Stakeholder Comments Template

Subject: Updating Interim Capacity Procurement Mechanism And Exceptional Dispatch Pricing and Bid Mitigation

Submitted By	Company	Date Submitted
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This template has been created to help stakeholders submit written comments on topics related to the June 9, 2010 "Updating Interim Capacity Procurement Mechanism and Exceptional Dispatch Pricing and Bid Mitigation" Issue Paper and June 16, 2010 stakeholder conference call. The Issue Paper and information regarding this stakeholder initiative can be found at http://www.caiso.com/27ae/27ae96bd2e00.html.

Please submit your comments on the items listed below in Microsoft Word to bmcallister@caiso.com no later than the close of business on June 23, 2010.

Your comments on any aspect of this stakeholder initiative are welcome. The comments received will assist the ISO with developing a straw proposal.

Interim Capacity Procurement Mechanism

1. Please provide your thoughts on the duration of the tariff provisions associated with a successor to the Interim Capacity Procurement Mechanism ("ICPM") and whether the tariff provisions should be permanent, i.e. there would not be a sunset date, or have some specified termination date. If you have a specific proposal, please provide it and indicate the reasons for your proposal.

Given the degree of controversy surrounding RCST and ICPM, it would be unproductive to continue to reconsider the central features of backstop procurement every few years, barring major changes in complementary policies, such as the CPUC's Resource Adequacy program. Consequently, Calpine recommends that the successor to ICPM, the CPM, have no explicit sunset date. However, the rules should be drafted in a sufficiently flexible fashion to allow periodic updating of certain aspects of the rules, such as the CPM price.

2. Please provide your thoughts regarding the compensation that should be paid for capacity procured under ICPM and Exceptional Dispatch. If you have a specific proposal, please provide it and indicate the reasons for your proposal.

Calpine supports compensatory capacity pricing for all forms of capacity, regardless of where and how they are procured. Compensatory pricing allows for a recovery of both capital costs as well as going-forward fixed costs. Consequently, Calpine endorses a CPM price based on the net cost of new entry (net CONE).

Given what we expect to be limited volumes of backstop procurement, we do not support the establishment of an auction-based market for CPM capacity. Instead, Calpine recommends an administratively determined price based on the calculation of net CONE that is embedded in the Department of Market Monitoring's annual reports. For example, the DMM's most recent annual report,[1] estimates that a CCGT in NP15 would have earned approximately $40/kW-year from energy and AS markets relative to its levelized fixed costs of $191/kW-year in 2009 yielding an estimate of net CONE of approximately $150/kW-year. A similar calculation for a CT yields an estimate of net CONE of approximately $157/kW-year.[2]

Given the substantial gap between net CONE and the current ICPM price Calpine could support a gradual transition between the current price and net CONE pricing. One possible approach would be to calculate a new CPM price each year as the average of the previous year's CPM price and the DMM's estimate of net CONE. For example, an average of the current ICPM price and an estimate of net CONE of $150/kW-year would yield a price of approximately $96/kW-year. Calpine also would consider caps on the maximum amount by which the price could adjust in any one year. A smooth and predictable trajectory to new entry pricing would allow load-serving entities to make timely and cost-effective adjustments to their procurement. In addition, an explicit link between the CPM price and net CONE will allow capacity prices to decline as energy and AS pricing increase, presumably with the introduction of scarcity pricing and modifications to the CAISO's AS markets.

Calpine recognizes that pricing at less than net CONE may support the limited short-term objective of ensuring that existing capacity is made available to the CAISO. Calpine is concerned, however, about the long-run efficiency implications of CPUC policy and CAISO market rules that consistently depress compensation for existing resources, including RA price caps, heavily mitigated energy and AS markets, and limitations on the ability of existing units to compete head-to-head with new

[1] See section 2.3 of http://www.caiso.com/2777/27778a322d0f0.pdf.

[2] Calpine is amenable to the use of multi-year averages of energy and AS gross margins in the calculation of net CONE.

resources in the long-term solicitations of the investor-owned utilities. Inadequate capacity compensation for existing resources is likely to lead to inefficient trade-offs between new and existing resources, inefficient trade-offs between supply-side and demand-side resources, and underinvestment in upgrades and maintenance of existing units. As the CAISO noted with respect to the argument that paying existing resources less than net CONE yields consumer savings:

> …the argument erroneously assumes that there is no consumer benefit to paying the clearing price to all capacity that clears, even if it enables existing resources to earn a return above their costs of staying in business. Although the approach advocated by these parties might appear cost-effective in the short run, it can easily result in an excessive amount of retirements by facilities that are unable to earn enough to invest in environmental upgrades or repowering.[3]

In addition, non-compensatory capacity pricing fosters an environment in which load-serving entities are obligated to enter into very expensive and/or long-term contracts in order to promote new investment because suppliers have limited opportunities for capital cost recovery beyond the terms of their initial PPAs. As the CAISO and others have noted:

> if a potential investor knows that a new facility will start to receive a much lower capacity price once its status changes from "new" to "existing" it will incorporate that expectation into its offer price prior to committing to constructing the new resource.[4]

The current paradigm, in which compensation for new and existing resources differs radically, allocates greater risk to load-serving entities and ultimately customers with respect to new resource development. Compensatory short-term capacity pricing would foster a more balanced procurement framework in which load-serving entities and suppliers could share risk through deals of varying tenors.

Calpine notes that compensatory capacity pricing is the norm in organized markets outside of California. New England, New York, and PJM all have centralized capacity markets that are designed to yield net CONE prices. Even MISO, which shares certain aspects of California's bilateral resource adequacy framework, has

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[3] *Reply Comments of the California Independent System Operator on Staff Recommendations on Capacity Market Structure* at 14 (http://docs.cpuc.ca.gov/EFILE/CM/80374.PDF).
[4] *Ibid.* at 15.

backstop capacity procurement at prices that are capped at an estimate of gross (not net) CONE and assesses penalties for capacity deficiencies at an estimate of gross CONE.[5]

3. Please provide your thoughts on the ISO's suggestion to broaden ICPM procurement authority through creation of a new category that would allow the ISO to procure capacity for up to 12 months in order to make resources with operational characteristics that are needed to reliably operate the electric grid available to the ISO.

Calpine supports the additional procurement of capacity through CPM as long as the pricing is compensatory. Calpine notes that the appropriate new entry pricing for units with particular operating characteristics may not equate to net CONE for generic capacity.

4. Please provide your thoughts on the ISO's suggestion to modify the criteria that would be used for choosing a resource to procure under ICPM from among various eligible resources so that it recognizes characteristics such as dispatchability and other operational characteristics that enhance reliable operations.

As discussed above, if the CAISO is using CPM to procure fundamentally different products, then it should structure procurement and pricing to reflect the relevant differences, i.e., the CAISO should not use a particular operating characteristic as a "tie-breaker" to choose between resources that it could pay one flat CPM price. Instead, it should determine an appropriate premium for the operating characteristic and pay the premium when it is required.[6]

5. Please provide your thoughts on the appropriate treatment of resources that may be procured through Exceptional Dispatch but then go out on Planned Outage during the period for which the resource has been procured. If you have a specific proposal, please provide it and indicate the reasons for your proposal.

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[5] See sections 69.7-69.10 of Module E of the MISO tariff (http://www.midwestmarket.org/publish/Document/1d44c3_11e1d03fcc5_-7cf90a48324a/Modules.pdf?action=download&_property=Attachment)

[6] In cases in which a particular operating characteristic is not required, the CAISO should not discriminate against units with the operating characteristic in its CPM procurement. Instead, the units should be eligible for procurement at a price that does not reflect the premium associated with the operating characteristic.

No comment.

6. If you would like to identify other issues that you believe should be discussed in this stakeholder initiative, please discuss those issues here.

No comments.

Exceptional Dispatch

7. Please provide your thoughts on what fair compensation is for non-Resource Adequacy, Reliability Must-Run Contract or ICPM capacity that is Exceptionally Dispatched.

Calpine supports the current link between ICPM pricing and pricing for non-RA, non-RMR, non-ICPM capacity that is exceptionally dispatched. It allows limited capacity compensation for units that generally do not receive other forms of capacity compensation. Calpine believes, however, that the CAISO should rely more on ex ante procurement mechanisms such as ICPM and less on ex post procurement mechanisms such as Exceptional Dispatch.[7] Capacity provides the CAISO with insurance. Ex ante procurement obligates the CAISO to pay appropriate premiums for the insurance. Ex post procurement allows the CAISO to pay for capacity only when the insurance is actually required, i.e., ex post procurement is analogous to a driver buying auto insurance after he has already been in an accident.

8. Please provide your thoughts on whether energy bids for resources dispatched under Exceptional Dispatch should continue to be mitigated under certain circumstances. If you have a specific proposal, please provide it, and indicate the reasons for your proposal.

See below.

9. Please provide your thoughts on whether to change the categories of bids subject to mitigation under Exceptional Dispatch (Targeted, Limited and FERC Approved) and whether to extend the bid mitigation for the existing categories.

[7] This comparison of the lead times for ICPM procurement and Exceptional Dispatch is relative. Ideally, capacity should be procured even further in advance of delivery than when ICPM procurement typically occurs.

Calpine believes that exceptional dispatches to mitigate congestion should be eliminated and hence the need to mitigate the associated energy bids obviated. Transmission congestion should be fully captured in the IFM, RTM, and other market software and priced appropriately. Calpine commends the CAISO's efforts to date to incorporate additional transmission-related and other constraints into the market software and looks forward to further reductions in exceptional dispatch.

10. If you would like to identify other issues that you believe should be discussed in this stakeholder initiative, please discuss those issues here.

No comments.

Other

11. Please provide any additional comments regarding any other topic that your want to address.

No comments.