

**SDG&E COMMENTS ON THE CAISO’S CAPACITY PROCUREMENT
MECHANISM PROPOSAL**

The final draft of the Capacity Procurement Mechanism (CPM) issued August 16, 2010, largely tracks the existing mechanism it seeks to replace. The price paid for CPM procurement would be updated to reflect current estimates of going-forward fixed costs, and the CAISO would continue to make 30-day capacity procurements to boost its ability to manage various operational situations that develop from time to time. The one major change is the CAISO’s proposal to seek authority to make longer term capacity purchases from a resource that might exit the market prematurely, in the CAISO’s judgment, for want of a Resource Adequacy (RA) contract.

At first blush, it would appear that adopting the new mechanism should be accomplished without significant controversy given that the current mechanism has been used relatively infrequently.¹ The conversation at the August 23 stakeholder meeting, however, produced no favorable endorsements from the seller or buyer camps, suggesting that the discord over the CPM stems fundamentally from other causes. Suppliers complained that the CPM is part of an overall scheme that has the effect of segmenting the RA market, thereby allowing “marginal” capacity to be procured for a short duration at a low total cost. Load-serving entities complained that the CPM intrudes upon the RA and long-term procurement programs regulated by the CPUC, thereby allowing the CAISO, in effect, to nullify compliance with RA obligations by incurring and allocating CPM costs to load-serving entities that are RA complaint. Under this line of thinking, the

¹ Indeed, the current mechanism has not been used at all for its primary purpose of procuring capacity to: (1) backstop the failures of load-serving entities to meet their assigned RA obligations, or (2) manage significant, unexpected events on the system.

CAISO has either failed to specify upfront the type, amount, and location of capacity it needs to operate the system reliably, or it is unable or unwilling to maintain reliability by using short-run energy and ancillary services prices to attract non-RA resources to the day-ahead markets. SDG&E suggests there may be more than a little conceptual truth in these perspectives.

SDG&E believes the CAISO has placed itself in this unenviable position by relying *exclusively* upon capacity-based products – that is, resources with a legal obligation to make an offer – to operate the day-ahead and real-time energy and ancillary services markets. There are other non-RA resources available to run, but the energy and ancillary services prices are suppressed by various forms of overly-zealous market power mitigation and thus provide compensation that is inadequate to ensure that these non-RA units will have financial incentives to be available in the day-ahead market. The CAISO operators understandably do not want to rely upon these overly-suppressed energy prices to attract non-RA resources to the day-ahead market, and therefore resort whenever slightly pressed to offering a backstop capacity contract to ensure that selected non-RA resources have a legal obligation to be available in the day-ahead market. Thus, a short-run system dispatch problem that should be solved by competing energy offers submitted by *all* generators capable of running – RA or otherwise – is distorted into a backstop capacity procurement exercise that continually intrudes upon the RA and long-term procurement functions regulated by the CPUC and local regulators.

A CPM focused on backstopping the RA program and dealing with significant, unexpected events would limit the opportunity for turning the CPM into a regulatory football being kicked from San Francisco to Washington and back. The CPUC and load-

serving entities accept the need for a CAISO backstop mechanism to cure RA deficiencies and to address significant, unexpected events, but that support becomes tenuous at best when the CAISO relies excessively on short-term capacity procurement to lubricate the day-ahead and real-time markets. The current practice needlessly calls into question the efficacy of the CPUC's RA and long-term procurement programs, and adds fuel to the supplier complaint that capacity is being procured on the cheap.

The CAISO's confusion about its capacity procurement backstop role reaches its zenith when it proposes to intervene in the forward capacity markets to prevent the mothballing of capacity that is not needed by any load-serving entity to meet next year's RA obligations. The CAISO is a full participant in the CPUC's RA proceeding where the RA obligations – system and local – are established. Each year the CAISO prepares an analysis of local capacity requirements, and so far the CPUC has dutifully adopted these requirements and imposed them on load-serving entities that are subject to its jurisdiction. If the CAISO has, or can develop, the ability to forecast these local capacity requirements for more than one year forward, then that information should be provided so load-serving entities can make forward procurement decisions that incorporate expected changes in the local capacity requirements. The forward bilateral capacity markets can handle this relatively simple problem if buyers and sellers are provided accurate information about expected changes in local capacity requirements. If accurate forward information cannot be developed by the CAISO and presented in the annual RA proceeding, then there is surely no reason for the CAISO to make long-term capacity purchases on the basis of speculation. There is simply no need for the CAISO to jump into the commercial market fray, ousting load-serving entities from performing

their procurement function, and there is a good deal of harm that can result from the CAISO becoming a participant in the market it is tasked with operating. Merely possessing such authority, even if unused, would distort the negotiations between suppliers and load-serving entities because of the possibility that the CAISO might take preemptory action.

In conclusion, SDG&E supports a CPM that is dedicated to: (1) curing any collective failure of load-serving entities to meet the system and local RA obligations, and (2) managing significant events that were not contemplated when the RA obligations were established. The CAISO should drop any notion that it should seek authority to intervene in forward capacity markets to avoid premature or inefficient mothballing of selected units. Rather, the CAISO should provide its best analysis of forward local capacity requirements and rely upon suppliers and load-serving entities to negotiate an economically-efficient outcome within the parameters of the CPUC's RA and long-term procurement programs. Further, the CAISO should revise its market power mitigation protocols to address the current imbalance of revenues being derived from the energy and capacity markets so that non-RA units will have adequate economic incentives to participate in the day-ahead and real-time energy and ancillary services markets. If use of the CPM is limited as discussed above, then suppliers will have little reason to complain about the CAISO's alleged segmentation of the forward capacity markets and the need for cost-of-new-entry pricing to avoid long-term market failure.

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