show that it has procured at least 80 percent of its load assessment five years out, which will increase to 100 percent by three years in advance of the compliance year. The Proposed Decision defers the details and technical requirements necessary to implement this obligation to a future proceeding.<sup>6</sup>

The ISO fully supports the Proposed Decision's recommendation to adopt a multi-year forward capacity procurement obligation. The ISO has maintained throughout this proceeding that the single most important modification to the RA program that must result from this proceeding is the establishment of a multi-year forward procurement requirement and demonstration of committed RA capacity to serve consumers within the ISO balancing authority area.<sup>7</sup> As stressed in the ISO's comments, a multi-year forward structure will allow transparent, economic competition between existing resources and new market-based investment to provide specified quantities of RA capacity at the system level and for each local capacity area.<sup>8</sup> This is an important improvement to the current annual RA structure, which the Proposed Decision has correctly found does not allow such competition between existing and new resources.<sup>9</sup> The multi-year forward structure will also accommodate economic decisions to repower or retire existing generation and to invest in new demand response capability, and can be linked explicitly to decisions whether to upgrade transmission into constrained areas of the grid or rely on non-transmission alternatives.

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<sup>6</sup> *Id.* at 90.

<sup>7</sup> ISO Comments October 1, 2008, p.3.

<sup>8</sup> ISO Comments October 8, 2009, pp. 3-6.

<sup>9</sup> Proposed Decision, p. 41.

The need for a multi-year forward process for estimating requirements and procuring RA capacity is endorsed not only by the ISO, it has broad support in the record, even among parties with otherwise diverse views on the issue of whether to continue the existing bilateral trading approach or develop a central capacity market. The parties supporting a multi-year ahead RA framework include the California Forward Capacity Market Advocates (“CFCMA”), Pacific Gas & Electric Company, Calpine Corporation, Constellation Energy Commodities Group, Inc., Constellation NewEnergy, Inc., and Energy Division Staff in its update modified capacity market proposal.<sup>10</sup>

In addition to this broad-based support, the adoption of the multi-year forward commitment is consistent with Public Utilities Code Section 380. That statute requires the CPUC, in consultation with the ISO, to establish RA requirements for all load-serving entities that achieve all of the following objectives: 1) facilitate development of new generating capacity and retention of existing generating capacity that is economic and needed; 2) equitably allocate the cost of generating capacity and prevent shifting of costs between customer classes; and 3) minimize enforcement requirements and costs. The statute further requires the CPUC to determine and authorize the most efficient and equitable means for achieving all of the following: 1) meeting the objectives of the statute; 2) ensuring that investment is made in new generating capacity; 3) ensuring that existing, economic generating capacity is retained; and 4) ensuring that the cost of generating capacity is equitably allocated. With respect to these statutory goals, the ISO fully agrees with the CPUC’s finding that a multi-year forward RA framework would, unlike the current one-year ahead RA program, be far more successful in facilitating

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<sup>10</sup> ISO Comments October 8, 2008, p. 2.

efficient investment in new generating capacity and economic decisions to retire or repower older capacity.

It is clear from the Staff Report and the comments of the parties that resource development in California in recent years cannot be attributed to significant merchant investment prompted by the RA program. Today's one-year ahead RA process does not provide sufficient lead time, either for investment decisions and commitments by investors or for economical comparison of alternative infrastructure investments in a manner that yields the most cost-effective outcomes for consumers. Requiring multi-year forward commitment of RA capacity will change that. It will provide greater certainty and stronger financial incentives for owners of existing generation and potential investors in new facilities to make economic decisions about maintaining, upgrading, or building new facilities depending on the prices and quantities at which future RA capacity is transacted. This should directly facilitate development of new generating capacity and retention of existing generating capacity that is economic as required by Public Utilities Code Section 380.

The ISO believes that establishing an ongoing annual process for conducting a multi-year forward assessment of RA capacity requirements should be a collaborative effort by the CPUC, California Energy Commission ("CEC") and ISO. This assessment should address capacity needs at the system-wide level and in local capacity areas, as well as the generator performance characteristics needed to support reliable grid operation as the diversity of supply and demand resources evolves. An important aspect of this collaborative assessment will be to consider expected shifts in the supply fleet in response to new environmental policies and regulation. The ISO looks forward

to working with the CPUC and CEC on this collaborative effort. Because of the complexity of issues that must be resolved to achieve a reasonable forecast of RA requirements and load-serving entity obligations several years in advance, and because this activity is fundamental to the success of the multi-year forward RA program, the ISO urges the CPUC to initiate this effort as early as possible.

### **III. BILATERAL TRADING APPROACH**

The Proposed Decision recommends retaining the current bilateral trading approach, under which load-serving entities will continue to procure RA capacity through bilateral contracts, with annual showings in which they will demonstrate their procurement of capacity to meet their multi-year forward requirements. The primary reason the Proposed Decision provides for preferring the bilateral trading approach to a centralized capacity market is that it will maintain the CPUC's current scope of jurisdiction over the RA program.<sup>11</sup> The Proposed Decision finds that the bilateral trading approach will provide the CPUC with direct authority to refine the program or remedy problems, whereas options that involve a centralized auction operated by the ISO would place a significant portion of the RA program under the jurisdiction of FERC. In addition, the Proposed Decision favors a bilateral trading regime on the grounds that it will: 1) be more conducive to the development of specialized resources that meet California's environmental objectives, and the avoidance of development of excess capacity, than a centralized auction would be; and 2) best meet the metrics of ensuring reliability, enabling new generation, and facilitating environmental policies.<sup>12</sup>

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<sup>11</sup> Proposed Decision, pp. 64-66.

<sup>12</sup> Id. at 66-69.

The ISO disagrees with the Proposed Decision's recommendation and submits that it is not supported by the record or consistent with Public Utilities Code 380. The ISO continues to believe, as stated in prior comments in this proceeding, that a central capacity market would complement and enhance the effectiveness of the multi-year forward RA program better than a purely bilateral approach.<sup>13</sup> Two essential strengths of a central capacity market that are not characteristics of the bilateral approach are the transparent capacity prices for capacity at the system level and in constrained local areas, and the accuracy with which the costs of capacity can be allocated based on each load-serving entity's actual load during each compliance month.

A capacity procurement approach that generates transparent capacity prices through a market clearing mechanism will lead to the most efficient procurement of RA capacity because it provides a level and open playing field for competition among existing generation, new generation investment, repowering or retirement decisions, and demand response investment. With regard to cost allocation, a central capacity market design allows for settlement of charges to load-serving entities and payments to suppliers at the end of each compliance month. This approach ensures that each load-serving entity is charged for its RA capacity requirement based on its actual load each month rather than based on a forecast. The ISO anticipates that a challenging and contentious task in moving to a multi-year forward RA requirement will be to determine quantitative capacity procurement obligations for each load-serving entity three to five years in advance of each compliance year, given the uncertainty associated with load forecasting and the potential for direct access load migration. A central capacity market featuring ex-post settlement for load-serving entities would very effectively resolve this

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<sup>13</sup> ISO Comments October 8, 2008, pp. 1-8.

concern. Moreover, this ex-post compliance approach under a central capacity market would better achieve the Section 380 requirement to minimize enforcement requirements and costs.

As another benefit, a central capacity market would provide an explicit platform for evaluating whether investment in new supply and demand response resources could substitute for a transmission upgrade into a constrained local load area. While it is possible today to compare the costs and benefits of non-transmission alternatives versus transmission upgrades, it is not necessarily practical to do so absent some mechanism for committing suppliers of the non-transmission alternatives to deliver the capacity by the time it will be needed. The central capacity market would provide the mechanism both for making the economic decision between transmission and non-wires alternatives and for committing the suppliers to deliver those non-wires resources that clear the market.

For these same reasons, the central capacity market is superior to the bilateral trading approach for purposes of Public Utilities Code Section 380. That statute requires the CPUC to adopt the most efficient and equitable means for meeting the objectives of the statute, ensuring that investment is made in new generating capacity, ensuring retention of existing generating capacity that is economic; and ensuring that the cost of generating capacity is allocated equitably. The central capacity market represents the most efficient and equitable means to fulfill the requirements of the statute because its market structure will provide greater transparency into RA prices and appropriate price signals than bilateral contracts whose prices and terms are not public. For this reason, a central capacity market will induce greater competition in the

supply of RA capacity than a purely bilateral contracting approach would do. In addition, as discussed above, the cost allocation approach of a central capacity market, which allocates responsibility for RA capacity costs to load-serving entities after the fact based on their actual load in each compliance month, avoids cost-shifting and is the most accurate approach. Accordingly, the ISO urges the CPUC to reject the recommendation of the Proposed Decision as insufficiently satisfying the requirements of Public Utilities Code Section 380 and adopt instead the central capacity market approach proposed by the ISO or the CFCMA.

The ISO believes that adoption of the central capacity market would not give rise to the significant concerns regarding jurisdiction that the Proposed Decision postulates. The Proposed Decision ignores FERC precedent that provides a clear statement of deference to state and local regulatory authorities to set RA requirements. In *California Independent System Operator*, 116 FERC ¶ 61,274 at p. 62,274 (2006), FERC stated that:

1117. The foregoing notwithstanding, we recognize the states' historical role in ensuring resource adequacy. The fact that we must, to fulfill our statutory responsibilities, be assured of a workable approach to resource adequacy does not mean that we should ignore the states' traditional role in this area. Rather, we can fulfill our jurisdictional responsibilities while also respecting the states' traditional role in this area. As a general matter, it is our responsibility to ensure that a workable resource adequacy requirement exists in a market such as that operated by the CAISO. This does not mean that we must determine all the elements of such a program in the first instance. Rather, we can, in appropriate circumstances, defer to state and Local Regulatory Authorities to set those requirements. Our primary responsibility is to ensure that a workable program exists and is adhered to by all LSEs.

The Proposed Decision also overlooks the fact that under the central capacity models discussed in this proceeding, the load-serving entities' owned generation and

bilaterally procured RA capacity, as overseen by the CPUC, would be self-supplied into the capacity market and would constitute the majority of RA capacity cleared through the central capacity market. Thus, a central capacity market would not undermine either the role of CPUC jurisdiction over bilateral capacity procurement or the role of compliance showings by its jurisdictional load-serving entities. The Commission will be able, among other things, to determine how much capacity its regulated load-serving entities are required to procure bilaterally and self-supply into the centralized capacity market, thereby limiting the price risk exposure faced by those entities.

In addition, the ISO does not believe that a central capacity market would adversely affect the CPUC's ability to achieve state environmental goals. Through continued oversight of the load-serving entities' bilateral procurement of RA capacity, the CPUC would retain its authority to direct their procurement of environmentally preferable resource types.

For these reasons, the ISO urges the Commission to reject the Proposed Decision's recommendation to rely solely on bilateral trading for forward RA procurement and instead adopt a central capacity market, which better meets the needs of the RA program and fulfills the requirements of Public Utilities Code Section 380.

In the event that the CPUC nonetheless finds in favor of the bilateral trading approach, the ISO is concerned that development of direct access could be foreclosed. As noted in the Proposed Decision, the viability of direct access may be adversely affected by bilateral trading because it would place an excessive burden on small energy service providers and load serving entities.<sup>14</sup> The ISO accordingly encourages the CPUC to implement the bilateral trading approach in a manner that alleviates this

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<sup>14</sup> Proposed Decision, p. 75.

burden and facilitates direct access. Similarly, we believe that it is critical that the bilateral approach not be an impediment to demand response participating in the RA program. The CPUC should also accommodate demand response into the long-term RA program. The ISO urges the CPUC to include both these topics explicitly in the scope of the follow-up proceeding to implement the multi-year forward RA program.

Finally, the ISO notes that in early 2010 it will begin a stakeholder process to develop a revised backstop procurement design that will complement the CPUC's long-term RA framework to ensure reliable grid operation.<sup>15</sup> As the ISO indicated in its prior comments submitted in this proceeding, temporary backstop procurement mechanisms such as the previous Reliability Capacity Services Tariff and the existing Interim Capacity Procurement Mechanism were not intended and cannot be expected to function as durable backstop mechanisms. The Proposed Decision appropriately recognizes that the absence of a durable backstop mechanism is a shortcoming of the current RA program, and that the backstop mechanism must provide the proper incentives to prevent that mechanism from becoming a primary procurement vehicle for load serving entities.

The need for a backstop procurement mechanism exists irrespective of whether the CPUC adopts a central capacity market or retains the current bilateral procurement approach in its final long-term resource adequacy decision. A central capacity market structure would, however, naturally incorporate the needed backstop mechanism through a sequence of reconfiguration auctions to make transparent adjustments to the amount of committed capacity as the compliance or delivery year gets closer, as has

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<sup>15</sup> The ISO is required by FERC to design and implement a replacement for the current Interim Capacity Procurement Mechanism by April 1, 2011, and therefore must initiate this effort early in 2010.

been proposed by the CFCMA and is part of the capacity market designs of other regional transmission organizations and independent system operators. In contrast, absent a central capacity market in California, the ISO's backstop procurement mechanism will be the only mechanism that provides a transparent capacity price signal to the market. Moreover, with a bilateral procurement structure where compliance is determined through multi-year forward showings by the load-serving entities, there will be an inefficient tradeoff by load-serving entities between the penalties assessed for any shortfall in their forward capacity procurement versus their allocated shares of the cost of backstop procurement. The central capacity market structure with ex-post allocation of costs avoids this complication of the load-serving entities' forward capacity procurement incentives.

#### **IV. CONCLUSION**

For the foregoing reasons, the CAISO respectfully requests that the Commission adopt the CAISO's positions and recommendations in this matter, and establish a long-term RA framework consistent with the discussion in these comments.

Respectfully submitted,

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December 2, 2009

## CERTIFICATE OF SERVICE

I hereby certify that on December 2, 2009, I served, by electronic and United States mail, a copy of the foregoing Comments of the California Independent System Operator on Proposed Decision to each party in Docket No. R.05-12-013.

Executed on December 2, 2009  
at Folsom, California

*/s/ Jane Ostapovich*

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