PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Establish Policies and Cost Recovery Mechanisms for Generation Procurement and Renewable Resource Development	R.01-10-24
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REPLY COMMENTS OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION ON THE PROPOSED DECISION OF ALJ WALWYN AND THE ALTERNATE PROPOSED DECISION OF PRESIDENT PEEVEY

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PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking To Establish Policies and Cost Recovery Mechanisms for Generation Procurement and Renewable Resource Development

R.01-10-024

REPLY COMMENTS OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION ON THE PROPOSED DECISION OF ALJ WALWYN AND THE ALTERNATE PROPOSED DECISION OF PRESIDENT PEEVEY

In accordance with California Public Utilities Commission Rule 77.6, the

California Independent System Operator Corporation ("ISO") respectfully submits these

Reply Comments on the Proposed Decision of ALJ Walwyn ("Proposed Decision") and
the Proposed Alternate Decision of Commissioner Peevey ("Peevey Alternate") in the
captioned proceeding. The ISO's Reply Comments respond to the opening comments
filed by the following parties: San Diego Gas & Electric Company ("SDG & E"); Pacific
Gas & Electric Company ("PG & E"); Southern California Edison Company ("SCE");
the California Energy Commission ("CEC"); and The Utility Reform Network
("TURN"). In particular, the ISO rebuts these parties' arguments opposing certain
Findings of Fact and Conclusions of Law in the Peevey Alternate. The ISO submits that
the Peevey Alternate should be adopted because, compared to the Proposed Decision and

In its Comments on the Proposed Decision of ALJ Walwyn and the Alternate Proposed Decision of Commissioner Peevey filed on December 8, 2003 in the captioned proceeding ("December 8 Comments"), the ISO anticipated and addressed many of the arguments that parties have made in their opening comments. The ISO also addressed certain of these issues in its Comments on the Alternate Proposed Decision of Commissioner Lynch filed on December 11, 2003 ("December 11 Comments") The ISO will not repeat the arguments contained in its previously filed comments except where necessary to summarize and/or clarify the ISO's position or emphasize an important point

the Lynch Alternate, the Peevey Alternate provides the most comprehensive and effective framework for ensuring resource adequacy in California.

I. REPLY COMMENTS

A. The ISO Is Committed To Making A Filing To Implement Resource Adequacy Requirements Throughout The ISO Control Area That Are Consistent With The Resource Adequacy Requirements Approved By The CPUC

The utilities support the goal enunciated in the Peevey Alternate that the resource adequacy requirement adopted by the CPUC should apply to all load serving entities ("LSEs) in California.² The utilities state, appropriately, that an effective resource adequacy requirement must apply to all LSEs in the ISO Control Area in order to prevent "free riding" by LSEs that are not subject to the CPUC's jurisdiction.³ The utilities recognize that ISO-enforced, FERC-approved tariff requirements are necessary to ensure that all LSE's in the ISO Control Area are subject to a resource adequacy requirement. However, the utilities are concerned that the (1) the ISO may not impose the same standards on all LSEs (*i.e.*, the CPUC-approved standards will apply to the utilities and some different set of standards will apply to non-CPUC regulated LSEs), (2) resource adequacy standards may not be effective for all LSEs beginning at the same time, and (3) the ISO may not enforce the standards equally for all LSEs.⁴ The utilities believe that the same standards should apply to all LSEs, and such standards should become effective for all LSEs at the same time. Thus, the utilities request that the CPUC state that it will

Comments of Pacific Gas and Electric Company On Proposed Alternate Decision of President Peevey at 6 ("PG & E Comments"), Southern California Edison Company's Comments on the Proposed Alternate Decision of President Peevey at 9 ("SCE Comments").

PG & E Comments at 6, SCE Comments at 9

PG & E Comments at 6-7; SCE Comments at 10

not require the utilities to meet any new reserve requirement until and unless the ISO makes the same requirements applicable to all LSEs.⁵

The ISO generally agrees with the utilities that any resource adequacy requirement should be consistently applied to all LSEs in the ISO Control Area. This is necessary, inter alia, so that reporting requirements can be standardized. As soon as practicable after the CPUC issues a final decision on all of the resource adequacy issues in this proceeding (including rulings on the issues set for discussion in the workshop), the ISO will put together detailed resource adequacy requirements applicable to all LSEs in the ISO Control Area that are based on the standards approved by the CPUC. The ISO will then circulate these resource adequacy requirements to stakeholders, hold meetings with stakeholders and seek stakeholder input on such resource adequacy requirements that may be reflected in a FERC filing. The ISO's intent will be to develop a final set of resource adequacy requirements applicable to all LSEs. Following the stakeholder process, ISO management will take to the ISO Board of Directors a proposal to implement consistent resource adequacy requirements throughout the ISO Control Area. The ISO would then file any Board-approved proposal with FERC. Assuming that the CPUC issues a final order early in the first quarter of 2004, the ISO would aim to make the aforementioned FERC filing by the end of the second quarter of 2004.

The ISO urges the CPUC to act now and not delay approving resource adequacy requirements for the utilities. The utilities account for approximately 85% of the load in the ISO Control Area. Concern about possible differences in resource adequacy requirements among all LSEs provides no justification for a failure by the CPUC to impose the requirements that are needed for the utilities to meet their obligation to serve

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⁵ PG & E Comments at 7-8, SCE Comments at 10.

load. As indicated above, the ISO strongly supports consistent requirements for all LSEs and will do what it can to provide for such consistent requirements. In particular, the ISO's intent is to act expeditiously and seek FERC approval of resource adequacy requirements for all LSEs that are consistent with the resource adequacy requirements approved by the CPUC.

B. Waiting Until 2007 Or 2008 To Fully Implement The Reserve Requirement Is Risky And Unwarranted

Several parties object to the Conclusion in the Peevey Alternate that the reserve requirement should be made effective January 1, 2005. For example, although TURN prefers that the reserve requirement not be implemented until 2008, TURN finds the Proposed Decision's recommendation of a January 1, 2007 implementation date to be acceptable. SCE supports the three-year phase-in period, an effective date of January 1, 2007, recommended in the Proposed Decision. PG & E contends that the reserve requirement ought to be phased in over a four-year period to be fully effective by January 1, 2008. The primary arguments in support of a longer phase-in period are as follows:

(1) a January 1, 2005 implementation date will result in the utilities competing with each other over a short period of time to procure substantial amounts of capacity, thereby driving up prices considerably; and (2) because there currently is a surplus, there is no need to "lock-up" capacity starting January 1, 2005.

The ISO recognizes that, if the CPUC requires the utilities to meet the reserve requirement by January 1, 2005 (as proposed in the Alternate), and the ISO makes a

Comments of the Utility Reform Network On The Proposed Decision Of ALJ Walwyn And The Alternate Decision Of Commissioner Peevey Regarding Short-Term And Long-Term Utility Procurement Plans For 2004 And Beyond at 13-14 ("TURN Comments")

SCE Comments at 9.

⁸ Comments of Pacific Gas and Electric Company On Proposed Decision of Administrative Law Judge Walwyn at 11 ("PG & E Comments on the PD")

Control Area-wide basis, there will be a limited amount of time available for many LSEs to satisfy the reserve requirement. That fact may support the CPUC moving back the January 1, 2005 effective date for the reserve requirement. If the CPUC does decide to move back the effective date for full implementation of the reserve requirement, the ISO strongly believes that the reserve requirement should be fully implemented "sooner" rather than "later." Importantly, the CPUC should not adopt the phase-in dates recommended in the Proposed Decision and the Lynch Alternate. These decisions implement the reserve requirement too far into the future and could subject California ratepayers to increased costs and, possibly, curtailments if the resource base deteriorates or there is a significant increase in peak demand.

The parties seeking to defer implementation of the reserve requirement acknowledge that there is a surplus of cheap energy today. Thus, conditions are favorable for negotiating long-term capacity deals now. Conditions may not be so favorable in the future. Further, claims that competition between the utilities for capacity will drive up costs significantly are mere speculation at this time. Given that there currently is a supply surplus, and the utilities only need to procure a limited amount of additional capacity to meet the reserve requirement, it is not certain that any "bidding war" will result. In any event, as the ISO indicated in its December 8 Comments, if there is evidence that the suppliers are exercising market power, the utilities can always come back to the CPUC and request that the effective date of the reserve requirement be pushed back.

The claims that there is no need to "lock up" capacity now because of the existing supply surplus are short-sighted. As the ISO indicated in its December 8 Comments, the ISO's most recent Five-Year Assessment shows that there could be a shortage of capacity as early as next summer under adverse conditions. Even under base conditions for resources, there could be a supply shortage in 2008 if there is high peak demand.

Further, the fact that there is excess capacity now does not mean that there will be excess capacity in 2005. Indeed, the Five-Year Assessment shows the supply-demand balance getting narrower and narrower between 2004 and 2008. The Five-Year Assessment does not even take into account the recent "mothballing" of approximately 1,400 MW of capacity (and the potential for "mothballing" an additional 3-4,000 MW). The Five-Year Assessment also recognizes the risk that nearly 4,000 MW of capacity could retire over the next several years. The potential for the "mothballing" and/or retirement of additional units is very real and cannot be ignored. This could create a capacity shortage in the near future if such capacity is not "locked-up.

Finally, parties ignore the fact that even if there is a capacity surplus, that capacity may not be available to serve California load if it is not "locked-up" to serve California load. A single bad hydro year could turn a capacity surplus into a capacity deficit, and problems could arise if the remaining capacity is not "locked-up" to serve load in California.

C. There Are No Compelling Reasons To Adopt A 15% Reserve Requirement

TURN and PG & E support a 15% reserve requirement and argue that a 17% reserve requirement is excessive. TURN Comments at 12-13; PG & E Comments at 3-5.

The CEC suggests that a 15% reserve requirement is appropriate as an interim measure

until a more comprehensive study is undertaken. CEC Comments at 12-13. The primary arguments against a 17% reserve level are (1) no independent analysis was undertaken showing that a 17% reserve level is needed to meet a standard of one-day-in-ten-year loss of load probability ("LOLP"), and (2) a 17% percent reserve requirement would increase costs without providing an equal amount of benefit

The ISO notes that no independent, comprehensive, proper and fully evaluated study was undertaken to demonstrate unequivocally that a 15% reserve requirement produces a one-day-in-ten-year LOLP The Proposed Decision states that a 15% reserve requirement exceeds planning standards of a one-day-in-ten-year loss of load. Proposed Decision at 22. This conclusion was reached based on the simulations performed under a Henwood RiskSym production simulation model submitted by PG & E. Id., citing PG &E Post-Hearing Brief at 33. However, the Proposed Decision ignores the fact that SCE submitted simulations using the Henwood RiskSym model that produced a 17% reserve margin based on a one-day-in-ten-year LOLP. Exhibit SCE-L-1, Minick at page, 3, line 11 through page 4, line 14, Laukert, page 27, line 17 through page 32, line 5 (April 15, 2003). Thus, the Henwood model that the ALJ relied on in support of her conclusion that a 15% reserve requirement is appropriate also produced a 17% reserve requirement (for SCE) based on a one-day-in-ten LOLP. Nowhere does the ALJ acknowledge the 17% reserve level generated by the Henwood RiskSym model submitted by SCE, let alone attempt to differentiate the two Henwood analyses. Under these circumstances, there is no reasonable evidentiary basis for concluding that a 15% reserve level is more appropriate than a 17% reserve level, especially given that both reserve levels were

generated by the same RiskSym model. Any finding that a 15% reserve level is the "correct" level would be arbitrary and capricious.

Moreover, neither of these Henwood RiskSym studies were really evaluated in this proceeding. In particular, the input assumptions and data were not tested. The ISO submits that, under these circumstances, the Henwood RiskSym study relied on by the ALJ does not – and cannot serve as a reasonable basis to approve a 15% reserve requirement. The ISO notes that, although the CEC supports a 15% reserve requirement on an interim basis, the CEC believes that such value should be replaced with a permanent value upon "completion of appropriate studies and policy review." CEC Comments at 13. Thus, it appears that even the CEC does not believe that the Henwood study submitted by PG &E – and relied on by the ALJ – constitutes an adequate basis upon which to develop a permanent reserve requirement level.

The most work and analysis regarding the appropriate level of any reserve requirement has been undertaken by the California Power Authority ("CPA") as part of the CPA's rulemaking in Docket No. 2002-07-01, and the CPA supports a 17% reserve requirement. Further, other independent system operators utilize a reserve margin of at least 17%. Under these circumstances, unless some party can clearly demonstrate by empirical evidence that 15% is the correct level for a reserve requirement, the CPUC should approve a 17% reserve requirement. No party in this proceeding has made a convincing showing that a 15% reserve level is adequate.

Finally, the CPUC should reject the argument that an additional 2% reserve requirement will place undue costs on ratepayers. As indicated in the ISO's December 8 Comments, capacity is cheap. December 8 Comments at 10. Further, a 2% reserve is

equivalent to the load in the San Francisco Peninsula. *Id.* at 6. It is unreasonable to subject this amount of load to potential excessive spot market prices or, worse yet, curtailment due to a lack of available supply. The ISO submits that obtaining "insurance" for this amount of load is prudent given the events of the past.

D. A Requirement That Utilities Procure 100% Of Their Capacity Requirements By The Month Ahead Is Appropriate

PG & E alleges that the requirement that utilities procure 90% of their capacity requirements a year in advance and 100% of their requirements a month ahead is unnecessary, will result in a waste of money, and will preclude the utilities from buying capacity on a short-term basis when it is advantageous to do so. For example, PG & E states that the 100% month ahead requirement will eliminate opportunities to save money by importing low cost economy power from the Pacific Northwest. *Id.* at 8. PG & E also questions the finding in the Peevey Alternate (p.23) that a month-ahead requirement "may result in downward pressure on energy prices in the short-term markets." ¹⁰

The ISO is disappointed by the level of resistance to a requirement that utilities procure sufficient capacity to meet their peak load plus the applicable planning reserve in the forward markets, at least one month ahead of time, rather than relying on spot market purchases and hoping there will be sufficient supplies at the last minute when few alternative options may be available. See tr. (Sheffrin) at 4423: 22-28; 4425: 8-12; 4426: 10-15; 4471: 8-13. If the CPUC heeds PG & E's recommendation, progress towards forward procurement of capacity resources by the utilities will not be sufficiently advanced. Utilities should be required to procure, and to demonstrate that they have

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⁹ PG & E Comments at 2-3, 8-9

procured, sufficient resources to meet 100% of their monthly peak load plus the applicable planning reserve one month ahead of time.

As explained in the ISO's December 8 Comments (pp. 11-12), this approach provides the utilities a large degree of flexibility to firm up their capacity commitments when market conditions are optimal, while ensuring that surplus supplies, to the extent they exist, are committed to California and are not diverted elsewhere or available only at very high prices due to adverse conditions such as a West-wide heat wave. Moreover, the month-ahead requirement would ensure that, if there are problems looming, the CPUC, the ISO and the utilities would have a month to attempt to line up additional supplies or encourage conservation rather than addressing a potential short fall at the last minute in a crisis mode. See December 8 Comments at 11.

The level of resistance to an obligation on the part of the utilities to line up sufficient capacity to meet their needs in the forward markets is unwarranted. Ultimately, the utilities must procure sufficient resources to meet the needs of their customers be it in forward markets or in the ISO's markets. When purchases are made at the last minute, the range of options available to meet unforeseen circumstances is substantially more narrow than if purchases are made ahead of time. See tr. (Sheffrin) at 4423: 22-28; 4425: 8-12; 4426: 10-15; 4471: 8-13.

PG & E has not provided a credible explanation as to why it is better to risk last minute purchases of needed capacity rather than to proceed with an orderly procurement of needed resources in advance of the day-ahead and real-time time frames. There is no basis to PG & E's claim that a monthly obligation will prevent PG & E from procuring economy energy from the Pacific Northwest. PG & E is confusing capacity with energy.

The month ahead obligation is a capacity obligation only; the utilities are not being required to procure 100% of their expected energy needs a month in advance. Thus, to the extent energy from the Pacific Northwest is available after the month ahead and is cheaper than the energy the utilities can purchase under their capacity contracts, they are free to purchase such energy and save money for their ratepayers.

The ISO also agrees with the conclusion in the Alternate that the existence of a month ahead obligation will place downward pressures on prices in the short-term markets. PG & E's objection to this conclusion defies logic. With a reserve requirement of 17 percent in place, suppliers with capacity contracts will essentially be required to make available 117% of the utilities' energy needs (at some point after the month ahead), but the utilities will only need to purchase 100% of their energy requirements (plus approximately seven percent operating reserves).11 Basic laws of supply and demand indicate that there will be downward pressures on prices under such conditions, i.e., where supply exceeds demand. Another way of looking at this situation is that capacity contracts may have a stated price at which the utilities can purchase energy under the contract. To the extent 100% of the utilities' capacity requirements are covered via capacity contracts, the utilities will not purchase energy at prices above those specified in the capacity contracts; they will only purchase energy at prices below the prices in the capacity contracts. This necessarily places downward pressures on energy prices; otherwise, competing suppliers will be unable to make any sales.

In sum, a resource adequacy regime is meaningless without some requirement that the utilities procure in the forward markets sufficient capacity to meet their customers'

The planning reserve establishes a margin over and above operating reserves to cover peak load uncertainties and other contingencies *See* CEC Comments at II.

needs. This is because any target reserve level (regardless of how high or how low) can easily be "met" if utilities are simply allowed to assume that resources will be available to meet their needs in the spot market.

The ISO urges the CPUC to adopt a monthly reliability obligation whereby utilities are required to show that they have procured sufficient capacity to meet 100% of their projected peak load plus the applicable planning reserve. This approach is a very reasonable middle ground. On the one hand, it does not unduly limit the ability of utilities to use short-term capacity purchases, and it allows utilities to procure resources for their customers when market conditions are optimal. On the other hand, it precludes the utilities from placing reliable cost-effective service to load at risk by waiting until the last minute to procure the resources needed to serve their customers' load.

II. CONCLUSION

Wherefore, for the foregoing reasons, and the reasons set forth in the ISO's

December 8 Comments and December 11 Comments, the ISO requests that the CPUC

approve the Peevey Alternate (along with the limited modifications thereto identified in

the ISO's December 8 Comments).

December 15, 2003

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PROOF OF SERVICE

I hereby certify that on December 15, 2003 I served, by electronic and U.S. mail, Reply Comments of The California Independent System Operator Corporation on the Proposed Decision of ALJ Walwyn and the Alternate Proposed Decision of President Peevey in Docket # R. 01-10-024.

DATED at Folsom, California on December 15, 2003

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