California Independent
System Operator

Memorandum

To: ISO Board of Governors

From: Armando Perez, Vice President of Planning & Infrastructure Development

Date: July 9, 2007

Re: ***Decision on Adopting the use of the Local Capacity Reliability Study Criteria as the Local Area Reliability Criteria for Reliability Must Run contracts***

This Memorandum requires Board action.

EXECUTIVE SUMMARY

Currently, the CAISO applies different, technical study criteria to its assessments of (1) the need for Reliability Must-Run (RMR) units and (2) local capacity needed to satisfy state-governed resource adequacy (RA) requirements. Local Area Reliability Study criteria are used for the RMR analysis, and Local Capacity Requirements Study criteria are used for the RA analysis.

Both sets of criteria address local reliability requirements, but the studies performed for RA purposes better align with mandatory NERC Planning Standards and other operating requirements. Thus, Management is asking the Board of Governors to replace the criteria used for RMR purposes with the more comprehensive criteria used for RA purposes. In so doing, the CAISO will simplify its process and reduce its workload.

This proposal avoids contentious cost allocation issues because they will be addressed in the stakeholder process currently underway to develop an Interim Capacity Procurement mechanism for implementation in 2008. In the event that process does not resolve the issue by 2008, the CAISO will develop a specific proposal for modifying RMR cost allocation policies.

The tariff change required to implement this recommendation must meet an August 3, 2007 deadline to submit a filing in compliance with the Federal Energy Regulatory Commission's (FERC) September 21, 2006 and April 20, 2007 orders on the Market Redesign and Technology Upgrade tariff. Those orders require the CAISO to distinguish the reliability criteria applicable to Local Area Reliability Studies used for RMR purposes and the Local Capacity Requirement Study used for RA purposes.

Management recommends that the Board adopt the following motion:

> ***Moved,***
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> ***That the ISO Board of Governors approve use of the LCR Study criteria and methodology as the single set of local reliability study criteria for purposes of determining both local***

Resource Adequacy capacity requirements and local Reliability Must-Run contract requirements.

ISSUE STATEMENT

Prior to deregulation of the electric industry in California, the individual Participating Transmission Owners (PTOs) had full control of their generating plants. If a local reliability criteria violation was detected, it was possible to address the violation by building new transmission or making sure a particular generating facility was on-line. Frequently, the generating unit option was preferred since the PTO had control over its own generating portfolio. Deregulation and divestiture of generating facilities by the PTOs changed this environment. Generating plants required for local reliability were no longer under the PTOs' control and, as a result, the CAISO created RMR contracts to assure generating plant availability. The CAISO performed an annual RMR technical study to develop request for proposals under its LARS process to secure RMR capacity.

From its inception RMR has been controversial. As such, the CAISO, CPUC and other market participants have collaborated to minimize the need for RMR by transitioning to a paradigm where sufficient local capacity is procured by LSEs through RA requirements. The CAISO has facilitated this transition by developing its Local Capacity Requirement (LCR) Study criteria. Local area capacity requirements based on the LCR Study criteria have been presented to stakeholders on many occasions over the last two years (2006 and 2007) and have been adopted by the CPUC as the basis for local procurement by its jurisdictional LSEs beginning in 2007 and again for 2008. (See, CPUC Decisions 06-06-064 and 07-06-029.)

As noted above, the LCR Study criteria used for RA purposes better conforms to the grid planning and operating standards promulgated by NERC/WECC that are applicable to the CAISO Controlled Grid. The Local Area Reliability Service (LARS) study criteria, while consistent with the LCR Study, are only a small subset of the new mandatory NERC/WECC standards and fail to account for local operational needs of the CAISO, especially in the LA Basin area. The LCR Study, but not the more-narrow LARS, evaluates the more appropriate set of NERC/WECC planning and other operating requirements necessary for the CAISO to satisfy the current mandatory reliability criteria.

The implementation of local capacity RA requirements based on the more comprehensive LCR Study criteria renders the RMR study criteria superfluous and likely a source of confusion. Prior to RA, the LARS process was used to identify resources for potential RMR contracting because there was no obligation on LSEs to make the capacity needed for local reliability available to the CAISO. That is no longer the case. RA local capacity requirements, which are based on the broader LCR Study criteria, impose an obligation for LSEs to procure the needed capacity. The result is that the CAISO may or may not be required to procure additional local capacity depending on the capacity contracted for by the LSEs. RMR procurement can then be used as a backup tool, but the LARS process is no longer the vehicle to study and procure capacity needed for local reliability. For this reason, the CAISO proposes that the Board of Governors approve a single set of local reliability study criteria, i.e. the existing LCR Study criteria, which can then be used for two purposes. First, it will permit the CAISO to conduct only one study to determine minimum local capacity requirements across the CAISO grid. Second, if necessary, it will facilitate the CAISO's ability to utilize the RMR contract as a backstop mechanism coextensive with the local RA requirement, but after LSEs have had the opportunity to demonstrate compliance with local RA requirements. This change will eliminate inefficiency and confusion created by maintaining two sets of study criteria.

POSITIONS OF THE PARTIES

This issue has been discussed with stakeholders on two occasions. The first instance occurred at a December 6, 2006, stakeholder meeting hosted by the CAISO to discuss the LCR Study criteria. The second instance occurred at a May 18, 2007 stakeholder meeting to discuss the CAISO's pending Interim Capacity Procurement proposal. Comments were received from stakeholders following the May 18th stakeholder meeting.

The primary, and virtually sole, concern raised by stakeholders relates to an alleged increase in potential RMR costs and the allocation of such costs. The concern regarding potentially increased RMR costs arises because applying the LCR Study criteria yield higher local capacity requirements when compared to the LARS criteria.[1] However, this potentially expanded scope of RMR procurement is unlikely given the policies pursued by the CAISO to minimize RMR procurement for local capacity purposes. As noted above, the imposition of local capacity RA requirements, with the threat of penalties by the CPUC or other local regulatory authorities for noncompliance, has resulted in a decrease in RMR procurement by the CAISO for capacity purposes. For 2007, the CAISO extended RMR contracts for 3,995 MW. This represented a 5,876 MW reduction from 2006. The extension included 2,753 MW because local RA capacity was not procured and 1,242 MW for ancillary services not expected under local RA contracts.[2] The CAISO will continue to primarily rely on LSE procurement to meet local capacity requirements.

Furthermore, the CAISO intends to utilize the Interim Capacity Procurement mechanism, currently under development in an ongoing stakeholder process, as its primary method to backstop procurement needs in the event LSEs fail to secure sufficient local capacity to meet reliability requirements. The CAISO anticipates filing with FERC its Interim Capacity Procurement proposal in September 2007 for implementation in 2008. Upon adoption of the Interim Capacity Procurement proposal by FERC, the use of RMR to procure local capacity should be limited to highly unusual or special circumstances, such as where the characteristics of the unit render the capacity payment under the Interim Capacity Procurement mechanism somehow insufficient to sustain the operational viability of the unit or if the local reliability services cannot be obtained from the RA resource. However, in the event the Interim Capacity Procurement mechanism is not timely authorized, the CAISO will only have the existing RMR contract authority as the sole means of engaging in backstop procurement for 2008 local requirements. Accordingly, this request to align the study criteria will facilitate the CAISO's ability to utilize the RMR contract as a backstop mechanism coextensive with the local RA requirement, but after LSEs have had the opportunity to demonstrate compliance with local RA requirements.

With respect to RMR costs, the CAISO acknowledges the potential need for changes to the cost allocation provisions of the *pro forma* RMR Contract if RMR in the event the Interim Capacity Procurement mechanism is delayed for any reason. Today, RMR costs are allocated to the investor-owned utility as the Responsible Utility under the RMR Contract where the RMR unit is located and then spread out into the Responsible Utility wholesale transmission customers through the Responsible Utility Reliability Services Tariff. This is inconsistent with the allocation of responsibility for local capacity under RA programs. Accordingly, the CAISO is committed to minimizing the use of RMR and developing the Interim Capacity Procurement mechanism to backstop for needed local capacity. In addition, the CAISO would purse modifications to RMR cost allocation policies in the event an Interim Capacity Procurement mechanism is delayed for any reason.

MANAGEMENT RECOMMENDATION

Management recommends that the CAISO Board of Directors approve the adoption of a single set of local reliability study criteria and methodology, the LCR Study criteria and methodology, as described in this memorandum.

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[1] Using 2007 data, the existing RMR study criteria results in 17,962 MW of needed capacity (9,969 MW market resources + 7,993 MW of QF/Muni/Nuclear resources), while the LCR criteria results in 22,935 MW of local capacity.

[2] In addition to the obligation to make capacity available to the CAISO, RMR contracts are also used to secure certain ancillary services, including black start and dual fuel capability. RA contracts do not provide for these services. Thus, the CAISO will continue to utilize RMR contracts to secure these services as necessary.