

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

Independent Energy Producers Association,	)	
	)	
Complainant,	)	
	)	
v.	)	Docket No. EL05-146-000
	)	
California Independent System Operator Corporation,	)	
	)	
Respondent	)	
	)	
	)	

**ANSWER OF THE  
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION  
TO THE COMPLAINT OF THE  
INDEPENDENT ENERGY PRODUCERS ASSOCIATIONS**

Pursuant to Rule 213 of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.213, the California Independent System Operator Corporation (“ISO”) respectfully submits its Answer to the Complaint of the Independent Energy Producers Association to Implement an Interim Reliability Capacity Services Tariff (“Complaint”). The ISO requests that the Commission act on the Complaint in a manner consistent with the discussion herein. In particular, the Commission should convene a technical conference to consider the nature and scope of a possible capacity service to replace the Commission-mandated Must-Offer Obligation subsequent to the implementation of the Resource Adequacy program that is being instituted under the direction of the California Public Utilities Commission (“CPUC”). However, the Commission

should deny the complaint to the extent that it seeks a determination that the existing Must-Offer Obligation is unjust and unreasonable and should be replaced or revised prior to June 1, 2006.

**I. Introduction and Summary.**

The Independent Energy Producers Association (“IEP”) filed this complaint on August 26, 2005, alleging that the Must-Offer Obligation is no longer just and reasonable. It asserts that the Must-Offer Obligation does not fairly compensate Generators for their capacity; creates a perverse incentive for load-serving entities to forego forward contracting opportunities; and artificially suppresses California Energy prices, providing inadequate price signals for new investment in Generation and transmission. IEP requests that the Commission replace the Must-Offer Obligation with a Reliability Capacity Services Tariff.

The ISO appreciates the concerns that prompted IEP to bring reliability compensation issues before the Commission. The ISO acknowledges that the circumstances in the larger California electricity market are such that both existing generating resources and new resource developers are challenged to secure stable opportunities to recover a return both on and of their investments. The ISO also recognizes that its current market structure for addressing reliability concerns, through a combination of Reliability Must-Run Generation, real-time Intra-Zonal Congestion management protocols, and the Must-Offer Obligation, fails to induce appropriate investment in the infrastructure necessary to ensure long-term service reliability to California consumers, i.e., it raises long-term reliability compensation issues, as those issues are discussed in *PJM Interconnection, LLC*, 107 FERC ¶ 61,112 (2004). This does not mean,

however, that the compensation of units operating under the Must-Offer Obligation, in the absence of a capacity compensation program, is unjust and unreasonable. The short-term compensation provided Must-Offer resources is commensurate with the service provided, is sufficient to cover a resource's operating costs, and provides an opportunity to recover fixed costs.

What the current structure for compensating reliability resources fails to provide is an effective long-term assurance of sufficient revenues to cover fixed costs and earn a return so as to encourage investment in Generation. While the ISO is retooling other aspects of its market design through the ISO's Market Redesign and Technology Upgrade ("MRTU"), the CPUC is addressing such long-term reliability compensation issues through the CPUC's Resource Adequacy Program. The ISO is an active participant in the CPUC process.

ISO agrees with IEP that, once a Resource Adequacy Program is in place in June 2006, an ISO-Tariff based capacity-based service may be both an appropriate substitute for the current Must-Offer Obligation and, once the CPUC's Resource Adequacy program becomes effective, a reasonable backstop mechanism should load-serving entity-based procurement fail to satisfy all of the ISO's reliability requirements. Before the details of such a service can be finalized, however, a number of issues, such as compensation, the duration of commitments, allocation of costs, and the timing of implementation need to be carefully evaluated and resolved. The ISO therefore supports IEP's request that the Commission convene a technical conference to address the development of a capacity-based backstop service.

Importantly, as a key input into this process, the ISO believes that no such ISO capacity service can be implemented before June 1, 2006, the earliest date on which the ISO could feasibly implement the necessary processes to support a back-stop capacity service.<sup>1</sup> As a practical matter, earlier implementation of a capacity-based service would be problematic because it would require the ISO to divert significant resources from, and would otherwise interfere with the development of, MRTU and the ISO's new integrated settlements software platform, the Settlements and Market Clearing Project ("SaMC").<sup>2</sup> In any event, an earlier implementation is not required because IEP has shown that suppliers are unfairly compensated under the current Must-Offer Obligation.

Therefore, the Commission should deny IEP's complaint as to the period prior to June 1, 2006, but, with regard to the period subsequent to June 1, 2006, should grant IEP's request and convene a technical conference for (1) receiving input from Market Participants regarding the appropriate nature of a back-up capacity program to be implemented in connection with implementation of the CPUC's Resource Adequacy Program in June 2006, and (2) designing the rules for such a "backstop."

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<sup>1</sup> June 1, 2006, is the earliest feasible date a backstop capacity service could be implemented to allow for adequate time to define and implement the policy details in the existing systems. This includes time to complete the necessary off-line studies and develop processes to determine the resources necessary to provide back-up capacity service.

<sup>2</sup> The implementation of SaMC is expected June 1, 2006. Basically, the same reasons that caused the ISO to seek – and the Commission to approve – a deferral of implementation of the Station Power program following Duke Energy's Complaint support deferred implementation of any Must-Offer Obligation replacement mechanism approved in this proceeding. See *California Independent System Operator Corporation*, 111 FERC ¶ 61,452 at PP 58-62 ("Station Power Order"). Further, a June 1, 2006 implementation date will allow the ISO to "synch up" the backstop with the CPUC's resource adequacy program, rather than developing a program and then having to modify the program when resource adequacy is implemented.

## II. Discussion

### A. The Commission Has Laid Out the Appropriate Framework for Analysis of IEP's Complaint in Previous Orders Regarding Reliability Compensation Issues.

The Commission has set forth the appropriate framework for analyzing IEP's Complaint in previous orders regarding reliability compensation issues. IEP relies upon one of these orders, *PJM Interconnection, LLC*, 107 FERC ¶ 61,112 (2004), which it cites as setting forth the Commission's "Reliability Compensation Issues ('RCI') policy." See Affidavit of A. Joseph Cavicchi ("Affidavit") at P 29. In *PJM*, the Commission explained that there are two categories of reliability compensation issues. Short-term Reliability Compensation Issues relate principally to the appropriate compensation for units that are needed for reliability and are subject to mitigation, with the result being that the units are receiving non-compensatory revenue, thereby impacting their ability to provide service. 107 FERC ¶ 61,112 at P 16. Long-term Reliability Compensation Issues relate principally to local capacity shortages identified in the organized market's reliability-based planning process resulting from the reasonably expected retirement of units or the need for new infrastructure that is not anticipated to be installed. *Id.*

The Commission explained that the preferred method for dealing with both types of reliability compensation issues is through market design solutions not contractual solutions. This is precisely the course that the ISO is pursuing through MRTU, which the Commission is addressing in Docket No. ER02-1656. In its orders in that docket, the Commission has recognized that, under MRTU, the ISO will rely upon its Integrated Forward Markets ("IFM") along with a

resource adequacy program, (such as that being implemented by the CPUC) to respond to the reliability issues currently addressed by the Must-Offer Obligation. *California Ind. System Oper. Corp.*, 108 FERC ¶ 61,254 at P 10 (2004). The Commission has instructed the ISO to examine the need for a back-up reliability program in light of the Resource Adequacy program in place at the time MRTU is initiated and has informed the ISO that the current Must-Offer Obligation will no longer be in effect at that time. *Id.* at 19.

In its most recent MRTU order, the Commission reiterated that a determination of the appropriate back-up mechanism to resource adequacy contracting is not ripe at this time. In response to IEP's rehearing request in which it sought consideration of a proposal for a capacity market, the Commission stated:

As stated in the July 2005 Order, the Commission believes it would be more productive for the CAISO to focus on market solutions, rather than ISO-administered backstop contracts, which the CAISO was exploring. In the July 2005 Order, the Commission encouraged the CAISO to focus its efforts on market solutions that rely on forward contracting by LSEs, rather than ISO-administered backstops. We acknowledge IEP's proposal to develop a capacity market or interim capacity payment mechanism to allow for a market-driven reliability backstop and encourage it to propose such an idea by actively engaging in the CAISO's stakeholder process so that that it might be proposed by the CAISO in the future, at which time we will act on it. At this time, we expect that forthcoming resource adequacy procedures and mitigation package will ensure just and reasonable rates.

*California Ind. System Oper. Corp.*, 112 FERC ¶ 61,310 at P 76 (2005).

Thus, the Commission has already addressed the reliability compensation issues subsequent to the implementation of MRTU, and specified steps to be taken with regard to any back-up program for Resource Adequacy subsequent to the implementation of MRTU. The Commission should therefore limit its consideration of IEP's complaint to long- and short-term compensation issues as they pertain to the period prior to the implementation of MRTU.

**B. The Commission Should Convene a Technical Conference to Investigate the Scope and Nature of a Possible Backup Capacity Service to Be Implemented When the CPUC Resource Adequacy Program Is Operative.**

The ISO has been working with the CPUC to ensure the development of a robust Resource Adequacy program that will address long-term compensation needs in the California markets. The ISO is confident that goal will be met when Resource Adequacy is implemented in June 2006. Nonetheless, the ISO recognizes that there may remain small unintended gaps that can appropriately be filled with a backstop service to the Resource Adequacy Program. The ISO therefore supports IEP's suggestion that Commission convene a technical conference to (1) address and receive stakeholder input regarding the propriety, scope and nature of such a backstop capacity program, and (2) begin the process of designing an appropriate backstop.<sup>3</sup> As IEP's proposal appears to recognize, Complaint at 29-30, for such a backstop capacity service to be effective, resources that are obligated to offer available capacity under the Must-

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<sup>3</sup> In the CPUC resource adequacy workshop process, the CAISO and other parties recognized the potential need for a backstop to cover the possibility of gaps in Resource Adequacy. The CAISO is supportive of a tariff based "backstop" provided it is properly designed and adequately addresses all ISO operational concerns.

Offer Obligation today that have not entered into a Resource Adequacy or RMR must be obligated to make such capacity available to the backstop capacity service. Of course, as under the Must-Offer Obligation, that capacity must be available to the ISO, at the ISO's option, in Real-Time.

Although IEP has made constructive suggestions for such a program, the ISO believes that there are several issues that require further examination. First, an appropriate term of service will have to be determined. Such a determination will require a delicate balancing of interests and objectives. Too long of a term, *e.g.*, one year or longer, could interfere with load-serving entity procurement efforts and should be avoided. On the other hand, a very short-term service may not provide the sought after service and revenue stability.

The term of service will also bear on, if not dictate, the ability of the ISO to select the specific resources needed to provide the particular reliability service. For example, today the ISO evaluates needs on a Day-Ahead basis, examining likely system and Zonal Loads, as well as loadings on specific lines and other transmission facilities, based on historical patterns, transmission and Generation outages, meteorological conditions, and other relevant factors. First, it determines its local needs. Then it evaluates Zonal and system needs. The IEP complaint contemplates that the ISO will decide whether it will need units for reliability purposes on a *seasonal* basis. In contrast to *daily* commitment decisions, seasonal commitments will require that the ISO rely on less accurate load forecast information and less certain planned resource outage and scheduled transmission clearance information.



In addition, this evaluation will be complicated by the fact that, under the CPUC's resource adequacy program, load-serving entities must demonstrate that they have procured 100% of their capacity needs for all months of the year on a month-ahead basis. Thus, the ISO will not know until the month ahead what resources the load-serving entities have procured. Procurement on a seasonal and possibly even on a monthly basis by the ISO under these circumstances might be problematic and inefficient and could lead to the over-procurement of resources. The ISO believes that the appropriate time period for which the capacity program determination should be made (seasonal, monthly, weekly, daily) can and should be addressed at the technical conference. Depending on the scope and final design of the resource adequacy program that goes into effect on June 1, 2006, different periods of unit-procurement may be appropriate. The ISO notes that, even in the case of system needs, it is possible that a seasonal determination could result in over-procurement. Further, under any circumstances, the ISO would need to retain the ability to call upon additional resources Day-Ahead if necessary.

Compensation issues are directly related to the length of the procurement. For example, local needs may be of short duration, and if the back-stop program serves only local needs, paying a unit for an entire season would be inefficient. Similarly, to the extent the ISO calls on a unit in the middle of a term, it may not be appropriate to compensate the unit as if the ISO had procured it for the entire season. For these reasons, the backstop mechanism may need to be flexible enough to accommodate terms shorter than a season.

Another issue which should be addressed at the technical conference is whether the basis for compensating backstop capacity should be the cost of a new resource, as recommended by IEP, or just the going forward fixed cost. For existing generation capacity, compensation based on the going forward fixed costs (*i.e.*, “avoidable” fixed costs if the unit were to deactivate) of the resource should be adequate to keep the unit on-line. On the other hand, in order to create incentives for new generation development, compensation based on the entire fixed costs may be necessary. Related to the basis for compensation for backstop capacity is the appropriate method of determining proxy market revenues to be offset against the capacity payment. These issues need to be fully discussed at the conference.

The technical conference also will need to address the allocation of the costs of the program. The methods currently used for allocating Minimum Load Cost Compensation or Start-up costs are not necessarily the appropriate cost allocation methods for a capacity product such as that proposed by IEP. Once the Resource Adequacy program is in place, the issues that drive the decision to procure capacity may differ from the issues that drive the Day-Ahead commitment decision under the existing Must-Offer Obligation.

Another issue that should be addressed at the technical conference is coordination of the backstop capacity program with the Resource Adequacy program. The ISO needs to have clear identification of the resources already under contract in the Resource Adequacy program and of the terms of the participation in the program. The time necessary to process such information

should not be under-estimated. The ISO will need to ensure that incentives under one program do not undermine efforts in the other. As noted above, in no way should any ISO reliability services procurement effort interfere with load-serving entity-based procurement efforts. In addition, the ISO does not want to create any incentive for entities to manipulate the availability of Resource Adequacy resources for the purpose of advantaging other non-Resource Adequacy Generation selected under the backstop capacity program.

**C. Implementation of a Capacity Services Program Prior to Implementation of Resource Adequacy Would Be Premature.**

The Complaint is unclear regarding the proposed startup of the proposed Reliability Capacity Services Tariff. IEP's own consultant recognizes that IEP's Reliability Capacity Services Tariff would need to be implemented at the time the Resource Adequacy program becomes effective. Affidavit at PP 48, 50. Implementation of the program prior to the institution of the CPUC's Resource Adequacy program, however, would be ineffective and could be counterproductive. Moreover, it is unnecessary, because IEP has not shown the Must-Offer Obligation to be unjust or unreasonable prior to the implementation of a Resource Adequacy program.

**1. Implementation of a Capacity Services Program Prior to the CPUC's Resource Adequacy Program Would Be Ineffective and Could Be Counter-Productive**

IEP's argument against the Must-Offer Obligation is based, in large part, on the need for an appropriate price signal for investment in new Generation and transmission facilities. However, following implementation of the Resource Adequacy program, a significant signal will be provided by that program (other

signals will eventually be provided through the MRTU markets). A temporary signal from an interim reliability capacity program – which would be replaced in importance by that of the Resource Adequacy program in June 2006 – would be ineffectual. Not only would the temporary nature of the price signal undermine the program's effectiveness in creating an incentive for new Generation, but there is a significant question whether the financial community would even be satisfied by the existence of a capacity services tariff absent a permanent source of revenue, such as firm contracts.

While short-term market price signals and the general market conditions appropriately influence Resource Adequacy contract negotiations, the ISO believes the implementation of a backstop capacity service should be timed and designed to limit its influence on the negotiating position of either the generators or Load-Serving Entities when negotiating Resource Adequacy arrangements. In order to limit the influence and role that the backstop capacity service has on such negotiations for the Resource Adequacy program, the ISO believes it is appropriate for all parties to know what the backstop capacity service terms and conditions will be, but allow the negotiations and contracting to complete prior to determining the extent to which the backstop capacity service is actually necessary. The backstop capacity service should not supersede the negotiation process. These issues should be among the topics vetted at the technical conference.

Further, a capacity services program could present operational issues prior to the implementation of a Resource Adequacy program. The ISO would

essentially be called upon to make large volume resource adequacy decisions on behalf of load serving entities. It is not in a position to do so.

Finally, a capacity service program would present significant implementation issues prior to June 2006. The ISO is under significant pressure to complete MRTU and the SaMC. With the current identified work to complete the first phase of SaMC, the ISO will not be able to make the necessary changes to implement a capacity based program like that proposed by IEP until at least June 1, 2006. The settlement and allocation of IEP's proposed program would require at the very least modification of existing charge-types. Operations would have to implement new procedures, and the program may require additional production simulation software to perform backstop resource decisions. The Commission has previously found that such concerns constitute sufficient reason for delaying the implementation of new pricing schemes, *i.e.*, the Station Power program that arose out of a Duke Energy complaint proceeding (and which the ISO proposed as Tariff Amendment 68 in compliance with the Commission's order on the Duke complaint)<sup>4</sup>. Station Power Order at P 62 (2005). For the same reasons, the Commission should defer implementation of any backstop capacity program until June 2006.<sup>5</sup> Besides the relationship to "SaMC", the ISO requires sufficient time to integrate final policy details into its existing system and processes and procedures. Implementation of these details requires new or

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<sup>4</sup> *Duke Energy Moss Landing LLC v. California Independent System Operator Corp.*, 109 FERC ¶ 61,170 (2004)

<sup>5</sup> In particular, this is necessary to avoid delays in the SaMC implementation schedule, duplicate system modifications and an inefficient allocation of ISO resources. See Tariff Amendment No. 68 Transmittal Letter at 15-16, Docket No. ER05-849, filed April 18, 2005; ISO Motion to Leave to File Answer and Answer to Motions to Intervene, Comments and Protests at 4-7, Docket No. ER05-849, filed May 24, 2005; Station Power Order at PP 58-62.

revised processes for determination of net revenue calculation, off-line studies for determination of resources needed for backstop capacity, and new costs allocation for the backstop service. Development of these processes can only occur after the policy details have been resolved.

**2. IEP has not shown that Must-Offer Obligation is currently unjust or unreasonable for purposes of short term compensation.**

Finally, it is not necessary to implement a capacity services program prior to the CPUC's Resource Adequacy program; although IEP contends that Generators are unable to receive fair compensation under the Must-Offer Obligation, it makes no real showing in that regard. In order to show that the Must-Offer obligation is unjust and unreasonable, IEP asserts that (1) the ISO's Energy market prices fail to correlate with supply and demand conditions and (2) the prices do not provide an incentive to invest in new generation capacity. These are not issues of whether current revenues are compensatory, and are thus not short-term compensation issues.

IEP's third assertion is that the Must-Offer Obligation fails to provide Generators with just and reasonable compensation. However, IEP only presents two types of evidence to support its claims. First, IEP notes that certain units were mothballed or retired, "presumably" because of lack of a capacity payment and revenues under the Must-Offer Obligation, and that the California Energy Commission has concluded that certain other units are at risk of retirement or mothballing, which IEP asserts are "logically" units subject to the Must-Offer Obligation. Second, IEP presents evidence that units subject to the Must-Offer

Obligation have only realized \$28-\$45/kW-yr contributions to fixed costs and maintenance during the most recent years.

IEP presents no basis for tying these facts to the Must-Offer Obligation and provides no basis by which the amounts it cites should be deemed non-compensatory. In particular, IEP does not provide data showing that specific units are not recovering their costs associated with providing Must-Offer Service. As a result, this evidence cannot support a finding that the Must-Offer Obligation is unjust or unreasonable. More significant, however, is that Generators operating in the ISO's markets under market-based rates are not guaranteed a particular recovery of their fixed costs. Generators operating under market-based rates have the opportunity to recover their fixed costs and a return through the market. When the Commission imposes an additional duty, such as the Must-Offer Obligation, it provides only for a recovery of the additional variable costs. As recently as this past June, the Commission reiterated that Must-Offer Generators operating at minimum load were entitled to the Instructed Energy payment for the Energy produced in addition to Minimum Load Cost Compensation and Start Up Cost, because the last two covered variable costs, and the first provided the opportunity to recover fixed costs.

Indeed, the Commission has already informed Generators of the appropriate resolution of concerns that the Must-Offer Obligation is insufficiently compensatory. The argument that Must-Offer Generators should receive a capacity payment is not new; it was raised early in the consideration of the Must-Offer Obligation. The Commission told Generators they had an option:

With respect to Duke's request that, in the alternative, the Commission allow generators to be fully compensated for capacity reserve service under the must-offer obligation, we find that if generators are dispatched under the must offer obligation, unless it is the marginal costs unit that sets the market clearing price, the generator will receive some contribution to fixed costs. Therefore, Duke's request is denied. Generators who are dissatisfied with this finding regarding cost recovery of only minimum load status costs may propose cost-based rates for their generating units with cost support including a reasonable rate of return on investment that reflects the unique conditions in California.

*San Diego Gas & Elec. Co. v. Sellers of Ancillary Serv.*, 99 FERC P 61,159 at 61,641 (2002). With that option, there is no basis to find that the Must-Offer Obligation is non-compensatory.



### III. Conclusion

For the reasons set forth above, the ISO stands ready to meet and work with IEP and stakeholders to discuss the backstop capacity program proposal further and possibly design a capacity backstop mechanism that can be implemented and replace the existing Must-Offer Obligation effective June 1, 2006. As requested by IEP, the Commission should convene a technical conference so that discussion and resolution of these matters can commence. However, for the reasons set forth herein, the Commission should not make any changes to the existing Must-Offer Obligation effective prior to June 1, 2006.

Respectfully submitted,

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Michael E. Ward

Anthony J. Ivancovich  
Associate General Counsel – Regulatory  
The California Independent System  
Operator Corporation  
151 Blue Ravine Road  
Folsom, CA 95630  
Tel: (916) 351-4400  
Fax: (916) 351-4436

Kenneth G. Jaffe  
Michael E. Ward  
Alston & Bird LLP  
601 Pennsylvania Avenue, NW  
North Building, 10th Floor  
Washington, DC 20004-2601  
Tel: (202) 756-3405  
Fax: (202) 756-3333

Counsel for the California Independent  
System Operator Corporation