Stakeholder Comments Template

Subject: Capacity Procurement Mechanism, and Compensation and Bid Mitigation for Exceptional Dispatch

Submitted by	Company	Date Submitted
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This template was created to help stakeholders structure their written comments on topics related to the August 16, 2010 Draft Final Proposal for Capacity Procurement Mechanism, and Compensation and Bid Mitigation for Exceptional Dispatch. Please submit comments (in MS Word) to bmcallister@caiso.com no later than the close of business on September 3, 2010.

Please add your comments below where indicated. Your comments on any aspect of the proposal are welcome. If you provide a preferred approach for a particular topic, your comments will be most useful if you provide the reasons and the business case.

Overall Proposal

1. Whether you support the overall proposal.

NRG objects to the aspects of the proposal related to compensation of generators whose capacity is needed to ensure system reliability, but are not picked up in the RA program. Failing to compensate these resources, which are by definition needed to keep the lights on, at a level that allows them to make debt payments and pay for necessary O&M expenditures borders on an abdication of the ISO's role to (i) provide for just and reasonable rates; and (ii) ensure system reliability.

The ISO's initial White Paper correctly identified the problem: generators needed for reliability are not earning sufficient revenues to allow them to recover their fixed O&M costs, debt service, and a return on equity. The ISO correctly noted that this is not a sustainable situation, and that unless resources are permitted to recover their fixed costs, there will be a flight of equity from the ISO's markets, thereby further marginalizing these markets in their role as providers of efficient long-run and short-run price signals. Resources needed for reliable operation of the system will not be available when needed. It is indeed troublesome that CAISO has expended so many resources to develop market-based pricing institutions to provide investment signals for a constrained grid, yet finds itself in nearly in the same position as before restructuring where the wholesale markets only priced residual energy. FERC's recent decision on station power will make it even more difficult for marginal units to survive.

The ISO's retreat to 'mitigated' marginal cost pricing is particularly troubling in light of the ISO's analysis that additional gas-fired generation will be necessary on the system going forward to ensure reliability. Despite (i) identifying the problem; (ii) having the problem confirmed by the Department of Market Monitoring in its 2009 Annual Report, Market Issues & Performance; (iii) having exclusive jurisdiction over the compensation for resource picked up in the CPM program; the ISO still declines to fix the problem.

2. Whether the proposal strikes the appropriate balance among difficult issues.

The ISO does not appear to have considered arguments raised by capacity suppliers that the current markets, which mitigate suppliers to their marginal cost in the energy, ancillary services, and resource adequacy markets, are headed towards failure. Nor did the ISO identify any principled economic analysis accounting for its proposal to make the existing ICP program permanent, despite its prior statements in the CPUC's RA proceeding that the status quo was not sustainable. In short – there appears to be a severe lack of balance in the ISO's proposal.

Capacity Procurement Mechanism ("CPM")

3. Whether the tariff provisions should have a specific sunset date or be open-ended.

NRG disagrees with the premise that the ISO's proposal should become permanent. It is simply another interim bandaid with no path forward towards sending generator price signals identified in the proposal. The ISO should, if it chooses to continue, with this proposal, include a roadmap and timeline for how and when it will address the problems identified in its initial White Paper.

4. The ability to procure capacity for planned transmission and generator outages or sustained, significant less-than-planned-output of intermittent resources.

NRG supports providing the ISO additional flexibility to procure additional resources when necessary. However, the ISO should ensure that there is feedback into the RA designation process to ensure that identified problems are fixed in future RA proceedings. The most effective manner of ensuring that such problems are addressed by the CPUC would be to price capacity procured via the backstop mechanism at a sufficiently high price. Such economic incentives would create a market-based mechanism for encouraging the CPUC to procure the needed capacity in the next year's RA program.

5. The proposed treatment of procured capacity that subsequently goes out on planned outage during the period for which the capacity has been procured.

NRG has no additional comments on this aspect of the ISO's proposal.

6. Modification of the criteria under section 43.3 of the ISO tariff for selecting capacity from among eligible capacity.

NRG remains concerned about the ISO's amorphous criteria used to prefer use-limited resources to non-use limited resources. As the ISO is aware, many fossil units in California have their total run hours limited by their air permits. As a practical matter, these limitations rarely come into play for peaking or high heat-rate units, and are largely irrelevant for monthly designations. In NRG's experience, its use-limited resources rarely (if ever) approach their annual emissions caps. Moreover, such restrictions are very unlikely to occur during the peak season (usually occurring in 3rd Quarter), which occur prior to units exceeding their air emissions limits.

In particular, resources limited due to physical characteristics (e.g., hydro resources) should be distinguished from resources that are use-limited because of annual air emissions requirements, but that are otherwise fully capable of responding to a dispatch.

NRG understands that resources that are use-limited because of air permit limitations are required to meet the Must Offer obligation applicable to all Resource Adequacy or CPM-designated resources. Additionally, bids from such resources already take into account lost opportunity costs and units are required to run, as dispatched, until their total number of run hours is expired.
Finally, it is important to note that all use-limited resources submit a use-limited plan, which can be updated monthly, that should aide the ISO is determining which resource best fits its needs. When the plan indicates that a resource has sufficient runtime available, the ISO should have the flexibility to procure use-limited resources that best fit the operational needs of the system.

7. Procurement of capacity that is needed for reliability and is at risk of retirement.

NRG is very supportive of the ISO's conceptual proposal to provide ICPM payments for resources at risk of retirement. The ISO correctly identifies the concern: there are many older generating units – particularly those within load pockets – that are needed to reliably operate the transmission system, but that are not currently Resource Adequacy-designated units. This creates a scenario where these units have no means of earning enough revenues in the existing energy markets to economically justify their continued operation. Such plants are likely to retire, particularly given the increased environmental capital expenditures that will be necessary to keep these units operating over the next several years, including the Once-Through Cooling requirements.

However, NRG has several concerns with the criteria the ISO proposes to adopt for units seeking to participate in the retirement prevention program. While on one hand, NRG understands the desire to ensure that resources are “serious” about retiring, it should be sufficient for a resource to show that a unit needed for reliability in the next several years (as identified by the ISO) has not been picked up in the RA program. By definition, the CPM payment stream allows a unit to recover only its marginal capacity costs. If a unit is not picked up at its marginal capacity costs, then the market is telling that unit that it is not needed and is free to retire.

For example, a 670 MW unit that is able to sell only half of its RA is recovering approximately ½ its costs to continue providing 670 MW of capacity. By the standards developed by both the CPUC and the CAISO, the unit requires 670 MW of Resource Adequacy sales to recover its marginal costs. By those same standards, the unit receives no contribution to its fixed costs from the energy or ancillary services markets, which are capped at marginal costs + 10 percent. Thus, it is not necessary for a unit to submit financial statements detailing its financial situation in order to demonstrate that the unit is in financial distress. In short – if the ISO needs the unit for reliability within the next several years, it must provide that resource a contract for the necessary length.

NRG further notes that making a false statement to the ISO and/or the market monitor is a violation of FERC’s Market Behavior Rules and could trigger penalties of $1 Million per day, per violation, and would be ruinous to a company’s reputation. Finally, the ISO should recognize that its proposal to provide a multi-year CPM designation is far cheaper than issuing the unit an RMR contract for two years. NRG thus encourages the ISO to develop a market solution, rather than rely on the RMR process.

Additionally, NRG identifies the following specific concerns with the criteria proposed by the ISO:

a) Resources should not be required to submit a 90 day retirement notice prior to seeking to participate.

Requiring units to submit a binding notice of retirement prior to attempting to qualify for the program would effectively prohibit its use. As just one example, announcing a retirement would mean notifying employees that they were about to be out of a job, triggering severance payments, making it virtually impossible to retain qualified personnel. Similarly, a unit that announces its retirement will generally cut back on maintenance and begin a “run to failure” period in which it uses existing stockpiles of materials (including fuel), but would generally not continue to procure firm fuel supplies on a going forward basis. It is to no one’s advantage to require a public statement of intent to retire prior to the ISO even beginning its analysis of whether the unit is needed.

b) Resources cannot be required to make damaging public statements about their financial condition prior to participating in the retirement prevention program.

Making statements about an entity's inability to continue as going-forward concern raises a host of issues. In addition to representing a potential SEC violation, such statements could trigger additional collateral calls from various counterparties (including natural gas suppliers or customers with PPAs), breaches of existing agreements (which often contain financial status clauses), and serious concerns for employees of the affected entities. This does not appear to the ISO's intent; but making such statements could trigger serious repercussions that could push an entity over the cliff.

c) Assumption of an RA Obligation in future years should not disqualify a resource from participation.

Entities may buy-out their remaining RA obligations (capped at $41/kw-year). It is not difficult to imagine a scenario where it is economically rational for an entity to transfer its future-year RA obligation to another unit, and then retire. As the ISO is well aware, Local RA capacity is not entirely fungible, and if the ISO identifies a resource that is necessary for reliability, it should be able to retain that resource. Certainly, a transferable RA obligation should not automatically disqualify the unit from participating in the market.

8. The compensation methodology for resources procured under CPM and Exceptional Dispatch.

See above.

<u>Exceptional Dispatch</u>

The ISO needs to comprehensively re-evaluate its reliance on the Exceptional Dispatch mechanism, including how it compensates resources that are exceptionally mitigated. It is ironic that the resources most needed for reliability are the same ones most heavily mitigated. While unmitigated market power cannot be allowed, the ISO should look to mitigation thresholds, such as those that currently exist in New York and New England that mitigate bids to a fixed threshold that exceeds minimal going forward costs. Effective mitigation does *not* require that no price differentiation must be suppressed. Otherwise, Exceptionally Dispatched units have no realistic means of recovering their fixed costs. Certainly, the ISO need to expedite completion of the long-overdue Competitive Path Assessment, which is critical to allowing price signals to appear on the ISO system.

1. Linking compensation for Exceptional Dispatch to the CPM Payment.

2. Extending the existing bid mitigation.

Other

1. Additional comments.

While NRG is disappointed with the ISO's Draft Final Proposal, we encourage the ISO to (a) provide a comprehensive plan for providing suppliers revenue adequacy, (b) address the specific concerns raised in NRG's comments. That being said, we welcome the opportunity to discuss these issues further with the ISO and would encourage the ISO to seek guidance from the MSC on these issues.