Capacity Procurement Mechanism Soft Offer Cap

Issue Paper

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1. Executive Summary

The ISO relies on its capacity procurement mechanism (CPM) authority to procure backstop capacity when either insufficient resource adequacy (RA) capacity was procured to ensure reliability or specific essential resources were not procured and shown as RA capacity to maintain reliable grid operations. Resource owners can offer available capacity into the ISO's competitive solicitation process (CSP) to supply CPM capacity, if and when needed. The CSP has a soft offer cap that allows resource owners to offer CPM capacity up to this cap without further ISO or regulatory review. The current soft offer cap is $6.31/kW-month. The ISO has a tariff obligation to consider updating this soft offer cap value every 4 years. The ISO is launching this initiative to fulfill that obligation and perform this review.

The recent RMR-CPM enhancements initiative received several comments from stakeholders concerned about the compensation scheme for 12-month CPM designations. These concerns expressed a sentiment that many of the CPM designations were close to the soft offer cap, concluding there may be little competition in the competitive solicitation process. Certain stakeholders recommended a pivotal supplier test be required for 12-month CPM designations. Given this feedback, the ISO will review and vet compensation for 12-month CPM designations in this initiative.

The recently concluded RMR-CPM enhancements initiative included changes to the reliability must-run (RMR) and the CPM mechanisms. Given the depth and breadth of this initiative, the ISO determined it was prudent to file the RMR tariff changes separate from the CPM tariff changes. The ISO filed the larger set of RMR-related tariff changes at FERC on April 23 and the overall CPM changes will be filed later based on the changes that come out of this initiative. The ISO received feedback to make proposals with holistic, rather than piecemeal changes to programs. Including the proposed CPM changes in this filing will be consistent with that feedback.

2. Plan for Stakeholder Engagement

This stakeholder initiative is organized to allow time for the careful consideration of issues regarding the CPM soft offer cap and related scope for this initiative, as outlined in this issue paper. The ISO intends to present its draft final proposal to its Board of Governors during the spring of 2020. The currently planned schedule for this initiative is shown below.

Table 1 – Stakeholder Initiative Schedule

Milestone	Date
Post Issue Paper	5/30/2019
Stakeholder Call	6/17/2019
Stakeholder Written Comments Due	7/1/2019
Post Straw Proposal	7/23/2019
Stakeholder Meeting	8/6/2019
Stakeholder Written Comments Due	8/20/2019
Revised Straw Proposal Posted	Sept 2019
Draft Final Proposal Posted	Nov 2019
Stakeholder Meeting	Dec 2019
Stakeholder Written Comments Due	Dec 2019
Board of Governors Meeting	Spring 2020

3. Background

The ISO relies on capacity procured through the resource adequacy framework to reliably operate the gird. The resources that are procured as resource adequacy capacity are required to be available to the ISO to meet the needs of the system all hours of the year. Occasionally, there are resources that want to retire from service but cannot as they are essential to maintaining grid reliability. When this happens, the ISO can use its RMR authority to retain these essential resources and defer their retirement. These RMR contracts may be in place as a stopgap measure while new resources are built or transmission is enhanced prior to the resource retiring from the market. There are also occasions when the resources needed or quantity of capacity procured through the resource adequacy program is simply not sufficient to meet the needs for reliable operations. When this happens, the ISO may rely on its CPM authority to procure additional capacity that was not ultimately procured and shown as resource adequacy capacity.

The competitive solicitation process is the process that the ISO uses to receive competitive bids from non-resource adequacy capacity for consideration in CPM designations. Resource owners have the opportunity to bid capacity, for total or partial output form a specific resource, into this process. This process is not mandatory, and this capacity is under no obligation to bid.

However, if the bid for the resource is accepted and awarded a CPM designation, the resource is then obliged to accept the CPM award and the associated obligations. These obligations include a 24x7 must offer obligation and making the awarded capacity subject to the ISO's Resource Adequacy Availability Incentive Mechanism (RAAIM) tool, which penalizes resources for not bidding into the market.[1]

The principle behind the competitive solicitation process is that any resource owner with excess non-resource adequacy capacity will bid their capacity, up to the resource's net qualifying capacity (NQC) value, into the competitive solicitation process for the opportunity to sell additional capacity under a CPM designation. Competition from multiple resource owners should suppress bids to a competitive level. Generally, this level may be computed as going forward fixed cost for a resource, less expected market revenues – considering potential market uncertainty, potentially inclusive of some portion of additional near-term capital additions necessary to operate the resource, plus a reasonable return.

CPM designations in local capacity areas can be more challenging given specific resources may be needed to reliably operate the grid in that particular area. If such a designation is necessary, the ISO may face a situation where only a few resources, or potentially a single resource, can satisfy the constraint. Because a small number of resources may have the potential and effectiveness needed to reliably operate the grid in that area, there may be no additional bids in the competitive solicitation process that can meet the need and the available resource would be designated at any bid price. This would effectively give the resource market power for its capacity.

Market power mitigation for the competitive solicitation process is provided through a soft offer cap. The soft offer cap is a proxy for the system marginal capacity cost and serves as a 'safe harbor' value that capacity owners are allowed bid up to, and receive that value for compensation if designated for a CPM award.[2] The resource owner does not have to justify any bid at or below the soft offer cap to receive that payment for a CPM designation. Currently, the soft offer cap is set at $75.67/kW-year, or $6.31/kW-month.

The soft offer cap was set four years ago in the capacity procurement mechanism replacement initiative. At that time, rules for updating the soft offer cap were established. The soft offer cap was set as a subset of the fixed costs for a new resource and includes insurance, ad valorem, and fixed operations and maintenance costs, but not capital and financing costs or taxes. Additionally, the costs were set using a mid-cost 550 MW advanced combined cycle resource with duct firing capability.[3] The values used to calculate the soft offer cap were taken from a

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[1] RAAIM is a bidding incentive mechanism that has a 96.5% target availability with a +/- 2% dead band, assessed on a monthly basis. Resources that bid into the market less frequently than 94.5% of intervals are charged the RAAIM penalty price, while resources that bid more frequently than 98.5% of intervals are eligible to receive an incentive payment.
[2] Resources are able to bid above the soft offer cap, but these costs need to be verified by the ISO, prior to awarding a CPM designation.
[3] The CEC cost of new generation study includes costs for a low-cost, mid-cost and high cost case for the resources studied.

CEC study for the cost of new generation, which was published at about the same time.[4] The initiative also established rules that the ISO would update the soft offer cap approximately every four years, when the CEC updates the cost of new generation study.

4. Scope

The scope of this initiative has been carefully considered to address the issues outlined below.

Issues to be included in scope of this initiative:

The ISO proposes the scope of this initiative will include the following items:

1. Update the soft offer cap for the CPM competitive solicitation process, including selection of the appropriate resource type and size that best reflects the system marginal capacity cost.
2. Examine compensation and mitigation for 12-month CPM designations.
3. Include previous changes developed in the RMR/CPM initiative for CPM bids above the soft offer cap.
4. Other CPM issues.

The scope of this initiative will not include any updates to the risk-of-retirement authority.

4.1. Updating the Soft Offer Cap

The CEC updated the study for the estimated cost of new generation in May 2019.[5] In response, the ISO is opening this initiative to update the soft offer cap for CPM, according to the rules outlined by the ISO in 2014. As a result, this initiative will investigate the current value of the soft offer cap, and will consider if this value should be changed in accordance with the values published in the updated CEC report.

This initiative may also consider if changes to the reference resource used to calculate the soft offer cap should be considered. The initial CEC study used to set the current soft offer cap included analysis for a mid-cost 550 MW advanced combined cycle resource with duct firing capability, the current updated report includes analysis for a similar 700 MW resource. The information included in the most recent publication may not be directly comparable because the resources are not identically sized. This initiative will consider the best approach for updating

[4] Estimated Cost of New Renewable and Fossil Generation in California, California Energy Commission, March 2015, https://www.energy.ca.gov/2014publications/CEC-200-2014-003/CEC-200-2014-003-SF.pdf.
[5] Estimated Cost of New Utility-Scale Generation in California: 2018 Update, California Energy Commission, May 2019, https://www.energy.ca.gov/2019publications/CEC-200-2019-005/CEC-200-2019-005.pdf.

the soft offer cap given these considerations. In addition, the ISO will examine the appropriate resource type that best reflects system marginal cost (i.e., a combined cycle unit vs. a gas turbine).

4.2. Assessing payment for 12-month CPM designations

In the RMR-CPM enhancements initiative, the ISO received several comments from stakeholders about compensation for 12-month CPM designations. Stakeholders pointed out that most of the CPM designations that the ISO made were at or near the $6.31/kW-month soft offer cap, and it was unlikely there was sufficient competition in the competitive solicitation process, leading to resources that could exert market power over CPM capacity payments. The ISO also received comments from some stakeholders who requested a 3 pivotal supplier test for all 12-month CPM designations to flag when the competitive solicitation process may be uncompetitive and mitigate capacity payments that such resource owners may be paid if awarded a 12-month CPM designation. In this initiative, the ISO is committed to reviewing the market power provisions and compensation for 12-month designations and considering changes.

4.3. CPM bids above the soft offer cap

In the RMR-CPM enhancements initiative, the ISO proposed broad changes to the RMR tool and some changes to the CPM tool. For the CPM tool, changes were proposed for resource owners that bid into the market at values above the soft offer cap. Currently, resources are allowed to bid into the CPM market at values above the soft offer cap; these bids must correspond to full cost of service. Resources that received CPM rewards for resources above the soft offer cap were allowed to receive this compensation in addition to keeping all market revenues earned. The RMR-CPM enhancements initiative proposed to more closely align this compensation with the compensation that resources received while bidding at or below the soft offer cap. The proposal stated that resources bidding above the soft offer cap would receive going forward fixed costs plus an additional 20% and would be allowed to retain market revenues.

The ISO filed the proposed changes to the RMR tool on April 23, independently from the proposed changes to the CPM tool. The proposed changes to the CPM bids above the soft offer cap has not been filed at FERC yet, but will be included with the filing that proceeds this initiative.

5. Next Steps

The ISO will discuss this issue paper with stakeholders during a call on June 17, 2019 at 10:00am PDT. Stakeholders are asked to submit written comments by July 1, 2019 to initiativecomments@caiso.com.