Capacity Procurement Mechanism Enhancements Track 2 – Straw Proposal

Comments by Department of Market Monitoring

July 24, 2023

Summary

DMM appreciates this opportunity to comment on the ISO's Capacity Procurement Mechanism (CPM) Enhancements Track 2 Straw Proposal and meeting.[1] Since establishing the CPM soft offer cap in 2014, the ISO's policy has been to set the CPM soft offer cap equal to the going forward fixed costs of a typical new gas-fired unit plus 20%.[2] The ISO set the current soft offer cap using estimates of going forward fixed costs derived from reports by the California Energy Commission (CEC). Units receiving these CPM payments also keep all net revenues earned from operating in the market.

In the previous soft offer cap initiative, DMM requested that the ISO review the accuracy of the cost estimates derived from CEC reports and provided extensive analysis showing that the current soft offer cap may be based on cost estimates that are significantly greater than the actual going forward fixed costs of most gas-fired resources.[3] Additionally, DMM suggests the ISO reconsider the appropriateness of including the 20% cost adder given a recent United States Court of Appeals case.[4]

The current straw proposal and workshop presentation details a more recent CEC estimate, but does not include any new analysis beyond updates to labor cost inputs and inflation. Based on analysis previously submitted by DMM, the current workshop material will set the soft offer cap substantially above the going forward fixed costs of gas-fired resources, and will therefore allow resources with market power in local areas to exercise that market power in capacity contract negotiations. Furthermore, as DMM has noted in prior comments, the proposal to offer soft offer cap compensation to resources under CPM, and to offer cost-of-service

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[1] *Capacity Procurement Mechanism Enhancements – Track 2 Straw Proposal*, CAISO, June 30, 2023: http://www.caiso.com/InitiativeDocuments/StrawProposal-CapacityProcurementMechanismEnhancements-Track2.pdf

[2] *Capacity Procurement Mechanism Replacement Draft Final Settlement Document for ISO Board of Governors*, CAISO, December 15, 2014, p. 15: http://www.caiso.com/Documents/DraftFinalSettlementProposal-CapacityProcurementMechanismReplacement.pdf

[3] *Supplemental Comments on Capacity Procurement Mechanism Soft Offer Cap Straw Proposal*, Department of Market Monitoring, September 10, 2019: http://www.caiso.com/InitiativeDocuments/DMMSupplementalComments-CapacityProcurementMechanismSoftOfferCap-StrawProposal.pdf

[4] *California Public Utilities Commission v. Federal Energy Regulatory Commission and California Independent System Operator.* United States Court of Appeals for the District of Columbia Circuit. No. 20-1388: https://www.cadc.uscourts.gov/internet/opinions.nsf/A7E4F1659200B2B4852587AE0054513A/$file/20-1388-1927124.pdf

compensation to resources under RMR, will allow resources with market power to self-select between the two forms of compensation: the CPM soft offer cap or full cost-of-service compensation under Reliability Must Run (RMR) contracts.

To be consistent with the ISO's long-standing policy for determining the soft offer cap, DMM continues to recommend that the ISO reassess the accuracy of cost estimates based on CEC reports and set the soft offer cap based on a more reliable and accurate estimate of going-forward fixed costs. DMM continues to recommend that in the next track of this initiative, the ISO give further consideration to the framework described in the ISO's prior CPM stakeholder initiative to test for and mitigate market power in CPM solicitations.[5]

Additional changes to the soft offer cap to include the cost of newly built resources have been suggested in previous initiatives, as well as by stakeholders. DMM supports the ISO not considering such a policy change in this track of the initiative. This would be a substantial change to the theory used to determine the soft offer cap and would warrant substantial stakeholder and Market Surveillance Committee discussion.

The rest of these comments provide additional details or explanation.

The CPM soft offer cap is substantially higher than the value prescribed by ISO's established soft offer cap policy.

Since establishing the CPM soft offer cap in 2014, the ISO's policy has been to set the CPM soft offer cap equal to the going forward fixed costs of a typical new gas-fired unit plus 20%. Units receiving CPM payments also keep all net revenues earned from operating in the market.

The ISO set the current soft offer cap using "the CEC's updated estimate for the levelized going-forward fixed costs of a mid-cost 550 MW combined cycle."[6] The CAISO's estimate of going forward fixed costs include three components from the CEC report: (1) fixed annual O&M, (2) insurance and (3) ad valorum (taxes).

In previous stakeholder processes, DMM has repeatedly expressed concerns that fixed O&M estimates based on the CEC report, which the ISO uses for setting the soft offer cap, significantly overstate the going forward costs of a typical combined cycle resource. DMM's August 2019 comments on the ISO's straw proposal explained why DMM believed a closer review of the cost estimates used in the CEC reports was needed, and recommended that the ISO perform additional review of the cost estimates developed from the CEC reports.[7] As explained in DMM's August 2019 comments:

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[5] *Capacity Procurement Mechanism Soft Offer Cap Straw Proposal*, CAISO, July 24, 2019, pp. 11-12: http://www.caiso.com/InitiativeDocuments/StrawProposal-CapacityProcurementMechanismSoftOfferCap.pdf

[6] 2014 CPM Draft Final Settlement Document, p. 15.

[7] *Comments on Capacity Procurement Mechanism Soft Offer Cap Straw Proposal*, Department of Market Monitoring, August 20, 2019, pp. 3-5: http://www.caiso.com/Documents/DMMComments-CapacityProcurementMechanismSoftOfferCap-StrawProposal.pdf

> DMM has numerous concerns about the cost data in the CEC reports, and recommends that the CAISO perform additional verification and/or an independent assessment of GFFC. The CEC report was not designed to provide an estimate of GFFC and was not intended to be used for the kind of rate-making that occurs when these data are being used for setting the soft cap. DMM understands that the data on costs of generation in the CEC report were initially developed prior to 2014 based on self-reported data collected through a survey. No details of this survey or the components/assumptions underlying the data used to estimate GFFC are provided in the report.
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> In addition, based on the limited information provided in the CEC report, the report appears to categorize almost all maintenance as being a fixed annual cost, rather than maintenance costs that actually depend on the usage of the unit (e.g. start-ups, run hours, and MWh produced). In the ISO market, a significant portion of these maintenance costs are incorporated in maintenance adders applied to startup, minimum load, and energy bids used to dispatch units and provide revenue recovery.[8]

DMM's analysis provided further evidence that the CEC report data used by the ISO significantly overestimates the actual going forward costs of gas-fired generating units. As shown in Attachment A of DMM's 2020 comments on the CPM Soft Offer Cap Draft Final Proposal,[9] the CEC's recent fixed O&M estimates are about three times higher than the higher end of the various estimates found by DMM. In the ISO's current straw proposal materials, the ISO does not address this concern, and simply seeks to continue to use the CEC's cost estimates updated for 2023 with increased labor input costs and inflation. DMM recommends that the ISO evaluate the appropriateness of using the CEC's O&M cost estimates, and set the soft offer cap based on a levelized going-forward fixed cost estimate that is more accurate and appropriate for the ISO's purposes.

Moreover, the continued use of the 20% adder used by the ISO does not reflect a case brought before the United States Court of Appeals (hereafter the Court) on the justification of the 20% adder.[10] The Court found a lack of substantial evidence for the 20% adder as a means of cost justification. The Federal Energy Regulatory Commission's approval of the 2020 tariff for the CPM relied on the 2015 CPM Order, and as the Court stated, "[s]tripped of its citation to the 2015 CPM Order, the Commission's order has little else, if anything, to support it [the cost adder]." DMM recommends the ISO reconsider the appropriateness of the 20% adder in light of the Court's recent ruling.

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[8] Ibid, p. 4.

[9] *Comments on Capacity Procurement Mechanism Soft Offer Cap Draft Final Proposal*, Department of Market Monitoring, January 24, 2020: [DMMComments-CapacityProcurementMechanismSoftOfferCap-DraftFinalProposal.pdf (caiso.com)](DMMComments-CapacityProcurementMechanismSoftOfferCap-DraftFinalProposal.pdf)

[10] *California Public Utilities Commission v. Federal Energy Regulatory Commission and California Independent System Operator.* United States Court of Appeals for the District of Columbia Circuit. No. 20-1388: https://www.cadc.uscourts.gov/internet/opinions.nsf/A7E4F1659200B2B4852587AE0054513A/$file/20-1388-1927124.pdf

DMM supports the ISO proposal to not consider incorporating the cost of new builds into the CPM soft offer cap during this track of the initiative.

In its prior CPM initiative, the ISO cites "significant changes to the grid's resource fleet to meet state goals… [and] as early as 2022 the numbers begin to reflect *the cost of building* solar and storage as the marginal capacity resources on the system" [emphasis added].[11] Similarly, stakeholders in the 2023 CPM Enhancements Track 2 workshop requested the ISO consider such changes to reflect the cost of building new resources.

Such changes suggests the ISO would be significantly deviating from its established policy for determining the value of the soft offer cap. If the ISO believes the soft offer cap should be based on the cost of *building* new clean resources that are required "to meet state goals to significantly reduce greenhouse gas emissions,"[12] the logic behind this major policy change should be vetted with stakeholders, the Market Surveillance Committee, and the Board in a lengthier and more appropriate stakeholder process than the current CPM Enhancements Track 2.

When the ISO developed the Capacity Procurement Mechanism in 2010, the ISO ran a lengthy stakeholder process in which it carefully vetted with stakeholders over numerous straw proposals whether to base the CPM compensation on (1) going forward fixed costs or (2) the cost of building new resources. In its 2010 CPM draft final proposal, the ISO concluded:

> The ISO's proposal to compensate suppliers for CPM designations on the basis of going-forward fixed costs is essentially the same rule that was adopted for the ICPM and approved by FERC… Going forward costs are generally understood as the minimum fixed costs needed to keep a generator available for operation.[13]

Furthermore, the ISO argued "that maintaining the going forward fixed cost pricing approach is also consistent with the criteria to minimize procurement through the backstop mechanism."[14] In other words, "to provide sufficient cost recovery under the voluntary CPM paradigm and not create incentives for load serving entities to forego bilateral RA contracts and instead rely on CPM backstop procurement," CPM compensation based on going forward fixed costs is sufficient.[15]

At the end of its extensive 2010 stakeholder process on this issue, the ISO also explained clearly why it had concluded to not base CPM compensation on the cost of building new capacity:

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[11] 2020 Draft Final Proposal, p. 7.

[12] 2020 Draft Final Proposal, p. 7.

[13] *Capacity Procurement Mechanism, and Compensation and Bid Mitigation for Exceptional Dispatch Revised Draft Final Proposal*, CAISO, September 15, 2010, p. 35: http://www.caiso.com/Documents/RevisedDraftFinalProposal15-Sep-2010.pdf

[14] 2010 Draft Final Proposal, p. 34.

[15] 2020 Draft Final Proposal, p. 7.

> In the absence of a well-designed investment mechanism, a CPM based on cost of new entry could in some locations simply raise capacity prices to buyers without encouraging new entry, and be judged not just and reasonable unless other protective mechanisms were established in the presence of barriers to investment.[16]

Other than the CPM soft offer cap, measures to protect against the exercise of market power in the bilateral capacity markets that support CAISO's spot markets have not been established. A proposal to set the soft offer cap substantially above the going forward fixed costs of resources no longer under contract would allow resources with market power in local areas to exercise that market power and "simply raise capacity prices to buyers without encouraging new entry."

Given the short timeline of the CPM Enhancements Track 2, DMM recommends that the ISO only potentially consider these substantial changes to the CPM in a future stakeholder process in which the ISO and stakeholders can more thoroughly vet any purported justification.

[16] 2010 Draft Final Proposal, p. 34.