

Comments of Calpine Corporation
Standard Capacity Product
September 11, 2008

Introduction and Overview

Calpine views this as a first step, not an overhaul of CPUC / RA

Calpine continues to support the basic structure of the capacity product described in the joint filing in December 2007 CPUC docket R05-12-013. However, to expedite the development of that product, Calpine recommends that the CAISO narrowly consider the development of a Standard Capacity Product (SCP) as the necessary next step to the rationalization of the RA system, rather than as a complete overhaul.

Specifically, we believe that the overall administration of the RA program should be left unchanged in the short run. Incremental improvements in both standardization and reliability can and should be made first, within the current framework.

Target the performance obligations and performance management and you are 90 percent of the way there.

The obligations and penalties/rewards systems for the SCP should be the exclusive focus of the CAISO at this time. These aspects of this unique product then can be rolled into the CAISO tariff. Commercial enterprises can then develop trading mechanisms and transactional vehicles.

While Calpine enthusiastically supports the extension of offer obligations and performance management mechanisms to all capacity transactions, including legacy contracts, at present, the CAISO should focus on the prospective SCP product.

Strike a balance between the interest in reliability and the desire for standardization.

Calpine notes that the SCP must strike an appropriate balance between the reliability needs of the CAISO and the market interest for standardization. Indeed the CAISO must fundamentally choose – or draw an appropriate balance -- between highly-granular, price-differentiated capacity products and highly-standardized, capacity products.

In its final determination, however, the CAISO must avoid the perception or reality of cross-subsidy within capacity definitions -- that inferior capacity is being overly-compensated at the expense of highly-reliable, dispatchable capacity.

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Response to Questions 1, 5, 6, 7, 20, 21 and 22 (scope and implementation)

Avoid the premature development of bulletin boards and registries

Calpine sees no immediate need for modifications to the RA demonstrations or compliance filings. Rather, we see SCP as a new form of capacity that will qualify as an RA resource.

Eventually, however, some form of CAISO logging system may be needed for purposes of capturing the initial commitment by the resource SC of the capacity quantity in order to trigger performance obligations and to ensure that a capacity certificate or tag can be verified as being valid. The capacity tag is analogous to a stock certificate or bearer bond whereby the holder (whether the initial purchaser or the tenth purchaser) is confident that it has a valid claim to the underlying rights to meet its verification obligation with the LRA (CPUC).

Nonetheless, modifications to the RA administration and enhancements to price transparency, as would be embodied in the “bulletin board” and “registry” concepts, should be deferred until after the CPUC issues an order in Phase 2 of the RA docket.

Avoid addressing that which is better performed in the commercial environment (confirmation letters)

The CAISO should be a participant in, but not the “owner” of the commercial product that transfers capacity between entities. Placing the confirmation letter in the CAISO tariff or Business Practice Manuals would create unnecessary barriers to trade and change.

The most important thing that the CAISO could do is to articulate a clear trigger when a resource has committed itself under the CAISO tariff as providing RA capacity. Once that is developed, commercial counterparties will have no difficulty in determining how to transact.

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Questions 2, 3, 4, 8, 9, 10, 11, 12, 13, 24 (obligations)

The objective of the SCP is to segregate capacity acquisition from the performance obligations

The essential function of the SCP is to segregate the LSE's acquisition of the capacity tag for purposes of making a resource adequacy showing to the LRA from the performance obligations provided by the resource to the CAISO. Once the resource SC elects to sell a tag, that resource SC is committed to make available that quantity of capacity to the CAISO for the performance period pursuant to the obligations set forth in the CAISO tariff. The purchaser, whether as the initial purchaser or as a purchaser in a secondary transaction, should have no obligations related to performance of such resource SC with respect to the committed capacity. Subsequently, the reporting LSE's performance responsibility ends with its submission of the SCP tags to meet its RA requirements.

The SCP obligation is to schedule or bid in appropriate markets

For RA capacity that has been committed by the resource SC through the initial sale of the SCP tag, the resource SC must make that RA capacity available to the CAISO by bidding the RA capacity in the Day Ahead market and, if applicable, in the Real Time market or otherwise self-schedule any capacity committed in bilateral transactions.

LSEs carry no obligations for replacement of non-performing capacity

Calpine supports a policy of "one and only one showing" which in essence means that LSEs have no obligation to replace non-performing capacity. Rather, the financial liability for replacement falls to the chronically non-performing generator. The obligation to provide replacement capacity (if needed and as discussed below) falls to either the generator or the CAISO.

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The SCP structure must strike a balance between standardization and reliability needs, while ensuring just compensation

Prior to answering many of the questions posed by the CAISO, Calpine believes that a foundational decision must be made by the CAISO regarding SCP in the light of two fundamentally diverging objectives.

The first objective of SCP is that “standard” implies the creation of an identical, fungible product that can be easily traded. However, this product is derived from resources that diverge widely in their performance characteristics and reliability value.

Absent explicit compensation for the operational differences between these resources, some resources will be under-compensated for their capacity contributions and others will be over-compensated. This would be clearly discriminatory.

The second, contravening objective is that grid reliability may require a finite set of non-standard, highly-granular products that could be compensated very differently. The need for these differentiated products could increase particularly as higher penetrations of intermittent renewable energy are integrated into the grid.

The CAISO must make a choice between these two objectives or draw a reasonable balance between them by adjusting NQC, obligations or performance penalties, as discussed below.

There are several ways to balance standardization and reliability.

- a. Use current NQC, apply identical offer obligations and allow in-period non-performance penalties to differentiate resources

This approach appears to require the least amount of change from the current RA framework, while providing, over time, the appropriate mix of reliability resources.

The risk of performance penalties allows different SCs to self-select their willingness to submit their capacity as a reliability product. If the SC of an energy-limited resource wishes to receive capacity compensation through the SCP, then it may do so. However, as the reliability value of the RA capacity commitment is less, it ultimately is compensated less as it is subject to penalties for non-performance .

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b. Derate NQC in advance of sale to reflect limits on availability or performance

This approach contemplates an adjustment to the NQC that an SC may sell from a resource that has operational limitations. If a resource is not expected to meet a certain threshold of annual availability then its NQC is reduced.

This approach could allow for the development of a standard SCP capacity tag, but would use administrative determinations as opposed to (or possibly in addition to) penalties to adjust expected compensation levels. This approach provides a means whereby resources could obtain higher compensation for higher value reliability services by simply having, on a relative basis, more SCP capacity tags to sell.

c. Reduce obligations to the least common denominator, and develop additional reliability products

This alternative would establish universal performance obligations but match those obligations to the least common denominator. That is, energy limited resources can commit capacity through the SCP, but no other units are held to any higher standards. In this way, all resources are compensated for an equivalent product and higher availability resources are not undercompensated by being required to provide a higher level of availability. However, to the extent that CAISO wishes to receive the benefits of the higher availability resources, those resources should receive separate and additional payments through a mechanism outside of the SCP contracting process

d. Develop different “flavors” of needed capacity products tailored to the explicit needs of the CAISO.

Different “flavors” of capacity product could be considered including peaking, fast ramping, use-limited, or quick start. This differentiation could resolve Calpine’s concerns about resource discrimination in which resources that are providing fundamentally different reliability services receive the same level of compensation. However, creating different “flavors” of capacity would likely reduce fungibility, reduce liquidity and may be the most cumbersome and ultimately, the least successful approach to creating a standardized product.

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Only after the CAISO chooses a method for achieving the “balance” above, can the specific conditions for A/S obligations, use-limited resources, QFs and legacy contracts be discussed

Several of the questions embedded in the CAISO template ask questions that presume or would logically lead to substantial product differentiation without compensation differentiation, a result that is unduly discriminatory.

For instance, the CAISO suggests that the SCP offer include an incremental obligation for qualified generation to provide Ancillary Services bids. While it may be reasonable for the SC to voluntarily satisfy the availability obligation by bidding the RA capacity in the A/S markets, the SCP should not obligate participation in the A/S markets as such requirement provides a differentiated product without differentiated pricing.

It is critical that the performance obligations be uniform and that resources that are able to provide greater operational flexibility and reliability value are not penalized by being required to provide such attributes through the RA capacity commitment while other resources, because of their operational limitations, or because of the nature of their technology, are relieved from providing the same level of reliability service. This would be clearly discriminatory.

As a result, Calpine believes that the incorporation, if appropriate, of unique rules for unique resources must only be made after the structural balance between reliability and standardization is drawn.

DSM is unique and may require a workshop of its own

The obligations and performance incentives associated with demand side management are less understood and more ambiguous than those of conventional generation. Calpine suggests that the CAISO convene a targeted and narrow stakeholder workshop to explore the relationships of DSM and SCP.

LSEs may need to take on a role for performance obligations associated with legacy contracts, but Calpine suggests that issue be deferred.

In the long term, Calpine believes that all RA resources should be subjected to CAISO obligations and performance incentives. Legacy contracts may require modification or transition periods to accommodate natural expiration. However, Calpine suggests that the application of SCP to legacy contracts be deferred until a later date.

Questions 14, 15, 16, (Performance Management)

Calpine prefers in-period financial incentives when compared with *ex post* reductions to NQC

Calpine supports the development of in-period, symmetrical financial incentives (penalties and rewards) as the primary vehicle for disciplining performance.

Calpine suggests that when evaluating in-period financial incentives and future reductions in NQC, the CAISO should consider the impacts of the mechanism on the following inter-related issues:

- The incentives the generator will have for expeditious resolution of the factors driving non-performance;
- The incentives that a generator will have for exceeding targeted thresholds for performance.
- The incentives that generators will have to offer capacity to RA buyers.

Calpine suggests that in all cases, in-period financial penalties provide better incentives and will promote better performance and reliability.

Indeed, in-period penalties will focus resources on resolving performance issues before the next performance period begins – probably monthly. Alternatively, structuring penalties as future reductions in NQC may provide less urgency in resolving the non-performance factors.

Additionally, in-period symmetrical financial incentives will provide direct and immediate feedback that encourages performance above targets. If beneficial incentives are substantial, it may encourage opportunities for short-term reliability investments.

Finally, in-period penalties will encourage generators to offer capacity only when they are confident of performance. This self-discipline will ensure that the CAISO obtains resources that are fully capable of performance.

Calpine cautions against dual use of both penalties and NQC reductions, as it seems this combination is likely to result in charging the generator is twice for non-performance.

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Performance measures should reflect the spirit of “forced-is-forced”.

Calpine agrees with the fundamental premise that the RA product is inherently a unit contingent obligation as opposed to a firm product. As such, some level of forced and planned outages is reasonably anticipated and is contained within the estimated planning reserve margin. Therefore, neither buyer nor seller of the SCP should bear any liability for reasonable outages. Buyers should not be required to replace non-performing generation and unless chronic and extraordinary, generators should not be exposed to replacement or penalty costs.

Both the SCE standard contract and the Joint Parties proposal suggested that 80 percent is a reasonable availability limitation. Of course, the cause of an outage (particularly if force majeure) should also be considered in calculation of availability targets and the possible application of penalties.

When backstop replacement of SCP must occur, ICPM is the vehicle and the price

The CAISO template questions seem to imply that yet another form of capacity contracting may be required if the CAISO is faced with chronic non-performance. Without endorsing the CAISO’s position on ICPM, Calpine proposes that the ICPM construct is sufficient. There is no need to develop yet another fractional capacity compensation mechanism.

Generators should have the option of replacing in-kind or paying penalties

In the case of chronic non-performance, a generator should have the right to supply comparable replacement capacity, or pay the ICPM-based penalty rate. However, such mechanisms should not result in exposing a generator to BOTH ICPM-based penalties AND “replacement cost damages.”