

Memorandum

To: ISO Board of Governors
From: Charles A. King, Vice President, Market Development & Program Management
Date: December 4, 2007
Re: *Briefing on Capacity Pricing Mechanism*

This memorandum does not require Board action.

The purpose of this memorandum is to provide a status update on the California Public Utility Commission's (CPUC) Long Term Resource Adequacy (LT-RA) proceeding and CAISO Management's involvement in that proceeding. The agenda for the proceeding, as established in the CPUC's December 2006 ruling, focuses on the consideration of potential long-term enhancements to the existing Resource Adequacy rules, including the question of whether to adopt a Centralized Capacity Market (CCM). Management has long been an advocate of developing a transparent, market-based "Capacity Pricing Mechanism" per the subject line of this memorandum, but to date has not yet formulated a position on whether a CCM is the preferred way to create such a mechanism.

The original schedule for the proceeding called for the issuance on November 2 of a Staff Report by the CPUC Energy Division with specific input and collaboration from the CAISO, and ultimately a decision by the CPUC in the first quarter of 2008 that would specify the CPUC's preferred LT-RA framework. The CAISO's charge within the Staff Report was not to offer a recommendation on whether to adopt a CCM, but more narrowly to compare alternative CCM design approaches and offer recommendations to address the hypothetical question, "If the CPUC decides to pursue a CCM, how should that CCM be designed?" After conducting a stakeholder process on this question from August through October, Management provided its recommendations as requested by the CPUC.

In parallel to CAISO Management's recommendations on the CCM design, the Market Surveillance Committee (MSC) provided its own LT-RA opinion to the CPUC. The MSC opinion was not limited to matters of CCM design, and in fact addressed a broader scope of LT-RA questions including the question of whether the CPUC should adopt a CCM at this time, and other aspects of the design of a LT-RA framework. In developing its opinion, MSC members participated in the CAISO stakeholder process and also conducted a full-day MSC meeting at the CPUC on October 1st. The MSC opinion was formally adopted by the committee on November 9th and is attached to this memorandum.

Because the MSC opinion addressed several important LT-RA issues that were beyond the scope of Management's recommendations on CCM design, Management felt it was important to respond to the MSC opinion to clarify those areas where Management's views are different to those of the MSC. Management's response to the MSC opinion was released

on November 27th and is available from the CAISO web site at the following link:
<http://www.caiso.com/1ca3/1ca3dadd6f980.pdf>

As of the date of this memorandum, the release of the Energy Division Staff Report has been delayed until December 7 or possibly later, although a revised schedule for the proceeding has not yet been issued by the CPUC. If the Staff Report is released on December 7 or shortly thereafter and the remainder of the proceeding occurs as originally scheduled, the final CPUC ruling can be expected in early April 2008. Between now and the final CPUC ruling, CAISO Management intends to be a party to the proceeding and contribute comments at each opportunity. If the CPUC decides to adopt a CCM, Management expects that the CAISO would be designated to develop and operate the CCM and include it as an element of the CAISO tariff. This activity would begin some time in 2008 after the startup of the MRTU markets.

In brief, the recommendations Management has articulated in its contribution to the Energy Division Staff Report and its response to the MSC opinion may be summarized as follows:

1. It is important for the CPUC to make some key decisions at this time to modify the existing RA framework, rather than deferring any significant changes to some future date as several stakeholders and the MSC recommend. In particular, it is necessary to resolve uncertainties about the future RA framework to create a stable environment for market-based investment in new infrastructure.
2. A major modification needed at this time is to move the demonstration of capacity procurement approximately four years forward of the delivery year, thus extending today's one-year/one-month-ahead RA process to a time frame that allows new investment in generation and demand response to compete effectively with existing capacity and to integrate with transmission planning.
3. The RA Must Offer Obligation (RA-MOO) should be retained as the basis of the definition of RA capacity (with potential enhancements to be considered). The RA-MOO entails a set of CAISO tariff provisions which define the linkage between the RA capacity procured by load serving entities (LSEs) and the energy and reserve capacity services such capacity must provide through its participation in the CAISO markets.
4. Although a CCM is not necessary under a multi-year forward RA framework, there are some important benefits of adopting a CCM in contrast to today's purely bilateral LSE "showing" which should be carefully considered. These include greater transparency of pricing and cost allocation, administrative simplification, compatibility with retail Direct Access, and incorporation of a straightforward "backstop" procurement mechanism.

In conclusion, Management emphasizes that the Long Term Resource Adequacy proceeding is very much a work in progress, with significantly different alternative approaches still undergoing vigorous debate. Although the imminent Energy Division Staff Report should be an important indicator of the CPUC staff's preferences and recommendations, the ultimate direction will not likely be resolved before the CPUC issues its ruling next spring. Management is continuing to be an active participant in the proceeding, and will brief the Board again when there is significant new information to report.