Summary of Testimony of
Eric Hildebrandt
on behalf of the
California Independent System Operator Corporation (“ISO”)

Eric Hildebrandt is Manager of Market Monitoring Systems in the ISO’s Department of Market Analysis. In that capacity he, among others, has responsibility for monitoring the performance of California’s competitive Energy and Ancillary Services markets and of recommending structural modifications to correct perceived market distortions. As part of his responsibility, Dr. Hildebrandt has monitored the market performance of so-called Reliability Must-Run Units (“RMR Units") -- generating units which, because of transmission constraints, must be available to provide Energy or Ancillary Services to avoid local threats to the reliability of the ISO Controlled Grid.

In his testimony, Dr. Hildebrandt explains the essential problem that gives rise to the need for the ISO to have a contractual right to call upon these strategically located generating units at a pre-defined price whenever they are not already scheduled to operate in the competitive Energy markets. In essence, absent that contractual right, the owner of an RMR Unit would be able to exercise locational market power and force the ISO, the transmission-owning utilities who reimburse the ISO, and ultimately the consumers of electricity in California, to pay whatever price the owner chose to demand.

After explaining the reason why it recently was necessary to restructure the form of the RMR Agreement, Dr. Hildebrandt turns to the remaining issues in this proceeding. The first issue is how much the ISO should be required to pay an owner of an RMR Unit, in fixed, monthly payments, for keeping the RMR Unit operational and available for the ISO to call upon, as needed, to be in operation in order to meet local reliability requirements (or Ancillary Services, which also are covered by the RMR Agreement). Dr. Hildebrandt identifies the three objectives that the ISO seeks to see achieve through the determination of the amount of that payment. These objectives are (1) ensuring that the unit will remain operational and available; (2) imposing the least cost on consumers that is reasonable given the costs incurred by RMR Owners in meeting RMR contract requirements; and (3) establishing a clear and transparent benchmark against which other resources that may be capable of providing equivalent reliability service can compete to displace the RMR Unit.

Dr. Hildebrandt explains that in order to keep its unit operational and available to the ISO, an RMR Owner must be reasonably assured of being compensated for its fixed and variable "going-forward" costs. If reasonably assured that level of compensation -- through a combination of market transactions and payments made by the ISO -- a rational profit-maximizing owner should keep its unit operational. Costs which already are sunk (e.g., construction costs) will exist whether or not a unit remains operational and therefore, as Dr. Hildebrandt explains, those costs should have no bearing on an RMR Owner's decision as to whether or not to keep a unit in service.

Dr. Hildebrandt proposes that the correct amount to pay an RMR Owner in fixed, monthly payments is the "incremental cost" imposed on the Owner by a unit's having been designated an RMR Unit. In order to determine this amount, one must determine whether an RMR Owner could reasonably be expected to recover the annual fixed going-forward costs of a unit through net revenues from market transactions. (In order to make that determination, one must estimate the net market revenues of a unit. The ISO has developed a computer model to estimate those revenues; the other ISO witness, Brian Theaker, will explain that model and present the results of the model with respect to the units at issue in this proceeding.) If an RMR Owner cannot reasonably be expected to recover all of a unit's fixed going-forward costs through net market revenues, the fixed payment from the ISO to the RMR Owner should equal the amount of fixed going-forward costs that the RMR Owner cannot reasonably be expected to recover. This is the amount an economically rational RMR Owner must receive, in addition to net market revenues, in order to keep a unit operational and available to the

ISO. If the Owner can reasonably be expected to recover all of a unit's fixed going-forward costs through net market revenues, the fixed payment from the ISO to the RMR Owner should equal the sum of all identifiable incremental costs imposed on the RMR Owner by virtue of the unit's having been designated an RMR Unit. These costs could be the minor costs of administering the RMR Agreement, or they could be more major costs, if the RMR Owner can establish their existence. It is appropriate for the RMR Owner to recover these identifiable incremental costs because the going-forward costs of a unit that has been designated an RMR Unit include these additional costs of being an RMR Unit; for the ISO not to pay these incremental costs would mean that the unit would earn less profit as a result of having been designated an RMR Unit.

Dr. Hildebrandt explains that this "incremental cost" approach to determining the amount of the fixed payment to an RMR Owner for an RMR Unit meets the three objectives of the ISO. It ensures that it is economically rational for the RMR Owner to keep the RMR Unit operational and available to the ISO; it does so at the lowest cost to consumers that is reasonable to the RMR Owner; and it enables the ISO to estimate the costs to it of an RMR Unit, so that the ISO can conduct a competition among other resources that might potentially be able to displace the RMR Unit.

Finally, Dr. Hildebrandt recommends a similar "incremental cost" methodology for determining the portion of the cost of ISO-approved Capital Additions or Repairs at an RMR Unit that the ISO should pay an RMR Owner. The ISO should pay the portion of the cost, if any, that the RMR Owner incurs *only* because the unit has been designated an RMR Unit; that is, in this case, the "incremental cost" of the unit's being an RMR Unit. In determining that incremental cost, any additional market revenues that the RMR Owner can reasonably be expected to earn as a consequence of incurring the RMR-imposed portion of the cost of the Capital Addition or Repair should be deducted.