Memorandum

To: ISO Board of Governors

From: Eric Hildebrandt, Executive Director, Market Monitoring

Date: March 20, 2019

Re: **DMM comments - Decision on reliability must-run and capacity procurement mechanism enhancements proposal**

This memorandum does not require Board action.

EXECUTIVE SUMMARY

The Department of Market Monitoring (DMM) supports moving forward with Management's proposed changes to the capacity procurement mechanism (CPM) and reliability must run (RMR) contracts. The proposal includes incremental enhancements that address several of the key fundamental flaws in the current CPM/RMR backstop procurement framework:

- RMR Condition 2 resources will be subjected to a must-offer obligation.
- The ISO will seek to limit RMR designations only to units that would retire or mothball without RMR contracts.
- Any compensation sought by CPM units above the $76/kW-year soft offer cap will be based on the unit's going forward fixed costs (GFFC), rather than going forward fixed costs plus full recovery of sunk fixed costs and a return on investment.

However, the ISO's proposal does not address some other key concerns with the ISO's current CPM/RMR procurement mechanisms that are needed as part of a comprehensive reform. The ISO has committed to reassessing the CPM soft offer cap in a separate stakeholder process in 2019.

DMM recommends that this process include consideration of other modifications, including tests for the competitiveness of CPM designations and modification of CPM compensation under uncompetitive conditions. DMM also recommends further assessment of changes in RMR compensation and strengthening of provisions to ensure RMR contracts are not provided for units that would not actually retire without RMR compensation.

MANAGMENT PROPOSAL

In April 2018, FERC directed the ISO to work on comprehensive reforms to its backstop procurement design.[1] The *Draft Final Proposal* addresses several of the key fundamental flaws in the current backstop procurement framework. However, the ISO's proposal does not address some other key concerns with the ISO's current backstop procurement mechanisms that are needed as part of a comprehensive reform. DMM supports moving forward with the incremental improvements in management's proposal, but recommends the ISO continue working on further changes needed as part of a comprehensive reform.

Must-Offer Requirement for RMR Units

Under the current RMR Condition 2 contract option, units receive full cost recovery plus a return on sunk investment. The RMR contract refers to that as a unit's *annual fixed revenue requirement* (AFRR). When dispatched to operate, RMR unit owners are reimbursed for operating costs, with any net market revenues being used to offset the AFRR payments to the unit.

However, the current RMR Condition 2 contract severely restricts when RMR units can be dispatched to operate — even when it would be economic do so. This creates market inefficiency and is inequitable for ratepayers who pay the AFRR payments of the unit.

This key flaw in the Condition 2 contract has been well known ever since the Condition 2 contract was created through a 1999 settlement.[2] The potential impact of this flaw was highlighted in fall 2017, when almost 700 MW of very efficient and flexible gas-fired capacity was designated as RMR for 2018 and then selected the Condition 2 contract option.

Under Management's proposal, resources under RMR Condition 2 contracts will be subject to a must-offer requirement, which requires that generation from Condition 2 units be bid at marginal cost. This addresses a key flaw in the Condition 2 contract. However, as discussed later in these comments, DMM believes further modifications in the RMR Condition 2 payments and requirements for unit eligibility should be considered as part of a continued review of CPM compensation and other provisions.

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[1] *Order rejecting tariff revisions,* ER18-641-000, April 12, 2018, p. 18. https://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=14887575

[2] *Motion to Intervene and Protest of the Department of Market Monitoring of the California Independent System Operator Corporation,* ER18-240, November 22, 2017, at pp. 9-14. https://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=14762784

Limiting RMR to Units Actually Facing Retirement

Under Managements proposal, the ISO will seek to limit RMR designations only to units that would retire or mothball without RMR contracts. DMM supports this goal, but recommends further clarification and restrictions of when CPM versus RMR should be used.

DMM's prior stakeholder comments note that the inclusion of resources indicating they will "mothball" (rather than retire) may have a major impact on the amount of resources that may end up under RMR contracts.[3] In practice, it may be difficult to distinguish between a unit that the owner indicates will be mothballed for an undetermined length of time versus one that would mothball for an extended or indefinite period. DMM believes that details governing the eligibility of units that may mothball for RMR designations may have a major impact on the amount of resources that may end up under RMR contracts.

DMM supports the ISO's proposal to require an officer-signed affidavit when a retirement notice is submitted to the ISO. However, the *Draft Final Proposal* also states that the ISO will not subject retirement notifications to an economic assessment.[4] Language relating to such economic assessment currently exists in Tariff Section 43 and the Reliability Requirements BPM.[5,6] These tariff and BPM sections require a resource owner of a unit at risk of retirement to submit an affidavit along with supporting financial information to the ISO and DMM which attest and demonstrate a unit is uneconomic absent ISO procurement.

The ISO has indicated that it plans to remove this tariff and BPM language. DMM encourages the ISO to maintain, at minimum, the current ROR provision that the resource owner attest it will be uneconomic for its resource to remain in service in the upcoming year absent procurement by the ISO or other entity. This is needed to help deter units that should not retire due to economics but are needed for reliability from seeking RMR compensation.

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[3] *Comments on Reliability Must Run and Capacity Procurement Mechanism Enhancements Revised Straw Proposal*, Department of Market Monitoring, October 23, 2018, p. 3: http://www.caiso.com/Documents/DMMComments-ReliabilityMust-RunandCapacityProcurementMechanismEnhancements-RevisedStrawProposal.pdf

[4] *Draft Final Proposal*, p. 17.

[5] Tariff Section 43A.2.6 (5)

[6] *BPM for Reliability Requirements,* Section 12.6.4.

Proposed CPM Compensation

Cost filings above the soft offer cap

DMM and the ISO have a long history dating back to 1999 of supporting the principle that units needed for local or system reliability which have market power should be compensated based on going forward fixed costs plus a reasonable *contribution* to sunk fixed costs.[7]

Under tariff provisions that have been in place since 2016 units offered CPM designation by the ISO may seek payments in excess of the $76/kW-year soft cap by filing at FERC using Schedule F of the pro forma RMR contract, which includes going forward fixed costs, plus full recovery of sunk fixed costs and a return on investment. CPM units also retain all net operating market revenues earned by operating in the ISO energy market. This level of compensation is unjust and unreasonable for entities bearing CPM costs and can create market inefficiencies.[8]

DMM supports changing cost recovery above the soft offer cap to a structure based on GFFC. However, the *Draft Final Proposal* would allow suppliers to file for recovery of their actual GFFC *plus* 20 percent and also retain all net market revenues. This may still allow for excessive cost recovery.

The ISO contends that the 20 percent adder is justified by prior FERC direction and is necessary to allow for some contribution to additional fixed costs. However, FERC's reasoning for rejecting the ISO's 2010 soft offer cap proposal ($55/kW-year, based on a reference unit's GFFC plus a 10% adder) was simply that the ISO *had not demonstrated* or *explained* how the proposed methodology would provide sufficient revenues for several specific types of costs or scenarios not directly addressed in the ISO's proposal. As FERC explained:

> …we find that CAISO has failed to demonstrate that the proposed long-term, fixed price CPM, which is based on a resource's going-forward costs plus a 10 percent adder, is just and reasonable compensation for the capacity procured to maintain reliable operations, and find that it may be unjust and unreasonable …..[9]
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> CAISO, in this filing, has not explained how the use of going-forward costs for CPM compensation will provide incentives or revenue sufficiency for resources to perform long-term maintenance or make improvements that may be necessary to satisfy new

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[7] *Motion to Intervene and Protest of the Department of Market Monitoring of the California Independent System Operator*, Docket No. ER18-641-000, February 2, 2018, pp.3-5, 11-15. http://www.caiso.com/Documents/Feb2_2018_DMMIntervention_Protest-RORCPM_ER18-641.pdf

[8] Ibid, pp. 10-11.

[9] *Order on tariff revisions,* 134 FERC ¶ 61,211, Docket No. ER11-2256, March 11, 2011, p. 19. https://www.ferc.gov/whats-new/comm-meet/2011/031711/E-12.pdf

> environmental requirements or address reliability needs associated with renewable resource integration …[10]

Based on this order, DMM does not believe that an adder less than 20 percent is inconsistent with prior FERC orders and guidance. The ISO has not yet sought to analyze or demonstrate in any FERC filing that a lower adder plus net market revenues received by CPM units would be sufficient to contribute to the type of additional fixed costs or plant upgrades cited by FERC.

In addition, DMM notes that the 2010 FERC ruling cited by the ISO applied to the *market-wide soft offer cap*, and did not apply to *resource-specific cost filings* above the soft offer cap. This represents a key difference, since resource specific cost filings ensure that compensation is based on the characteristics of each unit.

If the CPM process was competitive, suppliers would be expected to submit bids reflecting their GFFC *net* of projected market revenues, plus a reasonable profit. Instead, the ISO's primary proposal would allow suppliers to recover full GFFC *plus* 20 percent and also retain net market revenues. This may represent excessive compensation for units with locational market power.

Alternative proposal without 20 percent adder

The ISO proposes to also file an alternative framework for CPM compensation above the soft offer cap which would be based on a resource's GFFC *without* a 20 percent adder. While net market revenues may provide sufficient contribution to additional fixed costs for certain resources, under the alternative proposal there is no explicit contribution for the types of costs cited by FERC in its 2010 order (i.e. long term maintenance or environmental upgrades).

DMM has been recommending that instead of assigning an arbitrary percentage adder to GFFC (e.g. 20 percent) or allowing no adder at all (as in the alternative proposal), the ISO could allow suppliers seeking compensation above the soft offer cap to explicitly file for actual costs associated with long term maintenance or environmental upgrades. DMM believes such additional fixed costs are in practice a form of going forward costs and could be included in a supplier's resource-specific cost filing. Including necessary capital costs in a resource-specific cost filing would prevent resource-specific compensation above the soft offer cap from either being too high or too low.

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[10] Id., p. 20

Other CPM Compensation Issues

Soft offer cap for annual CPMs

The ISO's proposal does not address concerns that the soft offer cap may be too high when used as compensation for annual CPMs. In its 2015 CPM filing, the ISO explained that the current soft cap approach was a simple approach that was reasonable under the premise that CPM would be *rarely used* and would typically be used for *shorter periods*:

> The approach adopted in the Offer of Settlement recognizes that the CAISO rarely uses CPM and that, under such circumstances, a simpler approach that avoids complex market power mitigation measures and avoids litigation is a more prudent and reasonable approach….[11]
>
> This will promote efficiency and eliminate burdens associated with developing and establishing proceedings to set prices for individual resources in connection with a mechanism that is rarely used and, when used, typically only results in designations for short periods.[12]

The ISO issued annual CPMs to three resources for 2018.[13] DMM believes it is important and timely for the ISO to reassess its soft offer cap for annual CPMs. The current soft offer cap was justified under the assumption that use of CPM would be infrequent, and even less frequent for annual CPMs. There is some evidence and concern that these assumptions may no longer hold.

Competitiveness of CPM solicitations

As part of the ISO review of the soft offer cap for annual CPMs, DMM also encourages the ISO to consider options for applying a market power test to CPM solicitations and then linking limits on CPM compensation to the competitiveness of CPM solicitations.

Stakeholders have raised concerns that CPM solicitations, particularly annual CPM solicitations, are not competitive.[14] These concerns are based in part on the fact that prices for most CPM selections made by the ISO have cleared at or close to the soft offer cap.[15]

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[11] *Tariff Amendment and Offer of Settlement Regarding Capacity Procurement Mechanism Revisions and Request for Waiver of Notice Requirement,* California ISO, ER15-1783, May 26, 2015, p. 17. http://www.caiso.com/Documents/May26_2015_TariffAmendment_CapacityProcurementMechanism_Revisions_ER15-1783.pdf

[12] Id., p.20.

[13] *December 22, 2017 Year Ahead Local CPM Designation Report*, California ISO. https://www.caiso.com/Documents/December222017YearAheadLocalCPMDesignationReport.pdf

[14] *Comments on RMR and CPM Enhancements Revised Straw Proposal*, SCE, October 23, 2018, p.2. http://www.caiso.com/Documents/SCEComments-ReliabilityMust-RunandCapacityProcurementMechanismEnhancements-RevisedStrawProposal.pdf

[15] *December 22, 2017 Year Ahead Local CPM Designation Report*

A lack of competition – coupled with a soft offer cap that is too high for annual CPMs – raises concern that the CPM soft offer cap for annual CPMs is not an effective form of market power mitigation. DMM's own review indicates that recent monthly CPM solicitations in fall 2018 were not structurally competitive.

Merging CPM and RMR into a single backstop procurement mechanism

CPM designations will continue to be voluntary and can be declined by suppliers with market power that prefer RMR compensation. DMM shares concerns raised by other stakeholders that under the current and proposed framework, newer pivotal resources with undepreciated capital costs would have an incentive to self-select RMR compensation while older pivotal resources would prefer to self-select CPM compensation. It is not clear what efficiencies this self-selection provides.

A compensation structure based on 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 ISO, 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.

Paying cost-of-service, defined as a resource's annual fixed revenue requirement (AFRR), compensates resources with market power for sunk costs and can therefore send inefficient investment signals for longer term substitutes. Specifically, paying a required resource AFRR can create 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 AFRR 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.[16]

In the ISO's future discussions of the backstop procurement framework, the ISO should consider consolidating CPM and RMR or at the very least, aligning CPM and RMR compensation and adding supplemental rules to prevent self-selection between designations based on maximization of compensation.

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[16] *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

Limiting discretion over RMR depreciation methodology

Another refinement in RMR tariff provisions that the ISO should consider is to reduce the amount of discretion that resource owners have in selecting the depreciation method that will be used for RMR compensation. The more discretion that resource owners have in choosing the depreciation method used for a resource's cost-of-service RMR compensation, the more likely it will be for resource owners to threaten retirement and to seek RMR compensation rather than signing a resource adequacy contract or accepting CPM compensation.

DMM recognizes that defining the depreciation method, useful life and salvage value that each resource should use for RMR compensation could be complicated. However, the ISO should consider refining its RMR policy to at least prevent resources from choosing one depreciation method and set of input parameters for tax filings or financial statements and then choosing a different method and input parameters to maximize RMR compensation.

CONCLUSION

Management's proposal addresses several of the fundamental flaws in the current CPM/RMR backstop procurement framework. However, the ISO's proposal does not address some other key concerns with the ISO's current backstop procurement mechanisms that are needed as part of a comprehensive reform. DMM supports moving forward with the incremental improvements in Management's proposal, but recommends the ISO continue working on further changes needed as part of a comprehensive reform.