

Memorandum

To: ISO Board of Governors

From: Keith Casey, Vice President, Market & Infrastructure Development

Date: March 20, 2019

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

This memorandum requires Board action.

EXECUTIVE SUMMARY

At the November 2, 2017, Board of Governors meeting, Management committed to examine the relationship between reliability must-run (“RMR”) and capacity procurement mechanism (“CPM”) procurement and explore whether they can be better aligned or consolidated.

The California Public Utilities Commission (“CPUC”) and other local regulatory authorities have established resource adequacy (“RA”) programs designed to ensure that the ISO has sufficient resources offered into its market to maintain reliable grid operation. However, there can be circumstances where the RA capacity may not be sufficient to meet the ISO’s operational needs. In this case, the ISO uses provisions within its tariff authority to procure backstop capacity. The current provisions for backstop capacity include both the CPM and RMR. The CPM was developed in 2010 as the primary mechanism for procuring capacity in the event that load serving entities under-procured their RA requirement or when the RA capacity is insufficient to meet an unforeseen reliability need. The ISO’s RMR provisions have been in place and largely unchanged since the start of the ISO in 1998. The RMR provisions were designed to provide the ISO with the ability to procure resources needed to meet special reliability needs or to keep resources online that would otherwise be retired or taken out of service for a prolonged period (mothballed).

The addition of significant amounts of renewable resources to meet the state’s environmental goals has put many conventional resources under financial stress due to declining energy market revenues. As a result, the ISO has seen the need for increased backstop capacity procurement to ensure that critical reliability resources are available to meet the ISO’s operational needs. Stakeholders have raised

concerns that the ISO's current backstop procurement provisions are outdated and unclear as to when procurement should occur under CPM versus RMR. To address these concerns, Management proposes a comprehensive set of enhancements to its CPM and RMR backstop provisions. The proposed enhancements include:

- Clear rules for how and when RMR and CPM backstop procurement are used;
- Provisions for advance notice of upcoming resource retirements that could trigger future ISO backstop procurement;
- Simplified RMR structure with all retirement-related backstop procurement in the RMR tariff and only one compensation structure for RMR – cost of service;
- Must-offer obligation on RMR resources;
- Resource availability incentive mechanism based on methodology currently used for RA and CPM resources to ensure RMR resource bidding and availability;
- Updated rate of return for RMR resources and streamlined and automated RMR settlement leveraging existing ISO systems and processes; and
- More appropriate pricing for bids above the CPM soft-offer cap based on going-forward fixed cost compensation.

Management believes that the proposed clarifications and enhancements will result in the proper incentives for load serving entities and supply resources to contract to meet the ISO's reliability needs as the primary mechanism for securing sufficient resource capacity to meet operational needs. In the event ISO backstop capacity procurement is needed, the proposed enhancements provide effective measures to ensure that the ISO has the ability to procure resources needed to maintain a reliable grid and provide appropriate compensation for those resources.

Management proposes the following motion:

Moved, that the ISO Board of Governors approves the reliability must-run and capacity procurement mechanism enhancements proposal described in the memorandum dated March 20, 2019; and

Moved, that the ISO Board of Governors authorizes Management to make all necessary and appropriate filings with the Federal Energy Regulatory Commission to implement the proposal described in the memorandum, including any filings that implement the overarching initiative policy but contain discrete revisions to incorporate Commission guidance in any ruling on the proposed tariff amendment.

BACKGROUND

Since ISO startup in 1998, the ISO has had the authority to procure essential reliability services through RMR contracts. Under RMR contracts, resources are paid their full cost of service rates in exchange for being available for dispatch by the ISO to meet grid reliability needs. There were many RMR resources in the early years of ISO operations. In 2005, the RA program was established. It required resource procurement up to a planning reserve margin. This was accompanied by new backstop tariff provisions developed by the ISO in 2006 to procure for RA deficiencies that are now under the current CPM provisions. Under CPM, the ISO has the authority to competitively procure resources based on capacity bids to ensure the reliable operation of the grid under the following situations: (1) insufficient system, local or flexible RA capacity in year-ahead and/or month-ahead RA showings; (2) a collective deficiency of local capacity resources; (3) a “significant event” occurs; (4) ISO “exceptional dispatches” non-RA capacity; or (5) a resource is at risk of retirement that is needed for reliability in a future year. The ISO has updated the CPM several times since its inception.

RA procurement by load serving entities greatly minimized the need for RMR contracted resources. Between 2010 and 2016 there were only a handful of RMR resources under contract. However, in 2018 there was an uptick in the number of RMR resources – largely because of changes that have occurred on the system and in the market that has caused gas-fired resources to face increasing retirement pressures. Recent backstop procurement has identified concerns about the ISO’s current framework for RMR and CPM procurement. Stakeholders have argued that the 20-year-old RMR construct requires a holistic review and overhaul to reflect the needs of the transforming grid and to remain a viable backstop procurement mechanism. Also, stakeholders requested additional clarity for when CPM versus RMR procurement applies. Under the current construct, resources have some ability to select which backstop procurement construct (RMR or CPM) will provide them with the greatest revenue. Many market participants have raised concerns that the ISO’s backstop procurement mechanisms, due to their different compensation structures, may be providing inefficient incentives for resources to enter into the appropriate (RA, CPM or RMR) capacity contracts.

PROPOSAL

The ISO engaged with stakeholders over the past year to help develop enhancements to the RMR and CPM procurement mechanisms. The primary focus of this initiative was (1) “modernizing” the RMR agreement, (2) combining all retirement-related backstop procurement under RMR, and (3) clarifying when the ISO would use its RMR

versus CPM backstop procurement authority. Management has determined that CPM and RMR fill distinct backstop functions. Therefore, Management proposes to retain both the RMR and CPM backstop procurement mechanisms, with the following enhancements.

General Enhancements

Rules for Use of RMR and CPM

Management proposes clear rules for when the ISO would use either the RMR or CPM mechanism to procure capacity. Under the proposal, the ISO will only use RMR procurement to retain resources that would otherwise retire but are needed to maintain reliable grid operations. CPM will be used for all other backstop capacity procurement including curing load serving entity RA-procurement deficiencies, capacity needed for significant events on the grid that caused an unforeseen reliability need, and exceptional dispatches of non-RA resources.

Early Notification of Planned Resource Retirements

Management has established a report on the ISO website that notifies stakeholders when a resource has informed the ISO that it is planning to retire or mothball, thereby making the entire resource unavailable for an extended period of time. The report includes all resource notifications, regardless of size. For resources larger than 45 MW, the ISO expressly notifies stakeholders through a market notice. This early notification, which was implemented on July 6, 2018, provides stakeholders with information on upcoming resource retirements or mothballs that may trigger future ISO backstop procurement. Load serving entities can then consider procuring that resource, or other resources that can substitute for that resource's reliability contribution, in lieu of the ISO procuring that resource through its backstop procurement authority.

RMR Enhancements

Formal Retirement/Mothball Notice for RMR Designations

As discussed above in the early notification section, a resource can inform the ISO that it is planning to retire or mothball, thereby making the entire resource unavailable for an extended period of time. Stakeholders have raised concerns that the current RMR framework enables resources that may be planning to retire or mothball to "fish" to see if their resource is needed for reliability and therefore a possible RMR designation. This may cause resources to withhold from entering into an RA contract if they believe they could receive greater revenue through an RMR agreement. To address this concern, Management proposes that a resource owner must first submit

a formal retirement notice to the ISO before the ISO will study the need for the resource. Any resource that wants to be considered for an RMR designation must submit a formal, notarized retirement or mothball affidavit to the ISO. The affidavit will require the resource owner to state if it is retiring or mothballing because it is uneconomic for the resource to remain in operation, and eligible to receive an RMR designation, or if the resource is retiring for other reasons (such as loss of license). The notice must be signed by an officer of the company attesting that the resource will not remain in service and the decision to retire or mothball is definite unless some other type of ISO procurement of the resource occurs, the resource is sold to a non-affiliated entity, the entity receives some other contracts, or the resource enters into an RA contract. In the formal retirement or mothball notice, the resource must state that it is planning to retire or mothball at a certain date, but no later than 90 days prior to the date the resource intends to stop service. If the resource subsequently wants to come out of its mothball status early, it must submit a formal notice to the ISO that states which of the four conditions have changed for the resource, *i.e.* some other type of ISO procurement of the resource occurs, the resource is sold to a non-affiliated entity, the entity receives some other contracts, or the resource enters into an RA contract. The ISO has the right to refer the resource owner to the Federal Energy Regulatory Commission (“FERC”) if it appears that false information was submitted by the resource owner.

In addition, Management proposes to add new elements to the current retirement and mothball process to make it more orderly, mitigate the impacts on the RA program, and provide a longer runway for resource owners, if they so choose, to make significant business decisions in a timely manner. If a resource is an RA resource in the current RA year and is planning to retire or mothball, and the owner wants a longer runway to make decisions, it may submit a notice by February 1 of the current RA year and the ISO will perform a study and inform stakeholders of the results of the study by May 15. However, the ISO will not start its RMR procurement process for such a resource until September 1. This delay until September 1 provides an opportunity for LSEs to procure the resource rather than the ISO through RMR. This approach is consistent with the current RMR timeline where the ISO typically seeks new RMR designations from the Board at the September Board meeting. This timeline provides the necessary time for the ISO to negotiate the RMR agreement, which must be filed by October 31 (for a January 1 effective date) to satisfy the 60-day notice requirement in the Federal Power Act. Any new RMR designations will be conditional to allow for stakeholders to procure such resources prior to the end-of-October deadline for submitting annual year-ahead RA showings. This process can provide early information to resources that have submitted retirement or mothball notices that they

are not needed for reliability and can retire or mothball, or are needed and will be procured as RMR if they do not receive an RA contract, thus allowing the resource owner time to plan for the upcoming year.

Move Risk of Retirement CPM Authority into the RMR tariff section

The ISO currently has authority through the CPM section of the tariff to procure a resource that is at risk of retirement and is not needed for reliability in the next year but is needed in the following year. In this circumstance, the ISO can procure the resource for up to 12 months of the next year to provide a bridge to the second year with the expectation that load serving entities will procure the resource through an RA contract for year two. This type of bridging CPM authority has been referred to as “risk of retirement CPM.” Management proposes to merge the existing risk of retirement procurement authority from the CPM portion into the RMR portion of the tariff so there is one procurement mechanism for all retirement-related backstop procurement. As a result, all retirement procurement authority will be solely addressed through the RMR portion of the tariff, making the lines of authority clearer and more concise. The length of this type of RMR procurement will remain a maximum of one year, as it is now under the risk of retirement CPM tariff section.

Elimination of RMR Condition 1 Option

When RMR was initially established it made sense to offer resource owners an option where the owner could be paid for some of its fixed costs and also earn market rents that it could keep, known as “Condition 1.” Alternatively, the owner could be paid for all of its fixed and variable costs (i.e., “full cost of service”) and, in return, forfeit any market rents it earned, known as “Condition 2.” Currently a resource owner that enters into an RMR agreement can choose between the Condition 1 or Condition 2 option.

Management proposes to eliminate the Condition 1 option. Management proposes to retain only the Condition 2 option to ensure resources under RMR procurement receive no more than their regulatory approved cost of service, removing the potential incentive for resources to hold out of the bilateral capacity market for RMR procurement. This change also simplifies the RMR structure.

RMR Compensation and Rate of Return

RMR designations are mandatory, not voluntary. The ISO can require a resource seeking to retire or mothball to remain in service if the resource is necessary to maintain reliability. However, FERC precedent establishes the principle that for mandatory backstop procurement designations, an ISO/RTO must compensate a resource for its full cost of service, not merely its going forward costs.¹ Going-forward fixed costs do not include any rate of return, and therefore would imply a rate of return of zero percent, which would be inconsistent with this FERC precedent. Given this, the ISO is not proposing to change the current general RMR compensation structure of paying full cost of service, which includes a rate of return and may include major capital additions for major maintenance costs. As discussed above, Management proposes to retain the Condition 2 compensation scheme whereby the ISO will pay RMR resources their annualized full cost of service minus any market rents earned above the resource's variable costs. Full cost of service includes amortized fixed costs, necessary capital additions, and variable costs that the resource accrues while operating.

The ISO is, however, proposing to update the rate of return for an RMR resource's annual revenue requirements because the rate has not been updated in many years. The current fixed 12.25 percent return was established almost 20 years ago and is no longer applicable to current capital costs. Setting a new specific rate of return in a pro forma agreement that is generally applicable is challenging, so Management proposes to remove the 12.25 percent fixed rate of return currently in the pro forma agreement and require that a resource owner specify and support a rate of return for its FERC filing following designation for RMR service. This new approach is consistent with how rate cases are handled and it is the RMR owner who is responsible for filing the RMR agreement as its own rate schedule following ISO designation for RMR service. This approach is also consistent with how resources establish rate of return in rate cases for RMR service in other ISO/RTOs.² FERC establishes rates of return that reflect current capital market conditions while considering the individual RMR owners' unique debt and equity amounts reflected on their books.

¹ For example, in the 2016 order on compliance and rehearing to the New York ISO ("NYISO"), FERC rejected "arguments in this compliance proceeding that a generator should not be eligible to request compensation up to its full cost-of-service under NYISO's proposal." In its prior order, FERC stated that compensation to an RMR generator "must at a minimum allow for the recovery of the generator's going-forward costs, with parties having the flexibility to negotiate a cost based rate up to the full cost of service."

² See, e.g., *Constellation Mystic Power, LOC*, 164 FERC ¶ 61,127 (2018).

Must-Offer Obligation for RMR Resources

Management proposes that RMR resources have a must-offer obligation that is similar to the must offer obligation of RA resources. Under the proposal, all RMR resources will have a 24x7 must-offer obligation to the ISO market and be required to bid at a specified marginal cost-based rate so that the market can capture the energy value of the resource. Like RA resources, RMR resources will also be subject to bid generation if they do not bid, unless it is a use-limited resource.³ RMR resources must be in the market for all hours that the resource is physically capable of submitting bids, with the market committing and dispatching the resource based on the bid cost of the resource. Because the ISO pays the RMR resource its full annual cost of service, it is appropriate to have the resource's full participation in the energy and ancillary services market at a cost-based rate. Less than full participation could lead to unnecessary over-procurement and ratepayers not receiving the full value of the RMR resource. RMR resources must bid into the market at their full marginal energy and commitment costs. This will ensure that they are optimally scheduled and dispatched by the ISO market. Bid costs must include fuel, operation and maintenance, greenhouse gas emission, and grid management charge. Bids also must include major maintenance costs, and opportunity cost adders that reflect certain operational limitations of use-limited RMR resources.

Performance Incentive Mechanism for RMR Resources

It is important that RA, CPM and RMR resources all have performance incentives so they are motivated to provide the services for which they were procured. RA and CPM resources are subject to the resource adequacy availability incentive mechanism ("RAAIM"). RMR resources are currently subject to two performance penalties: (1) an hourly financial penalty for not being in full compliance with an RMR dispatch notice, and (2) a financial adjustment made at the end of the RMR agreement year if the RMR resource has exceeded the historical long-term planned outage availability metric established for that year.

Management proposes to eliminate these two RMR performance incentive provisions because they do not provide an incentive to submit bids and they limit the ISO's ability to streamline the RMR settlement process by requiring the ISO to track and validate availability in a separate tracking system from what the ISO uses for RA and CPM. Management further proposes that all RMR resources be subject to the RAAIM

³ The ISO will not submit bids for use-limited RMR resources because they are required to bid their opportunity costs determined by the ISO, which is not covered under the ISO's bid generation functionality. Use-limited RMR resources will have a 24x7 must-offer obligation under their contractual obligations just like non-use-limited RMR resources.

mechanism, which is the same performance incentive mechanism used for RA and CPM resources. The RAAIM penalty price for RMR resources will be the RMR agreement price in \$/kW-year. Using RAAIM as the RMR performance incentive allows the ISO to leverage current systems and functionality. If the ISO modifies RAAIM in the future, it can apply such a modified mechanism to RMR.

Cost Allocation for RMR Resources

Management proposes to shift the cost allocation for RMR resources away from the participating transmission owners and directly to load serving entities who are the actual recipients of the RMR benefits.

Allocate Flexible RA Credits for RMR Resources

Management proposes to allocate flexible RA credits from RMR designations to load serving entities to the extent the resource has met the operational requirements to be a flexible RA resource. This approach is appropriate because the ISO is procuring the entire resource and all of its attributes when the resource is procured under RMR.

Streamline and Automate RMR Settlement and Banking

Management proposes to leverage the current ISO settlement system and interface to automate the RMR validation and invoicing processes. The ISO currently performs RMR settlement manually outside of the ISO settlements system, and this change will significantly improve the efficiency of the process.

Management proposes to lower banking costs associated with RMR invoicing by using the ISO's market clearing account for all payments from, and disbursements to, RMR parties. This change will simplify RMR by eliminating the current requirement that multiple bank accounts be established for each RMR resource.

Align System and Flexible RMR Authority

Management proposes to align the pro forma RMR agreement with the ISO's existing RMR tariff authority to designate for system reliability purposes. Currently the pro forma RMR agreement discusses only RMR procurement for local reliability needs. The ISO needs to update the pro forma RMR agreement to reflect RMR designations for system and flexible reliability needs.

CPM Enhancements

CPM Compensation

CPM is a capacity procurement mechanism that utilizes a competitive solicitation process where potential suppliers submit capacity offers (bids) for year-ahead, month-ahead and intra-month services. There is a “soft-offer cap” on bids, which is intended to be an estimate of the going forward fixed costs of the marginal resource needed on the system, plus 20 percent. The soft-offer cap serves as a “safe harbor” where bids submitted below the cap do not have to be cost-justified with FERC.⁴ A resource can offer a bid price above the soft-offer cap price, but must make a cost justification filing at FERC, and FERC must approve the price. Currently, cost-justification for prices above the soft-offer cap must be based on the formula for determining the annual fixed cost of service of an RMR resource.

CPM designations can be for a term of one to twelve months, depending on the reliability need. CPM designations are for the specific MW of capacity needed to meet a reliability need and are typically for less than the full capacity of a resource. The ISO procures only the amount of capacity it needs (unlike an RMR agreement where the ISO must procure the entire resource and all of its capacity). The overwhelming majority of CPM designations to date have been for one-month or two-month durations. The ISO has procured for a 12-month term only once.⁵

If a resource has voluntarily submitted a bid into the competitive solicitation process and the ISO accepts that bid, then that resource cannot decline the CPM designation. If there are no effective bids in the competitive solicitation process, the ISO can offer a resource that did not submit a bid a CPM designation at the soft-offer cap price. The resource may decline the designation because CPM procurement is voluntary and the resource did not submit a bid.

As discussed above, resources currently seeking a CPM rate above the soft-offer cap must file with FERC to obtain a resource-specific rate based on the resource’s full fixed cost of service using the formula contained in the pro forma RMR agreement. Stakeholders have raised concerns that the current CPM compensation is excessive for CPM offers above the soft-offer cap because it includes the resources’ full cost of service in addition to the retention of all energy market revenues. To address this concern, Management proposes to file two alternative proposals with

⁴ The soft-offer cap is based on a reference resource -- currently a merchant-constructed mid-cost, 550 MW combined cycle resource with duct firing. The CPM soft-offer cap is currently \$6.31/kW-month (\$75.68/kW-year).

⁵ In December 2017, the ISO procured capacity from three different resources to cure a year-ahead annual RA showing deficiency for 2018.

FERC to change the current approach. First, as its preferred approach, Management proposes to allow a resource to file at FERC based on its resource-specific going-forward fixed costs (using the same cost categories on which the CPM soft-offer cap is based) plus a 20 percent cost adder and the ability to retain all market rents. This approach aligns with current FERC-approved CPM soft-offer cap. The preferred approach reflects FERC's prior guidance that CPM compensation should provide for some fixed-cost compensation above going-forward costs since FERC previously rejected an ISO proposal to base CPM compensation on going-forward fixed costs plus a 10-percent adder. Management proposes to also file an alternative proposal that FERC can consider if it does not accept Management's preferred proposal. The alternative proposal provides that prices above the soft-offer cap would be based on a resource's going-forward costs without a 20-percent adder. The alternative proposal recognizes prior FERC orders in other parts of the country that backstop procurement mechanisms that are voluntary need only provide at a minimum for recovery of going-forward costs.

POSITIONS OF THE PARTIES

Most stakeholders support enhancements to RMR as they agree that the RMR construct needs to be updated. Also, most stakeholders support having only one mechanism for retirement-related backstop procurement. Most stakeholders agree that compensation for CPM offers above the soft-offer cap should be reviewed. However, some stakeholders advocate for far-reaching RMR and CPM changes beyond what Management is proposing and what was considered in this initiative, particularly around RMR and CPM pricing. Some parties strongly oppose specific aspects of ISO Management's proposal and these concerns are discussed below and in the stakeholder comments matrix that is provided as Attachment A. Management has had to balance many diverse stakeholder positions to arrive at this proposal.

Must-Offer Obligation

Several resource owners oppose a 24x7 must-offer obligation for RMR resources. They are concerned that requiring RMR resources to bid into the market all hours at cost-based prices will inappropriately suppress prices in the energy market and cause RMR resources to run excessively.

Management disagrees. Having RMR resources submit bids at full marginal costs will result in efficient pricing and dispatch. ISO/RTO markets are based on the premise that in a competitive wholesale electricity market a resource's efficient offer is approximately equal to its marginal costs. In the ISO's market, this includes major maintenance and opportunity costs, as applicable. Management proposes to require

RMR resources to include these costs in their bids. Thus, bids from RMR resources should not be below their marginal costs. The proposed pricing of cost-based RMR market bids is consistent with FERC's competitive pricing principles.

Some resource owners argue that a 24x7 must-offer obligation may cause some resources to run more than they have in the past. This may or may not be true, but the argument ignores that RMR resources with high marginal costs, reflecting fuel and heat rate and major maintenance costs, will have high RMR cost-based bids, and therefore will run infrequently. Further, use-limited RMR resources will be required to bid opportunity costs, if applicable, which will make their cost-based bids even higher and less likely to be dispatched. RMR resources that may have eligible use-limits will be required to establish those limits during the RMR agreement negotiation process, resulting in agreed-upon use-limits that are translated into opportunity cost adders. To the extent there are approved capital items, such costs would be reflected in the major maintenance adder component of the bids. Because RMR resources will be required to bid into the market during all hours at a specified marginal cost, it is particularly important for these resources to have opportunity costs and major maintenance adders included in bids to prevent the resource from running excessively. The RMR agreement will require the RMR resources to include these components as part of their cost-based bids.

Use of Resource Adequacy Availability Incentive Mechanism

Management proposes that RMR resources will be subject to RAAIM, similar to RA and CPM resources. Several stakeholders support this approach, but many oppose using RAAIM. They argue instead that the ISO should apply a 24x7 availability standard for each RMR resource. Some stakeholders object to RMR resources being able to avoid RAAIM by providing substitute capacity that is not electrically located at the same bus and does not have identical attributes. They argue that this will allow RMR resources to substitute capacity that does not have an equivalent RAAIM penalty price, is not required to bid at marginal cost, and may not meet the reliability need for which the ISO granted the RMR designation.

Management does not agree with stakeholder concerns. The RAAIM performance incentive and substitution rules work well in operating the grid. RA, CPM and RMR resources are all needed to meet the ISO's reliability needs. The procurement mechanism used does not necessitate a different resource availability obligation.

Some stakeholders argue that RMR resources will have no incentive to provide availability during hours outside of the RAAIM availability assessment hours. Instead, they argue that RMR resources should have a 24x7 performance obligation. The ISO

disagrees. RMR resources will have the same 24x7 must-offer obligation applicable to RA and CPM resources, and FERC has recognized that a capacity resource's failure to meet its energy market obligations (such as a must-offer obligation) may be a tariff violation. The ISO notes that RA and CPM resources can meet the same reliability needs (as can an RMR resource) and the ISO does not assess their performance on a 24x7 basis. It is not credible to suggest that RMR owners will only make their resources available to meet the RAAIM availability assessment hours and then make their resource unavailable in all the other hours of the day through declaring a forced outage. Management proposes to report RMR resources' compliance with their must-offer obligation to the ISO Department of Market Monitoring on a monthly basis.

Stakeholder concerns that RMR resources might be unavailable when needed is also effectively addressed by the ISO's outage coordination process. Operations engineers will not approve outages impacting reliable operation and will require mitigation or cancellation of other outages before approving an outage.

Some stakeholders note the ISO is considering possible alternatives to RAAIM in its ongoing RA enhancements initiative. They argue that adopting RAAIM for RMR resources is inappropriate while this initiative is ongoing. These stakeholders ignore that RA and CPM resources are currently subject to RAAIM. If the ISO adopts a different performance metric going forward, the ISO will also apply it to RMR resources to ensure consistency across RA, CPM and RMR.

CPM Compensation

Some stakeholders prefer a different formula than that proposed by the ISO for the price that can be bid above the CPM soft-offer cap price. These stakeholders argue for using either cost of service pricing with a claw back of all market rents or paying only going-forward fixed costs with perhaps some small adder (less than 20 percent) as a contribution to capital. The former is essentially RMR pricing and the type of pricing that is required for mandatory backstop procurement. Acceptance of a CPM designation is voluntary, not mandatory. FERC precedent makes clear that pricing of voluntary backstop procurement need only provide for the recovery of going-forward fixed costs.

The recommendation of going-forward fixed costs plus a small adder ignores the fact that FERC previously rejected an ISO proposal to base compensation on going-forward fixed costs plus a 10-percent adder. The current CPM soft-offer cap is based on a 20-percent adder. FERC has been clear that CPM pricing must provide for some meaningful fixed-cost contribution to permit resources to undertake necessary

upgrades and capital maintenance. Management's preferred proposal for a price that can be bid above the soft-offer cap price is consistent with FERC's specific precedent regarding CPM compensation. The ISO's alternative approach, which FERC should consider only if it rejects the preferred approach, is based on FERC findings in other proceedings that voluntary backstop procurement must, at a minimum, provide for recovery of going-forward fixed costs.

Management seeks Board approval to file both primary and alternative tariff sheets. Timely approval is critical to the timely implementation of the ISO's proposal, and the filing of alternative tariff sheets will facilitate this outcome.

Several stakeholders sought changes to the CPM soft-offer cap, different compensation for CPM designations that last for 12 months, and/or imposition of additional market power mitigation measures. Some stakeholders argue that the ISO should consider paying only cost of service or going-forward fixed costs for 12-month CPM designations. These requested changes are beyond the scope of this initiative and the tariff changes Management is proposing. Management has committed to starting a stakeholder process this year to update the CPM pricing, including considering the compensation to be paid for 12-month CPM designations. The ISO tariff requires the ISO (or the California Energy Commission) to undertake a cost of service study before the ISO can change the CPM soft-offer cap. No such study has been undertaken at this time. Further changes to CPM pricing should be undertaken in connection with this cost study so that all decisions are based on the most up-to-date cost data. Also, there are significant implementation impacts associated with pricing 12-month CPMs differently that would not allow the RMR and CPM enhancements initiative to be implemented by the end of this year.

RMR Compensation

Several stakeholders want to reduce RMR compensation from the full cost of service pricing that has been in effect since the inception of RMR at the ISO. They argue for compensation that would not cover all of the amortized fixed costs, a rate of return, necessary capital additions, and variable costs that the resource accrues while operating. Management does not agree and believes that full cost of service compensation is appropriate given that the RMR designation at the ISO is mandatory. FERC precedent requires that mandatory backstop procurement -- like RMR -- be priced based on a resource's full cost of service, not just going-forward fixed costs.

Mothball Requirements

Several stakeholders want stronger requirements to mothball a resource than those proposed due to concerns that resource owners may “fish” for an RMR designation. To address this concern, the ISO has added additional requirements to the affidavit that must be submitted to mothball a resource.

Moving between RMR Procurement and Market Participation

Some stakeholders have expressed concern that the existing RMR provisions are not adequate to deter a resource from moving between RMR procurement and market participation. The ISO believes that its existing FERC-approved compensation rules appropriately address the potential of “toggling” between being an RMR resource and a market resource.

First, the RMR agreement compensates RMR owners for the year of RMR service on a year-by-year basis. RMR resources cannot voluntarily “toggle” between RMR and the market year-by-year. If the ISO offers an RMR agreement to a resource or an extension of an existing RMR agreement, the resource owner must accept it.

Second, to prevent resources from “fishing” for an RMR contract, if the resource is found not to be needed for reliability, it will be expected to retire or mothball as indicated in its affidavit.

Third, the ISO settlements system today and in the future will ensure that the RMR services provided are compensated at their cost of service. All market rents above those entitled under the agreement are applied to offset fixed costs payable under the RMR agreement. Thus, such RMR resources cannot recover amounts in excess of their FERC-approved fixed cost of service and actual variable costs.

Fourth, the ISO differs significantly from other ISOs/RTOs that have an RMR-like procurement mechanism in that the ISO does not upfront fund all capital addition costs. In other words, the accelerated, up-front payment of needed capital improvements that exist in other ISOs/RTOs does not exist in the ISO. Rather, the RMR resource owner must up-front fund or finance all capital additions. Each capital addition will have a depreciation schedule with the RMR compensation limited to the pro rata annual contribution for each year the resource remains under an RMR agreement. The ISO only compensates the RMR owner for a one-year portion of its capital addition costs for each year of RMR service based on the depreciation schedule, and FERC must approve the RMR agreement, including the depreciation schedule. Once the RMR agreement is terminated, the ISO’s contribution towards any balance of unpaid capital additions costs terminates if the resource returns to the market.



CONCLUSION

Management requests the ISO Board of Governors approve this proposal. The important enhancements to RMR and CPM are needed now and should be put in place promptly given the transforming needs of the grid.