California ISO

Stakeholder Comments Template

Capacity Procurement Mechanism Soft Offer Cap

This template has been created for submission of stakeholder comments on Capacity Procurement Mechanism (CPM) Soft Offer Cap that was published on July 24, 2019. The straw proposal, stakeholder meeting presentation, and other information related to this initiative may be found on the initiative webpage at: http://www.caiso.com/informed/Pages/StakeholderProcesses/CapacityProcurementMechanismSoft-OfferCap.aspx

Upon completion of this template, please submit it to initiativecomments@caiso.com. Submissions are requested by close of business on August 20, 2019.

Submitted by	Organization	Date Submitted
Michele Kito *415-703-2197* *Jaime Gannon* *415-703-2818*	*CPUC* *Energy Division*	*September 4, 2019*

Energy Division staff (ED staff or staff) appreciates CAISO's efforts 1) to address market power, as discussed with CAISO's Governing Board and discussed by CAISO management and the Market Surveillance Committee (MSC) and 2) to review the soft-offer cap, consistent with current tariff provisions. In sum, staff positions are as follows:

- Staff strongly supports the three-pivitol supplier test, and application of cost-based rates (through, effectively, the reliability must-run or RMR agreement) to address market power, as proposed in CAISO's straw proposal. At the CAISO Board meeting, CAISO management indicated that the RMR agreement is the backstop mechanism that CAISO has to address market power. However, ED staff has a several questions regarding the application of the three pivotal supplier test and the implementation of CAISO's proposed market power mechanism.

- As explained further below, staff does not support CAISO's proposal to maintain the soft-offer cap at the current level, which is based on an old study and includes a 20 percent adder, which is arbitrary and capricious because it is not based on data or analysis or reasoned application of economic principles.

- Staff supports the changes to CPM compensation above the soft-offer cap; although notes that these changes were already proposed and authorized by

CAISO's Governing Board. However, staff supports CAISO's alternative proposal, which does not include the 20 percent adder.

- Though not discussed in the straw proposal, ED staff continues to support allocation of flexible capacity for annual CPM designations.

Finally, ED staff requests that CAISO consult the MSC on this initiative. The MSC has been consulted and issued opinions on may of the previous CPM initiatives.[1] Further, in its Opinion on the RMR/CPM filing previously filed at FERC, the MSC noted that:

> *We agree with the CAISO's objective of defining distinct roles and pathways for RMR and CPM. Ideally, the RMR channel would be reserved for circumstances where there is little or no prospect that the market could provide a practical or competitive outcome. These instances could be thought of as situations in which the resources able to meet the reliability need possess material local market power in meeting the reliability need. We agree with the CAISO proposal that it is reasonable to address this market power by treating such instances as regulated services and to compensate resources providing these services according to traditional regulatory cost-of-service principles.*

Given the importance of issues associated with market power, ED staff believes that it would be helpful for the MSC to consider and address the outcome of this important and inter-related initiative.

ED Staff Supports Application of the Three Pivital Supplier Test

In its comments on CAISO's RMR filing, the CPUC and other parties raised the issue that the annual CPM designations for 2018 were not competitive – there was only one supplier in each of the local areas that could meet the need (i.e., Encina in the San Diego/IV Area, and Moss Landing in the sub-local area in the Bay Area) and that the CPMs were at or near the soft-offer cap.

To address the fact that resources in local areas may have market power (as identified when developing the local RA program in 2006), CAISO proposes a 3-pivotal supplier test for 12 month designations: "[t]he ISO is proposing to include a three pivotal supplier test to extend full cost of service contracts to resources awarded 12-month CPM designations that fail the pivotal supplier test."

---

[1] See Busnell, J., S. Harvey, and B. Hobbs, *Opinion on Reliabiity Must Run and Capacity Procurement Mechanism Enhancements*, March 21, 2019, F. Wolak, J. Bushnell, and B. Hobbs. *Opinion on "Interim Capacity Payment Mechanism under MRTU."* Novem-ber 2007, Wolak, F., Bushnell, J. and B. Hobbs. *Opinion on the Capacity Procurement Mechanism and Compensation and Bid Mitigation for Exceptional Dispatch*, October, 2010; Bushnell, J., Harvey, S., Hobbs, B. and S. Oren, *Opinion on Flexible Capacity Procurement: Risk of Retirement.* September, 2012.

ED staff supports using the three-pivotal supplier test in these circumstances. This is consistent with CAISO Board, CAISO management, and MSC discussions that indicate that the RMR agreement is the cost-based rate that is appropriate to address market power.[2]

At the same time, ED staff has a few clarifying questions regarding the application of this test:

- What happens if a resources that fails the three-pivotal supplier test declines the annual designation and the resource does not bid into the CSP (but is needed for reliability)? Will it be given a monthly CPM at the soft-offer cap?

- What happens if a partial unit is needed for reliability and fails the three-pivotal supplier test? Is there an RMR agreement for a partial unit? If so, how are the revenues attributed to the generator for the portion that participates in the market and the portion under an RMR agreement? If there is no RMR agreement/designation for a partial unit, would the CPM apply (even when the unit fails the three-pivotal supplier test)?

- Why would CAISO use the lowest cost-of-service, rather than the lowest cost-of-service, *less net revenues*, to determine the least expensive resource to customers when determining a CPM/RMR designation?

- Is it CAISO's understanding that it can make an annual designation for system deficiencies? Does CAISO only assess the 90 percent requirement? Or include full MIC? The CPUC only requires 90 percent for the 5 summer months, if CAISO found a shortfall in one or up to five months, would it issue an annual designation? Under what circumstances? If so, how could CAISO be sure that it is needed for system RA in the other months? And how would CAISO allocate the costs under these circumstances (e.g., to deficient LSE in one summer month and then pro-rata to all other LSEs in all other months)?

ED Staff Does Not Support CAISO's Proposal to Maintain the Soft-Offer Cap at Current Levels

CAISO proposes to retain the CPM at its current level, arguing that the level "changed very little," and arguing that the "going forward fixed costs for a new combined cycle did not materially change over the past five years." CAISO did not address retention of the 20 percent adder as requested by Staff in prior comments.

Staff does not believe that the current compensation for annual CPM designations is just and reasonable and believes that it is too high because it includes both a <u>20 percent adder</u> on a resource's GFFC <u>and</u> allows the resource to <u>retain market revenues</u>.

[2] See CAISO Board and CAISO management discussions at March 2019 Board meeting, available here:

Compensation at this level may result in a fully depreciated generator with market power choosing the CPM path rather than the RMR path to secure a contract (and choosing not to participate in the bilateral market).

CPM designations are meant to be obtained through a "competitive solicitation process." However, the two annual designations that occurred in 2017 (for 2018 compliance) were not competitive. Specifically, Encina received a CPM for 545 MW of capacity[3] at the soft offer cap of $6.31/kW-month,[4] but Encina was the only unit that could meet this specific local reliability need. Likewise, Moss Landing also received a CPM for all of 2018, for the remaining capacity available on the units (i.e., 510 MWs)[5] and received a price of $6.19/kW-month for 490 MW and the soft offer cap price of $6.31 per kW month for the remaining 20 MW,[6] but this was the only resource that could meet the specific Bay Area local reliability need identified by the CAISO.

Both of the annual CPM designations listed above were for significantly depreciated generators. Paying them the GFFC plus a 20 percent adder (in addition to net market revenues) could potentially incentivize resources with market power to utilize the CPM mechanism rather than participate in the bilateral market because the capacity prices at the CPM soft offer cap are potentially more lucrative.

In order to address market power concerns associated with CPM designations (especially annual designations), Staff proposes the elimination of the 20 percent adder. This will align the soft offer cap with prices in the bilateral market and mitigate withholding and market power concerns that have been raised in prior stakeholder comments.

Further, while CAISO has argued that the current soft-offer cap was approved by FERC and, therefore is just and reasonable, however, CAISO's current tariff provides them the flexibility to consider the use of a 20 percent adder in updating its CPM soft offer cap. The tariff specially states that the statekholder process may consider "what resource serves as the reference resource, the components of fixed costs that are considered in setting the CPM Soft Offer Cap, or <u>the use of a 20% adder</u> to costs to set the CPM Soft Offer Cap."[7]

While CAISO does not discuss the 20 percent adder in its straw proposal, we note that the justification provided in the past has been that going-forward fixed costs do not cover

---

3 CAISO, "Capacity Procurement Designation on 12/22/17," available at

http://www.caiso.com/Documents/CapacityProcurementMechanismDesignation-122217.html#search=CPM%20Encina

4 CAISO, "December 22, 2018 Year Ahead Local CPM Designation Report," available at http://www.caiso.com/Documents/December222017YearAheadLocalCPMDesignationReport.pdf.

5 CAISO, "Capacity Procurement Designation on 12/22/17," available at http://www.caiso.com/Documents/CapacityProcurementMechanismDesignation-122217.html#search=CPM%20Encina.

6 CAISO, "December 22, 2018 Year Ahead Local CPM Designation Report," available at http://www.caiso.com/Documents/December222017YearAheadLocalCPMDesignationReport.pdf.

7 CAISO Tariff 43A at 16

capital additions, such as major maintance. ED staff disagrees with this justification. Staff reviewed the CEC's 2014 report for additional information on the costs included with O&M and found the following:

> Fixed O&M costs are the costs that occur regardless of how much the plant operates. These costs are not uniformly defined by all interested parties but generally include staffing, overhead and equipment (including leasing), regulatory filings, and miscellaneous direct costs. The first-year cost is provided as an estimate and then escalated by inflation plus 0.5 percent real escalation.[8]

Staff understands that the O&M data was collected from 2012 survey data from existing power plants included in appendix B-2 of the CEC's 2014 report. The data from these plants is categorized into either a capital cost parameter or an Operating & Maintenance cost parameter. The O&M cost parameter includes "normal annual maintence costs, including scheduled overhaul frequency/costs." It is Staff's understanding that these fixed O&M costs include major maintence scheduled over the life of the asset. Thus, it is Staff's understanding that the major maintenance cost are technically covered in GFFC estimates and are not addional costs above the GGFC. Capital additions would include plant improvements to increase efficiency or MWh output of a facility, not maintence to maintain the existing operation of the plant. Staff believes this is an important element to understand to ensure that the soft offer cap is set appropriately.

The 2015 FERC Order approving the CPM soft offer cap states that:

> CAISO asserts that since the reference resource is based on the CEC's mid-cost case, CAISO claims that the 20 percent adder will allow for resources with costs higher than the mid-cost case to recover their fixed costs. CAISO also argues that the 20 percent adder establishes a CPM soft offer cap at the higher end of the range of resource adequacy prices, which will ensure that the CPM does not provide disincentives for load-serving entities to enter into bilateral resource adequacy contracts instead of relying on backstop CPM procurement. Finally, CAISO contends that the 20 percent adder will appropriately capture uncertain or difficult to quantify costs in addition to any margin of error in the CEC study.[9]

The order also notes CAISO belief that CPM soft-offer-cap will be sufficient to mitigate market power.

> CAISO states that its transition from administrative pricing to competitive pricing requires some form of market mitigation because there may be a limited pool of non-resource adequacy resources available to meet a given reliability need. Therefore, <u>CAISO explains that the potential exists for resources to exercise</u>

[8] CEC 2014 COG study at 144- https://www.energy.ca.gov/2014publications/CEC-200-2014-003/CEC-200-2014-003-SF.pdf

[9] 153 FERC ¶ 61,001 at 13

market power and asserts that the soft offer cap will both ameliorate these concerns and provide necessary market mitigation.[10]

As documented above, the soft-offer-cap has several purposes:

1.) It provides a buffer for resources that have fixed costs above the mid-case to be able to recover their costs under the CPM mechanism,
2.) It is provides a disincentive for LSEs to rely on the mechanism to meet their capacity needs (since CPM prices would be higher than current bilateral prices), and
3.) It is providing market power mitigation.

Purposes 2 and 3 appear contradictory, since providing a disincentive for an LSE to rely on the mechanism also provides an incentive for a generator to use that mechanism.

Removal of the 20 percent adder will still allow for resources that have cost higher than the reference units GFFC (purpose 1) to file for cost recovery at FERC. Removing the 20 percent adder will still keep the soft offer cap higher then the current weighted average capacity costs reported in the bilateral market. Therefore, it would still provide a disintentive for LSEs to rely on the mechanism (purpose 2). Finally removal of the 20 percent adder will more adequately mitigate market power (purpose 3) and withholding in the bilateral market since it will move the soft-offer-cap closer to average bilateral capacity prices.

ED Staff Supports Changes to Compensation Above the Soft-Offer Cap

The current tariff allows generators to file for compensation above the soft offer cap using the current RMR pro forma which allows for total cost recovery (AFRR).[11] As argued throughout the RMR and CPM enhancement stakeholder process and in response to CAISO's April RMR Tariff Filing, CAISO's existing tariff for CPM compensation above the soft offer cap is unjust and unreasonable because it allows for full sunk cost recovery (including return of and return on all undepreciated capital) as well as retention of net market revenues.

CAISO has proposed modifying its tariff to provide compensation based on a filing to FERC justinfying only GFFC and either 20 percent adder or without the 20 percent adder. For the reasons discussed above, and because generators retain net market revenues, ED staff does not support inclusion of the 20 percent adder.

---

[10] 153 FERC ¶ 61,001 at 14

[11] CAISO Tariff, § 43A.4.1.1.1 "For a resource whose sales are under FERC jurisdiction that is providing CPM Capacity to be compensated at a rate higher than the CPM Soft Offer Cap, the resource owner must make a limited resource-specific filing before FERC to determine the just and reasonable capacity price for the resource as calculated per Schedule F to the pro forma RMR Agreement in Appendix G of the CAISO Tariff."

CAISO Should Allocate the Flexible Capacity for Annual CPM Designations

Under current CPM tariff provisions for system or local designations, CAISO does not obtain the flexible capacity attributes, nor does it allocate the flexible capacity to load serving entities to reduce their otherwise applicable capacity requirements. For example, for the Encina and Moss Landing CPM designations that occurred in 2018, CAISO did not obtain the flexible capacity, nor did it allocate it to load serving entities.

As a result, these resources were required only to bid or self-schedule during the availability assessment hours (e.g., 4 to 9 pm), meaning that the larger must-offer assessment hours did not apply and, if the resource self-scheduled, they would not need to bid into the real-time market. Not allocating flexible capacity effectively strands the flexible capacity, removes the more stringent bidding requirements and penalty provisions, and potentially allows resources to avoid any real-time bidding obligations, all of which jeopardizes reliability if CAISO does not have access to flexible resources to address ramping and other reliability needs on the system.

In addition, CAISO does not allocate the flexible capacity benefits for system and local CPM annual designations (and did not in the instance of Encina and Moss Landing), meaning that despite the fact that consumers were ultimately paying the going-forward fixed costs (plus a 20 percent adder), customers did not receive all of the benefits that these resources could potentially provide.

ED staff believes that it is unreasonable to pay for capacity and not receive the corresponding benefits. The CAISO has recognized the benefits of allocating the flexible capacity associated with RMR agreements:

> [I]f the RMR resource has effective flexible capacity (EFC), it will have a flexible capacity MOO for the highest flexible capacity category for which the RMR capacity qualifies under the existing tariff. This change will update the RMR agreement to align it with the RA and CPM resources the CAISO relies on to serve demand and meet reliability needs through market optimization.[12]

Given that CAISO has filed tariff proposing to allocate the flexible capacity for RMR (for uneconomic resources), ED staff sees no reason not to allocate the flexible capacity for CPM designations (for economic resources) needed to backstop the resource adequacy program and urges CAISO to obtain the flexible MOO and allocate the corresponding capacity benefits.

---

[12] ER-19-1641-000 CAISOs April 22nd RMR and CPM Tariff Filing, p. 76.